

FS Bancorp, Inc.  
Form 10-Q  
November 13, 2017  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(Mark One)

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

For the quarterly period ended September 30, 2017 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 35589

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington 45 4585178  
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043

(Address of principal executive offices; Zip Code)

(425) 771 5299

(Registrant's telephone number, including area code)

None

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

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 3, 2017, there were 3,674,902 outstanding shares of the registrant's common stock.

Table of Contents

FS Bancorp, Inc.

Form 10 Q

Table of Contents

	Page Number
<b>PART I</b>	<b>FINANCIAL INFORMATION</b>
<u>Item 1.</u>	<u>Financial Statements</u>
	<u>Consolidated Balance Sheets at September 30, 2017 and December 31, 2016 (Unaudited)</u>
	3
	<u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2017 and 2016 (Unaudited)</u>
	4
	<u>Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2017 and 2016 (Unaudited)</u>
	5
	<u>Consolidated Statements of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2017 and 2016 (Unaudited)</u>
	6
	<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2017 and 2016 (Unaudited)</u>
	7
	<u>Notes to Consolidated Financial Statements</u>
	8 - 43
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	44 - 53
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	53
<u>Item 4.</u>	<u>Controls and Procedures</u>
	53
<b>PART II</b>	<b>OTHER INFORMATION</b>
	55
<u>Item 1.</u>	<u>Legal Proceedings</u>
	55
<u>Item 1A.</u>	<u>Risk Factors</u>
	55
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	55
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>
	55
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>
	55
<u>Item 5.</u>	<u>Other Information</u>
	55

<u>Item 6.</u>	<u>Exhibits</u>	56
<u>SIGNATURES</u>		58

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

Table of Contents

## Item 1. Financial Statements

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share amounts) (Unaudited)

	September 30, 2017	December 31, 2016
<b>ASSETS</b>		
Cash and due from banks	\$ 3,299	\$ 3,590
Interest-bearing deposits at other financial institutions	27,996	32,866
Total cash and cash equivalents	31,295	36,456
Certificates of deposit at other financial institutions	18,108	15,248
Securities available-for-sale, at fair value	78,103	81,875
Loans held for sale, at fair value	65,055	52,553
Loans receivable, net	753,854	593,317
Accrued interest receivable	3,217	2,524
Premises and equipment, net	15,463	16,012
Federal Home Loan Bank (“FHLB”) stock, at cost	3,047	2,719
Bank owned life insurance (“BOLI”), net	10,262	10,054
Servicing rights, held at the lower of cost or fair value	5,811	8,459
Goodwill	2,312	2,312
Core deposit intangible, net	1,417	1,717
Other assets	5,947	4,680
<b>TOTAL ASSETS</b>	<b>\$ 993,891</b>	<b>\$ 827,926</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing accounts	\$ 166,964	\$ 152,913
Interest-bearing accounts	673,614	559,680
Total deposits	840,578	712,593
Borrowings	10,270	12,670
Subordinated note:		
Principal amount	10,000	10,000
Unamortized debt issuance costs	(160)	(175)
Total subordinated note less unamortized debt issuance costs	9,840	9,825
Other liabilities	14,964	11,805
Total liabilities	875,652	746,893
<b>COMMITMENTS AND CONTINGENCIES (NOTE 9)</b>		
<b>STOCKHOLDERS’ EQUITY</b>		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.01 par value; 45,000,000 shares authorized; 3,674,902 and 3,059,503 shares issued and outstanding at September 30, 2017, and December 31, 2016, respectively	37	31

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

Additional paid-in capital	54,463	27,334
Retained earnings	65,049	55,584
Accumulated other comprehensive loss, net of tax	(128)	(536)
Unearned shares – Employee Stock Ownership Plan (“ESOP”)	(1,182)	(1,380)
Total stockholders’ equity	118,239	81,033
<b>TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY</b>	<b>\$ 993,891</b>	<b>\$ 827,926</b>

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except share amounts) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
<b>INTEREST INCOME</b>				
Loans receivable, including fees	\$ 11,715	\$ 9,241	\$ 31,488	\$ 26,014
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	637	538	2,034	1,751
Total interest and dividend income	12,352	9,779	33,522	27,765
<b>INTEREST EXPENSE</b>				
Deposits	1,045	808	2,793	2,411
Borrowings	114	50	259	177
Subordinated note	171	171	508	512
Total interest expense	1,330	1,029	3,560	3,100
NET INTEREST INCOME	11,022	8,750	29,962	24,665
PROVISION FOR LOAN LOSSES	450	600	450	1,800
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	10,572	8,150	29,512	22,865
<b>NONINTEREST INCOME</b>				
Service charges and fee income	879	899	2,743	2,489
Gain on sale of loans	5,025	5,922	13,840	14,722
Gain on sale of investment securities	143	146	380	146
Gain on sale of mortgage servicing rights ("MSR")	38	—	996	—
Earnings on cash surrender value of BOLI	68	71	208	211
Other noninterest income	274	210	637	557
Total noninterest income	6,427	7,248	18,804	18,125
<b>NONINTEREST EXPENSE</b>				
Salaries and benefits	7,140	6,287	20,174	16,510
Operations	1,577	1,450	4,506	4,221
Occupancy	650	597	1,939	1,775
Data processing	651	537	1,811	1,576
Gain on sale of other real estate owned ("OREO")	—	—	—	(150)
Loan costs	726	715	1,977	1,789
Professional and board fees	378	502	1,261	1,490
Federal Deposit Insurance Corporation ("FDIC") insurance	175	98	428	306
Marketing and advertising	192	202	512	553
Acquisition costs	—	—	—	389
Amortization of core deposit intangible	100	140	300	382
(Recovery) impairment on servicing rights	—	(216)	1	(2)
Total noninterest expense	11,589	10,312	32,909	28,839
INCOME BEFORE PROVISION FOR INCOME TAXES	5,410	5,086	15,407	12,151
PROVISION FOR INCOME TAXES	1,956	1,629	5,001	4,198

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

NET INCOME	\$ 3,454	\$ 3,457	\$ 10,406	\$ 7,953
Basic earnings per share	\$ 1.13	\$ 1.21	\$ 3.53	\$ 2.74
Diluted earnings per share	\$ 1.07	\$ 1.18	\$ 3.31	\$ 2.66

See accompanying notes to these consolidated financial statements.

4

---

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) (Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net Income	\$ 3,454	\$ 3,457	\$ 10,406	\$ 7,953
Other comprehensive income, before tax:				
Securities available-for-sale:				
Unrealized holding gain during period	80	29	1,012	1,224
Income tax provision related to unrealized holding gain	(28)	(8)	(357)	(433)
Reclassification adjustment for realized gain included in net income	(143)	(146)	(380)	(146)
Income tax provision related to reclassification for realized gain	50	50	133	50
Other comprehensive (loss) income, net of tax	(41)	(75)	408	695
COMPREHENSIVE INCOME	\$ 3,413	\$ 3,382	\$ 10,814	\$ 8,648

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Dollars in thousands, except share amounts) (Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Tax	Unearned ESOP Shares	Total Stockholders' Equity
BALANCE, January 1, 2016	3,242,120	\$ 32	\$ 30,692	\$ 46,175	\$ 78	\$ (1,637)	\$ 75,340
Net income	—	\$ —	—	7,953	—	—	\$ 7,953
Dividends paid (\$0.26 per share)	—	\$ —	—	(802)	—	—	\$ (802)
Share-based compensation	—	\$ —	588	—	—	—	\$ 588
Restricted stock awards	4,500	\$ —	—	—	—	—	\$ —
Common stock repurchased	(198,167)	\$ (1)	(4,902)	—	—	—	\$ (4,903)
Stock options exercised	9,300	\$ —	157	—	—	—	\$ 157
Other comprehensive income, net of tax	—	\$ —	—	—	695	—	\$ 695
ESOP shares allocated	—	\$ —	331	—	—	198	\$ 529
BALANCE, September 30, 2016	3,057,753	\$ 31	\$ 26,866	\$ 53,326	\$ 773	\$ (1,439)	\$ 79,557
BALANCE, January 1, 2017	3,059,503	\$ 31	\$ 27,334	\$ 55,584	\$ (536)	\$ (1,380)	\$ 81,033
Net income	—	\$ —	—	10,406	—	—	\$ 10,406
Dividends paid (\$0.31 per share)	—	\$ —	—	(941)	—	—	\$ (941)
Proceeds from public offering, net of expenses	587,234	\$ 6	25,612	—	—	—	\$ 25,618
Share-based compensation	—	\$ —	496	—	—	—	\$ 496
Common stock repurchased	(6,198)	\$ —	(275)	—	—	—	\$ (275)
Stock options exercised	34,363	\$ —	580	—	—	—	\$ 580
Other comprehensive income, net of tax	—	\$ —	—	—	408	—	\$ 408
ESOP shares allocated	—	\$ —	716	—	—	198	\$ 914

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

BALANCE, September 30, 2017	3,674,902	\$ 37	\$ 54,463	\$ 65,049	\$ (128)	\$ (1,182)	\$ 118,239
--------------------------------	-----------	-------	-----------	-----------	----------	------------	------------

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) (Unaudited)

	Nine Months Ended September 30,	
	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 10,406	\$ 7,953
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	450	1,800
Depreciation, amortization and accretion	2,577	3,779
Compensation expense related to stock options and restricted stock awards	496	588
ESOP compensation expense for allocated shares	914	529
Increase in cash surrender value of BOLI	(208)	(211)
Gain on sale of loans held for sale	(13,840)	(14,722)
Gain on sale of investment securities	(380)	(146)
Gain on sale of OREO	—	(150)
Gain on sale of MSR	(996)	—
Origination of loans held for sale	(520,358)	(584,073)
Proceeds from sale of loans held for sale	520,091	564,218
Impairment (recovery) of servicing rights	1	(2)
Changes in operating assets and liabilities		
Accrued interest receivable	(693)	(450)
Other assets	(79)	(7,481)
Other liabilities	2,668	5,063
Net cash from (used by) operating activities	1,049	(23,305)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	39,103	13,577
Maturities, prepayments, sales, and calls	6,531	9,039
Purchases	(41,320)	(47,432)
Maturities of certificates of deposit at other financial institutions	1,240	292
Purchase of certificates of deposit at other financial institutions	(4,102)	(1,882)
Loan originations and principal collections, net	(129,763)	(93,871)
Purchase of portfolio loans	(32,342)	—
Proceeds from sale of other real estate owned, net	—	682
Purchase of premises and equipment, net	(623)	(2,287)
FHLB stock, net	(328)	2,547
Proceeds from sale of MSR	4,827	—
Net cash received from acquisition	—	180,356
Net cash (used by) from investing activities	(156,777)	61,021
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	127,985	37,630

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

Borrowings, net	(2,400)	(77,740)
Dividends paid	(941)	(802)
Proceeds from stock options exercised	580	157
Common stock repurchased	(275)	(4,903)
Proceeds from issuance of common stock	25,618	—
Net cash from (used by) financing activities	150,567	(45,658)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(5,161)	(7,942)
CASH AND CASH EQUIVALENTS, beginning of period	36,456	24,455
CASH AND CASH EQUIVALENTS, end of period	\$ 31,295	\$ 16,513

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the period for:

Interest	\$ 3,528	\$ 2,931
Income taxes	\$ 5,800	\$ 4,420
Assets acquired in acquisition of branches (Note 2)	\$ —	\$ 181,575
Liabilities assumed in acquisition of branches (Note 2)	\$ —	\$ 186,393

SUPPLEMENTARY DISCLOSURES OF

NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES

Change in unrealized gain on investment securities	\$ 631	\$ 1,079
Transfer portfolio loans to loans held for sale	\$ 1,886	\$ —
Property received in settlement of loans	\$ —	\$ 525
Retention of gross mortgage servicing rights from loan sales	\$ 3,569	\$ 2,927

See accompanying notes to these consolidated financial statements

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Nature of Operations - FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the proposed holding company for 1st Security Bank of Washington (the “Bank” or “1st Security Bank”) in connection with the Bank’s conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based savings bank with 11 branches and seven loan production offices in suburban communities in the greater Puget Sound area which includes Snohomish, King, Pierce, Jefferson, Kitsap, and Clallam counties, and one loan production office in the market area of the Tri-Cities, Washington. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals. The Bank acquired four retail bank branches from Bank of America, National Association (“Bank of America”) (two in Clallam and two in Jefferson counties) on January 22, 2016, and these branches opened as 1st Security Bank branches on January 25, 2016. The Company and its subsidiary are subject to regulation by certain federal and state agencies and undergo periodic examination by these regulatory agencies.

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

Financial Statement Presentation - The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. 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”). It is recommended that these unaudited interim consolidated financial statements be read in conjunction with the Company’s Annual Report on Form 10 K with all of the audited information and footnotes required by U.S. GAAP for complete financial statements for the year ended December 31, 2016, as filed with the SEC on March 16, 2017. In the opinion of management, all normal adjustments and recurring accruals considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results for the three and nine months ended September 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017, or any other future period. The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan and lease losses, fair value of financial instruments, and the valuation of servicing rights.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented in thousands of dollars except per share amounts. In the narrative footnote discussion, amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above \$1.0 million. Amounts below \$1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2017 presentation with no change to consolidated net income or stockholders’ equity previously reported.

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

Segment Reporting - The Company operates in two business segments through the Bank: commercial and consumer banking and home lending. The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is regularly reviewed for the purpose of allocating resources and evaluating performance of the Company's businesses. The results for these business segments are based on management's accounting process, which assigns income statement

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

items and assets to each responsible operating segment. This process is dynamic and is based on management's view of the Company's operations. See Note 15 - Business Segments.

Subsequent Events - The Company has evaluated events and transactions subsequent to September 30, 2017, for potential recognition or disclosure.

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606), which creates Topic 606 and supersedes Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of 2014-09. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which amended the principal versus agent implementation guidance set for in ASU 2014-09. Among other things, ASU 2016-08 clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The ASU amends certain aspects of the guidance set forth in the FASB's new revenue standard related to identifying performance obligations and licensing implementation. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new guidance requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, which provides clarifying guidance in certain narrow areas and adds some practical expedients, but does not change the core revenue recognition principle in Topic 606. The ASU is effective for public entities for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. For financial reporting purposes, the ASU allows for either full retrospective adoption, meaning the ASU is applied to all of the periods presented, or modified retrospective adoption, meaning the ASU is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. As a bank holding company, key revenue sources, such as interest income have been identified as out of the scope of this new guidance. The Company's preliminary analysis suggests that the adoption of this accounting standard is not expected to have a material impact on the Company's consolidated financial statements as substantially all of the Company's other revenues are also excluded from the scope of the new guidance. New accounting guidance related to the adoption of this standard continues to be released by the FASB, which could impact the Company's preliminary analysis of materiality and may change the preliminary conclusions reached as to the application of this new guidance.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendments in this ASU require the exit price notion be used when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset

(i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The ASU also requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk (also referred to as “own credit”) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU No. 2016-01 is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

those fiscal years. Early adoption is permitted for certain provisions. The adoption of ASU No. 2016-01 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. Once adopted, we expect to report higher assets and liabilities as a result of including right-of-use assets and lease liabilities related to certain banking offices and certain equipment under noncancelable operating lease agreements, however, based on current leases, the adoption of ASU 2016-02 is expected to increase the new lease asset and related lease liability on our Consolidated Balance Sheets by less than 5% and not to have a material impact on our regulatory capital ratios.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements. Once adopted, we expect our allowance for loan losses to increase through a one-time adjustment to retained earnings, however, until our evaluation is complete the magnitude of the increase will be unknown.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This ASU is intended to address the appropriate classification of eight specific cash flow issues on the cash flow statement. Debt prepayment costs should be classified as an outflow for financing activities. Settlement of zero-coupon debt instruments divides the interest portion as an outflow for operating activities and the principal portion as an outflow for financing activities. Contingent consideration payments made after a business combination should be classified as outflows for financing and operating activities. Proceeds from the settlement of bank-owned life insurance policies should be classified as inflows from investing activities. Other

specific areas are identified in the ASU as to the appropriate classification of the cash inflows or outflows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and must be applied using a retrospective transition method to each period presented. Adoption of ASU 2016-15 is not expected to have a material impact on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The ASU was issued to simplify the subsequent measurement of goodwill and the amendment eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This ASU is effective for annual reporting periods beginning after December 31, 2019. Early adoption of the ASU is permitted. The Company expects this ASU to provide a simplified method of measuring goodwill impairment and does not expect this ASU to have a material impact on the Company's consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The ASU shortens the amortization period for certain callable debt securities held at a premium. The standard will take effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company's consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting. The ASU was issued to provide clarity as to when to apply modification accounting when there is a change in the terms or conditions of a share-based payment award. According to this ASU, an entity should account for the effects of a modification unless the fair value, vesting conditions, and balance sheet classification of the award is the same after the modification as compared to the original award prior to the modification. The standard is effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of ASU No. 2017-09 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This ASU amends the hedge accounting recognition and presentation requirements in ASC 815 to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity of and simplify the application of hedge accounting by preparers. The amendments in this ASU permit hedge accounting for hedging relationships involving nonfinancial risk and interest rate risk by removing certain limitations in cash flow and fair value hedging relationships. In addition, the ASU requires an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018 and early adoption is permitted. The adoption of ASU No. 2017-12 is not expected to have a material impact on the Company's consolidated financial statements.

NOTE 2 - BUSINESS COMBINATION

On January 22, 2016, the Company's wholly-owned subsidiary, 1st Security Bank, completed the purchase of four branches ("Branch Purchase") from Bank of America. The Branch Purchase included four retail bank branches located in the communities of Port Angeles, Sequim, Port Townsend, and Hadlock, Washington. In accordance with the Purchase and Assumption Agreement, dated as of September 1, 2015, between Bank of America and 1st Security Bank, the Bank acquired \$186.4 million of deposits, a small portfolio of performing loans, two owned bank branches, three leases associated with the bank branches and parking facilities and certain other assets of the branches. In

consideration of the purchased assets and transferred liabilities, 1st Security Bank paid (a) the unpaid principal balance and accrued interest of \$419,000 for the loans acquired, (b) the net book value, or approximately \$778,000, for the bank facilities and certain other assets associated with the acquired branches, and (c) a deposit premium of 2.50% on substantially all of the deposits assumed, which equated to approximately \$4.8 million. The transaction was settled with Bank of America paying cash of \$180.4 million to 1st Security Bank for the difference between these amounts and the total deposits assumed.

The Branch Purchase was accounted for under the acquisition method of accounting and accordingly, the assets and liabilities were recorded at their fair values on January 22, 2016, the date of acquisition. Determining the fair value of

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

assets and liabilities is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values become available. During the second quarter of 2016, the Company completed a re-evaluation of the core deposit intangible because a portion of the core deposits were excluded from the original valuation. The updated valuation of the core deposit intangible increased the fair value adjustment by \$100,000 to \$2.2 million from \$2.1 million resulting in a decrease of \$100,000 to the fair value adjustment of goodwill. The impact to consolidated net income was an increase in the amortization of the core deposit intangible for the six months ended June 30, 2016 of \$6,000 and was not considered material to the consolidated financial statements.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of acquisition:

January 22, 2016	Acquired Book Value	Fair Value Adjustments	Amount Recorded
<b>Assets</b>			
Cash and cash equivalents	\$ 180,356	\$ —	\$ 180,356
Loans receivable	417	—	417
Premises and equipment, net	697	267 (1)	964
Accrued interest receivable	2	—	2
Core deposit intangible	—	2,239 (2)	2,239
Goodwill	—	2,312 (3)	2,312
Other assets	103	—	103
<b>Total assets acquired</b>	<b>\$ 181,575</b>	<b>\$ 4,818</b>	<b>\$ 186,393</b>
<b>Liabilities</b>			
<b>Deposits:</b>			
Noninterest-bearing accounts	\$ 79,966	\$ —	\$ 79,966
Interest-bearing accounts	106,398	—	106,398
<b>Total deposits</b>	<b>186,364</b>	<b>—</b>	<b>186,364</b>
Accrued interest payable	7	—	7
Other liabilities	22	—	22
<b>Total liabilities assumed</b>	<b>\$ 186,393</b>	<b>\$ —</b>	<b>\$ 186,393</b>

**Explanation of Fair Value Adjustments**

- (1) The fair value adjustment represents the difference between the fair value of the acquired branches and the book value of the assets acquired. The Company utilized third-party valuations but did not receive appraisals to assist in the determination of fair value.
- (2) The fair value adjustment represents the value of the core deposit base assumed in the Branch Purchase based on a study performed by an independent consulting firm. This amount was recorded by the Company as an identifiable intangible asset and will be amortized as an expense on an accelerated basis over the average life of the core deposit base, which is estimated to be nine years.
- (3) The fair value adjustment represents the value of the goodwill calculated from the purchase based on the purchase price, less the fair value of assets acquired net of liabilities assumed.

Goodwill - The acquired goodwill represents the excess purchase price over the estimated fair value of the net assets acquired and was recorded at \$2.3 million on January 22, 2016.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the aggregate amount recognized for each major class of assets acquired and liabilities assumed by 1st Security Bank in the Branch Purchase:

	At January 22, 2016
Purchase price (1)	\$ 6,015
Recognized amounts of identifiable assets acquired and (liabilities assumed), at fair value:	
Cash and cash equivalents	186,371
Acquired loans	417
Premises and equipment, net	964
Accrued interest receivable	2
Core deposit intangible	2,239
Other assets	103
Deposits	(186,364)
Accrued interest payable	(7)
Other liabilities	(22)
Total fair value of identifiable net assets	3,703
Goodwill	\$ 2,312

(1) Purchase price includes premium paid on the deposits, the aggregate net book value of all assets acquired, and the unpaid principal and accrued interest on loans acquired.

## Core deposit intangible

The core deposit intangible represents the fair value of the acquired core deposit base. The core deposit intangible will be amortized on an accelerated basis over approximately nine years. Total amortization expense was \$100,000 and \$300,000 for the three and nine months ended September 30, 2017, and \$140,000 and \$382,000 for the same periods in 2016. Amortization expense for core deposit intangible is expected to be as follows at September 30, 2017:

Fourth Quarter 2017	\$ 100
2018	307
2019	235
2020	181
2021	166
Thereafter	428
Total	\$ 1,417

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 3 - SECURITIES AVAILABLE-FOR-SALE

The following tables present the amortized costs, unrealized gains, unrealized losses, and estimated fair values of securities available-for-sale at September 30, 2017 and December 31, 2016:

	September 30, 2017			Estimated
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Values
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 6,086	\$ 59	\$ (23)	\$ 6,122
Corporate securities	7,123	29	(77)	7,075
Municipal bonds	11,342	213	(116)	11,439
Mortgage-backed securities	39,733	85	(344)	39,474
U.S. Small Business Administration securities	14,018	43	(68)	13,993
Total securities available-for-sale	\$ 78,302	\$ 429	\$ (628)	\$ 78,103

	December 31, 2016			Estimated
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Values
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 8,150	\$ 12	\$ (94)	\$ 8,068
Corporate securities	7,654	14	(168)	7,500
Municipal bonds	15,183	164	(83)	15,264
Mortgage-backed securities	45,856	52	(713)	45,195
U.S. Small Business Administration securities	5,862	27	(41)	5,848
Total securities available-for-sale	\$ 82,705	\$ 269	\$ (1,099)	\$ 81,875

At September 30, 2017, the Bank had pledged nine securities held at the FHLB of Des Moines with a carrying value of \$10.9 million to secure Washington State public deposits of \$5.2 million with a \$2.0 million collateral requirement by the Washington Public Deposit Protection Commission.

Investment securities that were in an unrealized loss position at September 30, 2017 and December 31, 2016 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. Management believes that these securities are only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

September 30, 2017

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

	Less than 12 Months		12 Months or Longer		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses	Value	Losses
<b>SECURITIES</b>						
<b>AVAILABLE-FOR-SALE</b>						
U.S. agency securities	\$ 3,014	\$ (23)	\$ —	\$ —	\$ 3,014	\$ (23)
Corporate securities	—	—	1,919	(77)	1,919	(77)
Municipal bonds	4,834	(116)	—	—	4,834	(116)
Mortgage-backed securities	22,266	(247)	4,773	(97)	27,039	(344)
U.S. Small Business						
Administration securities	9,425	(68)	—	—	9,425	(68)
Total	\$ 39,539	\$ (454)	\$ 6,692	\$ (174)	\$ 46,231	\$ (628)

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2016		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>SECURITIES</b>						
<b>AVAILABLE-FOR-SALE</b>						
U.S. agency securities	\$ 6,998	\$ (94)	\$ —	\$ —	\$ 6,998	\$ (94)
Corporate securities	5,048	(106)	1,438	(62)	6,486	(168)
Municipal bonds	6,741	(83)	—	—	6,741	(83)
Mortgage-backed securities	39,373	(713)	—	—	39,373	(713)
U.S. Small Business						
Administration securities	2,963	(41)	—	—	2,963	(41)
Total	\$ 61,123	\$ (1,037)	\$ 1,438	\$ (62)	\$ 62,561	\$ (1,099)

There were 28 investments with unrealized losses of less than one year, and five investments with unrealized losses of more than one year at September 30, 2017. There were 48 investments with unrealized losses of less than one year, and two investments with unrealized losses of more than one year at December 31, 2016. The unrealized losses associated with these investments are believed to be caused by changes in market interest rates that are considered to be temporary and the Company does not intend to sell the securities, and it is not likely to be required to sell these securities prior to maturity. No other-than-temporary impairment was recorded for the nine months ended September 30, 2017, or for the year ended December 31, 2016.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The contractual maturities of securities available-for-sale at September 30, 2017 and December 31, 2016 are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	September 30, 2017		December 31, 2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. agency securities				
Due after one year through five years	\$ —	\$ —	\$ 4,000	\$ 3,956
Due after five years through ten years	4,086	4,141	4,150	4,112
Due after ten years	2,000	1,981	—	—
Subtotal	6,086	6,122	8,150	8,068
Corporate securities				
Due after one year through five years	5,127	5,156	5,659	5,625
Due after five years through ten years	1,996	1,919	1,995	1,875
Subtotal	7,123	7,075	7,654	7,500
Municipal bonds				
Due in one year or less	—	—	509	513
Due after one year through five years	2,013	2,059	5,326	5,386
Due after five years through ten years	3,297	3,420	7,476	7,492
Due after ten years	6,032	5,960	1,872	1,873
Subtotal	11,342	11,439	15,183	15,264
Mortgage-backed securities				
Federal National Mortgage Association (“FNMA”)	22,287	22,187	23,522	23,197
Federal Home Loan Mortgage Corporation (“FHLMC”)	11,123	10,970	14,950	14,662
Government National Mortgage Association (“GNMA”)	6,323	6,317	7,384	7,336
Subtotal	39,733	39,474	45,856	45,195
U.S. Small Business Administration securities				
Due after five years through ten years	12,069	12,051	5,862	5,848
Due after ten years	1,949	1,942	—	—
Subtotal	14,018	13,993	5,862	5,848
Total	\$ 78,302	\$ 78,103	\$ 82,705	\$ 81,875

The proceeds and resulting gains and losses, computed using specific identification, from sales of securities available-for-sale for the three and nine months ended September 30, 2017 and 2016 were as follows:

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	\$ 9,115	\$ 143	\$ -	\$ 39,103	\$ 413	\$ (33)

	Three Months Ended September 30, 2016			Nine Months Ended September 30, 2016		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	\$ 13,577	\$ 149	\$ (3)	\$ 13,577	\$ 149	\$ (3)

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio was as follows at September 30, 2017 and December 31, 2016:

	September 30, 2017	December 31, 2016
REAL ESTATE LOANS		
Commercial	\$ 63,180	\$ 55,871
Construction and development	129,407	94,462
Home equity	24,026	20,081
One-to-four-family (excludes loans held for sale)	170,187	124,009
Multi-family	43,408	37,527
Total real estate loans	430,208	331,950
CONSUMER LOANS		
Indirect home improvement	124,387	107,759
Solar	40,082	36,503
Marine	35,173	28,549
Other consumer	2,032	1,915
Total consumer loans	201,674	174,726
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	83,221	65,841
Warehouse lending	50,468	32,898
Total commercial business loans	133,689	98,739
Total loans receivable, gross	765,571	605,415
Allowance for loan losses	(10,598)	(10,211)
Deferred costs, fees, premiums, and discounts, net	(1,119)	(1,887)
Total loans receivable, net	\$ 753,854	\$ 593,317

Most of the Company's commercial and multi-family real estate, construction, residential, and/or commercial business lending activities are with customers located in the greater Puget Sound area and near our one loan production office located in the Tri-Cities, Washington. The Company originates real estate, consumer and commercial business loans and has concentrations in these areas, however, indirect home improvement loans are originated through a network of home improvement contractors and dealers located throughout Washington, Oregon, Idaho, and California. The Company also originates solar loans through contractors and dealers in the state of California. Loans are generally secured by collateral and rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

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

securing the loan. The following is a summary of each of the Company's loan portfolio segments and classes:

Real Estate Loans

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

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

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

generally not pre-sold. A portion of the one-to-four-family construction portfolio are custom construction loans to the intended occupant of the residence.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences, including home equity lines of credit in our market areas.

One-to-Four-Family Real Estate Lending. One-to-four-family residential loans include owner occupied properties (including second homes), and non-owner occupied properties. These loans originated by the Company are secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

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

Consumer Loans

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

Solar. Fixture secured loans for solar related home improvement projects are originated by the Company through its network of contractors and dealers, and are secured by the personal property installed in, on, or at the borrower's real property, and which may be perfected with a UCC 2 financing statement filed in the county of the borrower's residence.

Marine. Loans originated by the Company secured by boats to borrowers primarily located in its market areas.

Other Consumer. Loans originated by the Company, including automobiles, recreational vehicles, direct home improvement loans, loans on deposits, and other consumer loans, primarily consisting of personal lines of credit.

Commercial Business Loans

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

Warehouse Lending. Loans originated by the Company's mortgage and construction warehouse lending program through which the Company funds third-party lenders originating residential mortgage and construction loans for sale into the secondary market and speculative construction loans for residential properties built for sale to single family households. These loans are secured by the notes and assigned deeds of trust associated with the residential mortgage and construction loans on properties primarily located in the Company's market areas.



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables detail activity in the allowance for loan losses by loan categories at or for the three and nine months ended September 30, 2017 and 2016:

	At or For the Three Months Ended September 30, 2017				Total
	Real Estate	Consumer	Commercial Business	Unallocated	
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 4,144	\$ 2,669	\$ 2,453	\$ 877	\$ 10,143
Provision for loan losses	481	65	(130)	34	450
Charge-offs	(55)	(152)	(33)	—	(240)
Recoveries	35	208	2	—	245
Net (charge-offs) recoveries	(20)	56	(31)	—	5
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	4,605	2,790	2,292	911	10,598
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 210	\$ —	\$ 551	\$ —	\$ 761
Loans collectively evaluated for impairment	429,998	201,674	133,138	—	764,810
Ending balance	\$ 430,208	\$ 201,674	\$ 133,689	\$ —	\$ 765,571

	At or For the Nine Months Ended September 30, 2017				Total
	Real Estate	Consumer	Commercial Business	Unallocated	
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 3,547	\$ 2,082	\$ 2,675	\$ 1,907	\$ 10,211
Provision for loan losses	1,077	726	(357)	(996)	450
Charge-offs	(55)	(536)	(33)	—	(624)
Recoveries	36	518	7	—	561
Net charge-offs	(19)	(18)	(26)	—	(63)
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	4,605	2,790	2,292	911	10,598
Ending balance	\$ 4,605	\$ 2,790	\$ 2,292	\$ 911	\$ 10,598

LOANS RECEIVABLE

Loans individually evaluated for impairment	\$ 210	\$ —	\$ 551	\$ —	\$ 761
Loans collectively evaluated for impairment	429,998	201,674	133,138	—	764,810
Ending balance	\$ 430,208	\$ 201,674	\$ 133,689	\$ —	\$ 765,571

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	At or For the Three Months Ended September 30, 2016				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 3,477	\$ 2,039	\$ 1,823	\$ 1,612	\$ 8,951
Provision for loan losses	242	1	252	105	600
Charge-offs	(65)	(232)	—	—	(297)
Recoveries	64	262	6	—	332
Net (charge-offs) recoveries	(1)	30	6	—	35
Ending balance	\$ 3,718	\$ 2,070	\$ 2,081	\$ 1,717	\$ 9,586
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	3,718	2,070	2,081	1,717	9,586
Ending balance	\$ 3,718	\$ 2,070	\$ 2,081	\$ 1,717	\$ 9,586
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 209	\$ —	\$ —	\$ —	\$ 209
Loans collectively evaluated for impairment	316,309	170,576	117,124	—	604,009
Ending balance	\$ 316,518	\$ 170,576	\$ 117,124	\$ —	\$ 604,218

	At or For the Nine Months Ended September 30, 2016				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 2,874	\$ 1,681	\$ 1,396	\$ 1,834	\$ 7,785
Provision for loan losses	794	519	604	(117)	1,800
Charge-offs	(65)	(801)	—	—	(866)
Recoveries	115	671	81	—	867
Net recoveries (charge-offs)	50	(130)	81	—	1
Ending balance	\$ 3,718	\$ 2,070	\$ 2,081	\$ 1,717	\$ 9,586
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	3,718	2,070	2,081	1,717	9,586
Ending balance	\$ 3,718	\$ 2,070	\$ 2,081	\$ 1,717	\$ 9,586
<b>LOANS RECEIVABLE</b>					
	\$ 209	\$ —	\$ —	\$ —	\$ 209

Loans individually evaluated for impairment					
Loans collectively evaluated for impairment	316,309	170,576	117,124	—	604,009
Ending balance	\$ 316,518	\$ 170,576	\$ 117,124	\$ —	\$ 604,218

Nonaccrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on nonaccrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment obligations as they become due, or as required by regulatory authorities.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables provide information pertaining to the aging analysis of contractually past due loans and nonaccrual loans at September 30, 2017 and December 31, 2016:

	September 30, 2017				Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due			
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 63,180	\$ 63,180	\$ —
Construction and development	—	—	—	—	129,407	129,407	—
Home equity	111	16	138	265	23,761	24,026	154
One-to-four-family	—	—	—	—	170,187	170,187	142
Multi-family	—	—	—	—	43,408	43,408	—
Total real estate loans	111	16	138	265	429,943	430,208	296
<b>CONSUMER LOANS</b>							
Indirect home improvement	261	77	174	512	123,875	124,387	316
Solar	83	22	81	186	39,896	40,082	81
Marine	—	—	—	—	35,173	35,173	9
Other consumer	7	—	1	8	2,024	2,032	11
Total consumer loans	351	99	256	706	200,968	201,674	417
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	—	—	—	—	83,221	83,221	551
Warehouse lending	—	—	—	—	50,468	50,468	—
Total commercial business loans	—	—	—	—	133,689	133,689	551
Total loans	\$ 462	\$ 115	\$ 394	\$ 971	\$ 764,600	\$ 765,571	\$ 1,264

	December 31, 2016				Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due			
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 55,871	\$ 55,871	\$ —
Construction and development	—	—	—	—	94,462	94,462	—
Home equity	34	—	210	244	19,837	20,081	210
One-to-four-family	—	—	—	—	124,009	124,009	—
Multi-family	—	—	—	—	37,527	37,527	—

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

Total real estate loans	34	—	210	244	331,706	331,950	210
<b>CONSUMER LOANS</b>							
Indirect home improvement	268	278	167	713	107,046	107,759	435
Solar	92	—	69	161	36,342	36,503	69
Marine	8	—	—	8	28,541	28,549	—
Other consumer	3	2	4	9	1,906	1,915	7
Total consumer loans	371	280	240	891	173,835	174,726	511
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	—	—	—	—	65,841	65,841	—
Warehouse lending	—	—	—	—	32,898	32,898	—
Total commercial business loans	—	—	—	—	98,739	98,739	—
Total loans	\$ 405	\$ 280	\$ 450	\$ 1,135	\$ 604,280	\$ 605,415	\$ 721

There were no loans 90 days or more past due and still accruing interest at September 30, 2017 and December 31, 2016.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided at September 30, 2017 and December 31, 2016:

	September 30, 2017			
	Unpaid Principal Balance	Write- downs	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 154	\$ —	\$ 154	\$ —
One-to-four-family	68	(12)	56	—
Total real estate loans	222	(12)	210	—
<b>WITH AN ALLOWANCE RECORDED</b>				
Commercial business loans	551	—	551	88
Total	\$ 773	\$ (12)	\$ 761	\$ 88

	December 31, 2016			
	Unpaid Principal Balance	Write- downs	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 137	\$ —	\$ 137	\$ —
One-to-four-family	69	(12)	57	—
Total	\$ 206	\$ (12)	\$ 194	\$ —

The following tables present the average recorded investment in loans individually evaluated for impairment and the interest income recognized and received for the three and nine months ended September 30, 2017 and 2016:

	Three Months Ended September 30, 2017		September 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 201	\$ —	\$ 152	\$ —
One-to-four-family	56	1	58	1
Total real estate loans	257	1	210	1
<b>WITH AN ALLOWANCE RECORDED</b>				
Commercial business loans	551	23	—	—
Total	\$ 808	\$ 24	\$ 210	\$ 1



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Nine Months Ended September 30, 2017		September 30, 2016	
	Average Related Investment	Interest Income Recognized	Average Related Investment	Interest Income Recognized
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 220	\$ —	\$ 154	\$ 2
One-to-four-family	56	3	58	2
Total real estate loans	276	3	212	4
<b>WITH AN ALLOWANCE RECORDED</b>				
Commercial business loans	551	23	—	—
Total	\$ 827	\$ 26	\$ 212	\$ 4

**Credit Quality Indicators**

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

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

A description of the 10 risk grades is as follows:

Grades 1 and 2 - These grades include loans to very high quality borrowers with excellent or desirable business credit.

Grade 3 - This grade includes loans to borrowers of good business credit with moderate risk.

Grades 4 and 5 - These grades include "Pass" grade loans to borrowers of average credit quality and risk.

Grade 6 - This grade includes loans on management's "Watch" list and is intended to be utilized on a temporary basis for "Pass" grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.

Grade 7 - This grade is for "Other Assets Especially Mentioned" ("OAEM") in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.

Grade 8 - This grade includes "Substandard" loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.

Grade 9 - This grade includes "Doubtful" loans in accordance with regulatory guidelines where a loss is highly probable.

Grade 10 - This grade includes "Loss" loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

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

Homogeneous loans are risk rated based upon the FDIC's Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement,

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded “Pass” and risk rated “4” or “5” internally. Loans that are past due more than 90 days are classified “Substandard” and risk rated “8” internally until the loan has demonstrated consistent performance, typically six months of contractual payments. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

The following tables summarize risk rated loan balances by category at September 30, 2017 and December 31, 2016:

	September 30, 2017						Total
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 56,533	\$ 5,072	\$ 1,575	\$ —	\$ —	\$ —	\$ 63,180
Construction and development	129,407	—	—	—	—	—	129,407
Home equity	23,872	—	—	154	—	—	24,026
One-to-four-family	169,352	—	693	142	—	—	170,187
Multi-family	43,408	—	—	—	—	—	43,408
Total real estate loans	422,572	5,072	2,268	296	—	—	430,208
<b>CONSUMER LOANS</b>							
Indirect home improvement	124,071	—	—	316	—	—	124,387
Solar	40,001	—	—	81	—	—	40,082
Marine	35,164	—	—	9	—	—	35,173
Other consumer	1,961	—	—	71	—	—	2,032
Total consumer loans	201,197	—	—	477	—	—	201,674
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	76,302	306	828	5,785	—	—	83,221
Warehouse lending	44,969	5,499	—	—	—	—	50,468
Total commercial business loans	121,271	5,805	828	5,785	—	—	133,689
Total loans	\$ 745,040	\$ 10,877	\$ 3,096	\$ 6,558	\$ —	\$ —	\$ 765,571

(1) At September 30, 2017, the Company had agreed to sell a substandard shared/syndicated national credit at a slight discount to market. The \$1.9 million loan was excluded from the substandard totals listed above as the loan was classified as held for sale at September 30, 2017. The transaction settled in October 2017 at the September 30, 2017 fair value.



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2016						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 53,234	\$ 2,637	\$ —	\$ —	\$ —	\$ —	\$ 55,871
Construction and development	94,462	—	—	—	—	—	94,462
Home equity	19,871	—	—	210	—	—	20,081
One-to-four-family	124,009	—	—	—	—	—	124,009
Multi-family	37,527	—	—	—	—	—	37,527
Total real estate loans	329,103	2,637	—	210	—	—	331,950
<b>CONSUMER LOANS</b>							
Indirect home improvement	107,324	—	—	435	—	—	107,759
Solar	36,434	—	—	69	—	—	36,503
Marine	28,549	—	—	—	—	—	28,549
Other consumer	1,813	—	—	102	—	—	1,915
Total consumer loans	174,120	—	—	606	—	—	174,726
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	58,105	525	—	7,211	—	—	65,841
Warehouse lending	32,898	—	—	—	—	—	32,898
Total commercial business loans	91,003	525	—	7,211	—	—	98,739
Total loans	\$ 594,226	\$ 3,162	\$ —	\$ 8,027	\$ —	\$ —	\$ 605,415

## Troubled Debt Restructured Loans

Troubled debt restructured (“TDR”) loans are loans for which the Company, for economic or legal reasons related to the borrower’s financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The Company had one TDR loan on accrual and included in impaired loans at both September 30, 2017 and December 31, 2016, with a balance of \$56,000 and \$57,000, respectively, which was a one-to-four-family loan. The Company had no commitments to lend additional funds on this TDR loan at September 30, 2017.

For the three and nine months ended September 30, 2017 and 2016, there were no TDR loans that were modified in the previous 12 months that subsequently defaulted in the reporting period.

## NOTE 5 - SERVICING RIGHTS

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balances of permanent loans serviced for others were \$662.0 million and \$977.1 million at September 30, 2017 and December 31, 2016, respectively, and are carried at the lower of cost or market.

During the quarter ended June 30, 2017, the Company sold a portion of its mortgage servicing rights (“MSR”) with a book value of \$4.8 million, generating an associated gain of \$958,000. During the third quarter of 2017, a \$38,000 adjustment was made to mortgage servicing rights resulting in a revised gain of \$996,000 due to better than expected prepayments.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables summarize servicing rights activity and the respective book value at or for the three and nine months ended September 30, 2017 and 2016:

	At or For the Three Months Ended September 30,	
	2017	2016
Beginning balance	\$ 4,899	\$ 6,751
Additions	1,326	1,095
Servicing rights amortized	(414)	(408)
Recovery on servicing rights	—	216
Ending balance	\$ 5,811	\$ 7,654

	At or For the Nine Months Ended September 30,	
	2017	2016
Beginning balance	\$ 8,459	\$ 5,811
Additions	3,569	2,927
Sales	(4,751)	—
Servicing rights amortized	(1,465)	(1,086)
(Impairment) recovery on servicing rights	(1)	2
Ending balance	\$ 5,811	\$ 7,654

The fair market value of the permanent servicing rights' assets was \$7.3 million and \$11.7 million at September 30, 2017 and December 31, 2016, respectively. Fair value adjustments to servicing rights are mainly due to market based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following provides valuation assumptions used in determining the fair value of MSR at the dates indicated:

Key assumptions:	At September 30,	
	2017	2016
Weighted average discount rate	9.5 %	9.5 %
Conditional prepayment rate ("CPR")	11.3 %	16.4 %
Weighted average life in years	6.8	5.2



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Key economic assumptions and the sensitivity of the current fair value for single family MSR to immediate adverse changes in those assumptions at September 30, 2017 and December 31, 2016 were as follows:

	September 30, 2017		December 31, 2016	
Aggregate portfolio principal balance	\$ 658,599		\$ 973,139	
Weighted average rate of note	4.0	%	3.9	%
		0.5% Adverse Rate	1.0% Adverse Rate	
At September 30, 2017		Change	Change	
Conditional prepayment rate	Base 11.3 %	18.2 %	25.4	%
Fair value MSR	\$ 7,283	\$ 5,764	\$ 4,682	
Percentage of MSR	1.1 %	0.9 %	0.7	%
Discount rate	9.5 %	10.0 %	10.5	%
Fair value MSR	\$ 7,283	\$ 7,139	\$ 7,000	
Percentage of MSR	1.1 %	1.1 %	1.1	%
		0.5% Adverse Rate	1.0% Adverse Rate	
At December 31, 2016		Change	Change	
Conditional prepayment rate	Base 8.8 %	12.8 %	20.2	%
Fair value MSR	\$ 11,735	\$ 9,991	\$ 7,808	
Percentage of MSR	1.2 %	1.0 %	0.8	%
Discount rate	9.5 %	10.0 %	10.5	%
Fair value MSR	\$ 11,735	\$ 11,480	\$ 11,235	
Percentage of MSR	1.2 %	1.2 %	1.2	%

The above table shows the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four-family FNMA/FHLMC/GNMA/FHLB serviced home loan. The above table references a 50 basis point and 100 basis point decrease in note rates.

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made at a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The Company recorded \$430,000 and \$534,000 of gross contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage and commercial loans for the three months ended September 30, 2017 and 2016, respectively, and \$1.8 million and \$1.4 million for the nine months ended September 30, 2017 and 2016, respectively. The income, net of amortization, is reported in noninterest income on the Consolidated Statements of Income.

NOTE 6 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced (“TBA”) mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments for reporting purposes under U.S. GAAP. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the Consolidated Balance Sheets and measures those instruments at fair value.

The following tables summarize the Company's derivative instruments at the dates indicated:

September 30, 2017

	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 59,741	\$ 1,131	\$ —
Mandatory and best effort forward commitments with investors	33,491	4	—
Forward TBA mortgage-backed securities	77,000	104	—
TBA mortgage-backed securities forward sales paired off with investors	32,500	—	140

December 31, 2016

	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 33,289	\$ 818	\$ —
Mandatory and best effort forward commitments with investors	23,536	177	—
Forward TBA mortgage-backed securities	53,000	495	—
TBA mortgage-backed securities forward sales paired off with investors	44,000	747	—

The fair value of derivatives was impacted during the third quarter of 2017 by an increase in notional asset value partially offset by a decrease in the fair value on the derivative asset, specifically loan locks and loan commitments.

At September 30, 2017 and 2016, the Company had \$77.0 million and \$99.5 million of TBA trades with counterparties that required margin collateral of \$485,000 and \$872,000, respectively. This collateral is included in interest-bearing deposits at other financial institutions on the Consolidated Balance Sheets.

Changes in the fair value of the derivatives recognized in other noninterest income on the Consolidated Statements of Income and included in gain on sale of loans resulted in net gains of \$374,000 and \$697,000 for the three months ended September 30, 2017 and 2016, respectively, and net (loss) gain of (\$7,000) and \$1.7 million for the nine months ended September 30, 2017 and 2016, respectively.

## NOTE 7 - OTHER REAL ESTATE OWNED

There was no OREO activity for the three months ended September 30, 2017 and 2016. The following table presents the activity related to OREO at or for the nine months ended September 30, 2017 and 2016:

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

	At or For the Nine Months Ended September 30, 2017    2016	
Beginning balance	\$ —	\$ —
Net loans transferred to OREO	—	525
Capitalized costs	—	7
Gross proceeds from sale of OREO	—	(682)
Gain on sale of OREO	—	150
Ending balance	\$ —	\$ —

There were no OREO properties at September 30, 2017 and September 30, 2016. For the three and nine months ended September 30, 2017, and for the three months ended September 30, 2016, the Company recorded no net gain or loss on the disposal of OREO. For the nine months ended September 30, 2016, the Company recorded a \$150,000 net gain on the

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

disposal of OREO. There were no holding costs associated with OREO for the three and nine months ended September 30, 2017 and 2016.

There were no mortgage loan properties in the process of foreclosure at September 30, 2017. At December 31, 2016, there was a \$43,000 mortgage loan collateralized by residential real estate property in the process of foreclosure.

## NOTE 8 - DEPOSITS

Deposits are summarized as follows at September 30, 2017 and December 31, 2016:

	September 30, 2017(1)	December 31, 2016(1)
Noninterest-bearing checking	\$ 156,017	\$ 143,236
Interest-bearing checking	115,775	66,119
Savings	72,974	54,995
Money market(4)	236,036	242,849
Certificates of deposit less than \$100,000(2)	143,169	93,791
Certificates of deposit of \$100,000 through \$250,000	73,733	74,832
Certificates of deposit of \$250,000 and over(3)	31,927	27,094
Escrow accounts related to mortgages serviced	10,947	9,677
Total	\$ 840,578	\$ 712,593

(1) Includes \$138.2 million of deposits acquired in the Branch Purchase at September 30, 2017 and \$162.2 million at December 31, 2016.

(2) Includes \$92.2 million of brokered deposits at September 30, 2017 and \$47.1 million at December 31, 2016.

(3) Time deposits that meet or exceed the FDIC insurance limit.

(4) Includes \$10.0 million of brokered deposits at September 30, 2017 and none at December 31, 2016.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances at September 30, 2017 and December 31, 2016 were \$19.3 million and \$10.7 million, respectively.

Scheduled maturities of time deposits at September 30, 2017 for future periods ending are as follows:

	At September 30, 2017
Maturing in 2017	\$ 81,162
Maturing in 2018	75,057
Maturing in 2019	45,868
Maturing in 2020	14,980
Maturing in 2021	15,816
Thereafter	15,946
Total	\$ 248,829

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

Interest expense by deposit category for the three and nine months ended September 30, 2017 and 2016 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest-bearing checking	\$ 44	\$ 7	\$ 66	\$ 20
Savings and money market	356	257	937	757
Certificates of deposit	645	544	1,790	1,634
Total	\$ 1,045	\$ 808	\$ 2,793	\$ 2,411

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 9 - COMMITMENTS AND CONTINGENCIES

Commitments - The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The following table provides a summary of the Company's commitments at September 30, 2017 and December 31, 2016:

	September 30, 2017	December 31, 2016
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Commercial	\$ 108	\$ 108
Construction and development	82,115	57,016
One-to-four-family (includes loans held for sale)	117,997	79,870
Home equity	31,258	26,129
Multi-family	418	426
Total real estate loans	231,896	163,549
CONSUMER LOANS	10,025	8,527
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	46,912	31,775
Warehouse lending	58,231	51,102
Total commercial business loans	105,143	82,877
Total commitments to extend credit	\$ 347,064	\$ 254,953

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the amount of the total commitments do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon an extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of \$237,000 at September 30, 2017 and \$179,000 at December 31, 2016. One-to-four-family commitments included in the table above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company also sells one-to-four-family loans to the FHLB of Des Moines that require a limited level of recourse if the loans default and exceed a certain loss exposure. Specific to that recourse, the FHLB established a first loss account ("FLA") related to the loans and required a credit enhancement ("CE") obligation by the Bank to be utilized after the FLA is used. Based on loans sold through September 30, 2017, the total loans sold to the FHLB were \$40.5 million with the FLA being \$433,000 and the CE obligation at \$1.1 million or 2.6% of the loans outstanding. Management has established a holdback of 10% of the outstanding CE, or \$110,000, which is a part of the off-balance sheet holdback for loans sold.

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

There were no outstanding delinquencies on the loans sold to the FHLB of Des Moines at September 30, 2017 and December 31, 2016.

Contingent liabilities for loans held for sale - In the ordinary course of business, loans are sold with limited recourse against the Company and may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payoff, early payment defaults, breach of representation or warranty, servicing errors, and/or fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded reserves of \$1.0 million and \$955,000 to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at September 30, 2017 and December 31, 2016, which is included in other liabilities on the Consolidated Balance Sheets.

The Company has entered into a severance agreement with its Chief Executive Officer. The severance agreement, subject to certain requirements, generally includes a lump sum payment to the Chief Executive Officer equal to 24 months of base compensation in the event his employment is involuntarily terminated, other than for cause or the executive terminates his employment with good reason, as defined in the severance agreement.

The Company has entered into change of control agreements with its Chief Financial Officer, Chief Operating Officer, Chief Lending Officer, and two Executive Vice Presidents of Home Lending. The change of control agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the change of control agreements, the executive generally will be entitled to a change of control payment from the Company if the executive is involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the change of control agreements). In such an event, the executives would each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the change of control agreements.

The Bank received 7,158 shares of Class B common stock in Visa, Inc. as a result of the Visa initial public offering (“IPO”) in March 2008. These Class B shares of stock held by the Bank could be converted to Class A shares at a conversion rate of 1.6483 when all litigation pending as of the date of the IPO is concluded. However, at September 30, 2017, the date that litigation will be concluded cannot be determined. Until such time, the stock cannot be redeemed or sold by the Bank; therefore, it is not readily marketable and has a current carrying value of \$0. Visa, Inc. Class A stock’s market value at September 30, 2017 and December 31, 2016 was \$105.24 per share and \$77.73 per share, respectively.

Due to the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no material pending legal actions at September 30, 2017.

NOTE 10 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. Consequently, the fair value of the Company’s consolidated financial instruments will change when interest

rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans and deposits, and by investing in securities with terms that mitigate the Company's overall interest rate risk.

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with U.S. GAAP. Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The following definitions describe the levels of inputs that may be used to measure fair value:

Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Determination of Fair Market Values:

Securities Available-for-Sale - The fair value of securities available-for-sale are recorded on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid, and other market information, and for structured securities, cash flow, and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios. Transfers between the fair value hierarchy are determined through the third-party service provider which, from time to time will transfer between levels based on market conditions per the related security. All models and processes used take into account market convention (Level 2).

Mortgage and Nonmortgage Loans Held for Sale - The fair value of loans held for sale reflects the value of commitments with investors and/or the relative price as delivered into a TBA mortgage-backed security (Level 2).

Derivative Instruments - The fair value of the interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. TBA mortgage-backed securities are fair valued on similar contracts in active markets (Level 2) while locks and forwards with customers and investors are fair valued using similar contracts in the market and changes in the market interest rates (Levels 2 and 3).

Impaired Loans - Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management's assumptions. Management will utilize discounted cash flow impairment for TDRs when the change in terms results in a discount to the overall cash flows to be received (Level 3).

The following tables present securities available-for-sale measured at fair value on a recurring basis at September 30, 2017 and December 31, 2016:

Securities Available-for-Sale

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

	Level 1	Level 2	Level 3	Total
At September 30, 2017				
U.S. agency securities	\$ —	\$ 6,122	\$ —	\$ 6,122
Corporate securities	—	7,075	—	7,075
Municipal bonds	—	11,439	—	11,439
Mortgage-backed securities	—	39,474	—	39,474
U.S. Small Business Administration securities	—	13,993	—	13,993
Total	\$ —	\$ 78,103	\$ —	\$ 78,103

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Securities Available-for-Sale			Total
	Level 1	Level 2	Level 3	
At December 31, 2016				
U.S. agency securities	\$ —	\$ 8,068	\$ —	\$ 8,068
Corporate securities	—	7,500	—	7,500
Municipal bonds	—	15,264	—	15,264
Mortgage-backed securities	—	45,195	—	45,195
U.S. Small Business Administration securities	—	5,848	—	5,848
Total	\$ —	\$ 81,875	\$ —	\$ 81,875

The following table presents mortgage loans held for sale measured at fair value on a recurring basis at September 30, 2017 and December 31, 2016:

	Mortgage Loans Held for Sale			
	Level 1	Level 2	Level 3	Total
September 30, 2017	\$ —	\$ 65,055	\$ —	\$ 65,055
December 31, 2016	\$ —	\$ 52,553	\$ —	\$ 52,553

The following tables present the fair value of interest rate lock commitments with customers, individual forward sale commitments with investors, and paired off commitments with investors measured at their fair value on a recurring basis at September 30, 2017 and December 31, 2016:

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
September 30, 2017	\$ —	\$ —	\$ 1,131	\$ 1,131
December 31, 2016	\$ —	\$ —	\$ 818	\$ 818

	Individual Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
September 30, 2017	\$ —	\$ 104	\$ 4	\$ 108
December 31, 2016	\$ —	\$ 495	\$ 177	\$ 672

## Paired Off Commitments with Investors

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

	Level 1	Level 2	Level 3	Total
September 30, 2017	\$ —	\$ (140)	\$ —	\$ (140)
December 31, 2016	\$ —	\$ 747	\$ —	\$ 747

The following table presents impaired loans measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded at September 30, 2017 and December 31, 2016. The amounts disclosed below represent the fair values at the time the nonrecurring fair value measurements were evaluated.

	Impaired Loans			Total
	Level 1	Level 2	Level 3	
September 30, 2017	\$ —	\$ —	\$ 761	\$ 761
December 31, 2016	\$ —	\$ —	\$ 194	\$ 194

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Quantitative Information about Level 3 Fair Value Measurements - Shown in the table below is the fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at September 30, 2017:

Level 3 Fair Value Instrument	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average	
<b>RECURRING</b>					
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	95.0	%
Individual forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	95.0	%
<b>NONRECURRING</b>					
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 18.0%	11.6	%

An increase in the pull-through rate utilized in the fair value measurement of the interest rate lock commitments with customers and forward sale commitments with investors will result in positive fair value adjustments (and an increase in the fair value measurement). Conversely, a decrease in the pull-through rate will result in a negative fair value adjustment (and a decrease in the fair value measurement).

The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine months ended September 30, 2017 and 2016:

Three Months Ended September 30, 2017	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	Net change in fair value for gains/ (losses) relating to items held at end of period

Edgar Filing: FS Bancorp, Inc. - Form 10-Q

Interest rate lock commitments with customers	\$ 1,212	\$ 3,891	\$ (3,972)	\$ 1,131	\$ (81)
Individual forward sale commitments with investors	83	40	(119)	4	(79)
2016					
Interest rate lock commitments with customers	\$ 2,058	\$ 5,763	\$ (5,971)	\$ 1,850	\$ (208)
Individual forward sale commitments with investors	(3)	(60)	23	(40)	(37)

					Net change in fair value for gains/ (losses) relating to items held at end of period
	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	
Nine Months Ended September 30, 2017					
Interest rate lock commitments with customers	\$ 818	\$ 11,440	\$ (11,127)	\$ 1,131	\$ 313
Individual forward sale commitments with investors	177	(49)	(124)	4	(173)
2016					
Interest rate lock commitments with customers	\$ 698	\$ 14,039	\$ (12,887)	\$ 1,850	\$ 1,152
Individual forward sale commitments with investors	74	(267)	153	(40)	(114)

Gains (losses) on interest rate lock commitments carried at fair value are recorded in other noninterest income. Gains (losses) on forward sale commitments with investors carried at fair value are recorded within other noninterest income.

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Fair Values of Financial Instruments - The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these financial statements:

Cash, and Cash Equivalents and Certificates of Deposit at Other Financial Institutions - The carrying amounts of cash and short-term instruments approximate their fair value (Level 1).

Federal Home Loan Bank stock - The par value of FHLB stock approximates its fair value (Level 2).

Bank-owned Life Insurance - The estimated fair value is equal to the cash surrender value of policies, net of surrender charges (Level 1).

Accrued Interest - The carrying amounts of accrued interest approximate its fair value (Level 2).

Loans Receivable, Net - For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers or similar credit quality (Level 3).

Servicing Rights - The fair value of mortgage, commercial, and consumer servicing rights are estimated using net present value of expected cash flows using a third party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information where appropriate (Level 3).

Deposits - The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation on interest rates currently offered on similar certificates (Level 2).

Borrowings - The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

Subordinated Note - The fair value of the Subordinated Note is based upon the average yield of debt issuances for similarly sized issuances (Level 2).

Off-Balance Sheet Instruments - The fair value of commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the customers. The majority of the Company's off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value. The fair value of loan lock commitments with customers and investors reflect an estimate of value based upon the interest rate lock date, the expected pull-through percentage for the commitment, and the interest rate at year end (Level 2 and 3).

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table provides estimated fair values of the Company's financial instruments at September 30, 2017 and December 31, 2016:

	September 30, 2017		December 31, 2016	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets</b>				
Level 1 inputs:				
Cash and cash equivalents	\$ 31,295	\$ 31,295	\$ 36,456	\$ 36,456
Certificates of deposit at other financial institutions	18,108	18,108	15,248	15,248
Level 2 inputs:				
Securities available-for-sale, at fair value	78,103	78,103	81,875	81,875
Loans held for sale, at fair value	65,055	65,055	52,553	52,553
FHLB stock, at cost	3,047	3,047	2,719	2,719
Accrued interest receivable	3,217	3,217	2,524	2,524
Individual forward sale commitments with investors	104	104	495	495
Paired off commitments with investors	—	—	747	747
Level 3 inputs:				
Loans receivable, gross	765,571	779,284	605,415	670,183
Servicing rights, held at lower of cost or fair value	5,811	7,289	8,459	11,741
Fair value interest rate locks with customers	1,131	1,131	818	818
Individual forward sale commitments with investors	4	4	177	177
<b>Financial Liabilities</b>				
Level 2 inputs:				
Deposits	840,578	844,288	712,593	718,970
Borrowings	10,270	9,049	12,670	12,660
Subordinated note	9,840	9,805	9,825	9,805
Accrued interest payable	217	217	192	192
Paired off commitments with investors	140	140	—	—

## NOTE 11 - EMPLOYEE BENEFITS

## Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank are eligible to participate in the ESOP if they have been credited with at least 1,000 hours of service during the employees' first 12 month period and based on anniversary date will be vested into the ESOP. After two years of working at least 1,000 hours in each of those two years, the employee will be

100% vested in the ESOP.

The ESOP borrowed \$2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of \$10.17 per share during the second half of 2012. It is anticipated that the Bank will make contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation. Shares purchased by the ESOP with the loan proceeds are held in a suspense account and allocated to ESOP participants on a pro rata basis as principal and interest payments are made by the ESOP to FS Bancorp, Inc. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with funds from the Bank's discretionary contributions to the ESOP and earnings on the ESOP assets. Payments of principal and interest are due annually on December 31, the Company's fiscal year end. On December 31, 2016, the ESOP paid the fifth annual installment of principal in the amount of \$257,000, plus accrued interest of \$38,000 pursuant to the ESOP loan agreement.

36

---

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As shares are committed to be released from collateral, the Company reports compensation expense equal to the average daily market prices of the shares at September 30, 2017 for the prior 90 days. These shares become outstanding for earnings per share computations. The compensation expense is accrued monthly throughout the year. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense related to the ESOP for the three months ended September 30, 2017 and 2016 was \$360,000 and \$204,000, respectively, and \$914,000 and \$529,000 for the nine months ended September 30, 2017 and 2016, respectively.

Shares held by the ESOP at September 30, 2017 and 2016 were as follows (shown as actual):

	Balances at September 30, 2017	Balances at September 30, 2016
Allocated shares	126,589	102,359
Committed to be released shares	19,441	19,441
Unallocated shares	110,164	136,085
Total ESOP shares	256,194	257,885
Fair value of unallocated shares (in thousands)	\$ 5,180	\$ 3,703

## NOTE 12 - EARNINGS PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. For earnings per share calculations, the ESOP shares committed to be released are included as outstanding shares for both basic and diluted earnings per share.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the three end nine months ended September 30, 2017 and 2016:

	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
Numerator:	2017	2016	2017	2016
Net income (in thousands)	\$ 3,454	\$ 3,457	\$ 10,406	\$ 7,953

## Denominator:

Basic weighted average common shares outstanding	3,051,744	2,851,147	2,949,092	2,901,572
Dilutive shares	187,584	87,292	192,685	84,102
Diluted weighted average common shares outstanding	3,239,328	2,938,439	3,141,777	2,985,674
Basic earnings per share	\$ 1.13	\$ 1.21	\$ 3.53	\$ 2.74
Diluted earnings per share	\$ 1.07	\$ 1.18	\$ 3.31	\$ 2.66

## NOTE 13 - STOCK-BASED COMPENSATION

## Stock Options and Restricted Stock

In September 2013, the shareholders of FS Bancorp, Inc. approved the FS Bancorp, Inc. 2013 Equity Incentive Plan (“Plan”). The Plan provides for the grant of stock options and restricted stock awards.

Total share-based compensation expense for the Plan was \$138,000 and \$496,000 for the three and nine months ended September 30, 2017, respectively, and \$195,000 and \$588,000 for the three and nine months ended September 30, 2016, respectively.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Stock Options

The Plan authorizes the grant of stock options totaling 324,013 shares to Company directors and employees in which 322,000 option share awards under the Plan were granted with an exercise price equal to the market price of FS Bancorp's common stock at the grant date of May 8, 2014, of \$16.89 per share. These option share awards were granted as non-qualified stock options, having a vesting period of five years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Any unexercised stock options will expire 10 years after the grant date or sooner in the event of the award recipient's termination of service with the Company or the Bank. At September 30, 2017, 2,013 option share awards are available to be granted.

The fair value of each option award is estimated on the grant date using a Black-Scholes Option pricing model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The Company became a publicly held company in July 2012, therefore historical data was not available to calculate the volatility for FS Bancorp stock. Management utilized a proxy to determine the expected volatility of FS Bancorp's stock at grant date for the majority of stock options granted in 2014. The proxy chosen was the NASDAQ Bank Index, or NASDAQ Bank (NASDAQ symbol: BANK). This index provides the volatility of the banking sector for NASDAQ traded banks. The majority of smaller banks are traded on the NASDAQ given the costs and daily interaction required with trading on the New York Stock Exchange. The Company utilized the comparable Treasury rate for the discount rate associated with the stock options granted. The Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for the "Share-Based Payments" method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at 6.5 years.

The following table presents a summary of the Company's stock option plan awards during the nine months ended September 30, 2017 (shown as actual):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2017	295,850	\$ 16.89	7.36	\$ 5,638,901
Granted	—	—	—	—
Less exercised	34,363	\$ 16.89	—	\$ 919,380
Forfeited or expired	—	—	—	—
Outstanding at September 30, 2017	261,487	\$ 16.89	6.61	\$ 9,089,288
Expected to vest, assuming a 0.31% annual forfeiture rate	261,053	\$ 16.89	6.61	\$ 9,074,192
Exercisable at September 30, 2017	134,687	\$ 16.89	6.61	\$ 4,681,720

At September 30, 2017, there was \$368,000 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting

period of 1.6 years.

#### Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards totaling 129,605 shares to Company directors and employees, and 125,105 shares were granted on May 8, 2014 at a grant date fair value of \$16.89 per share. The remaining 4,500 restricted stock awards were granted January 1, 2016 at a grant date fair value of \$26.00 per share. Compensation expense is recognized over the vesting period of the awards based on the fair value of the restricted stock. The restricted stock awards' fair value is equal to the value on the grant date. Shares awarded as restricted stock vest ratably over a three-year period for directors and a five-year period for employees, beginning at the grant date. Any unvested restricted stock awards will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.

38

---

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents a summary of the Company's nonvested awards during the nine months ended September 30, 2017 (shown as actual):

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2017	68,763	\$ 17.49	\$ 1,202,401
Granted	—	—	—
Less vested	31,921	\$ 17.32	\$ 552,810
Forfeited or expired	—	—	—
Nonvested at September 30, 2017	36,842	\$ 17.63	\$ 649,591

At September 30, 2017, there was \$508,000 of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.6 years.

## NOTE 14 - REGULATORY CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 total capital (as defined) and common equity Tier 1 ("CET 1") capital to risk-weighted assets (as defined).

The Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below to be categorized as well capitalized. At September 30, 2017 and December 31, 2016, the Bank was categorized as well capitalized under applicable regulatory requirements. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes, at September 30 2017, that the Company and the Bank met all capital adequacy requirements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table compares the Bank's actual capital amounts and ratios at September 30, 2017 and December 31, 2016 to their minimum regulatory capital requirements and well capitalized regulatory capital at those dates (dollars in thousands):

Bank Only	Actual Amount	Ratio	For Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio
At September 30, 2017						
Total risk-based capital (to risk-weighted assets)	\$ 130,246	16.14 %	\$ 64,556	8.00 %	\$ 80,696	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 120,150	14.89 %	\$ 48,417	6.00 %	\$ 64,556	8.00 %
Tier 1 leverage capital (to average assets)	\$ 120,150	12.50 %	\$ 38,459	4.00 %	\$ 48,074	5.00 %
CET 1 capital (to risk-weighted assets)	\$ 120,150	14.89 %	\$ 36,313	4.50 %	\$ 52,452	6.50 %
At December 31, 2016						
Total risk-based capital (to risk-weighted assets)	\$ 93,309	13.87 %	\$ 53,813	8.00 %	\$ 67,266	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 84,876	12.62 %	\$ 40,360	6.00 %	\$ 53,813	8.00 %
Tier 1 leverage capital (to average assets)	\$ 84,876	10.33 %	\$ 32,862	4.00 %	\$ 41,078	5.00 %
CET 1 capital (to risk-weighted assets)	\$ 84,876	12.62 %	\$ 30,270	4.50 %	\$ 43,723	6.50 %

In addition to the minimum CET 1, Tier 1 and total capital ratios, the Bank has to maintain a capital conservation buffer consisting of additional CET 1 capital above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement was phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented to an amount equal to 2.5% of risk-weighted assets in January 2019. At September 30, 2017, the Bank's CET1 capital exceeded the required capital conservation buffer of 1.25%.

FS Bancorp, Inc. is a bank holding company subject to the capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. For a bank holding company with less than \$1.0 billion in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with \$1.0 billion or more in assets, at September 30, 2017, the Company would have exceeded all regulatory capital requirements. The

regulatory capital ratios calculated for FS Bancorp, Inc. at September 30, 2017 were 11.9% for Tier 1 leverage-based capital, 14.2% for Tier 1 risk-based capital, 15.5% for total risk-based capital, and 14.2% for CET 1 capital ratio.

NOTE 15 - BUSINESS SEGMENTS

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is currently evaluated by management. This process is dynamic and is based on management's current view of the Company's operations and is not necessarily comparable with similar information for other financial institutions. We define our business segments by

40

---

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

product type and customer segment which we have organized into two lines of business: commercial and consumer banking and home lending.

We use various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

a funds transfer pricing (“FTP”) system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets;

a cost per loan serviced allocation based on the number of loans being serviced on the balance sheet and the number of loans serviced for third parties;

an allocation based upon the square footage utilized by the home lending segment in Company owned locations;

an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on the number of full time employees (“FTEs”) in each segment; and

an allocation of the Company’s consolidated income taxes which are based on the effective tax rate applied to the segment’s pretax income or loss.

The FTP methodology is based on management’s estimated cost of originating funds including the cost of overhead for deposit generation.

A description of the Company’s business segments and the products and services that they provide is as follows:

Commercial and Consumer Banking Segment

The commercial and consumer banking segment provides diversified financial products and services to our commercial and consumer customers through Bank branches, ATMs, online banking platforms, mobile banking apps, and telephone banking. These products and services include deposit products; residential, consumer, business and commercial real estate lending portfolios and cash management services. We originate consumer loans, commercial and multi-family real estate loans, construction loans on residential and multi-family construction, and commercial business loans. At September 30, 2017, our retail deposit branch network consisted of 11 branches in the Pacific Northwest. At September 30, 2017 and December 31, 2016, our deposits totaled \$840.6 million and \$712.6 million, respectively. This segment is also responsible for the management of our investment portfolio and other assets of the Bank.

Home Lending Segment

The home lending segment originates one-to-four-family residential mortgage loans primarily for sale in the secondary markets as well as originating adjustable rate mortgage (“ARM”) loans held for investment. The majority of our mortgage loans are sold to or securitized by FNMA, FHLMC, GNMA or FHLB, while we retain the right to service these loans. Loans originated under the guidelines of the Federal Housing Administration or FHA, US Department of Veterans Affairs or VA, and United States Department of Agriculture or USDA are generally sold servicing released to a correspondent bank or mortgage company. We have the option to sell loans on a

servicing-released or servicing-retained basis to securitizers and correspondent lenders. A small percentage of our loans are brokered to other lenders. On occasion, we may sell a portion of our MSR portfolio. We manage the loan funding and the interest rate risk associated with the secondary market loan sales and the retained one-to-four-family mortgage servicing rights within this business segment. One-to-four-family loans originated for investment are allocated to the home lending segment with a corresponding provision expense and FTP for cost of funds.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Segment Financial Results

The tables below summarize the financial results for each segment based primarily on the number of FTEs and assets within each segment for the three and nine months ended September 30, 2017 and 2016:

	At or For the Three Months Ended September 30, 2017		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 812	\$ 10,210	\$ 11,022
Provision for loan losses	(127)	(323)	(450)
Noninterest income	5,014	1,413	6,427
Noninterest expense	(4,586)	(7,003)	(11,589)
Income before provision for income taxes	1,113	4,297	5,410
Provision for income taxes	(407)	(1,549)	(1,956)
Net income	\$ 706	\$ 2,748	\$ 3,454
Total average assets at period end	\$ 220,898	\$ 744,820	\$ 965,718
FTEs	119	204	323

	At or For the Three Months Ended September 30, 2016		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 793	\$ 7,957	\$ 8,750
Provision for loan losses	(16)	(584)	(600)
Noninterest income	5,982	1,266	7,248
Noninterest expense	(3,861)	(6,451)	(10,312)
Income before provision for income taxes	2,898	2,188	5,086
Provision for income taxes	(948)	(681)	(1,629)
Net income	\$ 1,950	\$ 1,507	\$ 3,457
Total average assets at period end	\$ 168,722	\$ 634,735	\$ 803,457
FTEs	110	195	305



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	At or For the Nine Months Ended September 30, 2017		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 1,857	\$ 28,105	\$ 29,962
Provision for loan losses	(324)	(126)	(450)
Noninterest income	14,863	3,941	18,804
Noninterest expense	(12,985)	(19,924)	(32,909)
Income before provision for income taxes	3,411	11,996	15,407
Provision for income taxes	(1,107)	(3,894)	(5,001)
Net income	\$ 2,304	\$ 8,102	\$ 10,406
Total average assets at period end	\$ 196,765	\$ 706,017	\$ 902,782
FTEs	119	204	323

	At or For the Nine Months Ended September 30, 2016		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 1,706	\$ 22,959	\$ 24,665
Provision for loan losses	(142)	(1,658)	(1,800)
Noninterest income	14,852	3,273	18,125
Noninterest expense	(10,593)	(18,246)	(28,839)
Income before provision for income taxes	5,823	6,328	12,151
Provision for income taxes	(2,012)	(2,186)	(4,198)
Net income	\$ 3,811	\$ 4,142	\$ 7,953
Total average assets at period end	\$ 147,873	\$ 642,283	\$ 790,156
FTEs	110	195	305

(1) Net interest income is the difference between interest earned on assets and the cost of liabilities to fund those assets. Interest earned includes actual interest earned on segment assets and, if the segment has excess liabilities, interest credits for providing funding to the other segment. The cost of liabilities includes interest expense on segment liabilities and, if the segment does not have enough liabilities to fund its assets, a funding charge based on the cost of assigned liabilities to fund segment assets.



Table of Contents

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

Forward-Looking Statements

This report may contain forward-looking statements, which can be identified by the use of words such as "believes," "expects," "anticipates," "estimates," or similar expressions. Forward-looking statements include, but are not limited to:

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

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

- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies, write offs, changes in our allowance for loan losses, and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our home lending operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;
- our ability to control operating costs and expenses;
- changes in consumer spending, borrowing, and savings habits;
- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act, changes in regulation policies and principles, an increase in regulatory capital requirements or change in the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products, and services and other risks described elsewhere in this Form 10 Q and our other reports filed with the U.S. Securities and Exchange Commission, including our Annual Report on Form 10 K for the year ended December 31,

2016.

44

---

## Table of Contents

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

### Overview

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

The Company is relationship-driven, delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities, and one loan production office located in the Tri-Cities, Washington. On January 22, 2016, the Company completed the Branch Purchase and acquired \$186.4 million in deposits and \$419,000 in loans based on financial information at that date. The four branches acquired are located in the communities of Port Angeles, Sequim, Port Townsend, and Hadlock, Washington. The Branch Purchase expanded our Puget Sound-focused retail footprint onto the Olympic Peninsula and provided an opportunity to extend our unique brand of community banking into those communities.

The Company also maintains its long-standing indirect consumer lending platform which operates throughout the West Coast. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is also actively involved in community activities and events within these market areas, which further strengthens our relationships within those markets.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

- Growing and diversifying our loan portfolio;
- Maintaining strong asset quality;
- Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;
- Capturing our customers' full relationship by offering a wide range of products and services by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers' banking needs; and
- Expanding the Company's markets.

The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, commercial real estate mortgage loans, home loans, commercial business loans, and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, solar panels, and other improvement renovations, represent the largest portion of the loan portfolio and have traditionally been the mainstay of our lending strategy. At September 30, 2017, consumer loans represented 26.3% of the Company's total gross loan portfolio, down from 28.9% at December 31, 2016, as real estate and commercial business loan originations have increased at a faster pace than consumer loan originations.

Indirect home improvement lending is dependent on the Bank's relationships with home improvement contractors and dealers. The Company funded \$24.6 million, or 1,490 loans during the quarter ended September 30, 2017, using its indirect home improvement contractor/dealer network located throughout Washington, Oregon, Idaho, and California with four contractors/dealers responsible for 45.5% of the funded loans dollar volume. During the nine months ended September 30,

45

---

Table of Contents

2017, the Company originated \$15.5 million in the state of California, and at September 30, 2017, held \$42.9 million in California originated consumer loans. Management has established a concentration limit of no more than 100% of the Bank's total risk-based capital for loans originated in California. At September 30, 2017, the limit was \$130.2 million.

The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Walk-in customers are also an important source of the Company's loan originations. During the nine months ended, the Company originated \$603.4 million of one-to-four-family loans which includes loans held for sale ("HFS"), loans held for investment, fixed seconds, and loans brokered to other institutions through the home lending segment, including brokered loans of \$5.7 million. During the nine months ended September 30, 2017, \$511.8 million of the loans originated were sold to investors, of which \$321.3 million were sold to the FNMA, FHLMC, FHLB, and/or GNMA with servicing rights retained for the purpose of further developing these customer relationships. At September 30, 2017, one-to-four-family residential mortgage loans held for investment, which excludes loans held for sale of \$65.1 million, totaled \$170.2 million, or 22.2%, of the total gross loan portfolio.

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

Since 2012, the Company has had an emphasis on diversifying lending products by expanding commercial real estate, commercial business and residential lending, while maintaining the current volume of production and historical growth of the consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as an important funding source.

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

The Company's earnings are primarily dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. Another significant influence on the Company's earnings is fee income from home lending activities. The Company's earnings

are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

#### Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex, or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to,

## Table of Contents

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 the following:

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

**Troubled Debt Restructured Loans.** TDRs are loans whose terms have been modified or restructured due to a borrower’s financial difficulty, including but not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status.

**Servicing Rights.** Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses.

Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount. If the Company later determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the Consolidated Balance Sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Derivatives and Hedging Activity.** ASC 815, “Derivatives and Hedging,” requires that derivatives of the Company be recorded in the consolidated financial statements at fair value. Management considers its accounting policy for derivatives to be critical because these instruments have certain interest rate risk characteristics that change in value

based upon changes in the capital markets. The Company's derivatives are primarily the result of its home lending activities in the form of commitments to extend credit, commitments to sell loans, TBA MBS trades and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded on the Consolidated Statements of Income with offsets to other assets or other liabilities on the Consolidated Balance Sheets.

Table of Contents

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

Deferred tax liabilities occur when taxable income is smaller than reported income on the income statements due to accounting valuation methods that differ from tax, as well as tax rate estimates and payments made quarterly and adjusted to actual at the end of the year. Deferred tax liabilities are temporary differences payable in future periods. The Company had a net deferred tax liability of \$1.4 million, and \$1.2 million, at September 30, 2017 and December 31, 2016, respectively.

#### Comparison of Financial Condition at September 30, 2017 and December 31, 2016

**Assets.** Total assets increased \$166.0 million, or 20.0%, to \$993.9 million at September 30, 2017, from \$827.9 million at December 31, 2016, primarily as a result of a \$160.5 million, or 27.1% increase in loans receivable, net, a \$12.5 million, or 23.8% increase in loans HFS, a \$2.9 million, or 18.8% increase in certificates of deposit at other financial institutions, and a \$1.3 million, or 27.1% increase in other assets, partially offset by a \$5.2 million, or 14.2% decrease in cash and cash equivalents, a \$3.8 million, or 4.6% decrease in securities available-for-sale, and a \$2.6 million, or 31.3% decrease in servicing rights.

Loans receivable, net increased \$160.5 million, or 27.1% to \$753.9 million at September 30, 2017, from \$593.3 million at December 31, 2016. The increase in loans receivable, net was primarily a result of increases in real estate and commercial business loans. Real estate loan increases included one-to-four-family loans held for investment of \$46.2 million, construction and development loans of \$34.9 million, commercial real estate loans of \$7.3 million, multi-family loans of \$5.9 million, and home equity loans of \$3.9 million. Changes in commercial business lending included a \$17.6 million increase in commercial business loans associated with our warehouse lending program and a \$17.4 million increase in commercial and industrial loans. Growth in consumer lending was \$26.9 million, reflecting growth in the Bank's long established indirect home improvement lending platform.

Loans HFS, consisting of one-to-four-family loans and one commercial and industrial loan, increased by \$12.5 million, or 23.8% to \$65.1 million at September 30, 2017, from \$52.6 million at December 31, 2016 due to increased loan originations. The Company will continue selling one-to-four-family loans into the secondary market for asset/liability management purposes.

One-to-four-family loans originated through the home lending segment which includes loans HFS, loans held for investment, fixed seconds, and loans brokered to other institutions increased \$27.3 million, or 12.6% to \$244.1 million during the quarter ended September 30, 2017, compared to \$232.9 million for the same quarter one year ago. One-to-four-family loans originated through the home lending segment increased \$19.3 million, or 3.3% to \$603.4 million during the nine months ended September 30, 2017, compared to \$584.1 million during the nine months ended September 30, 2016. Originations of one-to-four-family loans to purchase a home (purchase production) increased by \$68.0 million, or 17.2% with \$464.3 million in loan purchase production closing during the nine months ended

September 30, 2017, up from \$396.3 million for the nine months ended September 30, 2016. One-to-four-family loan originations for refinance (refinance production) decreased \$58.9 million, or 30.1% with \$136.6 million in refinance production closing during the nine months ended September 30, 2017, down from \$195.5 million for the nine months ended September 30, 2016. During the quarter ended September 30, 2017, the Company sold \$204.3 million of one-to-four-family loans, compared to sales of \$205.1 million for the same quarter one year ago. In addition, the margin on loans sold increased to 2.53% for the nine months ended September 30, 2017, from 2.48% for the nine months ended September 30, 2016.

Table of Contents

Purchase production was 76.1% of the total one-to-four-family loan originations versus 23.9% for refinance production during the third quarter of 2017, compared to 60.9% in purchase production versus 39.1% in refinance production during the same period 2016. Purchase production for the nine months ended September 30, 2017 was 77.3% of the total one-to-four-family loan originations versus 22.7% for refinance production, compared to 67.0% in purchase volume versus 33.0% in refinances for the nine months ended September 30, 2016. The increase in originations and purchase activity was primarily associated with the strong home purchase demand in the Pacific Northwest, while the decline in refinance activity reflects the rise in mortgage interest rates over the past year.

The ALLL at September 30, 2017 increased to \$10.6 million, or 1.4% of gross loans receivable, excluding loans HFS, compared to \$10.2 million, or 1.7% of gross loans receivable, excluding loans HFS, at December 31, 2016. Non-performing loans, consisting of non-accrual loans, increased to \$1.3 million at September 30, 2017, from \$721,000 at December 31, 2016. At September 30, 2017, non-performing loans consisted of \$551,000 of commercial and industrial loans, \$316,000 of indirect home improvement loans, \$154,000 of home equity loans, \$142,000 of one-to-four-family loans, \$81,000 of solar loans, \$11,000 of other consumer loans, and \$9,000 of marine loans. Non-performing loans to total gross loans was 0.2% at September 30, 2017, compared to 0.1% at December 31, 2016. Substandard loans decreased \$1.5 million, or 18.3%, to \$6.6 million at September 30, 2017, compared to \$8.0 million at December 31, 2016, primarily due to the transfer of \$1.9 million in substandard shared national credits to loans HFS sold at a slight discount to market early in October 2017. The Company recorded the expected discount based on the sales price as a loan charge-off during the third quarter of 2017. The Company had no OREO at September 30, 2017, or at December 31, 2016.

The Company sold \$9.0 million of securities AFS during the third quarter of 2017 realizing a gain of \$143,000. Those sales primarily provided additional funds for loan growth during the quarter. The sales of lower coupon investments enabled us to capitalize on the lower Treasury rates for a gain during the third quarter of 2017. The average yield on sold securities AFS during the quarter was 2.48%.

Liabilities. Total liabilities increased \$128.8 million, or 17.2%, to \$875.7 million at September 30, 2017, from \$746.9 million at December 31, 2016, due primarily to an increase in deposits. Total deposits increased \$128.0 million, or 18.0%, to \$840.6 million at September 30, 2017, from \$712.6 million at December 31, 2016. Relationship-based transactional accounts (noninterest-bearing checking, interest-bearing checking, and escrow accounts) increased \$63.7 million, or 29.1%, to \$282.7 million at September 30, 2017, from \$219.0 million at December 31, 2016. Money market and savings accounts increased \$11.2 million, or 3.7%, to \$309.0 million at September 30, 2017, from \$297.8 million at December 31, 2016. Time deposits increased \$53.1 million, or 27.1%, to \$248.8 million at September 30, 2017, from \$195.7 million at December 31, 2016. Non-retail certificates of deposit which includes brokered certificates of deposit, online certificates of deposit, and public funds increased \$39.4 million, or 65.5%, to \$99.7 million at September 30, 2017, compared to \$60.2 million at December 31, 2016. Wholesale funding (brokered deposits) were utilized to bridge short-term asset growth such as loans HFS and pay down higher cost short-term Federal Home Loan Bank (“FHLB”) Fed Funds advances. Approximately \$138.2 million of the acquired deposits from the Branch Purchase remain at 1st Security Bank at September 30, 2017. These branch locations have attracted new deposits with an aggregated total of \$220.8 million, including public funds at September 30, 2017. Management remains focused on growth in lower cost relationship-based deposits to fund long-term asset growth.

Borrowings decreased \$2.4 million, or 18.9%, to \$10.3 million at September 30, 2017, from \$12.7 million at December 31, 2016, primarily due to the repayment of FHLB Fed Funds advances.

Stockholders' Equity. Total stockholders' equity increased \$37.2 million, or 45.9% to \$118.2 million at September 30, 2017, from \$81.0 million at December 31, 2016. The increase in stockholders' equity during the nine months ended September 30, 2017, was primarily due to the issuance during the third quarter of 2017 of 587,234 shares of common stock at a price of \$47.00 per share for net proceeds of \$25.6 million and net income of \$10.4 million. Book value per

common share was \$33.52 at September 30, 2017, compared to \$28.32 at December 31, 2016.

Net proceeds received from the stock offering were used to fund the majority of a \$26.0 million contribution to the Bank at the end of the third quarter 2017 to provide additional Tier 1 capital for growth planned over the next 24 months. Management expects continued lending growth due to strong economic factors in the Pacific Northwest and, specifically, the communities we serve.

Table of Contents

We have common shares outstanding of 3,527,896 that were calculated using shares outstanding of 3,674,902 at September 30, 2017, less 36,842 unvested restricted stock shares, and 110,164 unallocated ESOP shares. Common shares of 2,861,135 were calculated using shares outstanding at December 31, 2016 of 3,059,503, less 68,763 unvested restricted stock shares, and 129,605 unallocated ESOP shares.

## Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2017 and 2016

General. Net income was unchanged at \$3.5 million, for both the three months ended September 30, 2017 and 2016 as the \$2.4 million increase in net interest income, after provision for loan losses was offset by a decline in noninterest income, an increase in noninterest expense, and an increase in provision for income taxes. Net income for the nine months ended September 30, 2017, increased \$2.5 million, or 30.8%, to \$10.4 million, from \$8.0 million for the nine months ended September 30, 2016. The increase in net income was primarily a result of a \$6.6 million, or 29.1% increase in net interest income, after provision for loan losses, partially offset by a \$4.1 million, or 14.1% increase in noninterest expense.

The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities to calculate the comparison of results of operations for the three and nine months ended September 30, 2017 and 2016:

Average Balances	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2017	2016	2017	2016
<b>Assets</b>				
Loans receivable, net (1)	\$ 803,399	\$ 643,989	\$ 725,247	\$ 600,343
Securities available-for-sale, at fair value	79,377	83,643	90,206	80,214
Interest-bearing deposits and certificates of deposit at other financial institutions	42,990	36,744	46,153	74,573
FHLB stock, at cost	4,034	1,407	3,658	2,004
Total interest-earning assets	929,800	765,783	865,264	757,134
Noninterest-earning assets (2)	35,868	37,674	37,501	33,022
Total assets	\$ 965,668	\$ 803,457	\$ 902,765	\$ 790,156
<b>Liabilities and stockholders' equity</b>				
Interest-bearing accounts	\$ 642,811	\$ 532,069	\$ 603,449	\$ 517,625
Borrowings	34,372	20,239	27,994	28,660
Subordinated note	9,837	9,817	9,832	9,812
Total interest-bearing liabilities	687,020	562,125	641,275	556,097
Noninterest-bearing accounts	169,367	153,209	163,079	147,848
Other noninterest-bearing liabilities	13,966	12,048	11,318	11,222
Stockholders' equity	95,315	76,075	87,093	74,989
Total liabilities and stockholders' equity	\$ 965,668	\$ 803,457	\$ 902,765	\$ 790,156

(1) Includes loans held for sale

(2) Includes BOLI, goodwill, and CDI

Net Interest Income. Net interest income increased \$2.3 million, or 26.0%, to \$11.0 million for the three months ended September 30, 2017, from \$8.8 million for the three months ended September 30, 2016. The increase in net interest income was primarily due to a \$2.5 million, or 26.8% increase in loans receivable interest income, due to an increase in the average loans receivable, net balance.

Net interest income increased \$5.3 million, or 21.5%, to \$30.0 million for the nine months ended September 30, 2017, from \$24.7 million for the nine months ended September 30, 2016. The increase in net interest income was primarily due to a \$5.5 million, or 21.0% increase in loans receivable interest income, due to an increase in the average loans receivable, net balance.

Table of Contents

The net interest margin (“NIM”) increased 15 basis points to 4.70% for the three months ended September 30, 2017, from 4.55% for the three months ended September 30, 2016, and increased 27 basis points to 4.63% for the nine months ended September 30, 2017, from 4.36% for the nine months ended September 30, 2016. The increased NIM reflects growth in higher yielding loans, compared to short term investments and cash. Management remains focused on matching deposit duration with the duration of earning assets where appropriate.

**Interest Income.** Interest income for the three months ended September 30, 2017, increased \$2.6 million, or 26.3%, to \$12.4 million, from \$9.8 million for the three months ended September 30, 2016. The increase during the period was primarily attributable to the increase in the average balance of loans receivable to \$803.4 million for the three months ended September 30, 2017, compared to \$644.0 million for the three months ended September 30, 2016. The average yield on interest-earning assets increased 18 basis points to 5.27% for the three months ended September 30, 2017, compared to 5.09% for the three months ended September 30, 2016. The increase in average yield on interest-earning assets compared to the same period a year earlier primarily reflects the growth in the loan portfolio and the proportionally larger level of loans in the average interest-earning asset mix.

Interest income for the nine months ended September 30, 2017, increased \$5.8 million, or 20.7%, to \$33.5 million, from \$27.8 million for the nine months ended September 30, 2016. The increase during the period was primarily attributable to the increase in the average balance of loans receivable to \$725.2 million for the nine months ended September 30, 2017, compared to \$600.3 million for the nine months ended September 30, 2016. The average yield on interest-earning assets increased 27 basis points to 5.18% for the nine months ended September 30, 2017, compared to 4.91% for the nine months ended September 30, 2016. The increase in average yield on interest-earning assets compared to the same period a year earlier primarily reflects the growth in the loan portfolio and the proportionally larger level of loans in the average interest-earning asset mix.

**Interest Expense.** Interest expense increased \$301,000, or 29.3%, to \$1.3 million for the three months ended September 30, 2017, from \$1.0 million for the same period of the prior year. The average cost of funds increased four basis points to 0.61% for the three months ended September 30, 2017, compared to 0.57% for the three months ended September 30, 2016 primarily due to the growth in interest-bearing deposits. The average cost of deposits increased four basis points to 0.51% for the three months ended September 30, 2017, compared to 0.47% for the three months ended September 30, 2016, reflecting rising interest rates over the last year and the increase in non-retail certificates of deposit.

Interest expense increased \$460,000, or 14.8%, to \$3.6 million for the nine months ended September 30, 2017, from \$3.1 million for the same period of the prior year, primarily due to growth in deposits. The average cost of funds was unchanged at 0.59% for the nine months ended September 30, 2017 and 2016. The average cost of deposits was also unchanged at 0.48% for both the nine months ended September 30, 2017 and 2016, reflecting steady deposit interest rates year over year. Management remains focused on matching deposit duration with the duration of earning assets where appropriate.

**Provision for Loan Losses** For the three and nine months ended September 30, 2017, the provision for loan losses was \$450,000, compared to \$600,000 and \$1.8 million, for the three and nine months ended September 30, 2016, respectively. The reduced provision for loan losses for the three and nine months ended September 30, 2017 was a result of the low level of charge-offs and the relatively low level of delinquent, nonperforming and classified loans, as well as the increasing percentage of real estate loans and improving real estate values in our market areas. Management also reviewed during the quarter the historical loss activity over the past 17 quarters and incorporated the decrease in the level of historical loss as a factor in determining a reduction in the required unallocated allowance for loan and lease losses at September 30, 2017. During the three months ended September 30, 2017, net recoveries totaled \$5,000 compared to \$35,000 during the three months ended September 30, 2016. Net charge-offs totaled \$63,000 during the nine months ended September 30, 2017, compared to net recoveries of \$1,000 during the

nine months ended September 30, 2016.

Noninterest Income. Noninterest income decreased \$821,000, or 11.3%, to \$6.4 million for the three months ended September 30, 2017, from \$7.2 million for the three months ended September 30, 2016. The decrease during the period was due to an \$897,000 reduction in gain on sale of loans, primarily associated with a decrease in the volume of loans/locks fair valued, and a reduction of gain on sale margins associated with the product mix in the Pacific Northwest, partially offset by a \$64,000 increase in other noninterest income.

51

---

Table of Contents

Noninterest income increased \$679,000, or 3.7%, to \$18.8 million for the nine months ended September 30, 2017, from \$18.1 million for the nine months ended September 30, 2016. The increase during the period was primarily due to increases in gain on sale of servicing rights of \$996,000, service charges and fee income of \$254,000, and gain on sale of investment securities of \$234,000, primarily offset by a decrease in gain on sale of loans of \$882,000 primarily associated with a decrease in the volume of loans/locks fair valued, and a reduction of gain on sale margins associated with the product mix in the Pacific Northwest.

Noninterest Expense. Noninterest expense increased \$1.3 million, or 12.4%, to \$11.6 million for the three months ended September 30, 2017, from \$10.3 million for the three months ended September 30, 2016. The increase in noninterest expense was primarily a result of an \$853,000 increase in salaries and benefits, which included \$42,000 in incentives and commissions for the loan production staff associated with continued strong loan production growth, a \$216,000 decrease in recovery of mortgage servicing rights, a \$127,000 increase in operations, and a \$114,000 increase in data processing, partially offset by a \$124,000 decrease in professional and board fees.

Noninterest expense increased \$4.1 million 14.1%, to \$32.9 million for the nine months ended September 30, 2017, from \$28.8 million for the nine months ended September 30, 2016. The increase in noninterest expense was primarily a result of a \$3.7 million increase in salaries and benefits, which included \$935,000 in incentives and commissions for the loan production staff, a \$285,000 increase in operations, a \$235,000 increase in data processing, a \$188,000 increase in loan costs, and a \$164,000 increase in occupancy expense, partially offset by a \$389,000 decrease in acquisition costs and a \$229,000 decrease in professional and board fees.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, weakened slightly to 66.4% for the three months ended September 30, 2017, compared to 64.5% for the three months ended September 30, 2016, and 67.5% for the nine months ended September 30, 2017, compared to 67.4% for the nine months ended September 30, 2016, representing a greater increase in noninterest expense as compared to a smaller increase in interest and noninterest income.

Provision for Income Tax. For the three months ended September 30, 2017, the Company recorded a provision for income tax expense of \$2.0 million on pre-tax income as compared to \$1.6 million for the three months ended September 30, 2016. The effective tax rates for the three months ended September 30, 2017 and 2016 were 36.2% and 32.0%, respectively. For the nine months ended September 30, 2017, the Company recorded a provision for income tax expense of \$5.0 million on pre-tax income as compared to \$4.2 million for the nine months ended September 30, 2016. The effective tax rates for the nine months ended September 30, 2017 and 2016 were 32.5% and 34.5%, respectively.

Liquidity

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

At September 30, 2017, the Bank's total borrowing capacity was \$247.1 million with the FHLB of Des Moines, with unused borrowing capacity of \$235.8 million. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. At September 30, 2017, the Bank held approximately \$320.1 million in loans that qualify as collateral for FHLB advances. In addition to the availability of liquidity from the FHLB of Des Moines, the Bank maintained a short-term borrowing line with the Federal Reserve Bank, with a current limit of \$96.0 million, and a combined credit limit of \$43.0 million in written Fed Funds lines of

credit through correspondent banking relationships at September 30, 2017. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. At September 30, 2017, the Bank held approximately \$195.3 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

At September 30, 2017, \$10.3 million in FHLB advances were outstanding, and no advances were outstanding against the Federal Reserve Bank line of credit, or the Fed Funds lines of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of Bank deposits or \$168.8 million at September 30, 2017.

## Table of Contents

Total brokered deposits at September 30, 2017 were \$102.2 million. Management utilizes brokered deposits to mitigate interest rate risk and liquidity risk exposure when appropriate.

Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and Fed Funds. On a longer term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and federal agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits, fund withdrawals, and to fund loan commitments. At September 30, 2017, the approved outstanding loan commitments, including unused lines of credit amounted to \$347.1 million, including undisbursed construction and development loans in process totaling \$82.1 million. Certificates of deposit scheduled to mature in three months or less at September 30, 2017, totaled \$81.2 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing relationship deposits will remain with the Bank.

As a separate legal entity from the Bank, FS Bancorp, Inc. must provide for its own liquidity. Sources of capital and liquidity for FS Bancorp, Inc. include distributions from the Bank and the issuance of debt or equity securities. Dividends and other capital distributions from the Bank are subject to regulatory notice. At September 30, 2017, FS Bancorp, Inc. had \$3.7 million in cash to meet liquidity needs.

### Commitments and Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. For information regarding our commitments and off-balance sheet arrangements, see Note 9 of the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

### Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at September 30, 2017, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a well capitalized status under the capital categories of the FDIC. Based on capital levels at September 30, 2017, the Bank was considered to be well capitalized. At September 30, 2017, the Bank exceeded all regulatory capital requirements with Tier 1 leverage-based capital, Tier 1 risk-based capital, total risk-based capital, and common equity Tier 1 capital ratios of 12.5%, 14.9%, 16.1%, and 14.9%, respectively. For additional information regarding the Bank's regulatory capital compliance, see the discussion included in Note 14 to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

For a bank holding company with less than \$1 billion in consolidated assets, such as FS Bancorp, Inc., the capital guidelines apply on a bank only basis and the Federal Reserve requires the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with \$1 billion or more in assets, at September 30, 2017, FS Bancorp, Inc. would have exceeded all regulatory capital requirements.

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

Not required for smaller reporting companies.

### Item 4. Controls and Procedures

(a)Evaluation of Disclosure Controls and Procedures

An evaluation of the disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the “Act”)) at September 30, 2017 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 Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures in effect at September 30, 2017 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

Table of Contents

management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b)Changes in Internal Controls

There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the three months ended September 30, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting 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 may be circumvented by the individual acts of some persons, by collusion of two or more people, or by 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 or 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.

Table of Contents

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

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company's Annual Report on Form 10 K for the year ended December 31, 2016.

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

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Table of Contents

Item 6. Exhibits

- 3.1 Articles of Incorporation of FS Bancorp, Inc. (1)
- 3.2 Bylaws of FS Bancorp, Inc. (2)
- 4.1 Form of Common Stock Certificate of FS Bancorp, Inc. (1)
- 10.1 Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams (1)
- 10.2 Form of Change of Control Agreement between 1st Security Bank of Washington and each of Joseph C. Adams, Matthew D. Mullet, Drew B. Ness, and Dennis V. O’Leary (1)
- 10.3 FS Bancorp, Inc. 2013 Equity Incentive Plan (the “2013 Plan”) (3)
- 10.4 Form of Incentive Stock Option Agreement under the 2013 Plan (3)
- 10.5 Form of Non-Qualified Stock Option Agreement under the 2013 Plan (3)
- 10.6 Form of Restricted Stock Agreement under the 2013 Plan (3)
- 10.7 Purchase and Assumption Agreement between Bank of America, National Association and 1st Security Bank dated September 1, 2015 (4)
- 10.8 Subordinated Loan Agreement dated September 30, 2015 by and among Community Funding CLO, Ltd. and the Company (5)
- 10.9 Form of change of control agreement with Donn C. Costa and Debbie L. Steck (6)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from the Company’s Quarterly Report on Form 10 Q for the quarter ended September 30, 2017 formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders’ Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.
  - (1) Filed as an exhibit to the Registrant’s Registration Statement on Form S 1 (333 177125) filed on October 3, 2011, and incorporated by reference.
  - (2) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on July 10, 2013 (File No. 001 35589).
  - (3) Filed as an exhibit to the Registrant’s Registration Statement on Form S 8 (333 192990) filed on December 20, 2013, and incorporated by reference.
  - (4) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on September 2, 2015 (File No. 001 35589).
  - (5) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on October 19, 2015 (File No. 001 35589).
  - (6) Filed as an exhibit to the Registrant’s Current Report on Form 8 K filed on February 1, 2016 (File No. 001 35589).

Table of Contents

Exhibit Index

Exhibit No.	Description
31.1	<u>Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
32.2	<u>Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
101	The following materials from the Company's Quarterly Report on Form 10 Q for the quarter ended September 30, 2017 formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.

Table of Contents

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.

FS BANCORP, INC.

Date: November 13, 2017 By: /s/Joseph C. Adams  
Joseph C. Adams,  
Chief Executive Officer  
(Duly Authorized Officer)

Date: November 13, 2017 By: /s/Matthew D. Mullet  
Matthew D. Mullet  
Secretary, Treasurer and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)