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Sound Financial Bancorp, Inc.  
Form 10-Q  
November 13, 2013

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

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, 2013

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," and "smaller reporting company" in Rule 12b-2 of the Act.

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

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(Do not check if smaller  
reporting company)

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

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

As of November 12, 2013, there were 2,550,810 shares of the registrant's common stock outstanding.

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SOUND FINANCIAL BANCORP, INC.  
FORM 10-Q  
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EXHIBITS

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Condensed Consolidated Balance Sheets  
(In thousands, except share amounts)

|  | September<br>30, 2013 | December<br>31, 2012 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  | (unaudited)           |                      |
| Cash and cash equivalents  | \$13,961              | \$12,727             |
| Available-for-sale securities, at fair value   | 16,639                | 22,900               |
| Loans held for sale  | 1,664                 | 1,725                |
| Loans  | 379,786               | 326,744              |
| Allowance for loan losses  | (4,115 )              | (4,248 )             |
| Total Loans, net   | 375,671               | 322,496              |
| Accrued interest receivable  | 1,313                 | 1,280                |
| Bank-owned life insurance (“BOLI”), net  | 10,950                | 7,220                |
| Other real estate owned (“OREO”) and repossessed assets, net   | 981                   | 2,503                |
| Mortgage servicing rights, at fair value   | 2,843                 | 2,306                |
| Federal Home Loan Bank (“FHLB”) stock, at cost   | 2,336                 | 2,401                |
| Premises and equipment, net  | 2,174                 | 2,256                |
| Other assets   | 3,196                 | 3,230                |
| Total assets   | \$431,728             | \$381,044            |
| <b>LIABILITIES</b>   |                       |                      |
| Deposits   |                       |                      |
| Interest-bearing   | \$306,767             | \$276,849            |
| Noninterest-bearing demand   | 34,575                | 35,234               |
| Total deposits   | 341,342               | 312,083              |
| Accrued expenses and other liabilities   | 3,520                 | 3,309                |
| Advance payments from borrowers for taxes and insurance  | 562                   | 331                  |
| Borrowings   | 40,381                | 21,864               |
| Total liabilities  | 385,805               | 337,587              |
| <b>COMMITMENTS AND CONTINGENCIES (NOTE 8)</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, 2,550,810 and 2,587,544 shares issued and outstanding as of September 30, 2013 and December 31, 2012, respectively | 26                    | 26                   |
| Additional paid-in capital   | 24,370                | 24,789               |
| Unearned shares - Employee Stock Ownership Plan (“ESOP”)   | (1,598 )              | (1,598 )             |
| Retained earnings  | 23,410                | 20,736               |
| Accumulated other comprehensive loss, net of tax   | (285 )                | (496 )               |
| Total stockholders' equity   | 45,923                | 43,457               |
| Total liabilities and stockholders' equity   | \$431,728             | \$381,044            |

See notes to condensed consolidated financial statements



SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Condensed Consolidated Statements of Income (unaudited)  
(In thousands, except share and per share amounts)

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2013                                | 2012      | 2013                               | 2012      |
| <b>INTEREST INCOME</b>   |                                     |           |                                    |           |
| Loans, including fees  | \$4,926                             | \$4,437   | \$14,268                           | \$13,459  |
| Interest and dividends on investments, cash and cash equivalents | 59                                  | 105       | 239                                | 244       |
| Total interest income  | 4,985                               | 4,542     | 14,507                             | 13,703    |
| <b>INTEREST EXPENSE</b>  |                                     |           |                                    |           |
| Deposits   | 528                                 | 540       | 1,527                              | 1,617     |
| Borrowings   | 50                                  | 56        | 164                                | 167       |
| Total interest expense   | 578                                 | 596       | 1,691                              | 1,784     |
| Net interest income  | 4,407                               | 3,946     | 12,816                             | 11,919    |
| <b>PROVISION FOR LOAN LOSSES</b>                                 | 450                                 | 1,075     | 1,150                              | 3,675     |
| Net interest income after provision for loan losses              | 3,957                               | 2,871     | 11,666                             | 8,244     |
| <b>NONINTEREST INCOME</b>  |                                     |           |                                    |           |
| Service charges and fee income                                   | 564                                 | 574       | 1,714                              | 1,638     |
| Earnings on cash surrender value of bank-owned life insurance    | 78                                  | 60        | 230                                | 179       |
| Mortgage servicing income  | 76                                  | 148       | 387                                | 346       |
| Fair value adjustment on mortgage servicing rights               | 271                                 | (211)     | 656                                | 97        |
| Other-than-temporary impairment losses on securities             | -                                   | (32)      | (30)                               | (156)     |
| Net gain on sale of loans  | 37                                  | 668       | 794                                | 1,226     |
| Total noninterest income   | 1,026                               | 1,207     | 3,751                              | 3,330     |
| <b>NONINTEREST EXPENSE</b>                                       |                                     |           |                                    |           |
| Salaries and benefits  | 1,858                               | 1,537     | 5,224                              | 4,242     |
| Operations   | 825                                 | 697       | 2,809                              | 2,007     |
| Regulatory assessments   | 57                                  | 108       | 239                                | 329       |
| Occupancy  | 353                                 | 314       | 961                                | 918       |
| Data processing  | 348                                 | 264       | 954                                | 769       |
| Net loss on OREO and repossessed assets                          | 125                                 | 265       | 963                                | 757       |
| Total noninterest expense  | 3,566                               | 3,185     | 11,150                             | 9,022     |
| Income before provision for income taxes                         | 1,417                               | 893       | 4,267                              | 2,552     |
| Provision for income taxes                                       | 423                                 | 281       | 1,333                              | 800       |
| Net income   | \$994                               | \$612     | \$2,934                            | \$1,752   |
| <b>Earnings per common share:</b>                                |                                     |           |                                    |           |
| Basic  | \$0.39                              | \$0.24    | \$1.14                             | \$0.68    |
| Diluted  | \$0.38                              | \$0.23    | \$1.11                             | \$0.67    |
| <b>Weighted average number of common shares outstanding:</b>     |                                     |           |                                    |           |
| Basic  | 2,576,995                           | 2,587,669 | 2,583,588                          | 2,585,694 |
| Diluted  | 2,634,087                           | 2,627,820 | 2,635,564                          | 2,616,070 |

See notes to condensed consolidated financial statements





SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
 Condensed Consolidated Statements of Comprehensive Income (unaudited)  
 (In thousands)

|  | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|-------|------------------------------------|---------|
|  | 2013                                | 2012  | 2013                               | 2012    |
| Net income   | \$994                               | \$612 | \$2,934                            | \$1,752 |
| Available for sale securities:   |                                     |       |                                    |         |
| Unrealized gains arising during the period, net of taxes of \$33, \$22, \$98 and \$43, respectively                      | 65                                  | 42    | 191                                | 83      |
| Reclassification adjustments for other-than-temporary impairment, net of taxes of \$0, \$11, \$10 and \$53, respectively | -                                   | 21    | 20                                 | 103     |
| Other comprehensive income, net of tax   | \$65                                | \$63  | \$211                              | \$186   |
| Comprehensive income   | \$1,059                             | \$675 | \$3,145                            | \$1,938 |

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Condensed Consolidated Statements of Stockholders' Equity  
For the Nine Months Ended September 30, 2013 and 2012 (unaudited)  
(In thousands, except number of shares)

|   | Shares      | Common<br>Stock | Additional<br>Paid-in<br>Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss, net of<br>tax | Total Stockholders'<br>Equity |
|---|-------------|-----------------|----------------------------------|----------------------------|----------------------|--|-------------------------------|
| Balances at<br>December 31,<br>2011                                     | 2,949,045   | \$30            | \$11,939                         | \$(693 )                   | \$18,096             | \$ (659 )  | \$ 28,713                     |
| Net income  |             |                 |                                  |                            | 1,752                |  | 1,752                         |
| Other<br>comprehensive<br>income, net of tax                            |             |                 |                                  |                            |                      | 186  | 186                           |
| Restricted stock<br>awards  | 11,000      |                 |                                  |                            |                      |  |                               |
| Cancel Sound<br>Community Bank<br>MHC shares                            | (1,621,435) | (16 )           |                                  |                            |                      |  | (16 )                         |
| Exchange of<br>common stock at<br>0.87423 shares<br>per common<br>share | (168,357 )  | (2 )            |                                  |                            |                      |  | (2 )                          |
| Fractional share<br>distribution  | (209 )      |                 |                                  |                            |                      |  |                               |
| Proceeds from<br>stock offering,<br>net of offering<br>costs            | 1,417,500   | 14              | 12,658                           |                            |                      |  | 12,672                        |
| Purchase of<br>common stock by<br>ESOP                                  |             |                 |                                  | (1,134 )                   |                      |  | (1,134 )                      |
| Share-based<br>compensation   |             |                 | 125                              |                            |                      |  | 125                           |
| Balances at<br>September 30,<br>2012                                    | 2,587,544   | \$26            | \$24,722                         | \$(1,827 )                 | \$19,848             | \$ (473 )  | \$ 42,296                     |

|                             | Shares    | Common<br>Stock | Additional<br>Paid-in<br>Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss, net of<br>tax | Total Stockholders'<br>Equity |
|-----------------------------|-----------|-----------------|----------------------------------|----------------------------|----------------------|--|-------------------------------|
| Balances at<br>December 31, | 2,587,544 | \$26            | \$24,789                         | \$(1,598 )                 | \$20,736             | \$ (496 )  | \$ 43,457                     |

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|   |           |      |          |          |     |          |         |             |
|---|-----------|------|----------|----------|-----|----------|---------|-------------|
| 2012  |           |      |          |          |     |          |         |             |
| Net income  |           |      |          | 2,934    |     |          |         | 2,934       |
| Other comprehensive income, net of tax            |           |      |          |          | 211 |          |         | 211         |
| Share-based compensation                          |           | 126  |          |          |     |          |         | 126         |
| Restricted stock forfeited and retired            | (734      | )    |          |          |     |          |         |             |
| Cash dividends on common stock (\$0.05 per share) |           |      |          | (260     | )   |          |         | (260        |
| Common stock repurchased                          | (36,000)  |      | (545     | )        |     |          |         | (545        |
| Balances at September 30, 2013                    | 2,550,810 | \$26 | \$24,370 | \$(1,598 | )   | \$23,410 | \$ (285 | ) \$ 45,923 |

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Condensed Consolidated Statements of Cash Flows (unaudited)  
(In thousands)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2013                               | 2012      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                                    |           |
| Net income  | \$2,934                            | \$1,752   |
| Adjustments to reconcile net income to net cash from operating activities               |                                    |           |
| Accretion of net premium on investments   | 402                                | 69        |
| Other-than-temporary impairment losses on securities                                    | 30                                 | 156       |
| Provision for loan losses   | 1,150                              | 3,675     |
| Depreciation and amortization   | 340                                | 284       |
| Compensation expense related to stock options and restricted stock                      | 126                                | 125       |
| Fair value adjustment on mortgage servicing rights                                      | (656 )                             | (97 )     |
| Additions to mortgage servicing rights  | (655 )                             | (544 )    |
| Amortization of mortgage servicing rights   | 774                                | 774       |
| Increase in cash surrender value of BOLI  | (230 )                             | (179 )    |
| Gain on sale of loans   | (794 )                             | (1,226 )  |
| Proceeds from sale of loans   | 110,658                            | 63,865    |
| Originations of loans held for sale   | (109,803 )                         | (65,373 ) |
| Loss on sale and write-downs of OREO and repossessed assets                             | 855                                | 314       |
| Change in operating assets and liabilities  |                                    |           |
| Accrued interest receivable   | (33 )                              | (15 )     |
| Other assets  | (76 )                              | (1,398 )  |
| Accrued interest payable  | (7 )                               | (6 )      |
| Other liabilities   | 218                                | 366       |
| Net cash from operating activities  | 5,233                              | 4,984     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                    |           |
| Proceeds from principal payments, maturities and sales of available for sale securities | 8,060                              | 1,219     |
| FHLB stock redeemed   | 65                                 | -         |
| Purchase of available for sale securities   | (1,910 )                           | (19,056 ) |
| Net increase in loans   | (56,100 )                          | (15,074 ) |
| Improvements to OREO and other repossessed assets                                       | (33 )                              | (392 )    |
| Proceeds from sale of OREO and other repossessed assets                                 | 2,475                              | 2,726     |
| Purchases of premises and equipment, net  | (258 )                             | (136 )    |
| Purchases of BOLI   | (3,500 )                           | -         |
| Net cash used by investing activities   | (51,201 )                          | (30,713 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                    |           |
| Net increase in deposits  | 29,259                             | 13,046    |
| Proceeds from borrowings  | 205,500                            | -         |
| Repayment of borrowings   | (186,983 )                         | (482 )    |
| Dividends paid on common stock  | (260 )                             | -         |
| Net change in advances from borrowers for taxes and insurance                           | 231                                | 251       |
| Common stock purchase by ESOP   | -                                  | (1,134 )  |
| Repurchase of common stock  | (545 )                             | -         |
| Proceeds from stock offering, net of offering costs                                     | -                                  | 12,672    |
| Net cash from financing activities  | 47,202                             | 24,353    |
| Net increase (decrease) in cash and cash equivalents                                    | 1,234                              | (1,376 )  |

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|  |          |          |
|--|----------|----------|
| Cash and cash equivalents, beginning of period | 12,727   | 17,031   |
| Cash and cash equivalents, end of period       | \$13,961 | \$15,655 |

**SUPPLEMENTAL CASH FLOW INFORMATION:**

|  |         |         |
|--|---------|---------|
| Cash paid for income taxes                                     | \$1,340 | \$750   |
| Interest paid on deposits and borrowings                       | \$1,698 | \$1,790 |
| Noncash net transfer from loans to OREO and repossessed assets | \$1,775 | \$2,375 |

See notes to condensed consolidated financial statements

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 (the “Bank”, collectively, “we,” “us,” “our,” or the “Company”). 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, 2012, as filed with the SEC on March 31, 2013 (“2012 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, 2012, included in the 2012 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 net income, retained earnings, stockholders’ equity or earnings per share.

On August 22, 2012, the Company completed its conversion from the mutual holding company structure and related public stock offering, so that it is now a stock holding company that is wholly owned by public shareholders. Please see Note 2 – Conversion and Stock Issuance for more information.

Note 2 – Conversion and Stock Issuance

The Company, a Maryland corporation, was organized by Sound Community MHC, Sound Financial, Inc. and Sound Community Bank to facilitate the “second-step” conversion of Sound Community Bank from the mutual holding company structure to the stock holding company structure (the “Conversion”). Upon consummation of the Conversion, which occurred on August 22, 2012, the Company became the holding company for Sound Community Bank and now owns all of the issued and outstanding shares of Sound Community Bank’s common stock.

In connection with the Conversion, the Company sold a total of 1,417,500 shares of common stock in offering to certain depositors of Sound Community Bank and others, including 113,400 shares to the Sound Community Bank employee stock ownership plan (“ESOP”). All shares were sold at a purchase price of \$10.00 per share. Proceeds from the offering, net of \$1.5 million in expenses, totaled \$12.7 million. The Company used \$1.1 million of the proceeds to fund the ESOP and made a \$7.5 million capital contribution to the Bank. In addition, concurrent with the offering, shares of Sound Financial, Inc. common stock owned by public stockholders were exchanged for 0.87423 shares of the Company’s common stock, with cash being paid in lieu of issuing any fractional shares. At September 30, 2013, the Company had 2,550,810 shares outstanding.

All share and per share information in this report for periods prior to the Conversion has been revised to reflect the 0.87423 Conversion exchange ratio.



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

Note 3 – Accounting Pronouncements Recently Issued or Adopted

In January 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Updated (“ASU”) No. 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. This update clarifies that ASU No. 2011-11 applies only to derivatives, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement are no longer subject to the disclosure requirements in ASU No. 2011-11. The amendments were effective for annual and interim reporting periods beginning on or after January 1, 2013. The adoption of ASU No. 2013-01 did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments were effective for annual and interim reporting periods beginning on or after December 15, 2012. The adoption of this update did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. This update permits the use of the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge account purposes. The amendment was effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this update did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This update requires an entity to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. No new recurring disclosures are required. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2013 and are to be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this update is not expected to have a material impact on the Company's consolidated financial statements.





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

Note 4 – Investments

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

|                                       | Amortized<br>Cost | Gains | Gross Unrealized<br>Losses 1<br>Year<br>Or Less |      | Losses<br>Greater<br>Than 1<br>Year | Estimated<br>Fair<br>Value |          |
|---------------------------------------|-------------------|-------|---|------|-------------------------------------|----------------------------|----------|
| September 30, 2013                    |                   |       |   |      |                                     |                            |          |
| Municipal bonds                       | \$1,910           | \$38  | \$-   | \$-  |                                     | \$1,948                    |          |
| Agency mortgage-backed securities     | 12,393            | 29    | (220  | ) -  |                                     | 12,202                     |          |
| Non-agency mortgage-backed securities | 2,767             | 83    | -   | (361 | )                                   | 2,489                      |          |
| Total                                 | \$17,070          | \$150 | \$(220  | )    | \$(361                              | )                          | \$16,639 |
| December 31, 2012                     |                   |       |   |      |                                     |                            |          |
| Agency mortgage-backed securities     | \$20,378          | \$27  | \$(278  | )    | \$-                                 | \$20,127                   |          |
| Non-agency mortgage-backed securities | 3,273             | 19    | -   | (519 | )                                   | 2,773                      |          |
| Total                                 | \$23,651          | \$46  | \$(278  | )    | \$(519                              | )                          | \$22,900 |

The amortized cost and fair value of investments available-for-sale at September 30, 2013, by contractual maturity, are shown below (in thousands). Expected maturities of investments available-for-sale 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 30, 2013 |               |
|---------------------|-----------------------|---------------|
|                     | Amortized<br>Cost     | Fair<br>Value |
| Due after ten years | \$17,070              | \$16,639      |

Securities with an amortized cost of \$11.6 million and fair value of \$12.2 million at September 30, 2013 were pledged to secure Washington State Public Funds. Additionally, the Company has letters of credit with a notional amount of \$25.0 million to secure public deposits.

There were no sales of available for sale securities during the three and nine months ended September 30, 2013 and 2012.

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The following table summarizes 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):

|                                       | Less Than 12 Months |                 | September 30, 2013<br>12 Months or Longer |                 | Total          |                 |
|---------------------------------------|---------------------|-----------------|---|-----------------|----------------|-----------------|
|                                       | Fair Value          | Unrealized Loss | Fair Value                                | Unrealized Loss | Fair Value     | Unrealized Loss |
| Agency mortgage-backed securities     | \$9,082             | \$(220)         | \$-                                       | \$-             | \$9,082        | \$(220)         |
| Non-agency mortgage-backed securities | -                   | -               | 646                                       | (361)           | 646            | (361)           |
| <b>Total</b>                          | <b>\$9,082</b>      | <b>\$(220)</b>  | <b>\$646</b>                              | <b>\$(361)</b>  | <b>\$9,728</b> | <b>\$(581)</b>  |

|                                       | Less Than 12 Months |                 | December 31, 2012<br>12 Months or Longer |                 | Total           |                 |
|---------------------------------------|---------------------|-----------------|--|-----------------|-----------------|-----------------|
|                                       | Fair Value          | Unrealized Loss | Fair Value                               | Unrealized Loss | Fair Value      | Unrealized Loss |
| Agency mortgage-backed securities     | \$17,685            | \$(278)         | \$-                                      | \$-             | \$17,685        | \$(278)         |
| Non-agency mortgage-backed securities | -                   | -               | 2,137                                    | (519)           | 2,137           | (519)           |
| <b>Total</b>                          | <b>\$17,685</b>     | <b>\$(278)</b>  | <b>\$2,137</b>                           | <b>\$(519)</b>  | <b>\$19,822</b> | <b>\$(797)</b>  |

The following table presents the cumulative roll forward of credit losses recognized in earnings during the three and nine months ended September 30, 2013 and 2012 relating to the Company's non-agency mortgage backed securities (in thousands):

|   | Three months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|---|-------------------------------------|--------------|------------------------------------|--------------|
|   | 2013                                | 2012         | 2013                               | 2012         |
| Estimated credit losses, beginning balance            | \$450                               | \$379        | \$420                              | \$256        |
| Additions for credit losses not previously recognized | -                                   | 33           | 30                                 | 156          |
| Reduction for increases in cash flows                 | -                                   | -            | -                                  | -            |
| Reduction for realized losses                         | -                                   | -            | -                                  | -            |
| <b>Estimated credit losses, ending balance</b>        | <b>\$450</b>                        | <b>\$412</b> | <b>\$450</b>                       | <b>\$412</b> |

As of September 30, 2013, our securities portfolio consisted of 17 agency mortgage-backed securities, five non-agency mortgage-backed securities and five municipal securities with a fair value of \$16.6 million. At September 30, 2013, 11 of the 17 agency mortgage-backed securities were in an unrealized loss position. All of the agency mortgage-backed securities in an unrealized loss position at September 30, 2013 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”).

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As of September 30, 2013, two of the five non-agency mortgage-backed securities were in an unrealized loss position. The unrealized losses were caused by changes in interest rates and market illiquidity causing a decline in the fair value subsequent to the purchase. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. While management does not intend to sell the non-agency mortgage-backed securities, and it is unlikely that the Company will be required to sell these securities before recovery of its amortized cost basis, management's impairment evaluation indicates that certain securities possess qualitative and quantitative factors that suggest an OTTI. These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. In addition to the qualitative factors, management's evaluation includes an assessment of quantitative evidence that involves the use of cash flow modeling and present value calculations as determined by considering the applicable OTTI accounting guidance. The Company compares the present value of the current estimated cash flows to the present value of the previously estimated cash flows. Accordingly, if the present value of the current estimated cash flows is less than the present value of the previous period's present value, an adverse change is considered to exist and the security is considered OTTI. The associated "credit loss" is the amount by which the security's amortized cost exceeds the present value of the current estimated cash flows. Based upon the results of the cash flow modeling, one security reflected OTTI of \$0 and \$30,000 during the three and nine months ended September 30, 2013. Estimating the expected cash flows and determining the present values of the cash flows involves the use of a variety of assumptions and complex modeling. In developing its assumptions, the Company considers all available information relevant to the collectability of the applicable security, including information about past events, current conditions, and reasonable and supportable forecasts. Furthermore, the Company asserts that the cash flows used in the determination of OTTI are its "best estimate" of cash flows.

#### Note 5 – Loans

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

|                            | At<br>September<br>30, 2013 | At<br>December<br>31, 2012 |
|----------------------------|-----------------------------|----------------------------|
| Real estate loans:         |                             |                            |
| One- to four- family       | \$ 116,616                  | \$ 95,784                  |
| Home equity                | 35,317                      | 35,364                     |
| Commercial and multifamily | 148,745                     | 133,620                    |
| Construction and land      | 43,780                      | 25,458                     |
| Total real estate loans    | 344,458                     | 290,226                    |
| Consumer loans:            |                             |                            |
| Manufactured homes         | 13,983                      | 16,232                     |
| Other consumer             | 9,393                       | 8,650                      |
| Total consumer loans       | 23,376                      | 24,882                     |
| Commercial business loans  | 14,842                      | 14,193                     |
| Total loans                | 382,676                     | 329,301                    |
| Deferred fees              | (1,226 )                    | (832 )                     |

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|                           |           |           |
|---------------------------|-----------|-----------|
| Loans held for sale       | (1,664 )  | (1,725 )  |
| Total loans, gross        | 379,786   | 326,744   |
| Allowance for loan losses | (4,115 )  | (4,248 )  |
| Total loans, net          | \$375,671 | \$322,496 |

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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, 2013 (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 loan losses:                     |                            |                |                                  |                          |                       |                   |                        |             |           |
| Individually<br>evaluated<br>for<br>impairment | \$407                      | \$186          | \$1                              | \$17                     | \$128                 | \$2               | \$2                    | \$-         | \$743     |
| Collectively<br>evaluated<br>for<br>impairment | 1,422                      | 747            | 507                              | 284                      | 116                   | 131               | 60                     | 105         | 3,372     |
| Ending<br>balance                              | \$1,829                    | \$933          | \$508                            | \$301                    | \$244                 | \$133             | \$62                   | \$105       | \$4,115   |
| Loans receivable:                              |                            |                |                                  |                          |                       |                   |                        |             |           |
| Individually<br>evaluated<br>for<br>impairment | \$4,745                    | \$1,894        | \$3,454                          | \$740                    | \$671                 | \$46              | \$565                  | \$-         | \$12,115  |
| Collectively<br>evaluated<br>for<br>impairment | 111,871                    | 33,423         | 145,291                          | 43,040                   | 13,312                | 9,347             | 14,277                 | -           | 370,561   |
| Ending<br>balance                              | \$116,616                  | \$35,317       | \$148,745                        | \$43,780                 | \$13,983              | \$9,393           | \$14,842               | \$-         | \$382,676 |

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, 2012 (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 loan losses:                     |                            |                |                                  |                          |                       |                   |                        |             |         |
| Individually<br>evaluated<br>for<br>impairment | \$392                      | \$247          | \$70                             | \$25                     | \$117                 | \$22              | \$145                  | \$-         | \$1,018 |
| Collectively<br>evaluated<br>for<br>impairment | 1,025                      | 750            | 422                              | 192                      | 143                   | 124               | 73                     | 501         | 3,230   |

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|                                       |          |          |            |           |           |         |           |        |           |
|---------------------------------------|----------|----------|------------|-----------|-----------|---------|-----------|--------|-----------|
| Ending balance                        | \$1,417  | \$997    | \$ 492     | \$ 217    | \$ 260    | \$146   | \$ 218    | \$ 501 | \$4,248   |
| Loans receivable:                     |          |          |            |           |           |         |           |        |           |
| Individually evaluated for impairment | \$6,016  | \$1,731  | \$ 2,127   | \$ 571    | \$ 654    | \$55    | \$ 839    | \$ -   | \$11,993  |
| Collectively evaluated for impairment | 89,768   | 33,633   | 131,493    | 24,887    | 15,578    | 8,595   | 13,354    | -      | 317,308   |
| Ending balance                        | \$95,784 | \$35,364 | \$ 133,620 | \$ 25,458 | \$ 16,232 | \$8,650 | \$ 14,193 | \$ -   | \$329,301 |

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The following table summarizes the activity in loan losses for the three months ended September 30, 2013 (in thousands):

|                            | Beginning<br>Allowance | Charge-offs | Recoveries | Provision | Ending<br>Allowance |
|----------------------------|------------------------|-------------|------------|-----------|---------------------|
| One-to four- family        | \$1,548                | \$(98 )     | \$-        | \$379     | \$1,829             |
| Home equity                | 890                    | (314 )      | 7          | 350       | 933                 |
| Commercial and multifamily | 583                    | -           | -          | (75 )     | 508                 |
| Construction and land      | 447                    | -           | -          | (146 )    | 301                 |
| Manufactured homes         | 267                    | (61 )       | 1          | 37        | 244                 |
| Other consumer             | 154                    | (11 )       | 12         | (22 )     | 133                 |
| Commercial business        | 97                     | -           | -          | (35 )     | 62                  |
| Unallocated                | 143                    | -           | -          | (38 )     | 105                 |
| Total                      | \$4,129                | \$(484 )    | \$20       | \$450     | \$4,115             |

The following table summarizes the activity in loan losses for the nine months ended September 30, 2013 (in thousands):

|                            | Beginning<br>Allowance | Charge-offs | Recoveries | Provision | Ending<br>Allowance |
|----------------------------|------------------------|-------------|------------|-----------|---------------------|
| One-to four- family        | \$1,417                | \$(424 )    | \$-        | \$836     | \$1,829             |
| Home equity                | 997                    | (535 )      | 13         | 458       | 933                 |
| Commercial and multifamily | 492                    | (192 )      | 34         | 174       | 508                 |
| Construction and land      | 217                    | (7 )        | -          | 91        | 301                 |
| Manufactured homes         | 260                    | (115 )      | 1          | 98        | 244                 |
| Other consumer             | 146                    | (38 )       | 26         | (1 )      | 133                 |
| Commercial business        | 218                    | (46 )       | -          | (110 )    | 62                  |
| Unallocated                | 501                    | -           | -          | (396 )    | 105                 |
| Total                      | \$4,248                | \$(1,357 )  | \$74       | \$1,150   | \$4,115             |

The following table summarizes the activity in loan losses for the three months ended September 30, 2012 (in thousands):

|                            | Beginning<br>Allowance | Charge-offs | Recoveries | Provision | Ending<br>Allowance |
|----------------------------|------------------------|-------------|------------|-----------|---------------------|
| One-to four- family        | \$1,676                | \$(609 )    | \$-        | \$708     | \$1,775             |
| Home equity                | 1,212                  | (216 )      | -          | 70        | 1,066               |
| Commercial and multifamily | 647                    | -           | -          | (7 )      | 640                 |
| Construction and land      | 181                    | (162 )      | -          | 141       | 160                 |
| Manufactured homes         | 336                    | (46 )       | -          | (18 )     | 272                 |
| Other consumer             | 173                    | (126 )      | 6          | 121       | 174                 |
| Commercial business        | 215                    | (38 )       | -          | 58        | 235                 |
| Unallocated                | 9                      | -           | -          | 2         | 11                  |
| Total                      | \$4,449                | \$(1,197 )  | \$6        | \$1,075   | \$4,333             |

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The following table summarizes the activity in loan losses for the nine months ended September 30, 2012 (in thousands):

|                            | Beginning<br>Allowance | Charge-offs | Recoveries | Provision | Ending<br>Allowance |
|----------------------------|------------------------|-------------|------------|-----------|---------------------|
| One-to four- family        | \$1,117                | \$(2,008 )  | \$4        | \$2,662   | \$1,775             |
| Home equity                | 1,426                  | (951 )      | 132        | 459       | 1,066               |
| Commercial and multifamily | 969                    | (503 )      | 83         | 91        | 640                 |
| Construction and land      | 105                    | (203 )      | -          | 258       | 160                 |
| Manufactured homes         | 290                    | (106 )      | -          | 88        | 272                 |
| Other consumer             | 213                    | (232 )      | 22         | 171       | 174                 |
| Commercial business        | 254                    | (45 )       | 10         | 16        | 235                 |
| Unallocated                | 81                     | -           | -          | (70 )     | 11                  |
| Total                      | \$4,455                | \$(4,048 )  | \$251      | \$3,675   | \$4,333             |

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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 or doubtful 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 ("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, 2013 by type of loan (in thousands):

| Grade:          | 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     |
|-----------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Pass            | \$104,567                  | \$30,594       | \$ 142,851                       | \$ 42,383                | \$ 12,361             | \$8,957           | \$ 13,825              | \$355,538 |
| Watch           | 10,085                     | 3,513          | 3,204                            | 754                      | 1,531                 | 414               | 474                    | 19,975    |
| Special Mention | 47                         | 138            | 652                              | -                        | -                     | -                 | 543                    | 1,380     |
| Substandard     | 1,917                      | 1,072          | 2,038                            | 643                      | 91                    | 22                | -                      | 5,783     |
| Doubtful        | -                          | -              | -                                | -                        | -                     | -                 | -                      | -         |
| Loss            | -                          | -              | -                                | -                        | -                     | -                 | -                      | -         |
| Total           | \$116,616                  | \$35,317       | \$ 148,745                       | \$ 43,780                | \$ 13,983             | \$9,393           | \$ 14,842              | \$382,676 |

The following table represents the internally assigned grades as of December 31, 2012 by type of loan (in thousands):

| Grade:          | 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     |
|-----------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Pass            | \$84,685                   | \$30,927       | \$ 130,721                       | \$ 24,641                | \$ 14,898             | \$ 8,102          | \$ 12,290              | \$306,264 |
| Watch           | 8,279                      | 3,064          | 954                              | 347                      | 1,312                 | 520               | 1,087                  | 15,563    |
| Special Mention | 490                        | 499            | 595                              | -                        | -                     | -                 | -                      | 1,584     |
| Substandard     | 2,329                      | 874            | 1,350                            | 471                      | 23                    | 28                | 815                    | 5,890     |

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|          |          |          |            |           |           |          |           |           |
|----------|----------|----------|------------|-----------|-----------|----------|-----------|-----------|
| Doubtful | -        | -        | -          | -         | -         | -        | -         | -         |
| Loss     | -        | -        | -          | -         | -         | -        | -         | -         |
| Total    | \$95,784 | \$35,364 | \$ 133,620 | \$ 25,458 | \$ 16,232 | \$ 8,650 | \$ 14,193 | \$329,301 |

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 three months 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 provisions.

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The following table presents the recorded investment in nonaccrual loans as of September 30, 2013 and December 31, 2012, by type of loan (in thousands):

|                            | September<br>30, 2013 | December<br>31, 2012 |
|----------------------------|-----------------------|----------------------|
| One- to four- family       | \$343                 | \$1,013              |
| Home equity                | 523                   | 332                  |
| Commercial and multifamily | 230                   | 1,106                |
| Construction and land      | -                     | 471                  |
| Manufactured homes         | 65                    | -                    |
| Other consumer             | -                     | 1                    |
| Commercial business        | -                     | 80                   |
| Total                      | \$1,161               | \$3,003              |

The following table represents the aging of the recorded investment in past due loans as of September 30, 2013 by type of loan (in thousands):

|                               | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than 90<br>Days Past<br>Due | Recorded<br>Investment<br>> 90 Days<br>and<br>Accruing | Total<br>Past Due | Current   | Total<br>Loans |
|-------------------------------|------------------------|------------------------|--|--|-------------------|-----------|----------------|
| One-to four-<br>family        | \$-                    | \$513                  | \$368                                  | \$-  | \$881             | \$115,735 | \$116,616      |
| Home equity                   | 618                    | 114                    | 523                                    | -  | 1,255             | 34,062    | 35,317         |
| Commercial and<br>multifamily | -                      | -                      | 230                                    | -  | 230               | 148,515   | 148,745        |
| Construction and<br>land      | -                      | -                      | -                                      | -  | -                 | 43,780    | 43,780         |
| Manufactured<br>homes         | 35                     | 68                     | 24                                     | -  | 127               | 13,856    | 13,983         |
| Other consumer                | 2                      | 5                      | -                                      | -  | 7                 | 9,386     | 9,393          |
| Commercial<br>business        | -                      | -                      | -                                      | -  | -                 | 14,842    | 14,842         |
| Total                         | \$655                  | \$700                  | \$1,145                                | \$-  | \$2,500           | \$380,176 | \$382,676      |

The following table represents the aging of the recorded investment in past due loans as of December 31, 2012 by type of loan (in thousands):

|  | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>Than 90<br>Days Past<br>Due | Recorded<br>Investment<br>> 90 Days<br>and<br>Accruing | Total<br>Past Due | Current | Total Loans |
|--|------------------------|------------------------|--|--|-------------------|---------|-------------|
|--|------------------------|------------------------|--|--|-------------------|---------|-------------|

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|                            |         |       |         |      |         |           |           |
|----------------------------|---------|-------|---------|------|---------|-----------|-----------|
| One-to four-family         | \$2,238 | \$572 | \$836   | \$81 | \$3,727 | \$92,057  | \$95,784  |
| Home equity                | 886     | 364   | 332     | -    | 1,582   | 33,782    | 35,364    |
| Commercial and multifamily | -       | -     | -       | -    | -       | 133,620   | 133,620   |
| Construction and land      | 243     | -     | 471     | -    | 714     | 24,744    | 25,458    |
| Manufactured homes         | 326     | 2     | -       | -    | 328     | 15,904    | 16,232    |
| Other consumer             | 65      | 2     | 1       | -    | 68      | 8,582     | 8,650     |
| Commercial business        | 63      | -     | 80      | -    | 143     | 14,050    | 14,193    |
| Total                      | \$3,821 | \$940 | \$1,720 | \$81 | \$6,562 | \$322,739 | \$329,301 |

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”). 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 based on payment activity as of September 30, 2013 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     |
|---------------|---------------------|-------------|----------------------------|-----------------------|--------------------|----------------|---------------------|-----------|
| Performing    | \$115,611           | \$34,695    | \$148,515                  | \$43,780              | \$13,918           | \$9,393        | \$14,842            | \$380,754 |
| Nonperforming | 1,005               | 622         | 230                        | -                     | 65                 | -              | -                   | 1,922     |
| Total         | \$116,616           | \$35,317    | \$148,745                  | \$43,780              | \$13,983           | \$9,393        | \$14,842            | \$382,676 |

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The following table represents the credit risk profile based on payment activity as of December 31, 2012 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    | \$94,641                   | \$34,647       | \$ 132,273                       | \$ 24,987                | \$ 16,203             | \$ 8,642          | \$ 13,996              | \$325,389 |
| Nonperforming | 1,143                      | 717            | 1,347                            | 471                      | 29                    | 8                 | 197                    | 3,912     |
| Total         | \$95,784                   | \$35,364       | \$ 133,620                       | \$ 25,458                | \$ 16,232             | \$ 8,650          | \$ 14,193              | \$329,301 |

**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 and amounts of any payment shortfall, length and reason for delay, and likelihood of return to stable performance. 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, 2013 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                 | \$343                  | \$539                          | \$-                  |
| Home equity                         | 361                    | 465                            | -                    |
| Commercial and multifamily          | 1,724                  | 1,724                          | -                    |
| Construction and land               | 562                    | 562                            | -                    |
| Manufactured homes                  | 67                     | 67                             | -                    |
| Other consumer                      | 12                     | 12                             | -                    |
| Commercial business                 | 427                    | 427                            | -                    |
| Total                               | \$3,496                | \$3,796                        | \$-                  |
| With an allowance recorded:         |                        |                                |                      |
| One-to four- family                 | \$4,402                | \$4,462                        | \$407                |
| Home equity                         | 1,533                  | 1,533                          | 186                  |
| Commercial and multifamily          | 1,730                  | 1,730                          | 1                    |
| Construction and land               | 178                    | 178                            | 17                   |
| Manufactured homes                  | 604                    | 604                            | 128                  |
| Other consumer                      | 34                     | 34                             | 2                    |
| Commercial business                 | 138                    | 138                            | 2                    |

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|                            |          |          |       |
|----------------------------|----------|----------|-------|
| Total                      | \$8,619  | \$8,679  | \$743 |
| Totals:                    |          |          |       |
| One-to-four family         | \$4,745  | \$5,001  | 407   |
| Home equity                | 1,894    | 1,998    | 186   |
| Commercial and multifamily | 3,454    | 3,454    | 1     |
| Construction and land      | 740      | 740      | 17    |
| Manufactured homes         | 671      | 671      | 128   |
| Other consumer             | 46       | 46       | 2     |
| Commercial business        | 565      | 565      | 2     |
| Total                      | \$12,115 | \$12,475 | \$743 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
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The following table presents loans individually evaluated for impairment as of December 31, 2012 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                 | \$2,521                | \$2,826                        | \$-                  |
| Home equity                         | 949                    | 1,132                          | -                    |
| Commercial and multifamily          | 1,883                  | 1,883                          | -                    |
| Construction and land               | 495                    | 608                            | -                    |
| Manufactured homes                  | 67                     | 67                             | -                    |
| Other consumer                      | 9                      | 49                             | -                    |
| Commercial business                 | 682                    | 682                            | -                    |
| Total                               | \$6,606                | \$7,247                        | \$-                  |
| With an allowance recorded:         |                        |                                |                      |
| One-to four- family                 | \$3,495                | \$3,651                        | \$392                |
| Home equity                         | 782                    | 782                            | 247                  |
| Commercial and multifamily          | 244                    | 244                            | 70                   |
| Construction and land               | 76                     | 76                             | 25                   |
| Manufactured homes                  | 587                    | 587                            | 117                  |
| Other consumer                      | 46                     | 46                             | 22                   |
| Commercial business                 | 157                    | 196                            | 145                  |
| Total                               | \$5,387                | \$5,582                        | \$1,018              |
| Totals:                             |                        |                                |                      |
| One-to four- family                 | \$6,016                | \$6,477                        | \$392                |
| Home equity                         | 1,731                  | 1,914                          | 247                  |
| Commercial and multifamily          | 2,127                  | 2,127                          | 70                   |
| Construction and land               | 571                    | 684                            | 25                   |
| Manufactured homes                  | 654                    | 654                            | 117                  |
| Other consumer                      | 55                     | 95                             | 22                   |
| Commercial business                 | 839                    | 878                            | 145                  |
| Total                               | \$11,993               | \$12,829                       | \$1,018              |

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
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The following table presents loans individually evaluated for impairment as of September 30, 2013 and 2012 by type of loan in thousands):

|                                     | Three Months Ended                |                                  |                                   |                                  |
|-------------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|                                     | September 30, 2013                |                                  | September 30, 2012                |                                  |
|                                     | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance recorded: |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$425                             | \$ 2                             | \$1,908                           | \$ 28                            |
| Home equity                         | 332                               | 4                                | 783                               | 9                                |
| Commercial and multifamily          | 2,269                             | -                                | 1,938                             | 26                               |
| Construction and land               | 563                               | -                                | 574                               | -                                |
| Manufactured homes                  | 67                                | 1                                | 70                                | 1                                |
| Other consumer                      | 16                                | -                                | 8                                 | 1                                |
| Commercial business                 | 238                               | 8                                | 847                               | 3                                |
| Total                               | \$3,907                           | \$ 15                            | \$6,126                           | \$ 68                            |
| With an allowance recorded:         |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$4,421                           | \$ 55                            | \$5,132                           | \$ 37                            |
| Home equity                         | 1,517                             | 14                               | 1,141                             | 9                                |
| Commercial and multifamily          | 866                               | 79                               | 245                               | 4                                |
| Construction and land               | 179                               | 2                                | 161                               | 1                                |
| Manufactured homes                  | 588                               | 11                               | 648                               | 10                               |
| Other consumer                      | 34                                | 1                                | 127                               | 2                                |
| Commercial business                 | 126                               | -                                | 255                               | 4                                |
| Total                               | \$7,729                           | \$ 162                           | \$7,708                           | \$ 67                            |
| Totals:                             |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$4,845                           | \$ 57                            | \$7,040                           | \$ 65                            |
| Home equity                         | 1,848                             | 18                               | 1,923                             | 18                               |
| Commercial and multifamily          | 3,135                             | 79                               | 2,183                             | 30                               |
| Construction and land               | 741                               | 2                                | 735                               | 1                                |
| Manufactured homes                  | 654                               | 12                               | 718                               | 11                               |
| Other consumer                      | 50                                | 1                                | 134                               | 3                                |
| Commercial business                 | 364                               | 8                                | 1,101                             | 7                                |
| Total                               | \$11,636                          | \$ 177                           | \$13,833                          | \$ 135                           |

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
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The following table presents loans individually evaluated for impairment as of September 30, 2013 and 2012 by type of loan (in thousands):

|                                     | Nine Months Ended                 |                                  |                                   |                                  |
|-------------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|                                     | September 30, 2013                |                                  | September 30, 2012                |                                  |
|                                     | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| With no related allowance recorded: |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$1,383                           | \$ 16                            | \$2,694                           | \$ 84                            |
| Home equity                         | 603                               | 9                                | 749                               | 32                               |
| Commercial and multifamily          | 1,798                             | 47                               | 1,874                             | 60                               |
| Construction and land               | 411                               | 1                                | 663                               | 21                               |
| Manufactured homes                  | 75                                | 3                                | 62                                | 4                                |
| Other consumer                      | 12                                | 1                                | 14                                | 2                                |
| Commercial business                 | 453                               | 18                               | 688                               | 13                               |
| Total                               | \$4,734                           | \$ 95                            | \$6,743                           | \$ 216                           |
| With an allowance recorded:         |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$4,120                           | \$ 157                           | \$5,268                           | \$ 129                           |
| Home equity                         | 1,191                             | 46                               | 1,146                             | 28                               |
| Commercial and multifamily          | 555                               | 79                               | 284                               | 7                                |
| Construction and land               | 127                               | 9                                | 131                               | 4                                |
| Manufactured homes                  | 571                               | 33                               | 554                               | 32                               |
| Other consumer                      | 40                                | 2                                | 101                               | 5                                |
| Commercial business                 | 196                               | 5                                | 217                               | 16                               |
| Total                               | \$6,800                           | \$ 331                           | \$7,700                           | \$ 221                           |
| Totals:                             |                                   |                                  |                                   |                                  |
| One-to four- family                 | \$5,503                           | \$ 173                           | \$7,962                           | \$ 213                           |
| Home equity                         | 1,794                             | 55                               | 1,895                             | 60                               |
| Commercial and multifamily          | 2,353                             | 126                              | 2,157                             | 67                               |
| Construction and land               | 538                               | 10                               | 794                               | 25                               |
| Manufactured homes                  | 646                               | 36                               | 615                               | 36                               |
| Other consumer                      | 52                                | 3                                | 115                               | 7                                |
| Commercial business                 | 648                               | 23                               | 905                               | 29                               |
| Total                               | \$11,533                          | \$ 426                           | \$14,443                          | \$ 437                           |

Forgone interest on nonaccrual loans was \$108,000 and \$191,000 at September 30, 2013 and 2012, respectively. There were no commitments to lend additional funds to borrowers whose loans were classified as nonaccrual, TDR or impaired at September 30, 2013 or December 31, 2012.

Troubled debt restructurings. Loans classified as TDRs totaled \$6.5 million and \$7.7 million at September 30, 2013 and December 31, 2012, 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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There were no new TDRs that occurred during the three months ended September 30, 2013.

The following table presents new TDRs by type of modification that occurred during the nine months ended September 30, 2013 (in thousands):

| Nine months ended September 30, 2013 |                           |                       |                       |                          |                              |                        |
|--------------------------------------|---------------------------|-----------------------|-----------------------|--------------------------|------------------------------|------------------------|
|                                      | Number<br>of<br>Contracts | Rate<br>Modifications | Term<br>Modifications | Payment<br>Modifications | Combination<br>Modifications | Total<br>Modifications |
| One-to four- family                  | 3                         | \$ -                  | \$ -                  | \$ -                     | \$ 878                       | \$ 878                 |
| Home equity                          | 1                         | -                     | -                     | -                        | 99                           | 99                     |
| <b>Total</b>                         | <b>4</b>                  | <b>\$ -</b>           | <b>\$ -</b>           | <b>\$ -</b>              | <b>\$ 977</b>                | <b>\$ 977</b>          |

The following table presents new TDRs by type of modification that occurred during the three months ended September 30, 2012 (in thousands):

| Three months ended September 30, 2012 |                           |                       |                       |                          |                              |                        |
|---------------------------------------|---------------------------|-----------------------|-----------------------|--------------------------|------------------------------|------------------------|
|                                       | Number<br>of<br>Contracts | Rate<br>Modifications | Term<br>Modifications | Payment<br>Modifications | Combination<br>Modifications | Total<br>Modifications |
| One-to four- family                   | 1                         | \$ -                  | \$ -                  | \$ -                     | \$ 197                       | \$ 197                 |
| Home equity                           | 1                         | -                     | -                     | -                        | 117                          | 117                    |
| <b>Total</b>                          | <b>2</b>                  | <b>\$ -</b>           | <b>\$ -</b>           | <b>\$ -</b>              | <b>\$ 314</b>                | <b>\$ 314</b>          |

The following table presents new TDRs by type of modification that occurred during the nine months ended September 30, 2012 (in thousands):

| Nine months ended September 30, 2012 |                           |                       |                       |                          |                              |                        |
|--------------------------------------|---------------------------|-----------------------|-----------------------|--------------------------|------------------------------|------------------------|
|                                      | Number<br>of<br>Contracts | Rate<br>Modifications | Term<br>Modifications | Payment<br>Modifications | Combination<br>Modifications | Total<br>Modifications |
| One-to four- family                  | 5                         | \$ -                  | \$ -                  | \$ -                     | \$ 561                       | \$ 561                 |
| Home equity                          | 2                         | -                     | -                     | -                        | 166                          | 166                    |
| Commercial and multifamily           | 2                         | -                     | -                     | -                        | 426                          | 426                    |
| Construction and land                | 2                         | -                     | -                     | -                        | 26                           | 26                     |
| Other consumer                       | 2                         | -                     | -                     | -                        | 14                           | 14                     |
| Commercial business                  | 3                         | \$ 121                | -                     | -                        | 186                          | 307                    |
| <b>Total</b>                         | <b>16</b>                 | <b>\$ 121</b>         | <b>\$ -</b>           | <b>\$ -</b>              | <b>\$ 1,379</b>              | <b>\$ 1,500</b>        |

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, 2013 and 2012, respectively.

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The following table represents financing receivables modified as TDRs within the previous 12 months for which there was a payment default during the three and nine months ended September 30, 2013 and 2012, respectively (in thousands):

|                            | Three months ended<br>September 30, |                | Nine months ended<br>September 30, |                |
|----------------------------|-------------------------------------|----------------|------------------------------------|----------------|
|                            | 2013                                | 2012           | 2013                               | 2012           |
| One-to four- family        | \$-                                 | \$1,246        | \$-                                | \$1,246        |
| Home equity                | 99                                  | 215            | 99                                 | 215            |
| Commercial and multifamily | -                                   | 1,366          | -                                  | 1,366          |
| Manufactured homes         | -                                   | 390            | -                                  | 471            |
| Other consumer             | -                                   | 27             | -                                  | 27             |
| Commercial business        | -                                   | 540            | -                                  | 540            |
| <b>Total</b>               | <b>\$99</b>                         | <b>\$3,784</b> | <b>\$99</b>                        | <b>\$3,865</b> |

For the preceding tables, a loan is considered in default when a payment is 31 days past due. No TDRs modified within the previous 12 months were three months past due as of September 30, 2013. One commercial real estate TDR was three months past due as of September 30, 2012 and therefore on nonaccrual status.

The Company had no commitments to extend additional credit to borrowers owing receivables whose terms have been modified in troubled debt restructurings.

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## Note 6 – 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, 2013 and December 31, 2012 (in thousands):

|                               | Fair Value at September 30, 2013 |           |         |         |
|-------------------------------|----------------------------------|-----------|---------|---------|
|                               | Total                            | Level 1   | Level 2 | Level 3 |
| <b>FINANCIAL ASSETS:</b>      |                                  |           |         |         |
| Cash and cash equivalents     | \$ 13,961                        | \$ 13,961 | \$-     | \$-     |
| Available for sale securities | 16,639                           | -         | 14,150  | 2,489   |
| FHLB stock                    | 2,336                            | -         | -       | 2,336   |
| Loans held for sale           | 1,664                            | -         | 1,664   | -       |
| Loans, net                    | 378,160                          | -         | -       | 378,160 |
| Accrued interest receivable   | 1,313                            | 1,313     | -       | -       |
| Mortgage servicing rights     | 2,843                            | -         | -       | 2,843   |
| <b>FINANCIAL LIABILITIES:</b> |                                  |           |         |         |
| Non-maturity deposits         | 185,000                          | -         | 185,000 | -       |
| Time deposits                 | 157,551                          | -         | 157,551 | -       |
| Borrowings                    | 40,360                           | -         | 40,360  | -       |
| Accrued interest payable      | 76                               | -         | 76      | -       |

  

|                               | Fair Value at December 31, 2012 |           |         |         |
|-------------------------------|---------------------------------|-----------|---------|---------|
|                               | Total                           | Level 1   | Level 2 | Level 3 |
| <b>FINANCIAL ASSETS:</b>      |                                 |           |         |         |
| Cash and cash equivalents     | \$ 12,727                       | \$ 12,727 | \$-     | \$-     |
| Available for sale securities | 22,900                          | -         | 20,127  | 2,773   |
| FHLB Stock                    | 2,401                           | -         | -       | 2,401   |
| Loans held for sale           | 1,725                           | -         | 1,725   | -       |
| Loans, net                    | 327,078                         | -         | -       | 327,078 |
| Accrued interest receivable   | 1,280                           | 1,280     | -       | -       |
| Mortgage servicing rights     | 2,306                           | -         | -       | 2,306   |
| <b>FINANCIAL LIABILITIES:</b> |                                 |           |         |         |
| Non-maturity deposits         | 177,097                         | -         | 177,097 | -       |
| Time deposits                 | 134,007                         | -         | 134,007 | -       |
| Borrowings                    | 21,708                          | -         | 21,708  | -       |
| Accrued interest payable      | 83                              | -         | 83      | -       |

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The following table presents the balance of assets measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012 (in thousands):

|                                       | Fair Value at September 30, 2013 |         |         |         |
|---------------------------------------|----------------------------------|---------|---------|---------|
|                                       | Total                            | Level 1 | Level 2 | Level 3 |
| Municipal bonds                       | \$1,948                          | \$-     | \$1,948 | \$-     |
| Agency mortgage-backed securities     | 12,202                           | -       | 12,202  | -       |
| Non-agency mortgage-backed securities | 2,489                            | -       | -       | 2,489   |
| Mortgage servicing rights             | 2,843                            | -       | -       | 2,843   |

  

|                                       | Fair Value at December 31, 2012 |         |          |         |
|---------------------------------------|---------------------------------|---------|----------|---------|
|                                       | Total                           | Level 1 | Level 2  | Level 3 |
| Agency mortgage-backed securities     | \$20,127                        | \$-     | \$20,127 | \$-     |
| Non-agency mortgage-backed securities | 2,773                           | -       | -        | 2,773   |
| Mortgage servicing rights             | 2,306                           | -       | -        | 2,306   |

For the nine months ended September 30, 2013 and 2012 there were no transfers between Level 1 and Level 2 nor between Level 2 and Level 3.

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, 2013:

| Financial Instrument                  | Valuation Technique  | Unobservable Input(s)       | Range (Weighted Average) |
|---------------------------------------|----------------------|-----------------------------|--------------------------|
| Mortgage Servicing Rights             | Discounted cash flow | Prepayment speed assumption | 219-550% (310%)          |
|                                       |                      | Discount rate               | 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 nine months ended September 30, 2013 and 2012 (in



thousands):

|                                  | Nine Months Ended<br>September 30, |         |
|----------------------------------|------------------------------------|---------|
|                                  | 2013                               | 2012    |
| Beginning balance, at fair value | \$2,773                            | \$2,933 |
| OTTI impairment losses           | (30 )                              | (156 )  |
| Sales and principal payments     | (477 )                             | (135 )  |
| Change in unrealized loss        | 223                                | 186     |
| Ending balance, at fair value    | \$2,489                            | \$2,828 |

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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 7 – Mortgage Servicing Rights.

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

|                             | Fair Value at September 30, 2013 |         |         |         |
|-----------------------------|----------------------------------|---------|---------|---------|
|                             | Total                            | Level 1 | Level 2 | Level 3 |
| Impaired loans:             |                                  |         |         |         |
| One- to four- family        | \$4,745                          | \$-     | \$-     | \$4,745 |
| Home equity                 | 1,894                            | -       | -       | 1,894   |
| Commercial and multifamily  | 3,454                            | -       | -       | 3,454   |
| Construction and land       | 740                              | -       | -       | 740     |
| Manufactured homes          | 671                              | -       | -       | 671     |
| Other consumer              | 46                               | -       | -       | 46      |
| Commercial business         | 565                              | -       | -       | 565     |
| OREO and repossessed assets | 981                              | -       | -       | 981     |

|                             | Fair Value at December 31, 2012 |         |         |         |
|-----------------------------|---------------------------------|---------|---------|---------|
|                             | Total                           | Level 1 | Level 2 | Level 3 |
| Impaired loans:             |                                 |         |         |         |
| One- to four- family        | \$6,016                         | \$-     | \$-     | \$6,016 |
| Home equity                 | 1,731                           | -       | -       | 1,731   |
| Commercial and multifamily  | 2,127                           | -       | -       | 2,127   |
| Construction and land       | 571                             | -       | -       | 571     |
| Manufactured homes          | 654                             | -       | -       | 654     |
| Other consumer              | 55                              | -       | -       | 55      |
| Commercial business         | 839                             | -       | -       | 839     |
| OREO and repossessed assets | 2,503                           | -       | -       | 2,503   |

The following tables present the total losses during the three and nine months ended September 30, 2013 and 2012 resulting from fair value adjustments (in thousands):

|                             | Three Months Ended |                    | Nine Months Ended  |                    |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
|                             | September 30, 2013 | September 30, 2012 | September 30, 2013 | September 30, 2012 |
| OREO and repossessed assets | \$80               | \$145              | \$855              | \$314              |
| Impaired loans              | 484                | 1,197              | 1,357              | 4,048              |

There were no liabilities carried at fair value, measured on a recurring or nonrecurring basis, at September 30, 2013 or December 31, 2012.

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, 2013:

| Financial Instrument | Valuation Technique(s) | Unobservable Input(s)                               | Range (Weighted Average) |
|----------------------|------------------------|---|--------------------------|
| OREO                 | Market approach        | Adjustment for differences between comparable sales | 1.9-43% (13%)            |
| Impaired loans       | Market approach        | Adjustment for differences between comparable sales | 0-100% (7%)              |

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.

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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, 2013 and December 31, 2012, 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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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 7 – Mortgage Servicing Rights

The unpaid principal balances of loans serviced for Federal National Mortgage Association at September 30, 2013 and December 31, 2012, totaled approximately \$361.9 million and \$365.7 million, respectively and were 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, 2013 and 2012 were as follows (in thousands):

|   | Three months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|---|-------------------------------------|---------|------------------------------------|---------|
|   | 2013                                | 2012    | 2013                               | 2012    |
| Beginning balance, at fair value                                | \$2,670                             | \$2,558 | \$2,306                            | \$2,437 |
| Servicing rights that result from transfers of financial assets | 160                                 | 226     | 655                                | 554     |
| Changes in fair value:  |                                     |         |                                    |         |
| Due to changes in model inputs or assumptions(1)                | 271                                 | (259 )  | 656                                | 97      |
| Other(2)  | (258 )                              | (211 )  | (774 )                             | (774 )  |
| Ending balance, at fair value                                   | \$2,843                             | \$2,314 | \$2,843                            | \$2,314 |

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

(2) 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 30, |   |       |   |
|--|------------------|---|-------|---|
|  | 2013             | % | 2012  | % |
| Prepayment speed (Public Securities Association "PSA" model) | 219              | % | 372   | % |
| Weighted-average life (years)                                | 5.98             |   | 3.86  |   |
| Yield to maturity discount rate                              | 10.01            | % | 10.00 | % |

The amount of contractually specified servicing, late and ancillary fees earned, recorded in mortgage servicing income on the Consolidated Statements of Income was \$78,000 and \$387,000 for the three and nine months ended September 30, 2013, respectively, and \$148,000 and \$346,000 for the three and nine months ended September 30, 2012, respectively.

Note 8 – 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 9 – Borrowings

The Company utilizes a loan agreement with the FHLB of Seattle. 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, 2013, the amount available to borrow under this agreement was approximately 35% of the Bank's total assets, or up to \$151.1 million, subject to the availability of eligible collateral. Based on eligible collateral, the total amount available under this agreement as of September 30, 2013 and December 31, 2012 was \$106.5 million and \$90.7 million, respectively. The Company had outstanding borrowings under this arrangement of \$40.4 million and \$21.9 million at September 30, 2013 and December 31, 2012, respectively. Additionally, the Company had outstanding letters of credit from the FHLB with a notional amount of \$25.0 million and \$31.5 million at September 30, 2013 and December 31, 2012, respectively, to secure public deposits. The net remaining amount available as of September 30, 2013 and December 31, 2012, was \$41.1 million and \$37.3 million, respectively.

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

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 \$15.8 million and \$11.8 and no outstanding borrowings under this program at September 30, 2013 and December 31, 2012, respectively.

The Company has access to an unsecured line of credit from the Pacific Coast Banker's Bank. The line has a two-year term maturing on June 30, 2014 and is renewable biannually. At September 30, 2013, the amount available under this line of credit was \$2.0 million. There was no balance on this line of credit as of September 30, 2013 and December 31, 2012, respectively.

Note 10 – Earnings Per Common Share

Non-vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of earnings per share pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Certain of the Company's non-vested restricted stock awards qualify as participating securities.

Net earnings, less any preferred dividends accumulated for the period (whether or not declared), is allocated between the common stock and participating securities pursuant to the two-class method. Basic earnings per common share is computed by dividing net earnings available to common shareholders by the weighted average number of common shares outstanding during the period, excluding participating non-vested restricted shares.

Diluted earnings per common share is computed in a similar manner, except that first the denominator is increased to include the number of additional common shares that would have been outstanding if potentially dilutive common shares, excluding the participating securities, were issued using the treasury stock method. For all periods presented, stock options, certain restricted stock awards and restricted stock units are the only potentially dilutive non-participating instruments issued by the Company. Next, we determine and include in diluted earnings per common share calculation the more dilutive effect of the participating securities using the treasury stock method or the two-class method. Undistributed losses are not allocated to the non-vested share-based payment awards (the participating securities) under the two-class method as the holders are not contractually obligated to share in the losses of the Company.

ESOP shares are considered outstanding for basic and diluted earnings per share when the shares are committed to be released.

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

|            | Three Months Ended    |                       | Nine Months Ended     |                       |
|------------|-----------------------|-----------------------|-----------------------|-----------------------|
|            | September 30,<br>2013 | September 30,<br>2012 | September 30,<br>2013 | September 30,<br>2012 |
| Net income | \$994                 | \$612                 | \$2,934               | \$1,752               |



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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Less net income attributable to participating securities(1) | 22        | 7         | 59        | 19        |
| Net income available to common shareholders                 | \$972     | \$605     | \$2,875   | \$1,733   |
| Weighted average number of shares outstanding, basic        | 2,576,995 | 2,587,669 | 2,583,588 | 2,585,694 |
| Effect of potentially dilutive common shares(2)             | 57,092    | 40,151    | 51,976    | 30,376    |
| Weighted average number of shares outstanding, diluted      | 2,634,087 | 2,627,820 | 2,635,564 | 2,616,070 |
| Earnings per share, basic                                   | \$0.39    | \$0.24    | \$1.14    | \$0.68    |
| Earnings per share, diluted                                 | \$0.38    | \$0.23    | \$1.11    | \$0.67    |

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

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

There were no shares considered anti-dilutive for the three and nine months ended September 30, 2013 or 2012.

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

## Note 11 – Stock-based Compensation

## Stock Options and Restricted Stock

In 2008, the Board of Directors adopted and stockholders approved an Equity Incentive Plan (the “Plan”) which was assumed by the Company in connection with the Conversion. The Plan permits the grant of restricted stock, restricted stock units, stock options, and stock appreciation rights. Under the 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, in each case, as adjusted for the Conversion exchange ratio.

As of September 30, 2013, on an adjusted basis, awards for stock options totaling 107,456 shares and awards for restricted stock totaling 49,771 shares of Company common stock have been granted, net of any forfeitures, to participants in the Plan. During the nine months ended September 30, 2013 and 2012, share-based compensation expense totaled \$42,000 and \$125,000, respectively. All of the awards vest in 20 percent annual increments commencing one year from the grant date. The options 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 period ended September 30, 2013:

|   | Shares   | Weighted-<br>Average<br>Exercise<br>Price | Weighted-Average<br>Remaining<br>Contractual<br>Term In Years | Aggregate<br>Intrinsic<br>Value |
|---|----------|---|---|---------------------------------|
| Outstanding at the beginning of the year                              | 115,936  | \$8.93                                    | 6.78  | \$170,426                       |
| Granted   | -        | -   |   |                                 |
| Exercised   | -        | -   |   |                                 |
| Forfeited   | (8,480 ) | \$9.07                                    |   |                                 |
| Expired   | -        | -   |   |                                 |
| Outstanding at September 30, 2013                                     | 107,456  | \$8.92                                    | 6.09  | \$665,153                       |
| Exercisable   | 70,115   | \$9.02                                    | 5.56  | \$427,000                       |
| Expected to vest, assuming a 0% forfeiture rate over the vesting term | 107,456  | \$8.92                                    | 6.09  | \$665,153                       |

As of September 30, 2013, there was \$66,000 of total unrecognized compensation cost related to non-vested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 5.1 years.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model that uses the assumptions noted in the table below. The dividend yield is based on the current quarterly dividend in effect at the time of the grant.

The Company (including the predecessor entity) became a publicly held company in January 2008, so the amount of historical stock price information available is limited. As a result, the Company elected to use a weighted-average of its peers' historical stock prices, as well as the Company's own historical stock prices to estimate volatility. The Company bases the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. The Company elected to use the Staff Accounting Bulletin No. 110, "Share-Based Payments" permitted by the Securities and Exchange Commission to calculate the expected term. This simplified method uses the vesting term of an option along with the contractual term, setting the expected life at a midpoint in between.

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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. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date.

The following is a summary of the Company's non-vested restricted stock awards during the nine months ended September 30, 2013:

| Non-vested Shares:   | Shares   | Weighted-Average<br>Grant-Date Fair<br>Value Per Share | Aggregate<br>Intrinsic<br>Value Per<br>Share |
|--|----------|--|--|
| Non-vested at January 1, 2013  | 24,747   | \$ 8.44  |  |
| Granted  | -        |  |  |
| Vested   | (9,487 ) |  |  |
| Forfeited  | (735 )   |  |  |
| Expired  | -        |  |  |
| Non-vested at September 30, 2013                                     | 14,525   | \$ 8.44  | \$15.11                                      |
| Expected to vest assuming a 0% forfeiture rate over the vesting term | 14,525   | \$ 8.44  | \$15.11                                      |

The aggregate intrinsic value of the non-vested restricted stock options as of September 30, 2013 was \$219,000.

As of September 30, 2013, there was \$43,000 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 2.0 years.

### 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 Conversion, the ESOP borrowed an additional \$1.1 million from the Company to purchase 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. At September 30, 2013, the remaining balances of the ESOP loans were \$638,000 and \$1.0 million, respectively.

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

At September 30, 2013, the ESOP was committed to release 22,900 shares of the Company's common stock to participants and held 151,115 unallocated shares remaining to be released in future years. The fair value of the 202,755 restricted shares held by the ESOP trust was \$3.1 million at September 30, 2013. ESOP compensation expense included in salaries and benefits was \$76,000 and \$249,000 for the three and nine months ended September 30, 2013, respectively. ESOP compensation expense included in salaries and benefits was \$61,000 and \$114,000 for

the three and nine months ended September 30, 2012.

Note 12 – Subsequent Event

On October 29, 2013 the Company declared a quarterly cash dividend of \$0.05 per common share, payable on November 27, 2013 to shareholders of record at the close of business November 13, 2013.

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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;
- 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;
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monetary and fiscal policies of the 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;
  - 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 other filings with the U.S. Securities and Exchange Commission (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.

References in this document to Sound Financial Bancorp or the (“Company”) 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” means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank, unless the context otherwise requires.

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## General

Sound Financial Bancorp, a Maryland corporation, is a full stock holding company for its wholly owned subsidiary, Sound Community Bank (the “Bank”). On August 22, 2012, Sound Financial Bancorp completed a public offering and share exchange as part of the Bank’s conversion from the mutual holding company structure and the elimination of Sound Financial, Inc. and Sound Community MHC (the “Conversion”). Please see Note 3 Conversion and Stock Issuance of the Notes to Consolidated Financial Statements under Item 1 of this report for more information. All share and per share information in this report for periods prior to the Conversion has been adjusted to reflect the 0.87423:1 exchange ratio on publicly traded shares.

Substantially all of Sound Financial Bancorp’s business is conducted through Sound Community Bank, which until December 28, 2012, was a federal savings bank subject to extensive regulation by the Office of the Comptroller of the Currency. During October 2012, the Bank filed an application to convert from a federally chartered savings bank to a Washington state-chartered commercial bank. The charter change was completed on December 28, 2012. As a Washington commercial bank, the Bank’s regulators are the Washington State Department of Financial Institutions (“WDFI”) and the FDIC. The Board of Governors of the Federal Reserve System (“Federal Reserve”) remains the primary federal regulator for the Company. The charter change primarily was undertaken to reduce regulatory examination costs and to move oversight of the Bank to the WDFI, which is focused on local community banks and financial institutions.

Sound Community Bank’s deposits are insured up to applicable limits by the FDIC. At September 30, 2013, Sound Financial Bancorp had total consolidated assets of \$431.7 million, net loans of \$375.7 million, deposits of \$341.3 million and stockholders’ equity of \$45.9 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 5th Avenue, Suite 200, Seattle, Washington, 98121.

Our principal business consists of attracting retail 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 wide variety of secured and unsecured consumer loan products, including manufactured 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 these loans with servicing retained to maintain the direct customer relationship and to continue providing strong customer service.

Our operating revenues are derived principally from earnings on interest earning assets, service charges and fees, and gains on the sale of loans. Our primary sources of funds are deposits, Federal Home Loan Bank (“FHLB”) advances and other borrowings, and payments received on loans and securities. We offer a variety of deposit accounts that provide a wide range of interest rates and terms, generally including savings, money market, term certificate and demand accounts.

Our noninterest expenses consist primarily of salaries and employee benefits, expenses for occupancy, marketing and data processing and FDIC deposit insurance premiums. Salaries and benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement and other employee benefits. Occupancy expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of lease payments, property taxes, depreciation charges, maintenance and the cost of utilities.

## 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 2012 Form 10-K. There have been no significant changes in the Company's application of accounting policies since December 31, 2012.

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Comparison of Financial Condition at September 30, 2013 and December 31, 2012

General. Total assets increased by \$50.7 million, or 13.3% to \$431.7 million at September 30, 2013 from \$381.0 million at December 31, 2012. This increase was primarily the result of a \$53.2 million, or 16.5% increase in our net loan portfolio and a \$3.7 million, or 51.7%, increase in the cash surrender value of BOLI partially offset by a \$6.3 million, or 27.3%, decrease in available for sale securities and a \$1.5 million, or 60.8%, decrease in OREO and other repossessed assets. Asset growth was funded by a \$29.3 million increase in deposits, an \$18.5 million increase in FHLB advances and a \$2.5 million increase in shareholders' equity, primarily as a result of net income.

Cash and Securities. Cash, cash equivalents and our available-for-sale securities in the aggregate decreased by \$5.0 million, or 17.6%, to \$30.6 million at September 30, 2013. Cash and cash equivalents increased by \$1.2 million, or 9.7%, to \$14.0 million at September 30, 2013. Available-for-sale securities, which consist primarily of agency mortgage-backed securities, decreased by \$6.3 million, or 27.3%, from \$22.9 million at December 31, 2012 to \$16.6 million at September 30, 2013 as a result of normal pay-downs and maturities, with the net proceeds being reinvested into loans.

At September 30, 2013, our available-for-sale securities portfolio consisted of \$2.8 million of non-agency mortgage-backed securities. These securities present a higher credit risk than agency mortgage-backed securities or municipal bonds, of which we had \$12.4 million and \$1.9 million, respectively, at September 30, 2013. In order to monitor the increased risk, management receives and reviews a credit surveillance report from a third party quarterly, which evaluates these securities based on a number of factors, including its credit scores, loan-to-value ratios, geographic locations, delinquencies and loss histories of the underlying mortgage loans. This analysis is prepared in order to project future losses based on various home price depreciation scenarios over a three-year horizon. Based on these reports, management ascertains the appropriate value for these securities and, during the nine months ended September 30, 2013, recorded an other-than-temporary impairment charge of \$30,000 on one of these non-agency securities. Please see Note 4 – Investments in the Notes to Consolidated Financial Statements under Item 1 of this report. The current market environment significantly limits our ability to mitigate our exposure to value changes in these more risky securities by selling them, and we do not anticipate these conditions to change significantly throughout the year. Accordingly, if the market and economic environment impacting the loans supporting these securities continues to deteriorate, we could determine that an other-than-temporary impairment must be recorded on these securities, as well as on any other securities in our portfolio. As a result, our future earnings, equity, regulatory capital and ongoing operations could be materially adversely affected.

Loans. Our total loan portfolio, including loans held for sale, increased \$53.4 million, or 16.2%, from \$329.3 million at December 31, 2012 to \$382.7 million at September 30, 2013. Loans held for sale decreased \$61,000 from \$1.7 million at December 31, 2012 to \$1.7 million at September 30, 2013.

The following table reflects the changes in the types of loans in our portfolio at September 30, 2013, as compared to December 31, 2012 (dollars in thousands):

|                            | September<br>30, 2013 | December<br>31, 2012 | Amount<br>Change | Percent<br>Change |   |
|----------------------------|-----------------------|----------------------|------------------|-------------------|---|
| One-to-four-family         | \$ 116,616            | \$ 95,784            | \$ 20,832        | 21.7              | % |
| Home equity                | 35,317                | 35,364               | (47 )            | (0.1 )            |   |
| Commercial and multifamily | 148,745               | 133,620              | 15,125           | 11.3              |   |
| Construction and land      | 43,780                | 25,458               | 18,322           | 72.0              |   |
| Manufactured homes         | 13,983                | 16,232               | (2,249 )         | (13.9 )           |   |
| Other consumer             | 9,393                 | 8,650                | 743              | 8.6               |   |
| Commercial business        | 14,842                | 14,193               | 649              | 4.6               |   |

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|             |           |           |          |      |   |
|-------------|-----------|-----------|----------|------|---|
| Total loans | \$382,676 | \$329,301 | \$53,375 | 16.2 | % |
|-------------|-----------|-----------|----------|------|---|

The most significant change in our loan portfolio was a result of increases in one- to four- family mortgage loans which was primarily a result of increases in higher yielding jumbo mortgage and other portfolio one-to four- family mortgage loans. Construction and land loans increased primarily a result of increased demand for new homes, reflecting the improvement in the housing market in the communities we serve. We work with a small number of well-established single family home builders in our market areas. Management monitors our exposure on construction loans closely and a third party evaluates each project's percentage of completion before any draw is allowed. Commercial and multifamily loans increased primarily as a result of continued efforts to expand and diversify our lending portfolio. Manufactured homes decreased as a result of a lack of demand for these types of loans by well-qualified borrowers. The loan portfolio remains well-diversified with commercial and multifamily real estate loans accounting for 38.9% of the portfolio, of which 27.9% were owner-occupied. Residential real estate loans accounted for 30.5% of the portfolio. Home equity, manufactured and other consumer loans accounted for 15.3% of the portfolio. Construction and land accounted for 11.4% of the portfolio and commercial business loans accounted for the remaining 3.9% of total loans at September 30, 2013.

**Mortgage Servicing Rights.** At September 30, 2013, we had \$2.8 million in mortgage servicing rights recorded at fair value compared to \$2.3 million at December 31, 2012. The increase was the result of a 18 basis point increase in the estimated market value of the portfolio during the nine month period from 63 basis points at December 31, 2012 to 81 basis points at September 30, 2013 primarily as a result of the increase in long-term mortgage rates slowing prepayment speeds. We record mortgage servicing rights on loans sold to Fannie Mae 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, 2013, our nonperforming assets totaled \$2.9 million, or 0.67% of total assets, compared to \$6.4 million, or 1.68% of total assets at December 31, 2012.

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

|   | Nonperforming Assets        |                            |                  |                   |
|---|-----------------------------|----------------------------|------------------|-------------------|
|   | At<br>September<br>30, 2013 | At<br>December<br>31, 2012 | Amount<br>Change | Percent<br>Change |
| Nonaccrual loans                          | \$1,161                     | \$3,003                    | \$(1,842 )       | (61.3 )%          |
| Accruing loans 90 days or more delinquent | -                           | 81                         | (81 )            | (100.0 )          |
| Nonperforming restructured loans          | 761                         | 828                        | (67 )            | (8.1 )            |
| OREO and repossessed assets               | 981                         | 2,503                      | (1,522 )         | (60.8 )           |
| Total nonperforming assets                | \$2,903                     | \$6,415                    | \$(3,512 )       | (54.7 )%          |

Nonperforming loans to total loans decreased to 0.50% of total gross loans at September 30, 2013 from 1.19% at December 31, 2012. This decrease reflects a \$2.0 million decrease in nonperforming loans during the nine month period ended September 30, 2013. Our largest nonperforming loans at September 30, 2013 consisted of a \$248,000 home equity loan secured by property located in Clallam County, Washington, a \$238,000 commercial real estate loan secured by property located in Clallam County, Washington and a \$230,000 commercial real estate loan secured by property located in Pierce County, Washington.

OREO and repossessed assets decreased during the nine months ended September 30, 2013 primarily due to improving economic conditions in our market and our continued focus on credit administration. During the nine months ended September 30, 2013, we repossessed 11 personal residences, one commercial land development and

eight manufactured homes. We sold 13 personal residences, two commercial land developments and 10 manufactured homes at an aggregate loss of \$855,000. Our largest OREO at September 30, 2013, consisted of a one- to four- family home with a recorded value of \$180,000 located in Mason County, Washington. Our next largest OREO properties were a \$179,000 one- to four- family home located in Columbia County, Washington and a \$131,000 one- to four- family home located in Snohomish 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.

Our allowance for loan losses at September 30, 2013 was \$4.1 million, or 1.08% of total loans receivable, compared to \$4.2 million, or 1.30% of total loans receivable at December 31, 2012. The \$133,000, or 3.1% decrease in the allowance for loan losses reflects the \$1.1 million provision for loan losses established during the nine months ended September 30, 2013 as a result of decreasing loan charge-offs and nonperforming loans during this period.

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

|   | Nine Months Ended<br>September 30, |   |         |   |
|---|------------------------------------|---|---------|---|
|   | 2013                               |   | 2012    |   |
| Balance at beginning of period  | \$4,248                            |   | \$4,455 |   |
| Charge-offs   | (1,357                             | ) | (4,048  | ) |
| Recoveries:   | 74                                 |   | 251     |   |
| Net charge-offs   | (1,283                             | ) | (3,797  | ) |
| Provisions charged to operations  | 1,150                              |   | 3,675   |   |
| Balance at end of period  | \$4,115                            |   | \$4,333 |   |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.52                               | % | 1.67    | % |
| Allowance as a percentage of nonperforming loans  | 206.58                             | % | 99.75   | % |
| Allowance as a percentage of total loans (end of period)                                  | 1.08                               | % | 1.40    | % |

Specific loan loss reserves decreased \$787,000 at September 30, 2013 compared to September 30, 2012 while general loan loss reserves increased \$567,000 at September 30, 2013, compared to September 30, 2012. Net charge-offs for the nine months ended September 30, 2013 were \$1.3 million, or 0.52% of average loans on an annualized basis, compared to \$3.8 million, or 1.67% of average loans for the same period in 2012. The decrease in net charge-offs was primarily due to improving economic conditions in our market area and continued efforts in credit administration and collections. As of September 30, 2013, the allowance for loan losses as a percentage of total loans receivable and nonperforming loans was 1.08% and 206.58%, respectively, compared to 1.45% and 99.75%, respectively, at December 31, 2012. The allowance for loan losses as a percentage of total loans receivable decreased primarily as a result improved credit metrics related to both specific and general reserves. This includes a decrease in expected losses on loans individually evaluated for impairment as a percentage of these loans and a decrease in expected losses on loans collectively evaluated for impairment. The decrease in loans individually evaluated is due to lower past due and impaired loans as a percentage of the overall loan portfolio and improving values for real estate in the markets where we lend. The decrease in loans collectively evaluated is due to a lower historical charge-off ratio as of September 30, 2013 compared to December 31, 2012. The allowance for loan losses as a percentage of nonperforming loans increased due to the decrease in nonperforming loans from \$3.0 million as of December 31, 2012 to \$1.2 million as of September 30, 2013.

Deposits. Total deposits increased by \$29.3 million, or 9.4%, to \$341.3 million at September 30, 2013 from \$312.1 million at December 31, 2012, primarily as a result of a \$27.6 million increase in demand accounts and a \$21.4 million, or 15.8%, increase in certificate of deposit accounts. This increase was partially offset by an \$18.5 million, or 21.4%, decrease in money market accounts, a \$746,000, or 2.7%, decrease in savings accounts and a \$443,000, or 11.6% decrease in escrow accounts. The increases were primarily a result of various marketing efforts during the period as we continued our emphasis on attracting relatively low-cost core deposit accounts. The decrease in money market and saving accounts was primarily of result of customers placing these funds in higher yielding certificate or interest-bearing demand accounts or other higher yielding investments, while the decrease in escrow accounts was due to the timing of tax and insurance payments.

A summary of deposit accounts with the corresponding weighted average cost of funds is presented below:

|                     |                         |
|---------------------|-------------------------|
| As of September 30, |                         |
| 2013                | As of December 31, 2012 |

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|                            | Amount    | Wtd. Avg.<br>Rate |   | Amount    | Wtd. Avg.<br>Rate |
|----------------------------|-----------|-------------------|---|-----------|-------------------|
| Noninterest-bearing demand | \$31,211  | 0.00              | % | \$31,427  | 0.00 %            |
| Interest-bearing demand    | 56,320    | 0.30              |   | 28,540    | 0.10              |
| Savings                    | 26,428    | 0.13              |   | 27,174    | 0.08              |
| Money market               | 67,677    | 0.30              |   | 86,149    | 0.32              |
| Certificates               | 156,342   | 1.15              |   | 134,986   | 1.33              |
| Escrow                     | 3,364     | 0.00              |   | 3,807     | 0.00              |
| Total deposits             | \$341,342 | 0.63              | % | \$312,083 | 0.69 %            |

Borrowings. FHLB advances increased \$18.5 million, or 84.7%, to \$40.4 million at September 30, 2013, with a weighted-average cost of 0.60%, from \$21.9 million at December 31, 2012, with a weighted-average cost of 1.12%. 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.

Stockholders' Equity. Total stockholders' equity increased \$2.5 million, or 5.7%, to \$45.9 million at September 30, 2013. This increase primarily reflects \$2.9 million in net income.

Comparison of Results of Operation for the Three and Nine Months Ended September 30, 2013 and 2012

General. Net income increased \$382,000 to \$994,000, or \$0.38 per diluted common share, for the three months ended September 30, 2013, compared to \$612,000, or \$0.23 per diluted common share, for the three months ended September 30, 2012. Net income increased \$1.2 million to \$2.9 million, or \$1.11 per diluted common share, for the nine months ended September 30, 2013, compared to \$1.8 million, or \$0.67 per diluted common share, for the nine months ended September 30, 2012. The primary reasons for the improvement in comparative periods were a decrease in the provision for loan losses and increased net interest income partially offset by lower gain on sale of loans and higher noninterest expense.

**Interest Income.** Interest income increased by \$443,000, or 9.8%, to \$5.0 million for the three months ended September 30, 2013, from \$4.5 million for the three months ended September 30, 2012. Interest income increased \$804,000, or 5.9%, to \$14.5 million for the nine months ended September 30, 2013, from \$13.7 million for the nine months ended September 30, 2012. The increase in interest income for both periods primarily reflected the increase in the average balance of interest-earning assets, in particular our average balance of loans receivable which outpaced the decline in the weighted average yield on our interest-earning assets during the three and nine months ended September 30, 2013 as compared to the same period last year.

Our weighted average yield on interest-earning assets was 5.15% and 5.18% for the three and nine months ended September 30, 2013, respectively, compared to 5.66% and 5.89% for the three and nine months ended September 30, 2012, respectively. The weighted average yield on loans decreased to 5.43% and 5.46% for the three and nine months ended September 30, 2013, respectively, from 5.77% and 5.92% for the three and nine months ended September 30, 2012. The average balance of gross loans receivable increased \$55.6 million, or 18.1% for the three months ended September 30, 2013 as compared to the same period last year. The average balance of gross loans receivable increased \$45.2 million, or 14.9% for the nine months ended September 30, 2013 as compared to the same period last year. The weighted average yield on available-for-sale securities (including OTTI) was 1.42% and 1.48% for the three and nine months ended September 30, 2013, respectively, compared to 1.81% and 1.75% for the three and nine months ended September 30, 2012, respectively, reflecting higher average balances of agency mortgage-backed securities and municipal bonds, which produce a lower yield than non-agency mortgage-backed securities. The average balance of available-for-sale securities increased \$3.6 million or 27.9% for the three months ended September 30, 2013 as compared to the same period last year. The average balance of available-for-sale securities increased \$12.1 million, or 179.6% for the nine months ended September 30, 2013 as compared to the same period last year.

**Interest Expense.** Interest expense decreased \$18,000, or 3.0%, to \$578,000 for the three months ended September 30, 2013, from \$596,000 for the three months ended September 30, 2012. Interest expense decreased \$93,000, or 5.2%, to \$1.7 million for the nine months ended September 30, 2013, from \$1.8 million for the nine months ended September 30, 2012. These decreases reflect overall lower interest rates paid on deposits and FHLB advances notwithstanding an increase in the average balances of deposits and FHLB advances during the periods. Our weighted average cost of interest-bearing liabilities was 0.71% for each of the three and nine months ended September 30, 2013, respectively, compared to 0.83% and 0.84% for the three and nine months ended September 30, 2012, respectively.

Interest paid on deposits decreased \$12,000, or 2.2%, to \$528,000 for the three months ended September 30, 2013, from \$540,000 for the three months ended September 30, 2012. Interest paid on deposits decreased \$90,000, or 5.6%, to \$1.5 million for the nine months ended September 30, 2013, from \$1.6 million for the nine months ended September 30, 2012. These decreases resulted from lower weighted average cost of deposits over the periods, which were partially offset by increases in the average balances of deposits outstanding in the periods. We experienced a five and seven basis point decrease in the average rate paid on deposits during the three and nine months ended September 30, 2013, respectively compared to the same period in 2012. This decrease in average rates was primarily a result of the re-pricing of matured certificates of deposit, most of which we were able to retain at lower rates.

Interest expense on borrowings decreased \$6,000, or 10.7%, to \$50,000 for the three months ended September 30, 2013 from \$56,000 for the three months ended September 30, 2012. The decrease was a result of a 217 basis point decrease in our cost of borrowings to 0.60% for the three months ended September 30, 2013 from 2.77% during the three months ended September 30, 2012. This decrease was partially offset by a \$25.3 million, or 313.7%, increase in the average balance of borrowings outstanding for the period.

Interest expense on borrowings decreased \$3,000, or 1.8%, to \$164,000 for the nine months ended September 30, 2013, from \$167,000 for the nine months ended September 30, 2012. The decrease was a result of a 200 basis point decrease in our cost of borrowings to 0.70% for the nine months ended September 30, 2013 from 2.70% during the



nine months ended September 30, 2013. This decrease was partially offset by a \$23.1 million, or 280.2%, increase in the average balance of borrowings outstanding for the period.

**Net Interest Income.** Net interest income increased \$461,000, or 11.7% to \$4.4 million for the three months ended September 30, 2013, from \$3.9 for the three months ended September 30, 2012. Net interest income increased \$897,000, or 7.5% to \$12.8 million for the nine months ended September 30, 2013, from \$11.9 for the nine months ended September 30, 2012. The increases for both the three and nine months ended September 30, 2013 primarily resulted from increased interest income due to higher average loan balances and to a lesser extent, lower rates paid on deposits and borrowings during these periods as compared to the same periods last year. Our average yield on loans receivable decreased during the three and nine months ended September 30, 2013 as compared to the same periods last year as new loan originations and repricing adjustable rate loans reflect the continued low rate environment. Our net interest margin was 4.55% and 4.58% for the three and nine months ended September 30, 2013, compared to 4.91% and 5.12% the three and nine months ended September 30, 2012.

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**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.

A provision of \$450,000 and \$1.2 million was made during the three and nine months ended September 30, 2013, respectively, compared to a provision of \$1.1 million and \$3.7 million during the three and nine months ended September 30, 2012, respectively. The reduced provision primarily reflects declines in loan charge-offs and nonperforming loans. Although the amount of our nonperforming assets and loan charge-offs have declined significantly over the last year, we believe that higher than historical levels of nonperforming assets and charge-offs will continue until the housing market, unemployment, and general economic market conditions further recover in our market area.

For the three months ended September 30, 2013, the annualized percentage of net charge-offs to average loans decreased 102 basis points to 0.53% from 1.55% for the three months ended September 30, 2012. For the nine months ended September 30, 2013, the annualized percentage of net charge-offs to average loans decreased 115 basis points to 0.52% from 1.67% for the nine months ended September 30, 2012. The ratio of nonperforming loans to total loans decreased to 0.50% at September 30, 2013 from 1.41% at September 30, 2012.

**Noninterest Income.** Noninterest income decreased \$181,000, or 15.0% to \$1.0 million for the three months ended September 30, 2013, as compared to \$1.2 million for the three months ended September 30, 2012 as reflected below (dollars in thousands):

|  | Three Months Ended<br>September 30, |         | Amount   | Percent  |
|--|-------------------------------------|---------|----------|----------|
|  | 2013                                | 2012    | Change   | Change   |
| Service charges and fee income                     | \$564                               | \$574   | \$(10 )  | (1.7 )%  |
| Earnings on cash surrender value of BOLI           | 78                                  | 60      | 18       | 30.0     |
| Mortgage servicing income                          | 76                                  | 148     | (72 )    | (48.6 )  |
| Fair value adjustment on mortgage servicing rights | 271                                 | (211 )  | 482      | (228.4 ) |
| Other-than-temporary impairment losses             | -                                   | (32 )   | 32       | (100.0 ) |
| Net gain on sale of loans                          | 37                                  | 668     | (631 )   | (94.5 )  |
| Total noninterest income                           | \$1,026                             | \$1,207 | \$(181 ) | (15.0 )% |

The fair value adjustment on mortgage servicing rights and increase in mortgage servicing income was positively impacted primarily due to slower prepayment speeds and growth in the mortgage servicing portfolio during the three months ended September 30, 2013. We sold \$16.5 million and \$24.2 million of loans to Fannie Mae during the three months ended September 30, 2013 and 2012, respectively. The gain on sale of loans decreased as a result of declines in the loan sale margin and amount of loans sold to Fannie Mae during the three months ended September 30, 2013 as compared to the same period last year primarily due to the recent increase in mortgage interest rates. The decrease in OTTI was a result of improving credit trends in the Company's non-agency mortgage-backed securities. The increase in earnings on cash surrender value of BOLI was primarily a result of earnings on an additional \$3.5 million of BOLI purchased in the first quarter of 2013.

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Noninterest income increased \$421,000, or 12.6% to \$3.8 million for the nine months ended September 30, 2013, as compared to \$3.3 million for the nine months ended September 30, 2012 as reflected below (dollars in thousands):

|  | Nine Months Ended     |                       | Amount<br>Change | Percent<br>Change |   |
|--|-----------------------|-----------------------|------------------|-------------------|---|
|  | September 30,<br>2013 | September 30,<br>2012 |                  |                   |   |
| Service charges and fee income                     | \$1,713               | \$1,638               | \$75             | 4.6               | % |
| Earnings on cash surrender value of BOLI           | 231                   | 179                   | 52               | 29.1              |   |
| Mortgage servicing income                          | 387                   | 346                   | 41               | 11.8              |   |
| Fair value adjustment on mortgage servicing rights | 656                   | 97                    | 559              | 576.3             |   |
| Other-than-temporary impairment losses             | (30 )                 | (156 )                | 126              | (80.8 )           | ) |
| Net gain on sale of loans                          | 794                   | 1,226                 | (432 )           | (35.2 )           | ) |
| Total noninterest income                           | \$3,751               | \$3,330               | \$421            | 12.6              | % |

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The fair value adjustment on mortgage servicing rights and increase in mortgage servicing income was positively impacted primarily due to slower prepayment speeds and growth in the mortgage servicing portfolio during the current nine month period. The gain on sale of loans decreased as a result of declines in the loan sale margin for loans sold to Fannie Mae during the nine months ended September 30, 2013 as compared to the same period last year. We sold \$63.8 million and \$56.6 million of loans to Fannie Mae during the nine months ended September 30, 2013 and 2012, respectively. Refinancing activity was particularly significant in 2012 and in the first six months of 2013, however, the rise in mortgage interest rates in the second quarter of 2013 resulted in lower refinancing activity and gain on sale of loans. The decrease in OTTI was a result of improving credit trends in the Company's non-agency mortgage-backed securities. The increase in earnings on cash surrender value of bank-owned life insurance was primarily a result of additional earnings as a result of a \$3.5 million purchase of BOLI in the first quarter of 2013.

Noninterest Expense. Noninterest expense increased \$381,000, or 12.0%, to \$3.6 million during the three months ended September 30, 2013 as compared to \$3.2 million during the three months ended September 30, 2012, as reflected below (dollars in thousands):

|  | Three Months Ended    |                       | Amount<br>Change | Percent<br>Change |   |
|--|-----------------------|-----------------------|------------------|-------------------|---|
|  | September 30,<br>2013 | September 30,<br>2012 |                  |                   |   |
| Salaries and benefits                              | \$1,858               | \$1,537               | \$321            | 20.9              | % |
| Operations   | 825                   | 697                   | 128              | 18.4              |   |
| Regulatory assessments                             | 57                    | 108                   | (51 )            | (47.2 )           |   |
| Occupancy  | 353                   | 314                   | 39               | 12.4              |   |
| Data processing                                    | 348                   | 264                   | 84               | 31.8              |   |
| Losses and expenses on OREO and repossessed assets | 125                   | 265                   | (140 )           | (52.8 )           |   |
| Total noninterest expense                          | \$3,566               | \$3,185               | \$381            | 12.0              | % |

Salaries and benefits expense increased during the three months ended September 30, 2013 primarily due to increased loan production by commission-based loan officers and from a modest increase in full time equivalent employees ("FTEs"). Operations expense increased primarily due to higher loan administration expenses and higher education and training expenses during the three months ended September 30, 2013 in an effort to expand our investment in knowledge and core competencies of our employees. Regulatory assessments were lower due to a decrease in FDIC insurance assessments and the Bank's change from a national to state charter resulting in the WDFI as the Bank's primary regulator. Losses and expenses on OREO and repossessed assets decreased during the three months ended September 30, 2013 primarily due to lower levels of OREO and other repossessed assets during the three months ended September 30, 2013.

Noninterest expense increased \$2.1 million, or 23.6%, to \$11.2 million during the nine months ended September 30, 2013 as compared to \$9.0 million during the nine months ended September 30, 2012, as reflected below:

|  | Nine Months Ended     |                       | Amount<br>Change | Percent<br>Change |   |
|--|-----------------------|-----------------------|------------------|-------------------|---|
|  | September 30,<br>2013 | September 30,<br>2012 |                  |                   |   |
| Salaries and benefits                              | \$5,224               | \$4,242               | \$982            | 23.1              | % |
| Operations   | 2,809                 | 2,007                 | 802              | 40.0              |   |
| Regulatory assessments                             | 239                   | 329                   | (90 )            | (27.4 )           |   |
| Occupancy  | 961                   | 918                   | 43               | 4.7               |   |
| Data processing                                    | 954                   | 769                   | 185              | 24.1              |   |
| Losses and expenses on OREO and repossessed assets | 963                   | 757                   | 206              | 27.2              |   |

|                           |           |          |          |      |   |
|---------------------------|-----------|----------|----------|------|---|
| Total noninterest expense | \$ 11,150 | \$ 9,022 | \$ 2,128 | 23.6 | % |
|---------------------------|-----------|----------|----------|------|---|

Salaries and benefits expense increased during the nine months ended September 30, 2013 primarily due to increased loan production by commission-based loan officers and from a modest increase in full time equivalent employees (“FTEs”). Operations expense increased primarily due to higher loan administration expenses, higher education and training expenses and a \$412,000 recourse provision for loans sold during the nine months ended September 30, 2013. Although our loans are generally sold without recourse, other than standard representations and warranties, we may have to repurchase a loan sold to Fannie Mae if it is determined that the loan does not meet their credit requirements, or if one of the parties involved in the loan misrepresented pertinent facts, committed fraud, or if the loan were 90 days past due within 120 days of the loan funding date. In light of our increased loan sales during 2012 and 2013, a recourse provision was initially established during the first quarter of 2013 to provide for estimated loan repurchases. There was no recourse provision in 2012. Regulatory assessments were lower due to a decrease in FDIC insurance assessments and the Bank’s change from a national to state charter resulting in the WDFI as the Bank’s primary regulator. Losses and expenses on OREO and repossessed assets increased during the nine months ended September 30, 2013 primarily due to the sale of two commercial land developments during the nine months ended September 30, 2013.

**Income Tax Expense.** For the three months ended September 30, 2013, we had income tax expense of \$423,000 on our pre-tax income as compared to \$281,000 for the three months ended September 30, 2012. The effective tax rates for the three months ended September 30, 2013 and 2012 were 29.9% and 31.5%, respectively. For the nine months ended September 30, 2013, we had income tax expense of \$1.3 million on our pre-tax income as compared to \$800,000 for the nine months ended September 30, 2012. The effective tax rates for the nine months ended September 30, 2013 and 2012 were 31.2% and 31.3%, respectively.

## Liquidity

The Management Discussion and Analysis in Item 7 of the Company's 2012 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, 2013.

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, 2013, the Bank had \$30.6 million in cash and investment securities available for sale and \$1.7 million 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 \$41.1 million in Federal Home Loan Bank advances, \$15.8 million through the Federal Reserve's Discount Window and \$2.0 million through 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, 2013, outstanding loan commitments, including unused lines and letters of credit totaled \$65.0 million. Certificates of deposit scheduled to mature in one year or less at September 30, 2013, totaled \$84.0 million. Based on our competitive pricing, we believe that a majority of maturing deposits will remain with the Bank.

As disclosed in our Condensed Consolidated Statements of Cash Flows in Item 1 of this Quarterly Report on Form 10-Q, cash and cash equivalents increased \$1.3 million to \$14.0 million as of September 30, 2013, from \$12.7 million as of December 31, 2012. Net cash provided by operating activities was \$5.2 million for the nine months ended September 30, 2013. Net cash of \$51.2 million was used in investing activities during the nine months ended September 30, 2013 and consisted principally of loan originations, net of principal repayments and purchases of BOLI and municipal bonds. The \$47.2 million of cash provided by financing activities during the nine months ended September 30, 2013 primarily consisted of a \$29.3 million net increase in deposits and an \$18.5 million net increase in FHLB advances.

As a separate legal entity from the Bank, the Company must provide for its own liquidity. At September 30, 2013, the Company, on an unconsolidated basis, had \$2.3 million 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, 2013, 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, 2013, is as follows (in thousands):

|                                     | At<br>September<br>30, 2013 |
|-------------------------------------|-----------------------------|
| Off-balance sheet loan commitments: |                             |
| Residential mortgage commitments    | \$5,382                     |
| Undisbursed portion of loans closed | 28,647                      |
| Unused lines of credit              | 30,450                      |
| Irrevocable letters of credit       | 513                         |
| Total loan commitments              | \$64,992                    |

### Capital

Sound Community Bank is subject to minimum capital requirements imposed by regulations of the FDIC. Based on its capital levels at September 30, 2013, 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, 2013, 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, 2013 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   |
| As of September 30, 2013               |           |        |                               |        |  |         |
| Tier 1 Capital to average assets       | \$ 42,522 | 10.32% | \$ 16,487                     | ≥ 4.0% | \$ 20,609  | ≥ 5.0%  |
| Tier 1 Capital to risk-weighted assets | \$ 42,522 | 13.03% | \$ 13,050                     | ≥ 4.0% | \$ 19,575  | ≥ 6.0%  |
| Total Capital to risk-weighted assets  | \$ 46,584 | 14.28% | \$ 26,100                     | ≥ 8.0% | \$ 32,624  | ≥ 10.0% |

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

The Company provided information about market risk in Item 7A of its 2012 Form 10-K. There have been no material changes in our market risk since our 2012 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, 2013, 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, 2013, 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.

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 nine months ended September 30, 2013, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.





## 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

The following table sets forth information for the three months ended September 30, 2012 with respect to our repurchases of our outstanding common shares:

|  | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total<br>number of<br>shares<br>purchased<br>as part of<br>publicly<br>announced<br>plans or<br>programs | Maximum<br>number of<br>shares that<br>may yet be<br>purchased<br>under the<br>plans or<br>programs |
|--|---|------------------------------------|--|---|
| July 1, 2013 – July 31, 2013           | ---                                       | ---                                | ---  | ---   |
| August 1, 2013 – August 31, 2013       | 16,600                                    | \$ 15.00                           | 16,600   | 112,740   |
| September 1, 2013 – September 30, 2013 | 19,400                                    | \$ 15.21                           | 36,000   | 93,340  |
| Total                                  | 36,000                                    | \$ 15.11                           | 36,000   |   |

On August 23, 2013, the Company announced that its board of directors authorized the Company to purchase up to 129,340 shares of common stock in the open market or privately negotiated transaction from time to time over a twelve month period subject to market conditions and other factors. The stock repurchase program will expire on August 22, 2014 unless completed sooner or otherwise extended.

## Item 3 Defaults Upon Senior Securities

Nothing to report.

## Item 4 Mine Safety Disclosures

Not Applicable

## Item 5. Other Information

Nothing to report.



EXHIBIT INDEX

Exhibits:

- 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 Summary of Director Board Fee Arrangements (incorporated herein by reference to the Annual Report on Form 10-K filed with the SEC on March 31, 2011 (File No. 000-52889))
- 10.10 Sound Financial Bancorp, Inc. 2008 Equity Incentive Plan (incorporated herein by reference to the Annual Report on Form 10-K filed with the SEC on March 31, 2009 (File No. 000-52889))
- 10.11 Forms of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreements under the 2008 Equity

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|       |  |
|-------|--|
| 10.12 | 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))<br>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)) |
| 10.13 | Sound Financial Bancorp, Inc. 2013 Equity Incentive Plan   |
| 10.14 | Form of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreements under the 2013 Equity Incentive Plan  |
| 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))   |
| 11    | Statement re computation of per share earnings (See Note 10 of the Notes to Condensed Consolidated Financial Statements contained in 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*  |

- In accordance with Rule 406T of Regulation S-T, these interactive data files are deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are not deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those section.

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, 2013

By: /s/ Laura Lee Stewart  
Laura Lee Stewart  
President and Chief Executive Officer

Date: November 13, 2013

By: /s/ Matthew P. Deines  
Matthew P. Deines  
Executive Vice President and Chief Financial Officer