Waterstone Financial, Inc.
Form 10-K
March 03, 2017
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

F O R M 1 0 - K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016

Commission file number: 001-36271

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

Maryland	90-1026709
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
11200 W Plank Ct, Wauwatosa, Wisconsin	53226
(Address of principal executive offices)	(Zip Code)

(414) 761-1000
Registrant's telephone number, including area code:

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

Common Stock, $0.01 Par Value	The NASDAQ Stock Market, LLC
(Title of class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:
NONE

Indicate by check mark whether the registrant is a well-known seasoned issuer (as defined in Rule 405 of the 1933 Act).

Yes No T

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the 1934 Act.

Yes No T

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 T 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files)

Yes T No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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

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

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

Yes No T

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the price at which the common equity was last sold on June 30, 2016 as reported by the NASDAQ Global Select Market® was approximately $447.1 million.

As of February 28, 2017, 29,446,462 shares of the Registrant's Common Stock were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Document	Part of Form 10-K Into Which Portions of Document are Incorporated
Proxy Statement for Annual Meeting of Shareholders on May 16, 2017	Part III

WATERSTONE FINANCIAL, INC.

FORM 10-K ANNUAL REPORT TO THE SECURITIES AND EXCHANGE COMMISSION
FOR THE YEAR ENDED DECEMBER 31, 2016

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PART 1

Item 1. Business

Forward-Looking Statements

This Form 10-K may contain or incorporate by reference various forward-looking statements, which can be identified by the use of words such as "estimate," "project," "believe," "intend," "anticipate," "plan," "seek," "expect" and similar expressions and verbs in the future tense. These 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 portfolio;
- Estimates of our risks and future costs and benefits.

These forward-looking statements are based on current beliefs and expectations of our management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements.

- general economic conditions, either nationally or in our market area, that are different than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins and yields, our mortgage banking revenues or reduce the fair value of financial instruments or reduce the origination levels in our lending business, or increase the level of defaults, losses or prepayments on loans we have made and make whether held in portfolio or sold in the secondary markets;
- adverse changes in the securities or secondary mortgage markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- our ability to manage market risk, credit risk and operational risk in the current economic conditions;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities;
- decreased demand for our products and services;
- changes in tax policies or assessment policies;
- the inability of third-party provider to perform their obligations to us;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission or the Public Company Accounting Oversight Board;
- our ability to retain key employees;
- significant increases in our loan losses; and
- changes in the financial condition, results of operations or future prospects of issuers of securities that we own.

See also the factors regarding future operations discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" below.

Waterstone Financial, Inc.

Waterstone Financial, Inc., a Maryland corporation ("New Waterstone"), was organized in June 2013. Upon completion of the mutual-to-stock conversion of Lamplighter Financial, MHC in January 2014, New Waterstone became the holding company of WaterStone Bank SSB and succeeded to all of the business and operations of Waterstone Financial, Inc., a Federal corporation ("Waterstone-Federal") and each of Waterstone-Federal and Lamplighter Financial, MHC ceased to exist. In this report, we refer to WaterStone Bank, our wholly owned subsidiary, both before and after the reorganization, as "WaterStone Bank" or the "Bank."

New Waterstone did not engage in any business prior to the completion of the mutual-to-stock conversion of Lamplighter Financial, MHC on January 22, 2014. Consequently, this Annual Report on Form 10-K reflects the financial condition and operating results of Waterstone-Federal and its subsidiaries, including the Bank, until January 22, 2014, and of New Waterstone, and its subsidiaries, including the Bank, thereafter. The words "Waterstone Financial," "we" and "our" thus are intended to refer to Waterstone-Federal and its subsidiaries with respect to matters and time periods occurring on or before January 22, 2014, and to New Waterstone and its subsidiaries with respect to matters and time periods occurring thereafter.

Waterstone Financial, Inc. and its subsidiaries, including WaterStone Bank, are referred to herein as the "Company," "Waterstone Financial," or "we."

The Company maintains a website at www.wsbonline.com. We make available through that website, free of charge, copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, amendments to those reports and proxy materials as soon as is reasonably practical after the Company electronically files those materials with, or furnishes them to, the Securities and Exchange Commission. You may access those reports by following the links under "Investor Relations" at the Company's website. Information on this website is not and should not be considered a part of this document.

Waterstone Financial's executive offices are located at 11200 West Plank Court, Wauwatosa, Wisconsin 53226, and its telephone number at this address is (414) 761-1000.

BUSINESS OF WATERSTONE BANK

General

WaterStone Bank is a community bank that has served the banking needs of its customers since 1921. WaterStone Bank also has an active mortgage banking subsidiary, Waterstone Mortgage Corporation, which had 77 offices in 22 states as of December 31, 2016.

WaterStone Bank conducts its community banking business from 11 banking offices located in Milwaukee, Washington and Waukesha Counties, Wisconsin, as well as a loan production office in Minneapolis, Minnesota. WaterStone Bank's principal lending activity is originating one- to four-family and multi-family residential real estate loans for retention in its portfolio. At December 31, 2016, such loans comprised 33.4% and 47.4%, respectively, of WaterStone Bank's loan portfolio. WaterStone Bank also offers home equity loans and lines of credit, construction and land loans, commercial real estate and commercial business loans, and consumer loans. WaterStone Bank funds its loan production primarily with retail deposits and Federal Home Loan Bank advances. Our deposit offerings include certificates of deposit, money market savings accounts, transaction deposit accounts, non-interest bearing demand accounts and individual retirement accounts. Our investment securities portfolio is comprised principally of mortgage-backed securities, government-sponsored enterprise bonds, municipal obligations, and other debt securities.

WaterStone Bank is subject to comprehensive regulation and examination by the Wisconsin Department of Financial Institutions (the "WDFI") and the Federal Deposit Insurance Corporation.

WaterStone Bank's executive offices are located at 11200 West Plank Court, Wauwatosa, Wisconsin 53226, and its telephone number is (414) 761-1000. Its website address is www.wsbonline.com.

WaterStone Bank's mortgage banking operations are conducted through its wholly-owned subsidiary, Waterstone Mortgage Corporation. Waterstone Mortgage Corporation originates single-family residential real estate loans for sale into the secondary market. Waterstone Mortgage Corporation utilizes lines of credit provided by WaterStone Bank as a primary source of funds, and also utilizes a line of credit with another financial institution as needed. On a consolidated basis, Waterstone Mortgage Corporation originated approximately $2.38 billion, which excludes the loans originated from Waterstone Mortgage Corporation and purchased by WaterStone Bank, in mortgage loans held for sale during the year ended December 31, 2016.

Market Area

WaterStone Bank. WaterStone Bank's market area is broadly defined as the Milwaukee, Wisconsin metropolitan market, which is geographically located in the southeast corner of the state. WaterStone Bank's primary market area is Milwaukee and Waukesha counties and the five surrounding counties of Ozaukee, Washington, Jefferson, Walworth and Racine. We have six branch offices in Milwaukee County, four branch offices in Waukesha County and one branch office in Washington County. At June 30, 2016 (the latest date for which information was publicly available), 49.2% of deposits in the State of Wisconsin were located in the seven-county metropolitan Milwaukee market and 43.3% of deposits in the State of Wisconsin were located in the three counties in which the Bank has a branch office.

WaterStone Bank's primary market area for deposits includes the communities in which we maintain our banking office locations. Our primary lending market area is broader than our primary deposit market area and includes all of the primary market area noted above but extends further west to the Madison, Wisconsin market and further north to the Appleton and Green Bay, Wisconsin markets. In addition, in October 2013 we opened a loan production office in Minneapolis, Minnesota, which has a primary lending market area of the Minneapolis-St. Paul, Minnesota metropolitan market.

Waterstone Mortgage Corporation. As of December 31, 2016, Waterstone Mortgage Corporation had 15 offices in Wisconsin, 13 offices in Florida, nine offices in Pennsylvania, six offices in Minnesota, five offices in Indiana, Ohio, and Texas, two offices in each of Arizona, California, Maryland, and Virginia, and one office in each of Colorado, Georgia, Idaho, Illinois, Iowa, Maine, Massachusetts, New Hampshire, Oregon, Tennessee, and Washington.

Competition

WaterStone Bank. WaterStone Bank faces competition within our market area both in making real estate loans and attracting deposits. The Milwaukee-Waukesha-West Allis metropolitan statistical area has a high concentration of financial institutions, including large commercial banks, community banks and credit unions. The Federal Deposit Insurance Corporation has determined that our market area is a "high-rate" area with regard to deposit pricing as compared to the rest of the United States. As of June 30, 2016, based on the Federal Deposit Insurance Corporation's annual Summary of Deposits Report, we had the eighth largest market share in our metropolitan statistical area out of 51 financial institutions in our metropolitan statistical area, representing 1.5% of all deposits.

Our competition for loans and deposits comes principally from commercial banks, savings institutions, mortgage banking firms and credit unions. We face additional competition for deposits from money market funds, brokerage firms, and mutual funds. Some of our competitors offer products and services that we do not offer, such as trust services and private banking.

Our primary focus is to build and develop profitable consumer and commercial customer relationships while maintaining our role as a community bank.

Waterstone Mortgage Corporation. Waterstone Mortgage Corporation faces competition for originating loans both directly within the markets in which it operates and from entities that provide services throughout the United States through internet services. Waterstone Mortgage Corporation's competition comes principally from other mortgage banking firms, as well as from commercial banks, savings institutions and credit unions.

Lending Activities

The scope of the discussion included under "Lending Activities" is limited to lending operations related to loans originated for investment. A discussion of the lending activities related to loans originated for sale is included under "Mortgage Banking Activities."

Historically, our principal lending activity has been originating mortgage loans for the purchase or refinancing of residential real estate. Generally, we retain the loans that we originate, which we refer to as loans originated for investment. One- to four-family residential mortgage loans represented $392.8 million, or 33.4%, of our total loan portfolio at December 31, 2016. Multi-family residential mortgage loans represented $558.6 million, or 47.4%, of our total loan portfolio at December 31, 2016. We also offer construction and land loans, commercial real estate loans, home equity lines of credit and commercial loans. At December 31, 2016, commercial real estate loans, commercial business loans, home equity loans, and land and construction loans totaled $159.4 million, $26.8 million, $21.8 million and $18.2 million, respectively.

Loan Portfolio Composition. The following table sets forth the composition of our loan portfolio in dollar amounts and as a percentage of the total portfolio at the dates indicated.

	At December 31,									
	2016		2015		2014		2013		2012	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in Thousands)									
Mortgage loans:										
Residential real estate:										
One- to four-family	$392,817	33.35 %	$381,992	34.26 %	$411,979	37.62 %	$413,614	37.85 %	$460,821	40.65 %

Multi-family	558,592	47.42	%	547,250	49.08	%	522,281	47.70	%	521,597	47.75	%	514,363	45.37 %
Home equity	21,778	1.85	%	24,326	2.18	%	29,207	2.67	%	35,432	3.24	%	36,494	3.22 %
Construction and land	18,179	1.54	%	19,148	1.72	%	17,081	1.56	%	31,905	2.92	%	33,818	2.98 %
Commercial real estate	159,401	13.53	%	118,820	10.66	%	94,771	8.65	%	71,698	6.56	%	65,495	5.78 %
Commercial loans	26,798	2.28	%	23,037	2.07	%	19,471	1.78	%	18,296	1.67	%	22,549	1.99 %
Consumer	319	0.03	%	361	0.03	%	200	0.02	%	134	0.01	%	132	0.01 %
Total loans	1,177,884	100.00	%	1,114,934	100.00	%	1,094,990	100.00	%	1,092,676	100.00	%	1,133,672	100.00 %
Allowance for loan losses	(16,029	)		(16,185	)		(18,706	)		(24,264	)		(31,043	)
Loans, net	$1,161,855			$1,098,749			$1,076,284			$1,068,412			$1,102,629	

Loan Portfolio Maturities and Yields. The following table summarizes the final maturities of our loan portfolio at December 31, 2016. Maturities are based upon the final contractual payment dates and do not reflect the impact of prepayments and scheduled monthly payments that will occur.

Due during the year ended December 31,	One- to four-family Amount	Weighted Average Rate		Multi-family Amount	Weighted Average Rate		Home Equity Amount	Weighted Average Rate		Construction and Land Amount	Weighted Average Rate	
	(Dollars in Thousands)											
2017	$17,193	4.77	%	$28,856	3.98	%	$2,722	4.83	%	$1,600	3.57	%
2018	6,611	4.48	%	37,410	4.25	%	2,509	5.30	%	909	4.48	%
2019	5,545	4.90	%	46,663	4.36	%	1,826	4.59	%	1,002	4.46	%
2020	2,731	4.71	%	64,352	4.29	%	3,547	4.78	%	6,504	3.26	%
2021	8,477	4.96	%	88,961	4.20	%	3,233	4.88	%	2,612	3.88	%
2022 and thereafter	352,260	4.50	%	292,350	4.18	%	7,941	4.54	%	5,552	4.34	%
Total	$392,817	4.53	%	$558,592	4.20	%	$21,778	4.76	%	$18,179	3.83	%

Due during the year ended December 31,	Commercial Real Estate Amount	Weighted Average Rate		Commercial Amount	Weighted Average Rate		Consumer Amount	Weighted Average Rate		Total Amount	Weighted Average Rate	
	(Dollars in Thousands)											
2017	$7,363	4.90	%	$13,593	4.02	%	$154	6.71	%	$71,481	4.30	%
2018	12,361	4.16	%	5,261	3.87	%	20	3.97	%	65,081	4.27	%
2019	23,763	4.49	%	1,708	4.24	%	14	5.00	%	80,521	4.44	%
2020	17,046	4.23	%	3,539	4.48	%	-	0.00	%	97,719	4.25	%
2021	21,725	4.21	%	2,171	4.42	%	131	4.54	%	127,310	4.26	%
2022 and thereafter	77,143	4.17	%	526	4.74	%	-	0.00	%	735,772	4.33	%
Total	$159,401	4.26	%	$26,798	4.11	%	$319	5.57	%	$1,177,884	4.32	%

The following table sets forth the scheduled repayments of fixed and adjustable rate loans at December 31, 2016 that are contractually due after December 31, 2017.

	Due After December 31, 2017 Fixed	Adjustable	Total
	(In Thousands)		
Mortgage loans			
Real estate loans:			
One- to four-family	$16,434	$359,190	$375,624
Multi-family	181,725	348,011	529,736
Home equity	4,888	14,168	19,056
Construction and land	12,857	3,722	16,579
Commercial	77,973	74,065	152,038
Commercial	9,084	4,121	13,205
Consumer	165	-	165

Total loans	$303,126	$803,277	$1,106,403

One- to Four-Family Residential Mortgage Loans. One- to four-family residential mortgage loans totaled $392.8 million, or 33.4% of total loans at December 31, 2016. One- to four-family residential mortgage loans originated for investment during the year ended December 31, 2016 totaled $78.0 million, or 30.7% of all loans originated for investment. Our one- to four-family residential mortgage loans have fixed or adjustable rates. Our adjustable-rate mortgage loans generally provide for maximum annual rate adjustments of 200 basis points, with a lifetime maximum adjustment of 600 basis points. Our adjustable-rate mortgage loans typically amortize over terms of up to 30 years, and are indexed to the 12-month LIBOR rate. Single family adjustable rate mortgages are originated at both our community banking segment and our mortgage banking segment.   We do not and have never offered residential mortgage loans specifically designed for borrowers with sub-prime credit scores, including Alt-A and negative amortization loans. Further, prior to 2007, we did not offer indexed, adjustable-rate loans other than home equity lines of credit, and we have never offered "teaser rate" first mortgage products.

Adjustable rate mortgage loans can decrease the interest rate risk associated with changes in market interest rates by periodically repricing, but involve other risks because, as interest rates increase, the loan payments by the borrower increase, thus increasing the potential for default by the borrower. At the same time, the marketability of the underlying collateral may be adversely affected by higher interest rates. Upward adjustment of the contractual interest rate is also limited by the maximum periodic and lifetime interest rate adjustments permitted by our loan documents and, therefore, the effectiveness of adjustable rate mortgage loans in decreasing the risk associated with changes in interest rates may be limited during periods of rapidly rising interest rates. Moreover, during periods of rapidly declining interest rates the interest income received from the adjustable rate loans can be significantly reduced, thereby adversely affecting interest income.

All residential mortgage loans that we originate include "due-on-sale" clauses, which give us the right to declare a loan immediately due and payable in the event that, among other things, the borrower sells or otherwise transfers the real property subject to the mortgage and the loan is not repaid. We also require homeowner's insurance and where circumstances warrant, flood insurance, on properties securing real estate loans. The average one- to four-family first mortgage loan balance was $178,000 on December 31, 2016, and the largest outstanding balance on that date was $4.6 million, which is a consolidation loan that is collateralized by 29 properties. A total of 80.4% of our one- to four-family loans are collateralized by properties in the state of Wisconsin.

Multi-family Real Estate Loans. Multi-family loans totaled $558.6 million, or 47.4% of total loans at December 31, 2016. Multi-family loans originated for investment during the year ended December 31, 2016 totaled $118.1 million, or 46.5% of all loans originated for investment. These loans are generally secured by properties located in our primary market area. Our multi-family real estate underwriting policies generally provide that such real estate loans may be made in amounts of up to 80% of the appraised value of the property provided the loan complies with our current loans-to-one borrower limit. Multi-family real estate loans are offered with interest rates that are fixed for periods of up to five years or are variable and either adjust based on a market index or at our discretion. Contractual maturities do not exceed 10 years while principal and interest payments are typically based on a 30-year amortization period. In reaching a decision whether to make a multi-family real estate loan, we consider gross revenues and the net operating income of the property, the borrower's expertise and credit history, business cash flow, and the appraised value of the underlying property. In addition, we will also consider the terms and conditions of the leases and the credit quality of the tenants. We generally require that the properties securing these real estate loans have debt service coverage ratios (the ratio of earnings before interest, income taxes, depreciation and amortization divided by interest expense and current maturities of long term debt) of at least 1.15 times. Generally, multi-family loans made to corporations, partnerships and other business entities require personal guarantees by the principals and by the owners of 20% or more of the borrower.

A multi-family borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, payment history reviews and periodic face-to-face meetings with the borrower. We generally require borrowers with aggregate outstanding balances exceeding $1.0 million to provide updated financial statements and federal tax returns annually. These requirements also apply to all guarantors on these loans. We also require borrowers with rental investment property to provide an annual report of income and expenses for the property, including a tenant list and copies of leases, as applicable. The average outstanding multi-family mortgage loan balance was $869,000 on December 31, 2016, with the largest outstanding balance at $13.9 million. At December 31, 2016, our largest exposure to one multi-family borrower or to a related group of borrowers was $36.2 million.

Loans secured by multi-family real estate generally involve larger principal amounts than owner-occupied, one- to four-family residential mortgage loans. Because payments on loans secured by multi-family properties often depend on the successful operation or management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy.

Home Equity Loans and Lines of Credit. We also offer home equity loans and home equity lines of credit, both of which are secured by owner-occupied and non-owner occupied one- to four-family residences. At December 31, 2016, outstanding home equity loans and equity lines of credit totaled $21.8 million, or 1.9% of total loans outstanding. At December 31, 2016, the unadvanced portion of home equity lines of credit totaled $14.4 million. Home equity loans and lines originated for investment during the year ended December 31, 2016 totaled $5.0 million, or 2.0% of all loans originated for investment. The underwriting standards utilized for home equity loans and home equity lines of credit include a determination of the applicant's credit history, an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan, and the value of the collateral securing the loan. Home equity loans are offered with adjustable rates of interest and with terms up to 10 years. The loan-to-value ratio for our home equity loans and our lines of credit is generally limited to 90% when combined with the first security lien, if applicable. Our home equity lines of credit have ten-year terms and adjustable rates of interest, subject to a contractual floor, which are indexed to the prime rate, as reported in The Wall Street Journal. Interest rates on home equity lines of credit are generally limited to a maximum rate of 18%. The average outstanding home equity loan balance was $41,000 at December 31, 2016, with the largest outstanding balance at that date of $573,000.

Construction and Land Loans. We originate construction loans for the acquisition of land and the construction of single-family residences, multi-family residences, and commercial real estate buildings. At December 31, 2016, construction and land loans totaled $18.2 million, or 1.5% of total loans. Construction and land loans originated for investment during the year ended December 31, 2016 totaled $5.9 million, or 2.3% of all loans originated for investment. At December 31, 2016, the unadvanced portion of these construction loans totaled $21.1 million.

Our construction mortgage loans generally provide for the payment of interest only during the construction phase, which is typically up to nine months although our policy is to consider construction periods as long as 12 months or more. At the end of the construction phase, the construction loan converts to a longer-term mortgage loan. Construction loans can be made with a maximum loan-to-value ratio of 90%, provided that the borrower obtains private mortgage insurance if the loan balance exceeds 80% of the lesser of the appraised value or acquisition cost of the secured property. The average outstanding construction loan balance totaled $1.6 million on December 31, 2016, with the largest outstanding balance at $5.2 million. The average outstanding land loan balance was $170,000 on December 31, 2016, and the largest outstanding balance on that date was $942,000.

Before making a commitment to fund a construction loan, we require an appraisal of the property by an independent licensed appraiser. We also review and inspect each property before disbursement of funds during the term of the construction loan. Loan proceeds are disbursed after inspection based on either the percentage of completion method or the actual cost of the completed work.

Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction cost is inaccurate, we may be required to advance funds beyond the amount originally committed in order to protect the value of the property. Additionally, if the estimate of value is inaccurate, we may be confronted with a project, when completed, with a value that is insufficient to ensure full repayment of the loan.

Commercial Real Estate Loans. Commercial real estate loans totaled $159.4 million at December 31, 2016, or 13.5% of total loans, and are made up of loans secured by office and retail buildings, industrial buildings, churches, restaurants, other retail properties and mixed use properties. Commercial real estate loans originated for investment during the year ended December 31, 2016 totaled $35.4 million, or 13.9% of all loans originated for investment. These loans are generally secured by property located in our primary market area. Our commercial real estate underwriting policies provide that such real estate loans may be made in amounts of up to 80% of the appraised value of the property. Commercial real estate loans are offered with interest rates that are fixed up to five years or are variable and either adjust based on a market index or at our discretion. Contractual maturities do not exceed 10 years while principal and interest payments are typically based on a 30-year amortization period. In reaching a decision whether to make a commercial real estate loan, we consider gross revenues and the net operating income of the property, the borrower's expertise and credit history, business cash flow, and the appraised value of the underlying property. In addition, we will also consider the terms and conditions of the leases and the credit quality of the tenants. We generally require that the properties securing these real estate loans have debt service coverage ratios (the ratio of earnings before interest, income taxes, depreciation and amortization divided by interest expense and current maturities of long term debt) of at least 1.15 times. Environmental surveys are required for commercial real estate loans when environmental risks are identified. Generally, commercial real estate loans made to corporations, partnerships and other business entities require personal guarantees by the principals and by the owners of 20% or more of the borrower.

A commercial real estate borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, payment history reviews and periodic face-to-face meetings with the borrower. We generally require borrowers with aggregate outstanding balances exceeding $1.0 million to provide annual updated financial statements and federal tax returns. These requirements also apply to all guarantors on these loans. We also require borrowers to provide an annual report of income and expenses for the property, including a tenant list and copies of leases, as applicable. The average commercial real estate loan in our portfolio at December 31, 2016 was $766,000, and the largest outstanding balance at that date was $8.6 million.

Commercial Loans. Commercial loans totaled $26.8 million at December 31, 2016, or 2.3% of total loans, and are made up of loans secured by accounts receivable, inventory, equipment and real estate. Commercial loans originated for investment during the year ended December 31, 2016 totaled $11.7 million, or 4.6% of all loans originated.

Our commercial loans are generally made to borrowers that are located in our primary market area. Working capital lines of credit are granted for the purpose of carrying inventory and accounts receivable or purchasing equipment. These lines require that certain working capital ratios must be maintained and are monitored on a monthly or quarterly basis. Working capital lines of credit are short-term loans of 12 months or less with variable interest rates. At December 31, 2016, the unadvanced portion of working capital lines of credit totaled $15.1 million. Outstanding balances fluctuate up to the maximum commitment amount based on fluctuations in the balance of the underlying collateral. Personal property loans secured by equipment are considered commercial business loans and are generally made for terms of up to 84 months and for up to 80% of the value of the underlying collateral. Interest rates on equipment loans may be either fixed or variable. Commercial business loans are generally variable rate loans with initial fixed rate periods of up to five years.

A commercial business borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, usually quarterly, payment history reviews and periodic face-to-face meetings with the borrower. The average outstanding commercial loan at December 31, 2016 was $209,000 and the largest outstanding balance on that date was $5.0 million.

The following table shows loan origination, principal repayment activity, transfers to real estate owned, charge-offs and sales during the years indicated.

	As of or for the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Total gross loans receivable and held for sale at beginning of year	$1,281,450	$1,220,063	$1,189,697
Real estate loans originated for investment:			
Residential			
One- to four-family	78,045	41,835	48,325
Multi-family	118,072	117,657	88,958
Home equity	5,037	7,265	4,177
Construction and land	5,878	11,085	8,806
Commercial real estate	35,443	43,138	29,294
Total real estate loans originated for investment	242,475	220,980	179,560
Consumer loans originated for investment	-	688	10
Commercial loans originated for investment	11,692	23,467	7,863
Total loans originated for investment	254,167	245,135	187,433
Principal repayments	(185,020)	(203,271)	(159,619)
Transfers to real estate owned	(4,590)	(15,580)	(16,645)
Loan principal charged-off	(1,607)	(6,340)	(8,855)
Net activity in loans held for investment	62,950	19,944	2,314
Loans originated for sale	2,378,926	1,986,147	1,661,376
Loans sold	(2,320,194)	(1,944,704)	(1,633,324)
Net activity in loans held for sale	58,732	41,443	28,052
Total gross loans receivable and held for sale at end of year	$1,403,132	$1,281,450	$1,220,063

Origination and Servicing of Loans. All loans originated for investment are underwritten pursuant to internally developed policies and procedures. While we generally underwrite owner-occupied residential mortgage loans to Freddie Mac and Fannie Mae standards, due to several unique characteristics, our loans originated prior to 2008 do not conform to the secondary market standards. The unique features of these loans include interest payments in advance of the month in which they are earned and discretionary rate adjustments that are not tied to an independent index.

Exclusive of our mortgage banking operations, we retain in our portfolio all of the loans that we originate. At December 31, 2016, WaterStone Bank was not servicing any loan it originated and subsequently sold to unrelated third parties. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, contacting delinquent mortgagors, supervising foreclosures and property dispositions in the event of unremedied defaults, making certain insurance and tax payments on behalf of the borrowers and generally administering the loans.

Loan Approval Procedures and Authority. WaterStone Bank's lending activities follow written, non-discriminatory, underwriting standards and loan origination procedures established by WaterStone Bank's board of directors. The loan approval process is intended to assess the borrower's ability to repay the loan, the viability of the loan and the adequacy of the value of the property that will secure the loan, if applicable. To assess the borrower's ability to repay, we review the employment and credit history and information on the historical and projected income and expenses of borrowers.

Loan officers, with concurrence from independent credit officers and underwriters, are authorized to approve and close any loan that qualifies under WaterStone Bank underwriting guidelines within the following lending limits:

- A secured one- to four-family mortgage loan up to $500,000 for a borrower with total outstanding loans from us of less than $1,000,000 that is independently underwritten can be approved by select loan officers.
- A loan up to $500,000 for a borrower with total outstanding loans from us of less than $500,000 can be approved by select commercial loan officers.
- Any secured mortgage loan ranging from $500,001 to $2,999,999 or any new loan to a borrower with outstanding loans from us exceeding $1,000,000 must be approved by the Officer Loan Committee.
- Any loan for $3,000,000 or more must be approved by the Officer Loan Committee and the board of directors prior to closing. Any new loan to a borrower with outstanding loans from us exceeding $10,000,000 must be reviewed by the board of directors.

Asset Quality

When a loan becomes more than 30 days delinquent, WaterStone Bank sends a letter advising the borrower of the delinquency. The borrower is given a specific date by which delinquent payments must be made or by which they must contact WaterStone Bank to make arrangements to bring the loan current over a longer period of time. If the borrower fails to bring the loan current within the specified time period or to make arrangements to cure the delinquency over a longer period of time, the matter is referred to legal counsel and foreclosure or other collection proceedings are considered.

All loans are reviewed on a regular basis, and loans are placed on non-accrual status when they become 90 or more days delinquent. When loans are placed on non-accrual status, unpaid accrued interest is reversed, and further income is recognized only to the extent received when collection of the remaining principal balance is reasonably assured.

Non-Performing Assets. Non-performing assets consist of non-accrual loans and other real estate owned. Loans are generally placed on non-accrual status when contractually past due 90 days or more as to interest or principal payments. Additionally, whenever management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, management may place such loans on non-accrual status immediately, rather than waiting until the loan becomes 90 days past due. At the time a loan is placed on non-accrual status, previously accrued and uncollected interest on such loans is reversed and additional income is recorded only to the extent that payments are received and the collection of principal is reasonably assured. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The table below sets forth the amounts and categories of our non-accrual loans and real estate owned at the dates indicated.

	At December 31,				
	2016	2015	2014	2013	2012
	(Dollars in Thousands)				
Non-accrual loans:					
Residential					
One- to four-family	$7,623	$13,888	$23,918	$30,207	$46,467
Multi-family	1,427	2,553	12,001	13,498	23,205
Home equity	344	437	445	1,585	1,578
Construction and land	-	239	401	4,195	2,215
Commercial real estate	422	460	947	938	668
Commercial	41	27	299	521	511
Consumer	-	-	-	17	24
Total non-accrual loans	9,857	17,604	38,011	50,961	74,668
Real estate owned					
One- to four-family	2,141	4,610	10,896	12,980	17,353
Multi-family	-	209	2,210	3,040	9,890
Construction and land	5,082	5,262	5,400	6,258	7,029
Commercial real estate	300	300	300	385	1,702
Total real estate owned	7,523	10,381	18,806	22,663	35,974
Valuation allowance at end of period	(1,405)	(1,191)	(100)	-	-
Total real estate owned, net	6,118	9,190	18,706	22,663	35,974
Total non-performing assets	$15,975	$26,794	$56,817	$73,624	$110,642
Total non-accrual loans to total loans, net	0.84 %	1.58 %	3.47 %	4.66 %	6.59 %
Total non-accrual loans to total assets	0.55 %	1.00 %	2.13 %	2.62 %	4.50 %
Total non-performing assets to total assets	0.89 %	1.52 %	3.18 %	3.78 %	6.66 %

All loans that meet or exceed 90 days with respect to past due principal and interest are recognized as non-accrual. Troubled debt restructurings which are still on non-accrual either due to being past due 90 days or greater, or which have not yet performed under the modified terms for a reasonable period of time, are included in the table above. In addition, loans which are past due less than 90 days are evaluated to determine the likelihood of collectability given other credit risk factors such as early stage delinquency, the nature of the collateral or the results of a borrower fiscal review. When the collection of all contractual principal and interest is determined to be unlikely, the loan is moved to non-accrual status and an updated appraisal of the underlying collateral is ordered. This process generally takes place between contractual past due dates 60 and 90 days. Upon determining the updated estimated value of the collateral, a loan loss provision is recorded to establish a specific reserve to the extent that the outstanding principal balance exceeds the updated estimated net realizable value of the collateral. When a loan is determined to be uncollectible, generally coinciding with the initiation of foreclosure action, the specific reserve is reviewed for adequacy, adjusted if necessary, and charged-off.

The following table sets forth activity in our non-accrual loans for the years indicated.

At and for the Year Ended December 31,				
2016	2015	2014	2013	2012
(Dollars in Thousands)				

Balance at beginning of year	$17,604	$38,011	$50,961	$74,668	$78,218
Additions	3,114	10,165	21,585	33,488	44,617
Transfers to real estate owned	(4,590)	(15,580)	(16,645)	(13,552)	(22,282)
Charge-offs	(667)	(3,809)	(7,099)	(11,792)	(8,379)
Returned to accrual status	(4,183)	(5,824)	(4,470)	(26,005)	(8,194)
Principal paydowns and other	(1,421)	(5,359)	(6,321)	(5,846)	(9,312)
Balance at end of year	$9,857	$17,604	$38,011	$50,961	$74,668

Total non-accrual loans decreased by $7.7 million, or 44.0%, to $9.9 million as of December 31, 2016 compared to $17.6 million as of December 31, 2015. The ratio of non-accrual loans to total loans receivable was 0.84% at December 31, 2016 compared to 1.58% at December 31, 2015. During the year ended December 31, 2016, $4.6 million were transferred to real estate owned, $667,000 in loan principal was charged off, $1.4 million in principal payments were received and $4.2 million in loans were returned to accrual status. Offsetting this activity, $3.1 million in loans were placed on non-accrual status during the year ended December 31, 2016.

Of the $9.9 million in total non-accrual loans as of December 31, 2016, $9.4 million in loans have been specifically reviewed to assess whether a specific valuation allowance is necessary. A specific valuation allowance is established for an amount equal to the impairment when the carrying value of the loan exceeds the present value of expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral with an adjustment made for costs to dispose of the asset. Based upon these specific reviews, a total of $2.1 million in partial charge-offs have been recorded with respect to these loans as of December 31, 2016. Partially charged-off loans measured for impairment based upon net realizable collateral value are maintained in a "non-performing" status and are disclosed as impaired loans. In addition, specific reserves totaling $510,000 have been recorded as of December 31, 2016. The remaining $498,000 of non-accrual loans were reviewed on an aggregate basis and $100,000 in general valuation allowance was deemed necessary related to those loans as of December 31, 2016. The $100,000 in general valuation allowance is based upon a migration analysis performed with respect to similar non-accrual loans in prior periods.

The outstanding principal balance of our five largest non-accrual loans as of December 31, 2016 totaled $2.1 million, which represents 21.1% of total non-accrual loans as of that date. These five loans are carried net of cumulative life-to-date charge-offs of $15,000. Aggregate specific valuation allowances with respect to these five loans total $106,000 as of December 31, 2016.

For the year ended December 31, 2016, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was $701,000. We received $531,000 of interest payments on such loans during the year ended December 31, 2016. Interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

There were no accruing loans past due 90 days or more during the years ended December 31, 2016, 2015 or 2014.

Troubled Debt Restructurings. The following table summarizes troubled debt restructurings by the Company's internal risk rating.

	At December 31,				
	2016	2015	2014	2013	2012
	(Dollars in Thousands)				
Troubled debt restructurings					
Substandard	$7,025	$14,436	$22,629	$25,258	$48,449
Watch	3,112	3,103	3,488	4,329	11,172
Total troubled debt restructurings	$10,137	$17,539	$26,117	$29,587	$59,621

Troubled debt restructurings totaled $10.1 million at December 31, 2016, compared to $17.5 million at December 31, 2015. At December 31, 2016, $9.4 million of troubled debt restructurings, or 92.5%, were performing in accordance with their restructured terms. All troubled debt restructurings are considered to be impaired and are risk rated as either substandard or watch and are included in the internal risk rating tables disclosed in the notes to the consolidated financial statements. Specific reserves have been established to the extent that the collateral-based impairment analyses indicate that a collateral shortfall exists or to the extent that a discounted cash flow analysis results in an impairment.

We do not participate in government-sponsored troubled debt restructuring programs. Our troubled debt restructurings are short-term modifications. Typical initial restructured terms include six to twelve months of principal forbearance, a reduction in interest rate or both. Restructured terms do not include a reduction of the outstanding principal balance unless mandated by a bankruptcy court. Troubled debt restructuring terms may be renewed or further modified at the end of the initial term for an additional period if performance has been acceptable and the short-term borrower difficulty persists.

Information with respect to the accrual status of our troubled debt restructurings is provided in the following table.

	At December 31, 2016		2015	
	Accruing	Non-accruing	Accruing	Non-accruing
	(In Thousands)			
One- to four-family	$3,296	$ 2,399	$3,900	$ 5,739
Multi-family	2,514	1,427	2,546	2,317
Home equity	49	97	-	98
Construction and land	-	-	1,556	-
Commercial real estate	295	60	1,306	77
	$6,154	$ 3,983	$9,308	$ 8,231

The following table sets forth activity in our troubled debt restructurings for the years indicated.

	At or for the Year Ended December 31, 2016		2015	
	Accruing	Non-accruing	Accruing	Non-accruing
	(In Thousands)			
Balance at beginning of year	$9,308	$ 8,231	$10,819	$ 15,298
Additions	49	-	-	1,005
Change in accrual status	-	-	-	-
Charge-offs	-	(207)	-	(358)
Returned to contractual/market terms	(2,567)	(2,780)	(1,044)	(3,965)
Transferred to real estate owned	-	(839)	-	(3,039)
Principal paydowns and other	(636)	(422)	(467)	(710)
Balance at end of period	$6,154	$ 3,983	$9,308	$ 8,231

For the year ended December 31, 2016, gross interest income that would have been recorded had our troubled debt restructurings been current in accordance with their contractual terms was $592,000. We received $513,000 of interest payments on such loans during the year ended December 31, 2016. Interest payments received on non-accrual troubled debt restructurings are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

If a restructured loan is current in all respects and a minimum of six consecutive restructured payments have been received, it can be considered for return to accrual status. After a restructured loan that is current in all respects reverts to contractual/market terms, if a credit department review indicates no evidence of elevated market risk, the loan is removed from the troubled debt restructuring classification.

Loan Delinquency. The following table summarizes loan delinquency in total dollars and as a percentage of the total loan portfolio:

	At December 31,	
	2016	2015
	(Dollars in Thousands)	
Loans past due less than 90 days	$2,910	$2,599
Loans past due 90 days or more	5,289	8,932
Total loans past due	$8,199	$11,531
Total loans past due to total loans receivable	0.70 %	1.03 %

Past due loans decreased by $3.3 million, or 28.9%, to $8.2 million at December 31, 2016 from $11.5 million at December 31, 2015. Loans past due 90 days or more decreased by $3.6 million, or 40.8%, during the year ended December 31, 2016 while loans past due less than 90 days increased by $311,000, or 12.0%. The $3.6 million decrease in loans past due 90 days or more was primarily due to a decrease in the one- to four-family real estate loans of $1.9 million and multi-family real estate loans of $1.5 million during the year ended December 31, 2016.

Potential Problem Loans. We define potential problem loans as substandard loans which are still accruing interest. We do not necessarily expect to realize losses on all potential problem loans, but we recognize potential problem loans carry a higher probability of default and require additional attention by management. The aggregate principal amounts of potential problem loans as of December 31, 2016 and 2015 were approximately $5.6 million and $8.4 million, respectively. Management believes it has established an adequate allowance for probable loan losses as appropriate under generally accepted accounting principles.

Real Estate Owned.

Total real estate owned decreased by $3.1 million, or 33.4%, to $6.1 million at December 31, 2016, compared to $9.2 million at December 31, 2015. During the year ended December 31, 2016, $4.6 million was transferred from loans to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled $7.0 million. Write-downs totaled $656,000 during the year ended December 31, 2016.

New appraisals received on real estate owned and collateral dependent impaired loans are based upon an "as is value" assumption. During the period of time in which we are awaiting receipt of an updated appraisal, loans evaluated for impairment based upon collateral value are measured by the following:

· Applying an updated adjustment factor to an existing appraisal;

· Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;

· Comparing the estimated current value of the collateral to that of updated sales values experienced on similar collateral;

· Comparing the estimated current value of the collateral to that of updated values seen on current appraisals of similar collateral; and

· Comparing the estimated current value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

We owned 30 properties at December 31, 2016, compared to 69 properties as of December 31, 2015 and 142 properties at December 31, 2014. Habitable real estate owned is managed with the intent of attracting a lessee to generate revenue. Foreclosed properties are transferred to real estate owned at estimated net realizable value, with charge-offs, if any, charged to the allowance for loan losses upon transfer to real estate owned. The fair value is primarily based upon updated appraisals in addition to an analysis of current real estate market conditions.

Allowance for Loan Losses

We establish valuation allowances on loans that are deemed to be impaired. A loan is considered impaired when, based on current information and events, it is probable that we will not be able to collect all amounts due according to the contractual terms of the loan agreement. A valuation allowance is established for an amount equal to the impairment when the carrying amount of the loan exceeds the present value of the expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral.

We also establish valuation allowances based on an evaluation of the various risk components that are inherent in the loan portfolio. The risk components that are evaluated include past loan loss experience; the level of non-performing and classified assets; current economic conditions; volume, growth, and composition of the loan portfolio; adverse situations that may affect the borrower's ability to repay; the estimated value of any underlying collateral; regulatory guidance; and other relevant factors. The allowance is increased by provisions charged to earnings and recoveries of previously charged-off loans and reduced by charge-offs. The appropriateness of the allowance for loan losses is reviewed and approved quarterly by the WaterStone Bank board of directors. The allowance reflects management's best estimate of the amount needed to provide for the probable loss on impaired loans and other inherent losses in the loan portfolio, and is based on a risk model developed and implemented by management and approved by the WaterStone Bank board of directors.

Actual results could differ from this estimate, and future additions to the allowance may be necessary based on unforeseen changes in loan quality and economic conditions. In addition, the Federal Deposit Insurance Corporation and the WDFI, as an integral part of their examination process, periodically review WaterStone Bank's allowance for loan losses. Such regulators have the authority to require WaterStone Bank to recognize additions to the allowance based on their judgments of information available to them at the time of their review or examination.

Any loan that is 90 or more days past due is placed on non-accrual and classified as a non-performing loan. A loan is classified as impaired when it is probable that we will be unable to collect all amounts due in accordance with the terms of the loan agreement. Non-performing loans are then evaluated and accounted for in accordance with generally accepted accounting principles.

The following table sets forth activity in our allowance for loan losses for the years indicated.

	At or for the Year Ended December 31,				
	2016	2015	2014	2013	2012
	(Dollars in Thousands)				
Balance at beginning of year	$16,185	$18,706	$24,264	$31,043	$32,430
Provision for loan losses	380	1,965	1,150	4,532	8,300
Charge-offs:					
Mortgage loans					
One- to four-family	1,003	3,855	2,424	8,706	6,472
Multi-family	489	2,281	5,247	1,640	1,108
Home equity	112	72	191	630	485
Construction and land	3	84	496	1,480	1,668
Commercial real estate	-	45	199	160	1,182
Consumer	-	3	5	-	4
Commercial	-	-	293	8	59
Total charge-offs	1,607	6,340	8,855	12,624	10,978
Recoveries:					
Mortgage loans					

One- to four-family	811	649	1,833	957	667
Multi-family	152	992	189	258	56
Home equity	36	110	14	35	25
Construction and land	72	58	75	51	250
Commercial real estate	-	40	27	-	-
Consumer	-	5	6	6	-
Commercial	-	-	3	6	293
Total recoveries	1,071	1,854	2,147	1,313	1,291
Net charge-offs	536	4,486	6,708	11,311	9,687
Allowance at end of year	$16,029	$16,185	$18,706	$24,264	$31,043
Ratios:					
Allowance for loan losses to non-performing loans at end of year	162.62%	91.94 %	49.21 %	47.61 %	41.58 %
Allowance for loan losses to loans outstanding at end of year	1.36 %	1.45 %	1.71 %	2.22 %	2.74 %
Net charge-offs to average loans outstanding	0.05 %	0.37 %	0.55 %	0.94 %	0.76 %
Current year provision for loan losses to net charge-offs	70.90 %	43.80 %	17.14 %	40.07 %	85.68 %
Net charge-offs to beginning of the year allowance	3.31 %	23.98 %	27.65 %	36.44 %	29.87 %

Allocation of Allowance for Loan Losses. The following table sets forth the allowance for loan losses allocated by loan category, the total loan balances by category, and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	At December 31, 2016			2015			2014		
	Allowance for Loan Losses	% of Loans in Category to Total Loans	% of Allowance in Category to Total Allowance	Allowance for Loan Losses	% of Loans in Category to Total Loans	% of Allowance in Category to Total Allowance	Allowance for Loan Losses	% of Loans in Category to Total Loans	% of Allowance in Category to Total Allowance
	(Dollars in Thousands)								
Real Estate:									
Residential									
One- to four-family	$7,164	33.35 %	44.69 %	$7,763	34.26 %	47.96 %	$9,877	37.62 %	52.80 %
Multi-family	4,809	47.42 %	30.00 %	5,000	49.08 %	30.89 %	5,358	47.70 %	28.64 %
Home equity	364	1.85 %	2.27 %	433	2.18 %	2.68 %	422	2.67 %	2.26 %
Construction and land	1,016	1.54 %	6.34 %	904	1.72 %	5.59 %	687	1.56 %	3.67 %
Commercial real estate	1,951	13.53 %	12.17 %	1,680	10.66 %	10.38 %	1,951	8.65 %	10.43 %
Commercial	713	2.28 %	4.45 %	396	2.07 %	2.45 %	403	1.78 %	2.15 %
Consumer	12	0.03 %	0.07 %	9	0.03 %	0.06 %	8	0.02 %	0.04 %
Total allowance for loan losses	$16,029	100.00 %	100.00 %	$16,185	100.00 %	100.00 %	$18,706	100.00 %	100.00 %

	At December 31, 2013			2012		
	Allowance for Loan Losses	% of Loans in Category to Total Loans	% of Allowance in Category to Total Allowance	Allowance for Loan Losses	% of Loans in Category to Total Loans	% of Allowance in Category to Total Allowance
	(Dollars In Thousands)					
Real Estate:						
Residential						
One- to four-family	$11,549	37.85 %	47.59 %	$17,819	40.65 %	57.40 %
Multi-family	7,211	47.75 %	29.72 %	7,734	45.37 %	24.90 %
Home equity	1,807	3.24 %	7.45 %	2,097	3.22 %	6.76 %
Construction and land	1,613	2.92 %	6.65 %	1,323	2.98 %	4.26 %
Commercial real estate	1,402	6.56 %	5.78 %	1,259	5.78 %	4.06 %
Commercial	648	1.67 %	2.67 %	781	1.99 %	2.52 %
Consumer	34	0.01 %	0.14 %	30	0.01 %	0.10 %
Total allowance for loan losses	$24,264	100.00 %	100.00 %	$31,043	100.00 %	100.00 %

All impaired loans meeting the criteria established by management are evaluated individually, based primarily on the value of the collateral securing each loan and the ability of the borrowers to repay according to the terms of the loans, or based upon an analysis of the present value of the expected future cash flows under the original contract terms as compared to the modified terms in the case of certain troubled debt restructurings. Specific loss allowances are established as required by this analysis. At least once each quarter, management evaluates the appropriateness of the balance of the allowance for loan losses based on several factors some of which are not loan specific, but are reflective of the inherent losses in the loan portfolio. This process includes, but is not limited to, a periodic review of loan collectability in light of historical experience, the nature and volume of loan activity, conditions that may affect the ability of the borrower to repay, underlying value of collateral and economic conditions in our immediate market area. All loans for which a specific loss review is not required are segregated by loan type and a loss allowance is established by using loss experience data and management's judgment concerning other matters it considers significant including trends in non-performing loan balances, impaired loan balances, classified asset balances and the current economic environment. The allowance is allocated to each category of loans based on the results of the above analysis.

The above analysis is both quantitative and subjective, as it requires us to make estimates that are susceptible to revisions as more information becomes available. Although we believe that we have established the allowance at levels appropriate to absorb probable and estimable losses, additions may be necessary if future economic conditions differ substantially from the current environment.

At December 31, 2016, the allowance for loan losses was $16.0 million, compared to $16.2 million at December 31, 2015. As of December 31, 2016, the allowance for loan losses to total loans receivable was 1.36% and 162.62% of non-performing loans, compared to 1.45%, and 91.94%, respectively at December 31, 2015. The decrease in the allowance for loan losses during the year ended December 31, 2016 reflects a continued stabilization in both the quality of the loan portfolio as well as the overall local real estate market. During each period we experienced a stabilization or improvement in a number of key loan-related loan quality metrics, including impaired loans, substandard loans, charge-offs, loans contractually past due and non-accrual loans.

Net charge-offs totaled $536,000, or 0.05% of average loans for the year ended December 31, 2016, compared to $4.5 million, or a 0.37% of average loans for the year ended December 31, 2015. The $4.0 million decrease in net charge-offs was primarily the result of a decrease in charge-offs in all categories except a slight increase in home equity and consumer loans. Net charge-offs related to loans secured by one- to four-family residential loans decreased $3.0 million, or 94.0%, to $192,000 for year ended December 31, 2016, as compared to $3.2 million for the year ended December 31, 2015. Net charge-offs related to loans secured by multi-family residential loans decreased $952,000, or 73.9%, to $337,000 for year ended December 31, 2016, as compared to $1.3 million for the year ended December 31, 2015. Partially offsetting the decreases, net charge-offs related to loans secured by home equity loans increased $114,000, or 300.0%, to $76,000 for year ended December 31, 2016, as compared to a recovery of $38,000 for the year ended December 31, 2015.

Mortgage Banking Activity

In addition to the lending activities previously discussed, we also originate single-family residential mortgage loans for sale in the secondary market through Waterstone Mortgage Corporation. We originated $2.38 billion in mortgage loans held for sale during the year ended December 31, 2016, which was an increase of $392.8 million, or 19.8%, from the $1.99 billion originated during the year ended December 31, 2015. The loans sold volume increased during the year ended December 31, 2016 such that total mortgage banking income increased $21.8 million, or 21.9%, to $121.1 million during the year ended December 31, 2016 compared to $99.3 million during the year ended December 31, 2015. The increase in loan production volume was driven by a 20.1% increase in mortgage purchase products and a 27.4% increase in refinance products. In addition, margins increased for the year ended December 31, 2016 compared to December 31, 2015. We sell loans on both a servicing-released and a servicing retained basis. Waterstone Mortgage Corporation has contracted with a third party to service the loans for which we retain servicing.

Our overall margin can be affected by the mix of both loan type (conventional loans versus governmental) and loan purpose (purchase versus refinance). Conventional loans include loans that conform to Fannie Mae and Freddie Mac standards, whereas governmental loans are those loans guaranteed by the federal government, such as a Federal Housing Authority or U.S. Department of Agriculture loan. Loans originated for the purchase of a residential property, which generally yield a higher margin than loans originated for refinancing existing loans, comprised 82.9% of total originations during the year ended December 31, 2016, compared to 83.7% of total originations during the year ended December 31, 2015. The mix of loan type trended slightly towards more conventional loans and less governmental loans comprising 65.1% and 34.9% of all loan originations, respectively, during the year ended December 31, 2016, compared 66.4% and 33.6% of all loan originations, respectively, during the year ended December 31, 2015.

Investment Activities

Wauwatosa Investments, Inc. is WaterStone Bank's investment subsidiary headquartered in the State of Nevada. Wauwatosa Investments, Inc. manages the back office function for WaterStone Bank's investment portfolio. Our Chief Financial Officer and Treasury Officer are responsible for executing purchases and sales in accordance with our investment policy and monitoring the investment activities of Wauwatosa Investments, Inc. The investment policy is reviewed annually by management and changes to the policy are recommended to and subject to the approval of our board of directors. Authority to make investments under the approved investment policy guidelines is delegated by the board to designated employees. While general investment strategies are developed and authorized by management, the execution of specific actions rests with the Chief Financial Officer and Treasury Officer who may act jointly in performing security trades. The Chief Financial Officer and Treasury Officer are responsible for ensuring that the guidelines and requirements included in the investment policy are followed and that all securities are considered prudent for investment. The Chief Financial Officer and the Treasury Officer are authorized to execute investment transactions (purchases and sales) without the prior approval of the board provided they are within the scope of the established investment policy.

Our investment policy requires that all securities transactions be conducted in a safe and sound manner. Investment decisions are based upon a thorough analysis of each security instrument to determine its quality, inherent risks, fit within our overall asset/liability management objectives, effect on our risk-based capital measurement and prospects for yield and/or appreciation.

Consistent with our overall business and asset/liability management strategy, which focuses on sustaining adequate levels of core earnings, our investment portfolio is comprised primarily of securities that are classified as available for sale. During the year ended December 31, 2016, no investment securities were sold. During the year ended December 31, 2015, one municipal security was sold with a total book value of $991,000 was sold at a gain of $44,000. During the year ended December 31, 2014, no investment securities were sold.

Available for Sale Portfolio

Government Sponsored Enterprise Bonds. At December 31, 2016, our Government sponsored enterprise bond portfolio totaled $2.5 million, all of which were issued by Federal National Mortgage Association ("Fannie Mae") and were classified as available for sale. The weighted average yield on these securities was 1.18% and the weighted average remaining average life was 1.3 years at December 31, 2016. While these securities generally provide lower yields than other investments in our securities investment portfolio, we maintain these investments, to the extent appropriate, for liquidity purposes and prepayment protection. The estimated fair value of our government sponsored enterprise bond portfolio at December 31, 2016 was $3,000 more than the amortized cost of $2.5 million.

Mortgage-backed Securities and Collateralized Mortgage Obligations. We purchase mortgage-backed securities and collateralized mortgage obligations guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. We invest in mortgage-backed securities and collateralized mortgage obligations to achieve positive interest rate spreads with minimal administrative expense, and to lower our credit risk. We regularly monitor the credit quality of this portfolio.

Mortgage-backed securities and collateralized mortgage obligations are created by the pooling of mortgages and the issuance of a security. These securities typically represent a participation interest in a pool of single-family or multi-family mortgages, although we focus our investments on mortgage related securities backed by one- to four-family mortgages. The issuers of such securities pool and resell the participation interests in the form of securities to investors such as WaterStone Bank, and in the case of government agency sponsored issues, guarantee the payment of principal and interest to investors. Mortgage-backed securities and collateralized mortgage obligations generally yield less than the loans that underlie such securities because of the cost of payment guarantees, if any, and credit enhancements. These fixed-rate securities are usually more liquid than individual mortgage loans.

At December 31, 2016, mortgage-backed securities totaled $73.4 million. The mortgage-backed securities portfolio had a weighted average yield of 2.39% and a weighted average remaining life of 3.6 years at December 31, 2016. The estimated fair value of our mortgage-backed securities portfolio at December 31, 2016 was $555,000 more than the amortized cost of $72.9 million. Mortgage-backed securities valued at $67.8 million are pledged as collateral for borrowings at December 31, 2016. A $1.7 million mortgage-backed security is pledged as collateral for mortgage banking activity at December 31, 2016. Investments in mortgage-backed securities involve a risk that actual prepayments may differ from estimated prepayments over the life of the security, which may require adjustments to the amortization of any premium or accretion of any discount relating to such instruments, thereby changing the net yield on such securities. There is also reinvestment risk associated with the cash flows from such securities or if such securities are redeemed by the issuer. In addition, the market value of such securities may be adversely affected in a rising interest rate environment, particularly since all of our mortgage-backed securities have a fixed rate of interest. The relatively short weighted average remaining life of our mortgage-backed security portfolio mitigates our potential risk of loss in a rising interest rate environment.

At December 31, 2016, collateralized mortgage obligations totaled $62.0 million. At December 31, 2016, the collateralized mortgage obligations portfolio consisted entirely of securities backed by government sponsored enterprises or U.S. Government agencies. The collateralized mortgage obligations portfolio had a weighted average yield of 2.11% and a weighted average remaining life of 3.5 years at December 31, 2016. The estimated fair value of our collateralized mortgage obligations portfolio at December 31, 2016 was $295,000 less than the amortized cost of $62.3 million. Collateralized mortgage obligations valued at $16.6 million are pledged as collateral for borrowings at December 31, 2016. A $646,000 collateralized mortgage obligation security is pledged as collateral for mortgage banking activity at December 31, 2016. Investments in collateralized mortgage obligations involve a risk that actual prepayments may differ from estimated prepayments over the life of the security, which may require adjustments to the amortization of any premium or accretion of any discount relating to such instruments, thereby changing the net yield on such securities. There is also reinvestment risk associated with the cash flows from such securities or if such securities are redeemed by the issuer. In addition, the market value of such securities may be adversely affected in a rising interest rate environment, particularly since all of our collateralized mortgage obligations have a fixed rate of interest. The relatively short weighted average remaining life of our collateralized mortgage obligation portfolio mitigates our potential risk of loss in a rising interest rate environment.

Municipal Obligations. These securities consist of obligations issued by school districts, counties and municipalities or their agencies and include general obligation bonds, industrial development revenue bonds and other revenue bonds. Our investment policy requires that such municipal obligations be rated A+ or better by a nationally recognized rating agency at the date of purchase. A security that is downgraded below investment grade will require additional analysis of creditworthiness and a determination will be made to hold or dispose of the investment. At December 31, 2016, our municipal obligations portfolio totaled $70.7 million, all of which was classified as available for sale. The weighted average yield on this portfolio was 3.55% at December 31, 2016, with a weighted average remaining life of 6.6 years. The estimated market value of our municipal obligations bond portfolio at December 31, 2016 was $385,000 more than the amortized cost of $70.3 million. During the year ended December 31, 2012, the Company identified two municipal securities that were deemed to be other-than-temporarily impaired. Both securities were issued by a tax incremental district in a municipality located in Wisconsin.   During the year ended December 31, 2012, the Company's analysis of two securities in this municipality resulted in $100,000 in credit losses that were charged to earnings with respect to these two municipal securities. An additional $17,000 credit loss was charged to earnings during the year ended December 31, 2014 with respect to these two securities as a sale occurred at a discounted price. During the year ended December 31, 2016, one of these municipal issuer bonds matured. The Company received the full principal and interest on the bond and recovered $23,000 of previously recorded other-than-temporary impairment. As of December 31, 2016, the remaining impaired bond had an amortized cost of $116,000 and a total life-to-date impairment of $94,000.

Other Debt Securities. As of December 31, 2016, we held other debt securities with a fair value of $17.0 million and amortized cost of $17.4 million. Other debt securities include a trust preferred security issued by a financial institution and corporate bonds. The weighted average yield on this portfolio is 4.45% at December 31, 2016, with a weighted average remaining life of 15.6 years.

Certificates of Deposit. At December 31, 2016, we held certificates of deposit with a fair value and amortized cost of $1.2 million. The weighted average yield on these securities was 1.47% and the weighted average remaining average life was 1.4 years at December 31, 2016. While these certificates generally provide lower yields than other investments in our securities investment portfolio, we maintain these investments, to the extent appropriate, for liquidity purposes and prepayment protection.

Investment Securities Portfolio.

The following table sets forth the carrying values of our available for sale securities portfolio at the dates indicated.

	At December 31, 2016		2015		2014	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)					
Securities available for sale:						
Mortgage-backed securities	$72,858	$73,413	$95,911	$96,667	$115,670	$117,128
Collateralized mortgage obligations						
Government sponsored enterprise issued	62,297	62,002	70,605	70,428	58,821	59,071
Government sponsored enterprise bonds	2,500	2,503	3,750	3,746	6,750	6,711
Municipal obligations	70,311	70,696	77,509	79,159	76,037	77,108
Other debt securities	17,399	16,950	17,401	16,963	7,404	7,528
Certificates of deposit	1,225	1,231	2,695	2,695	5,880	5,897
Total securities available for sale	$226,590	$226,795	$267,871	$269,658	$270,562	$273,443

The following table sets forth the amortized cost and estimated fair value of securities, by issuer, as of December 31, 2016, that exceeded 10% of our stockholders' equity as of that date.

	At December 31, 2016	
	Amortized Cost	Fair Value
	(In Thousands)	
Fannie Mae	$89,866	$90,010
Freddie Mac	$43,041	$43,143

Portfolio Maturities and Yields. The composition and maturities of the securities portfolio at December 31, 2016 are summarized in the following table. Maturities are based on the final contractual payment dates and do not reflect the impact of prepayments or early redemptions that may occur. Municipal obligation yields have not been adjusted to a tax-equivalent basis. Certain mortgage related securities have interest rates that are adjustable and will reprice annually within the various maturity ranges. These repricing schedules are not reflected in the table below.

	One Year or Less		More than One Year through Five Years		More than Five Years through Ten Years		More than Ten Years		Total Securities	
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
	(Dollars in Thousands)									
Securities available for sale:	$370	4.91 %	$65,925	2.32 %	$2,330	2.72 %	$4,233	3.16 %	$72,858	2.39 %

Mortgage-backed securities										
Collateralized mortgage obligations										
Government sponsored enterprise issued	299	3.26 %	59,462	2.12 %	2,536	1.76 %	-	-	62,297	2.11 %
Government sponsored enterprise bonds	-	-	2,500	1.18 %	-	-	-	-	2,500	1.18 %
Municipal obligations	8,492	2.22 %	12,457	2.79 %	41,332	3.80 %	8,030	4.84 %	70,311	3.55 %
Other debt securities	-	-	5,007	2.70 %	-	-	12,392	5.16 %	17,399	4.45 %
Certificates of deposit	245	1.45 %	980	1.84 %	-	-	-	-	1,225	1.47 %
Total securities available for sale	$9,406	2.34 %	$146,331	2.27 %	$46,198	3.64 %	$24,655	4.71 %	$226,590	2.81 %

Sources of Funds

General. Deposits have traditionally been our primary source of funds for use in lending and investment activities. We also rely on advances from the Federal Home Loan Bank of Chicago and borrowings from other commercial banks in the form of repurchase agreements collateralized by investment securities. In addition to deposits and borrowings, we derive funds from scheduled loan payments, investment maturities, loan prepayments, retained earnings and income on earning assets. While scheduled loan payments and income on earning assets are relatively stable sources of funds, deposit inflows and outflows can vary widely and are influenced by prevailing market interest rates, economic conditions and competition from other financial institutions.

Deposits. A majority of our depositors are persons who work or reside in Milwaukee and Waukesha Counties and, to a lesser extent, other southeastern Wisconsin communities. We offer a selection of deposit instruments, including checking, savings, money market deposit accounts, and fixed-term certificates of deposit. Deposit account terms vary, with the principal differences being the minimum balance required, the amount of time the funds must remain on deposit and the interest rate. As of December 31, 2016, certificates of deposit comprised 70.2% of total customer deposits, and had a weighted average cost of 1.03% on that date. Our reliance on certificates of deposit has resulted in a higher cost of funds than would otherwise be the case if demand deposits, savings and money market accounts made up a larger part of our deposit base. Development of our branch network and expansion of our commercial products and services and aggressively seeking lower cost savings, checking and money market accounts are expected to result in decreased reliance on higher-cost certificates of deposit.

Interest rates paid, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market rates, liquidity requirements, rates paid by competitors and growth goals. To attract and retain deposits, we rely upon personalized customer service, long-standing relationships and competitive interest rates. We also provide remote deposit capture, internet banking and mobile banking.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and other prevailing interest rates and competition. The variety of deposit accounts that we offer allows us to be competitive in obtaining funds and responding to changes in consumer demand. Based on historical experience, management believes our deposits are relatively stable. The ability to attract and maintain money market accounts and certificates of deposit, and the rates paid on these deposits, has been and will continue to be significantly affected by market conditions. At December 31, 2016 and December 31, 2015, $666.6 million and $650.1 million of our deposit accounts were certificates of deposit, of which $469.3 million and $508.4 million, respectively, had maturities of one year or less.

Deposits increased by $56.1 million, or 6.3%, from December 31, 2015 to December 31, 2016. The increase in deposits was the result of a $39.5 million, or 16.2%, increase in total transaction accounts and a $16.5 million, or 2.5%, increase in time deposits. The Company had no deposits obtained from brokers as of December 31, 2016 and December 31, 2015.

The following table sets forth the distribution of total deposit accounts, by account type, at the dates indicated.

	At December 31,														
	2016					2015					2014				
	Balance	Percent		Weighted Average Rate		Balance	Percent		Weighted Average Rate		Balance	Percent		Weighted Average Rate	
	(Dollars in Thousands)														
Deposit type:															
Demand deposits	$78,393	8.26	%	0.00	%	$69,170	7.74	%	0.00	%	$63,885	7.39	%	0.00	%

NOW accounts	41,978	4.42 %	0.05 %	33,503	3.75 %	0.06 %	28,277	3.27 %	0.06 %
Savings	62,514	6.58 %	0.04 %	59,256	6.63 %	0.04 %	58,783	6.80 %	0.04 %
Money market	99,942	10.53 %	0.41 %	81,375	9.11 %	0.41 %	60,380	6.99 %	0.14 %
Total transaction accounts	282,827	29.79 %	0.16 %	243,304	27.23 %	0.15 %	211,325	24.45 %	0.06 %
Certificates of deposit	666,584	70.21 %	1.03 %	650,057	72.77 %	0.97 %	652,635	75.55 %	0.83 %
Total deposits	$949,411	100.00 %	0.77 %	$893,361	100.00 %	0.75 %	$863,960	100.00 %	0.64 %

	At December 31, 2013			2012		
	Balance	Percent	Weighted Average Rate	Balance	Percent	Weighted Average Rate
	(Dollars in Thousands)					
Deposit type:						
Demand deposits	$45,850	3.68 %	0.00 %	$39,767	4.23 %	0.00 %
NOW accounts	47,425	3.81 %	0.03 %	44,373	4.72 %	0.03 %
Savings	451,476	36.27 % (1)	0.01 %	54,837	5.84 %	0.10 %
Money market	62,240	5.00 %	0.11 %	63,616	6.77 %	0.15 %
Total transaction accounts	606,991	48.76 % (1)	0.02 %	202,593	21.56 %	0.08 %
Certificates of deposit	637,750	51.24 %	0.69 %	736,920	78.44 %	0.83 %
Total deposits	$1,244,741	100.00 % (1)	0.36 %	$939,513	100.00 %	0.67 %

(1) As of December 31, 2013, savings accounts included $388.7 million in deposits from our second-step offering. These deposits had a stated rate of 0.01%. Exclusive of these deposits the weighted average rate of the remaining savings accounts, total transaction accounts and total deposits was 0.04%, 0.05% and 0.53%, respectively.

At December 31, 2016, the aggregate balance of certificates of deposit of $100,000 or more was approximately $237.2 million. The following table sets forth the maturity of those certificates at December 31, 2016.

	(In Thousands)
Due in:	
Three months or less	$ 34,173
Over three months through six months	37,188
Over six months through 12 months	97,862
Over 12 months	67,990
Total	237,213

Borrowings. Our borrowings at December 31, 2016 consist of $295.0 million in advances from the Federal Home Loan Bank of Chicago, $84.0 million in repurchase agreements collateralized by investment securities and $8.2 million outstanding balance in short-term repurchase agreements used to finance loans held for sale. The following table sets forth information concerning balances and interest rates on borrowings at the dates and for the periods indicated.

	At or For the Year Ended December 31,		
	2016	2015	2014
Borrowings:	(Dollars in Thousands)		
Balance outstanding at end of year	$387,155	$441,203	$434,000
Weighted average interest rate at the end of year	2.27 %	3.88 %	3.89 %
Maximum amount of borrowings outstanding at any month end during the year	$414,745	$474,000	$454,686
Average balance outstanding during the year	$381,803	$437,964	$442,731
Weighted average interest rate during the year	3.39 %	3.94 %	3.93 %

Subsidiary Activities

Waterstone Financial currently has one wholly-owned subsidiary, WaterStone Bank, which in turn has three wholly-owned subsidiaries. Wauwatosa Investments, Inc., which holds and manages our investment portfolio, is located and incorporated in Nevada. Waterstone Mortgage Corporation is a mortgage banking business incorporated in Wisconsin. Main Street Real Estate Holdings, LLC is an inactive Wisconsin limited liability corporation and previously owned WaterStone Bank office facilities and held WaterStone Bank office facility leases.

Wauwatosa Investments, Inc. Established in 1998, Wauwatosa Investments, Inc. operates in Nevada as WaterStone Bank's investment subsidiary. This wholly-owned subsidiary owns and manages the majority of the consolidated investment portfolio. It has its own board of directors currently comprised of its President, the WaterStone Bank Chief Financial Officer, Treasury Officer and the Chairman of Waterstone Financial's board of directors.

Waterstone Mortgage Corporation. Acquired in February 2006, Waterstone Mortgage Corporation is a mortgage banking business with offices in 22 states. It has its own board of directors currently comprised of its President, its Chief Operating Officer, its Chief Financial Officer, the WaterStone Bank Chief Executive Officer, Chief Financial Officer and Executive Vice President and General Counsel.

Main Street Real Estate Holdings, LLC. Established in 2002, Main Street Real Estate Holdings, LLC was established to acquire and hold WaterStone Bank office and retail facilities, both owned and leased. Main Street Real Estate Holdings, LLC currently conducts real estate broker activities limited to real estate owned.

Personnel

As of December 31, 2016, we had 895 full-time equivalent employees. A total of 178 are WaterStone Bank employees and 717 are employees of Waterstone Mortgage Corporation. Our employees are not represented by any collective bargaining group. Management believes that we have good working relations with our employees.

Supervision and Regulation

General

WaterStone Bank is a stock savings bank organized under the laws of the State of Wisconsin. The lending, investment, and other business operations of WaterStone Bank are governed by Wisconsin law and regulations, as well as applicable federal law and regulations, and WaterStone Bank is prohibited from engaging in any operations not authorized by such laws and regulations. WaterStone Bank is subject to extensive regulation, supervision and examination by the WDFI and by the Federal Deposit Insurance Corporation. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance fund and depositors, and not for the protection of security holders. WaterStone Bank also is regulated to a lesser extent by the Federal Reserve Board, governing reserves to be maintained against deposits and other matters. WaterStone Bank also is a member of and owns stock in the Federal Home Loan Bank of Chicago, which is one of the 11 regional banks in the Federal Home Loan Bank System.

Under this system of regulation, the regulatory authorities have extensive discretion in connection with their supervisory, enforcement, rulemaking and examination activities and policies, including rules or policies that: establish minimum capital levels; restrict the timing and amount of dividend payments; govern the classification of assets; determine the adequacy of loan loss reserves for regulatory purposes; and establish the timing and amounts of assessments and fees. Moreover, as part of their examination authority, the banking regulators assign numerical ratings to banks and savings institutions relating to capital, asset quality, management, liquidity, earnings and other factors. These ratings are inherently subjective and the receipt of a less than satisfactory rating in one or more categories may result in enforcement action by the banking regulators against a financial institution. A less than satisfactory rating may also prevent a financial institution, such as WaterStone Bank or its holding company, from obtaining necessary regulatory approvals to access the capital markets, pay dividends, acquire other financial institutions or establish new branches.

In addition, we must comply with significant anti-money laundering and anti-terrorism laws and regulations, Community Reinvestment Act laws and regulations, and fair lending laws and regulations. Government agencies have the authority to impose monetary penalties and other sanctions on institutions that fail to comply with these laws and regulations, which could significantly affect our business activities, including our ability to acquire other financial institutions or expand our branch network.

As a savings and loan holding company, Waterstone Financial is required to comply with the rules and regulations of the Federal Reserve Board. It is required to file certain reports with the Federal Reserve Board and is subject to examination by and the enforcement authority of the Federal Reserve Board. Waterstone Financial is also subject to the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

Any change in applicable laws or regulations, whether by the WDFI, the Federal Deposit Insurance Corporation, the Federal Reserve Board or Congress, could have a material adverse impact on the operations and financial performance of Waterstone Financial, WaterStone Bank and Waterstone Mortgage Corporation.

Set forth below is a brief description of material regulatory requirements that are or will be applicable to WaterStone Bank, Waterstone Mortgage Corporation and Waterstone Financial. The description is limited to certain material aspects of the statutes and regulations addressed, and is not intended to be a complete description of such statutes and regulations and their effects on WaterStone Bank, Waterstone Mortgage Corporation and Waterstone Financial.

Intrastate and Interstate Merger and Branching Activities

Wisconsin Law and Regulation. Any Wisconsin savings bank meeting certain requirements may, upon approval of the WDFI, establish one or more branch offices in the state of Wisconsin or the states of Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, and Ohio. In addition, upon WDFI approval, a Wisconsin savings bank may establish a branch office in any other state as the result of a merger or consolidation.

Federal Law and Regulation. The Interstate Banking Act permits the federal banking agencies to, under certain circumstances, approve acquisition transactions between banks located in different states, regardless of whether an acquisition would be prohibited under state law. The Interstate Banking Act, as amended, authorizes de novo branching into another state at locations at which banks chartered by the host state could establish a branch. Additionally, the IBA authorizes branching by merger, subject to certain state law limitations.

Loans and Investments

Wisconsin Law and Regulations. Under Wisconsin law and regulation, WaterStone Bank is authorized to make, invest in, sell, purchase, participate or otherwise deal in mortgage loans or interests in mortgage loans without geographic restriction, including loans made on the security of residential and commercial property. Wisconsin savings banks also may lend funds on a secured or unsecured basis for business, commercial or agricultural purposes, provided the total of all such loans does not exceed 20% of the savings bank's total assets, unless the WDFI authorizes a greater amount. Loans are subject to certain other limitations, including percentage restrictions based on total assets.

Wisconsin savings banks may invest funds in certain types of debt and equity securities, including obligations of federal, state and local governments and agencies. Subject to prior approval of the WDFI, compliance with capital requirements and certain other restrictions, Wisconsin savings banks may invest in residential housing development projects. Wisconsin savings banks may also invest in service corporations or subsidiaries with the prior approval of the WDFI, subject to certain restrictions. Similarly, the line of credit that WaterStone Bank provides to Waterstone Mortgage Corporation is subject to the approval of the WDFI.

Wisconsin savings banks may make loans and extensions of credit, both direct and indirect, to one borrower in amounts up to 15% of the savings bank's capital plus an additional 10% for loans fully secured by readily marketable collateral. In addition, and notwithstanding the 15% of capital and additional 10% of capital limitations set forth above, Wisconsin savings banks may make loans to one borrower, or a related group of borrowers, for any purpose in an amount not to exceed $500,000, or to develop domestic residential housing units in an amount not to exceed the lesser of $30 million or 30% of the savings bank's capital, subject to certain conditions. At December 31, 2016, WaterStone Bank did not have any loans which exceeded the "loans-to-one borrower" limitations.

In addition, under Wisconsin law, WaterStone Bank must qualify for and maintain a level of qualified thrift investments equal to 60% of its assets as prescribed in Section 7701(a)(19) of the Internal Revenue Code of 1986, as amended. A Wisconsin savings bank that fails to meet this qualified thrift lender test becomes subject to certain operating restrictions otherwise applicable only to commercial banks. At December 31, 2016, WaterStone Bank maintained 91.1% of its assets in qualified thrift investments and therefore met the qualified thrift lender requirement.

Federal Law and Regulation. Federal Deposit Insurance Corporation regulations also govern the equity investments of WaterStone Bank and, notwithstanding Wisconsin law and regulations, Federal Deposit Insurance Corporation regulations prohibit WaterStone Bank from making certain equity investments and generally limit WaterStone Bank's equity investments to those that are permissible for national banks and their subsidiaries. Under Federal Deposit Insurance Corporation regulations, WaterStone Bank must obtain prior Federal Deposit Insurance Corporation approval before directly, or indirectly through a majority-owned subsidiary, engaging "as principal" in any activity that is not permissible for a national bank unless certain exceptions apply. The activity regulations provide that state banks that meet applicable minimum capital requirements would be permitted to engage in certain activities that are not permissible for national banks, including certain real estate and securities activities conducted through subsidiaries. The Federal Deposit Insurance Corporation will not approve an activity that it determines presents a significant risk to the Federal Deposit Insurance Corporation insurance fund. The current activities of WaterStone Bank and its subsidiaries are permissible under applicable federal regulations.

Loans to, and other transactions with, affiliates of WaterStone Bank, such as Waterstone Financial, are restricted by the Federal Reserve Act and regulations issued by the Federal Reserve Board thereunder. See "—Transactions with Affiliates and Insiders" below.

Lending Standards

Wisconsin Law and Regulation. Wisconsin law and regulations issued by the WDFI impose on Wisconsin savings banks certain fairness in lending requirements and prohibit savings banks from discriminating against a loan applicant based upon the applicant's physical condition, developmental disability, sex, marital status, race, color, creed, national origin, religion or ancestry.

Federal Law and Regulation. The federal banking agencies have adopted uniform regulations prescribing standards for extensions of credit that are secured by liens on interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate. Under the joint regulations adopted by the federal banking agencies, all insured depository institutions, such as WaterStone Bank, must adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens or interests in real estate or are made for the purpose of financing permanent improvements to real estate. These policies must establish loan portfolio diversification standards, prudent underwriting standards (including loan-to-value limits) that are clear and measurable, loan administration procedures, and loan documentation, approval and reporting requirements. The real estate lending policies must reflect consideration of the Interagency Guidelines for Real Estate Lending Policies that have been adopted by the federal bank regulators.

The Interagency Guidelines, among other things, require a depository institution to establish internal loan-to-value limits for real estate loans that are not in excess of the following supervisory limits:

- for loans secured by raw land, the supervisory loan-to-value limit is 65% of the value of the collateral;
- for land development loans (i.e., loans for the purpose of improving unimproved property prior to the erection of structures), the supervisory limit is 75%;
- for loans for the construction of commercial, over four-family or other non-residential property, the supervisory limit is 80%;
- for loans for the construction of one- to four-family properties, the supervisory limit is 85%; and
- for loans secured by other improved property (e.g., farmland, completed commercial property and other income-producing property, including non-owner occupied, one- to four-family property), the limit is 85%.

Although no supervisory loan-to-value limit has been established for owner-occupied, one- to four-family and home equity loans, the Interagency Guidelines state that for any such loan with a loan-to-value ratio that equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Deposits

Wisconsin Law and Regulation. Under Wisconsin law, WaterStone Bank is permitted to establish deposit accounts and accept deposits. WaterStone Bank's board of directors, or its designee, determines the rate and amount of interest to be paid on or credited to deposit accounts subject to Federal Deposit Insurance Corporation limitations.

Deposit Insurance

Wisconsin Law and Regulation. Under Wisconsin law, WaterStone Bank is required to obtain and maintain insurance on its deposits from a deposit insurance corporation. The deposits of WaterStone Bank are insured up to the applicable limits by the Federal Deposit Insurance Corporation.

Federal Law and Regulation. WaterStone Bank is a member of the Deposit Insurance Fund, which is administered by the Federal Deposit Insurance Corporation. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation, generally up to a maximum of $250,000.

The Federal Deposit Insurance Corporation imposes an assessment against all depository institutions. An institution's assessment rate depends upon the perceived risk of the institution to the Deposit Insurance Fund, with less risky institutions paying lower rates. Currently, assessments for institutions of less than $10 billion of total assets are based on financial measures and supervisory ratings derived from statistical models estimating the probability of failure within three years. That system was effective July 1, 2016 and replaces a system under which each institution was assigned to a risk category. Assessment rates (inclusive of possible adjustments) currently range from 1.5 to 30 basis points of each institution's total assets less tangible capital. The current scale, also effective July 1, 2016, is a reduction from the previous range of 2.5 to 45 basis points. The Federal Deposit Insurance Corporation may increase or decrease the range of assessments uniformly, except that no adjustment can deviate more than two basis points from the base assessment rate without notice and comment rulemaking. The existing system represents a change, required by the Dodd-Frank Act, from the Federal Deposit Insurance Corporation's prior practice of basing the assessment on an institution's aggregate deposits.

The Federal Deposit Insurance Corporation has the authority to increase insurance assessments. A significant increase in insurance premiums would have an adverse effect on the operating expenses and results of operations of WaterStone Bank. We cannot predict what deposit insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the Federal Deposit Insurance Corporation upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the Federal Deposit Insurance Corporation. We do not know of any practice, condition or violation that might lead to termination of deposit insurance.

In addition to the Federal Deposit Insurance Corporation assessments, the Financing Corporation (FICO) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2016, the annualized FICO assessment was equal to 0.60 basis points of total assets less tangible capital.

Capitalization

Wisconsin Law and Regulation. Wisconsin savings banks are required to maintain a minimum capital to assets ratio of 6% and must maintain total capital necessary to ensure the continuation of insurance of deposit accounts by the Federal Deposit Insurance Corporation. If the WDFI determines that the financial condition, history, management or earning prospects of a savings bank are not adequate, the WDFI may require a higher minimum capital level for the savings bank. If a Wisconsin savings bank's capital ratio falls below the required level, the WDFI may direct the savings bank to adhere to a specific written plan established by the WDFI to correct the savings bank's capital deficiency, as well as a number of other restrictions on the savings bank's operations, including a prohibition on the declaration of dividends. At December 31, 2016 and 2015, WaterStone Bank's capital to assets ratio, as calculated under Wisconsin law, was 20.90% and 20.43%, respectively.

Federal Law and Regulation. Federal regulations require Federal Deposit Insurance Corporation insured depository institutions to meet several minimum capital standards: a common equity Tier 1 capital to risk-based assets ratio of 4.5%, a Tier 1 capital to risk-based assets ratio of 6.0%, a total capital to risk-based assets of 8.0%, and a 4.0% Tier 1 capital to total assets leverage ratio. The existing capital requirements were effective January 1, 2015 and are the result of a final rule implementing regulatory amendments based on recommendations of the Basel Committee on Banking Supervision and certain requirements of the Dodd-Frank Act.

Common equity Tier 1 capital is generally defined as common stockholders' equity and retained earnings. Tier 1 capital is generally defined as common equity Tier 1 and additional Tier 1 capital. Additional Tier 1 capital includes certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries. Total capital includes Tier 1 capital (common equity Tier 1 capital plus additional Tier 1 capital) and Tier 2 capital. Tier 2 capital is comprised of capital instruments and related surplus, meeting specified requirements, and may include cumulative preferred stock and long-term perpetual preferred stock, mandatory convertible securities, intermediate preferred stock and subordinated debt. Also included in Tier 2 capital is the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and, for institutions that have exercised an opt-out election regarding the treatment of Accumulated Other Comprehensive Income ("AOCI"), up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Institutions that have not exercised the AOCI opt-out have AOCI incorporated into common equity Tier 1 capital (including unrealized gains and losses on available-for-sale-securities). Calculation of all types of regulatory capital is subject to deductions and adjustments specified in the regulations.
In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, all assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests) are

multiplied by a risk weight factor assigned by the regulations based on the risks believed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. For example, a risk weight of 0% is assigned to cash and U.S. government securities, a risk weight of 50% is generally assigned to prudently underwritten first lien one to four- family residential mortgages, a risk weight of 100% is assigned to commercial and consumer loans, a risk weight of 150% is assigned to certain past due loans and a risk weight of between 0% to 600% is assigned to permissible equity interests, depending on certain specified factors.

In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted asset above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented at 2.5% on January 1, 2019.

In assessing an institution's capital adequacy, the Federal Deposit Insurance Corporation takes into consideration, not only these numeric factors, but qualitative factors as well, including the bank's exposure to interest rate risk. The Federal Deposit Insurance Corporation has the authority to establish higher capital requirements for individual institutions where deemed necessary due to a determination that an institution's capital level is, or is likely to become, inadequate in light of particular circumstances.

Safety and Soundness Standards

Each federal banking agency, including the Federal Deposit Insurance Corporation, has adopted guidelines establishing general standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, asset quality, earnings and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder.

Prompt Corrective Regulatory Action

Federal bank regulatory authorities are required to take "prompt corrective action" with respect to institutions that do not meet minimum capital requirements. For these purposes, the statute establishes five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Under the regulations, as amended effective January 1, 2015 to incorporate the previously mentioned amendments to the regulatory capital requirements, a bank is deemed to be (i) "well capitalized" if it has total risk-based capital of 10.0% or more, has a Tier 1 risk-based capital ratio of 8.0% or more, has a Tier 1 leverage capital ratio of 5.0% or more and a common equity Tier 1 ratio of 6.5% or more, and is not subject to any written capital order or directive; (ii) "adequately capitalized" if it has a total risk-based capital ratio of 8.0% or more, a Tier 1 risk-based capital ratio of 6.0% or more, a Tier 1 leveraged capital ratio of 4.0% or more and a common equity Tier 1 ratio of 4.5% or more, and does not meet the definition of "well capitalized"; (iii) "undercapitalized" if it has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio that is less than 6.0%, a Tier 1 leverage capital ratio that is less than 4.0% or a common equity Tier 1 ratio of less than 4.5%; (iv) "significantly undercapitalized" if it has a total risk-based capital ratio that is less than 6.0% and a Tier 1 risk-based capital ratio that is less than 4.0% or a common equity Tier 1 ratio of less than 3.0%; and (v) "critically undercapitalized" if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

Federal law and regulations also specify circumstances under which a federal banking agency may reclassify a well capitalized institution as adequately capitalized and may require an institution classified as less than well capitalized to comply with supervisory actions as if it were in the next lower category (except that the Federal Deposit Insurance Corporation may not reclassify a significantly undercapitalized institution as critically undercapitalized).

The Federal Deposit Insurance Corporation may order savings banks that have insufficient capital to take corrective actions. For example, a savings bank that is categorized as "undercapitalized" is subject to growth limitations and is required to submit a capital restoration plan, and a holding company that controls such a savings bank is required to guarantee that the savings bank complies with the restoration plan. A "significantly undercapitalized" savings bank may be subject to additional restrictions. Savings banks deemed by the Federal Deposit Insurance Corporation to be "critically undercapitalized" would be subject to the appointment of a receiver or conservator.

At December 31, 2016, WaterStone Bank was considered well-capitalized with a common equity Tier 1 ratio of 28.29%, Tier 1 leverage ratio of 21.17%, a Tier 1 risk-based ratio of 28.29% and a total risk based capital ratio of 29.50%.

Dividends

Under Wisconsin law and applicable regulations, a Wisconsin savings bank that meets its regulatory capital requirements may declare dividends on capital stock based upon net profits to the Parent company, provided that its paid-in surplus equals its capital stock. If the paid-in surplus of the savings bank does not equal its capital stock, the board of directors may not declare a dividend unless at least 10% of the net profits of the preceding half year, in the case of quarterly or semi-annual dividends, or 10% of the net profits of the preceding year, in the case of annual dividends, has been transferred to paid-in surplus. In addition, prior WDFI approval is required before dividends exceeding 50% of net profits for any calendar year may be declared and before a stock dividend may be declared out of retained earnings. Under WDFI regulations, a Wisconsin savings bank which has converted from mutual to stock form also is prohibited from paying a dividend on its capital stock if the payment causes the regulatory capital of the savings bank to fall below the amount required for its liquidation account.

The Federal Deposit Insurance Corporation has the authority to prohibit WaterStone Bank from paying dividends if, in its opinion, the payment of dividends would constitute an unsafe or unsound practice in light of the financial condition of WaterStone Bank. Institutions may not pay dividends if they would be "undercapitalized" following payment of the dividend within the meaning of the prompt corrective action regulations.

Information with respect to dividends declared and paid by Waterstone Financial is disclosed under Holding Company Dividends.

Liquidity and Reserves

Wisconsin Law and Regulation. Under WDFI regulations, all Wisconsin savings banks are required to maintain a certain amount of their assets as liquid assets, consisting of cash and certain types of investments. The exact amount of assets a savings bank is required to maintain as liquid assets is set by the WDFI, but generally ranges from 4% to 15% of the savings bank's average daily balance of net withdrawable accounts plus short-term borrowings (the "Required Liquidity Ratio"). At December 31, 2016, WaterStone Bank's Required Liquidity Ratio was 8.0%, and WaterStone Bank was in compliance with this requirement. In addition, 50% of the liquid assets maintained by a Wisconsin savings bank must consist of "primary liquid assets," which are defined to include securities issued by the United States Government and United States Government agencies. At December 31, 2016, WaterStone Bank was in compliance with this requirement.

Federal Law and Regulation. Under federal law and regulations, WaterStone Bank is required to maintain sufficient liquidity to ensure safe and sound banking practices. Regulation D, promulgated by the Federal Reserve Board, imposes reserve requirements on all depository institutions, including WaterStone Bank, which maintain transaction accounts or non-personal time deposits. Checking accounts, NOW accounts, Super NOW checking accounts, and certain other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits (including certain money market deposit accounts) at a savings institution. For 2016, a depository institution is required to maintain average daily reserves equal to 3% on the first $110.2 million of transaction accounts, plus 10% of that portion of total transaction accounts in excess of $110.2 million. The first $15.2 million of otherwise reservable balances (subject to adjustment by the Federal Reserve Board) are exempt from the reserve requirements. These percentages and threshold limits are subject to adjustment by the Federal Reserve Board. Savings institutions have authority to borrow from the Federal Reserve's "discount window," but Federal Reserve policy generally requires savings institutions to exhaust all other sources before borrowing from the Federal Reserve. As of December 31, 2016, WaterStone Bank met its Regulation D reserve requirements.

Transactions with Affiliates and Insiders

Wisconsin Law and Regulation. Under Wisconsin law, a savings bank may not make a loan to a person owning 10% or more of its stock, an affiliated person, agent, or attorney of the savings bank, either individually or as an agent or partner of another, except as under the rules of the WDFI and regulations of the Federal Deposit Insurance Corporation. In addition, unless the prior approval of the WDFI is obtained, a savings bank may not purchase, lease or acquire a site for an office building or an interest in real estate from an affiliated person, including a shareholder owning more than 10% of its capital stock, or from any firm, corporation, entity or family in which an affiliated person or 10% shareholder has a direct or indirect interest.

Federal Law and Regulation. Sections 23A and 23B of the Federal Reserve Act govern transactions between an insured savings bank, such as WaterStone Bank, and any of its affiliates, including Waterstone Financial. The Federal Reserve Board has adopted Regulation W, which comprehensively implements and interprets Sections 23A and 23B, in part by codifying prior Federal Reserve Board interpretations under Sections 23A and 23B.

An affiliate of a savings bank is any company or entity that controls, is controlled by or is under common control with the savings bank. A subsidiary of a savings bank that is not also a depository institution or a "financial subsidiary" under federal law is not treated as an affiliate of the savings bank for the purposes of Sections 23A and 23B; however, the Federal Deposit Insurance Corporation has the discretion to treat subsidiaries of a savings bank as affiliates on a case-by-case basis. Sections 23A and 23B limit the extent to which a savings bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such savings bank's capital stock and surplus, and limit all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus. The statutory sections also require that all such transactions be on terms that are consistent with safe and sound banking practices. The term "covered transaction" includes the making of loans, purchase of assets, issuance of guarantees and other similar types of transactions. Further, most loans and other extensions of credit by a savings bank to any of its affiliates must be secured by collateral in amounts ranging from 100% to 130% of the loan amounts, depending on the type of collateral. In addition, any covered transaction by a savings bank with an affiliate and any purchase of assets or services by a savings bank from an affiliate must be on terms that are substantially the same, or at least as favorable, to the savings bank as those that would be provided to a non-affiliate.

A savings bank's loans to its executive officers, directors, any owner of more than 10% of its stock (each, an insider) and any of certain entities affiliated with any such person (an insider's related interest) are subject to the conditions and limitations imposed by Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O thereunder. Under these restrictions, the aggregate amount of the loans to any insider and the insider's related interests may not exceed the loans-to-one-borrower limit applicable to national banks, which is comparable to the loans-to-one-borrower limit applicable to WaterStone Bank's loans. All loans by a savings bank to its insiders and insiders' related interests in the aggregate may not exceed the savings bank's unimpaired capital and unimpaired surplus. With certain exceptions, loans to an executive officer, other than loans for the education of the officer's children and certain loans secured by the officer's residence, may not exceed the greater of $25,000 or 2.5% of the savings bank's unimpaired capital and unimpaired surplus, but in no event more than $100,000. Regulation O also requires that any proposed loan to an insider or a related interest of that insider be approved in advance by a majority of the board of directors of the savings bank, with any interested director not participating in the voting, if such loan, when aggregated with any existing loans to that insider and the insider's related interests, would exceed either $500,000 or the greater of $25,000 or 5% of the savings bank's unimpaired capital and surplus. Generally, such loans must be made on substantially the same terms as, and follow credit underwriting procedures that are no less stringent than, those that are prevailing at the time for comparable transactions with other persons and must not present more than a normal risk of collectability.

An exception to this requirement is made for extensions of credit made pursuant to a benefit or compensation plan of a bank that is widely available to employees of the savings bank and that does not give any preference to insiders of the bank over other employees of the bank. Consistent with these requirements, the Bank offered employees special terms for home mortgage loans on their principal residences. Effective April 1, 2006, this program was discontinued for new loan originations. Under the terms of the discontinued program, the employee interest rate is based on the Bank's cost of funds on December 31st of the immediately preceding year and is adjusted annually. At December 31, 2016, the rate of interest on an employee rate mortgage loan was 1.72%, compared to the weighted average rate of 4.25% on all single family mortgage loans. This rate decreased to 1.19% effective March 1, 2017. Employee rate mortgage loans totaled $1.5 million, or 0.4%, of our residential mortgage loan portfolio on December 31, 2016.

Transactions between Bank Customers and Affiliates

Under Wisconsin and federal laws and regulations, Wisconsin savings banks, such as WaterStone Bank, are subject to the prohibitions on certain tying arrangements. A savings bank is prohibited, subject to certain exceptions, from extending credit to or offering any other service to a customer, or fixing or varying the consideration for such extension of credit or service, on the condition that such customer obtain some additional service from the institution or certain of its affiliates or not obtain services of a competitor of the institution.

Examinations and Assessments

WaterStone Bank is required to file periodic reports with and is subject to periodic examinations by the WDFI and FDIC. Federal regulations require annual on-site examinations for all depository institutions except certain well-capitalized and highly rated institutions with assets of less than $500 million which are examined every 18 months. Recent legislation extended the 18 month examination cycle to qualifying institutions of less than $1 billion in assets, subject to agency implementing regulations. WaterStone Bank is required to pay examination fees and annual assessments to fund its supervision.

Customer Privacy

Under Wisconsin and federal law and regulations, savings banks, such as WaterStone Bank, are required to develop and maintain privacy policies relating to information on its customers, restrict access to and establish procedures to protect customer data. Applicable privacy regulations further restrict the sharing of non-public customer data with non-affiliated parties if the customer requests.

Community Reinvestment Act

Under the Community Reinvestment Act, WaterStone Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The Community Reinvestment Act does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the Community Reinvestment Act. The Community Reinvestment Act requires the Federal Deposit Insurance Corporation, in connection with its examination of WaterStone Bank, to assess WaterStone Bank's record of meeting the credit needs of its community and to take that record into account in the Federal Deposit Insurance Corporation's evaluation of certain applications by WaterStone Bank. For example, the regulations specify that a bank's Community Reinvestment Act performance will be considered in its expansion (e.g., branching) proposals and may be the basis for approving, denying or conditioning the approval of an application. As of the date of its most recent regulatory examination, WaterStone Bank was rated "satisfactory" with respect to its Community Reinvestment Act compliance.

Federal Home Loan Bank System

The Federal Home Loan Bank System, consisting of 11 Federal Home Loan Banks, is under the jurisdiction of the Federal Housing Finance Board. The designated duties of the Federal Housing Finance Board are to supervise the Federal Home Loan Banks; ensure that the Federal Home Loan Banks carry out their housing finance mission; ensure that the Federal Home Loan Banks remain adequately capitalized and able to raise funds in the capital markets; and ensure that the Federal Home Loan Banks operate in a safe and sound manner.

WaterStone Bank, as a member of the Federal Home Loan Bank of Chicago, is required to acquire and hold shares of capital stock in the Federal Home Loan Bank of Chicago in specified amounts. WaterStone Bank is in compliance with this requirement with an investment in Federal Home Loan Bank of Chicago stock of $13.3 million at December 31, 2016.

Among other benefits, the Federal Home Loan Banks provide a central credit facility primarily for member institutions. It is funded primarily from proceeds derived from the sale of consolidated obligations of the Federal Home Loan Bank System. It makes advances to members in accordance with policies and procedures established by the Federal Housing Finance Board and the board of directors of the Federal Home Loan Bank of Chicago. At December 31, 2016, WaterStone Bank had $295.0 million in advances from the Federal Home Loan Bank of Chicago.

USA PATRIOT Act

The USA PATRIOT Act gives the federal government powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. The USA PATRIOT Act also required the federal banking agencies to take into consideration the effectiveness of controls designed to combat money laundering activities in determining whether to approve a merger or other acquisition application of a member institution. Accordingly, if we engage in a merger or other acquisition, our controls designed to combat money laundering would be considered as part of the application process. We have established policies, procedures and systems designed to comply with these regulations.

Regulation of Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is subject to numerous federal, state and local laws and regulations and may be subject to various judicial and administrative decisions imposing various requirements and restrictions on its business. These laws, regulations and judicial and administrative decisions to which Waterstone Mortgage Corporation is subject include those pertaining to: real estate settlement procedures; fair lending; fair credit reporting; truth in lending; compliance with net worth and financial statement delivery requirements; compliance with federal and state disclosure and licensing requirements; the establishment of maximum interest rates, finance charges and other charges; secured transactions; collection, foreclosure, repossession and claims-handling procedures; other trade practices and privacy regulations providing for the use and safeguarding of non-public personal financial information of borrowers; and guidance on non-traditional mortgage loans issued by the federal financial regulatory agencies. Waterstone Mortgage Corporation may also be required to comply with any additional requirements that its customers may be subject to by their regulatory authorities.

Holding Company Regulation

Waterstone Financial is a unitary savings and loan holding company subject to regulation and supervision by the Federal Reserve Board. The Federal Reserve Board has enforcement authority over Waterstone Financial and its non-savings institution subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a risk to WaterStone Bank. In addition, any company that owns or controls, directly or indirectly, more than 25% of the voting securities of a state savings bank is subject to regulation as a savings bank holding company by the WDFI. Waterstone Financial is subject to regulation as a savings bank holding company under Wisconsin law. However, the WDFI has not issued specific regulations governing savings bank holding companies.

As a savings and loan holding company, Waterstone Financial's activities are limited to those activities permissible by law for financial holding companies (if Waterstone Financial makes an election to be treated as a financial holding company and meets the other requirements to be a financial holding company) or multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, incidental to financial activities or complementary to a financial activity. Such activities include lending and other activities permitted for bank holding companies, insurance and underwriting equity securities. Multiple savings and loan holding companies are authorized to engage in activities specified by federal regulation.

Federal law prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of another savings institution or savings and loan holding company without prior written approval of the Federal Reserve Board, and from acquiring or retaining control of any depository institution not insured by the Federal Deposit Insurance Corporation. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider such things as the financial and managerial resources and future prospects of the company and institution involved, the effect of the acquisition on and the risk to the federal deposit insurance fund, the convenience and needs of the community and competitive factors. A savings and loan holding company may not acquire a savings institution in another state and hold the target institution as a separate subsidiary unless it is a supervisory acquisition under Section 13(k) of the Federal Deposit Insurance Act or the law of the state in which the target is located authorizes such acquisitions by out-of-state companies.

Savings and loan holding companies historically have not been subject to consolidated regulatory capital requirements, although bank holding companies have been. The Dodd-Frank Act requires the Federal Reserve Board to establish minimum consolidated capital requirements for depository institution holding companies that are as stringent as those required for the insured depository subsidiaries. The final capital rule discussed above implemented the consolidated capital requirements for bank and savings and loan holding companies (of greater than $1 billion in consolidated assets), effective January 1, 2015. Waterstone Financial's consolidated capital exceeded the minimum requirements as of December 31, 2016.

The Dodd-Frank Act extended the "source of strength" doctrine to savings and loan holding companies. The Federal Reserve Board promulgated regulations implementing the "source of strength" policy, which requires holding companies to act as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

The Federal Reserve Board has issued a policy statement regarding the payment of dividends and the repurchase of shares of common stock by bank holding companies and savings and loan holding companies. In general, the policy provides that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. Regulatory guidance provides for prior regulatory consultation with respect to capital distributions in certain circumstances such as where the company's net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend or the company's overall rate of earnings retention is inconsistent with the company's capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. The policy statement also states that a holding company should inform the Federal Reserve Board supervisory staff prior to redeeming or repurchasing common stock or perpetual preferred stock if the holding company is experiencing financial weaknesses or if the repurchase or redemption would result in a net reduction, as of the end of a quarter, in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred. These regulatory policies may affect the ability of Waterstone Financial to pay dividends, repurchase shares of common stock or otherwise engage in capital distributions.

Holding Company Dividends

Waterstone Financial will not be permitted to pay dividends on its common stock if its stockholders' equity would be reduced below the amount of the liquidation account established by Waterstone Financial in connection with the conversion. The source of dividends will depend on the net proceeds retained by Waterstone Financial and earnings thereon, and dividends from WaterStone Bank. In addition, Waterstone Financial will be subject to state law limitations and federal bank regulatory policy on the payment of dividends. Maryland law generally limits dividends if the corporation would not be able to pay its debts in the usual course of business after giving effect to the dividend or if the corporation's total assets would be less than the corporation's total liabilities plus the amount needed to satisfy the preferential rights upon dissolution of stockholders whose preferential rights on dissolution are superior to those receiving the distribution.

The dividend rate and continued payment of dividends will depend on a number of factors, including our capital requirements, our financial condition and results of operations, tax considerations, statutory and regulatory limitations, and general economic conditions.

Federal Securities Laws Regulation

Securities Exchange Act. Waterstone Financial common stock is registered with the Securities and Exchange Commission. Waterstone Financial is subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934.

Shares of common stock purchased by persons who are not affiliates of Waterstone Financial may be resold without registration. Shares purchased by an affiliate of Waterstone Financial are subject to the resale restrictions of Rule 144 under the Securities Act of 1933. If Waterstone Financial meets the current public information requirements of Rule 144 under the Securities Act of 1933, each affiliate of Waterstone Financial that complies with the other conditions of Rule 144, including those that require the affiliate's sale to be aggregated with those of other persons, would be able to sell in the public market, without registration, a number of shares not to exceed, in any three-month period, the greater of 1% of the outstanding shares of Waterstone Financial, or the average weekly volume of trading in the shares during the preceding four calendar weeks. In the future, Waterstone Financial may permit affiliates to have their shares registered for sale under the Securities Act of 1933.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 is intended to improve corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. We have policies, procedures and systems designed to comply with these regulations, and we review and document such policies, procedures and systems to ensure continued compliance with these regulations.

Change in Control Regulations

Under the Change in Bank Control Act, no person may acquire control of a savings and loan holding company such as Waterstone Financial unless the Federal Reserve Board has been given 60 days' prior written notice and has not issued a notice disapproving the proposed acquisition, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Control, as defined under federal law, means ownership, control of or holding irrevocable proxies representing more than 25% of any class of voting stock, control in any manner of the election of a majority of the institution's directors, or a determination by the regulator that the acquiror has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the institution. Acquisition of more than 10% of any class of a savings and loan holding company's voting stock constitutes a rebuttable determination of control under the regulations under certain circumstances including where, as is the case with Waterstone Financial, the issuer has registered securities under Section 12 of the Securities Exchange Act of 1934.

In addition, federal regulations provide that no company may acquire control of a savings and loan holding company without the prior approval of the Federal Reserve Board. Any company that acquires such control becomes a "savings and loan holding company" subject to registration, examination and regulation by the Federal Reserve Board.

Further, without the prior written approval of the Federal Reserve Board, no person may make an offer or announcement of an offer to purchase shares or actually acquire shares of a converted institution or its holding company for a period of three years from the date of the completion of the conversion if, upon the completion of such offer, announcement or acquisition, the person would become the beneficial owner of more than 10% of the outstanding stock of the institution or its holding company. The Federal Reserve Board has defined "person" to include any individual, group acting in concert, corporation, partnership, association, joint stock company, trust, unincorporated organization or similar company, a syndicate or any other group formed for the purpose of acquiring, holding or disposing of securities of an insured institution. However, offers made exclusively to a bank or its holding company, or to an underwriter or member of a selling group acting on the converting institution's or its holding company's behalf for resale to the general public, are excepted. The regulation also provides civil penalties for willful violation or assistance in any such violation of the regulation by any person connected with the management of the converting institution or its holding company or who controls more than 10% of the outstanding shares or voting rights of a converted institution or its holding company.

Federal and State Taxation

Federal Taxation

General. Waterstone Financial and subsidiaries are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. Waterstone Financial and subsidiaries constitute an affiliated group of corporations and, therefore, are eligible to report their income on a consolidated basis. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to Waterstone Financial or WaterStone Bank. The company is no longer subject to federal tax examinations for years before 2014.

Method of Accounting. For federal income tax purposes, Waterstone Financial currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31 for filing its federal income tax returns.

Bad Debt Reserves. Prior to the Small Business Protection Act of 1996 (the "1996 Act"), WaterStone Bank was permitted to establish a reserve for bad debts and to make annual additions to the reserve. These additions could, within specified formula limits, be deducted in arriving at our taxable income. As a result of the 1996 Act, WaterStone Bank was required to use the specific charge-off method in computing its bad debt deduction beginning with its 1996 federal tax return. Savings institutions were required to recapture any excess reserves over those established as of December 31, 1987 (base year reserve). At December 31, 2016, WaterStone Bank had no reserves subject to recapture in excess of its base year.

Waterstone Financial is required to use the specific charge-off method to account for tax bad debt deductions.

Taxable Distributions and Recapture. Prior to 1996, bad debt reserves created prior to 1988 were subject to recapture into taxable income if WaterStone Bank failed to meet certain thrift asset and definitional tests or made certain distributions. Tax law changes in 1996 eliminated thrift-related recapture rules. However, under current law, pre-1988 tax bad debt reserves remain subject to recapture if WaterStone Bank makes certain non-dividend distributions, repurchases any of its common stock, pays dividends in excess of earnings and profits, or fails to qualify as a "bank" for tax purposes. At December 31, 2016, our total federal pre-base year bad debt reserve was approximately $16.7 million.

Alternative Minimum Tax. The Internal Revenue Code imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, less any available exemption. The alternative minimum tax is imposed to the extent it exceeds the regular income tax. Net operating losses can offset no more than 90% of alternative taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. Due to a federal net operating loss carry back generated in 2008, Waterstone Financial became subject to alternative minimum tax for 2006 and 2007. At December 31, 2016, the Company had no such amounts available as credits for carryover.

Net Operating Loss Carryovers. A financial institution may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. A 2009 federal tax law change allows for a one-time carry back of either 2008 or 2009 taxable losses for up to five years. Waterstone Financial had a federal net operating loss carryforward of $3.0 million at December 31, 2011, which was fully utilized during the year ended December 31, 2012. At December 31, 2016, the Company had no federal net operating loss carryovers.

Corporate Dividends-Received Deduction. Waterstone Financial may exclude from its federal taxable income 100% of dividends received from WaterStone Bank as a wholly-owned subsidiary by filing consolidated tax returns. The corporate dividends-received deduction is 80% when the corporation receiving the dividend owns at least 20% of the stock of the distributing corporation. The dividends-received deduction is 70% when the corporation receiving the dividend owns less than 20% of the distributing corporation.

State Taxation

The Company is subject to primarily the Wisconsin corporate franchise (income) tax and taxation in a number of states due primarily to the operations of the mortgage banking segment. Under current law, the state of Wisconsin imposes a corporate franchise tax of 7.9% on the combined taxable incomes of the members of our consolidated income tax group.

The Company is no longer subject to state income tax examinations by certain state tax authorities for years before 2012.

As a Maryland business corporation, Waterstone Financial is required to file an annual report and pay franchise taxes to the state of Maryland.

Item 1A. Risk Factors

An investment in our securities is subject to risks inherent in our business and the industry in which we operate. Before making an investment decision, you should carefully consider the risks and uncertainties described below and all other information included in this report. The risks described below may adversely affect our business, financial condition and operating results. In addition to these risks and the other risks and uncertainties described in Item 1, "Business-Forward Looking Statements" and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," there may be additional risks and uncertainties that are not currently known to us or that we currently deem to be immaterial that could materially and adversely affect our business, financial condition or operating results. The value or market price of our securities could decline due to any of these identified or other risks. Past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

We operate in a highly regulated environment and we are subject to supervision, examination and enforcement action by various bank regulatory agencies.

We are subject to extensive supervision, regulation, and examination by the WDFI, the Federal Deposit Insurance Corporation and the Federal Reserve Board. As a result, we are limited in the manner in which we conduct our business, undertake new investments and activities, and obtain financing. This system of regulation is designed primarily for the protection of the Deposit Insurance Fund and our depositors, and not for the benefit of our stockholders. Under this system of regulation, the regulatory authorities have extensive discretion in connection with their supervisory, enforcement, rulemaking and examination activities and policies, including rules or policies that: establish minimum capital levels; restrict the timing and amount of dividend payments; govern the classification of assets; determine the adequacy of loan loss reserves for regulatory purposes; and establish the timing and amounts of assessments and fees.

Moreover, as part of their examination authority, the banking regulators assign numerical ratings to banks and savings institutions relating to capital, asset quality, management, liquidity, earnings and other factors. These ratings are inherently subjective and the receipt of a less than satisfactory rating in one or more categories may result in enforcement action by the banking regulators against a financial institution. A less than satisfactory rating may also prevent a financial institution, such as WaterStone Bank or its holding company, from obtaining necessary regulatory approvals to access the capital markets, pay dividends, acquire other financial institutions or establish new branches.

Federal regulations governing the mutual-to-stock conversion required that we prepare a business plan that addresses, among other items, our projected operations and activities for three years following the conversion. The business plan is a confidential document that was submitted to the banking regulatory agencies and may not reflect currently unanticipated potential business opportunities or activities, such as increased dividends or acquisitions of other financial institutions. Federal regulations require that we operate within the parameters of the business plan, and that the Federal Reserve Board approve any material deviation from the business plan. This could affect our ability to conduct activities that deviate from the regulatory business plan that would otherwise benefit our stockholders.

In addition, we must comply with significant anti-money laundering and anti-terrorism laws and regulations, Community Reinvestment Act laws and regulations, and fair lending laws and regulations. Government agencies have the authority to impose monetary penalties and other sanctions on institutions that fail to comply with these laws and regulations, which could significantly affect our business activities, including our ability to acquire other financial institutions or expand our branch network.

Changing interest rates may have a negative effect on our results of operations.

Our earnings and cash flows are dependent on our net interest income and income from our mortgage banking operations. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. Changes in market interest rates could have an adverse effect on our financial condition and results of operations. If rates further decline or continue to stay in a low rate environment, it could have a negative effect on net interest margin, reduced net interest income, and devaluation of our deposit base.
Decreases in interest rates often result in increased prepayments of loans and mortgage-related securities, as borrowers refinance their loans to reduce borrowings costs. Under these circumstances, we are subject to reinvestment risk to the extent we are unable to reinvest the cash received from such prepayments in loans or other investments that have interest rates that are comparable to the interest rates on existing loans and securities.

Increases in interest rates can also have an adverse impact on our results of operations. A portion of our loans have adjustable interest rates. While the higher payment amounts we would receive on these loans in a rising interest rate environment may increase our interest income, some borrowers may be unable to afford the higher payment amounts, which may result in a higher rate of loan delinquencies and defaults, as well as lower loan originations, as borrowers who may qualify for a loan based on certain mortgage repayments, may not be able to afford repayments based on higher interest rates for the same loan amounts. The marketability of the underlying collateral also may be adversely affected in a high interest rate environment.

Although we have implemented asset and liability management strategies designed to reduce the effects of changes in interest rates on our results of operations, any substantial, unexpected, prolonged change in market interest rate could have a material adverse effect on our financial condition and results of operations. Also, our interest rate models and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Management of Market Risk."

We rely heavily on certificates of deposit, which has increased our cost of funds and could continue to do so in the future.

Our reliance on certificates of deposit to fund our operations has resulted in a higher cost of funds than would otherwise be the case if we had a higher percentage of demand deposits, savings deposits and money market accounts. In addition, if our certificates of deposit do not remain with us, we may be required to access other sources of funds, including loan sales, other types of deposits, including replacement certificates of deposit, securities sold under agreements to repurchase, advances from the Federal Home Loan Bank of Chicago and other borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on our certificates of deposit.

We intend to increase our commercial business lending, and we intend to continue our commercial real estate and multi-family residential real estate lending, which may expose us to increased lending risks and have a negative effect on our results of operations.

We continue to focus on originating commercial business, commercial real estate and multi-family residential real estate loans. These types of loans generally have a higher risk of loss compared to our one- to four-family residential real estate loans. Commercial business loans may expose us to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, commercial business and commercial real estate loans may also involve relatively large loan balances to individual borrowers or groups of borrowers. These loans also have greater credit risk than residential real estate loans as repayment is generally dependent upon the successful operation of the borrower's business. Also, the collateral underlying commercial business loans may fluctuate in value. Some of our commercial business loans are collateralized by equipment, inventory, accounts receivable or other business assets, and the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use. Multi-family residential real estate and commercial real estate loans involve increased risk because repayment is dependent on income being generated in amounts sufficient to cover property maintenance and debt service. In addition, if loans that are collateralized by real estate become troubled and the value of the real estate has been significantly impaired, then we may not be able to recover the full contractual amount of principal and interest that we anticipated at the time we originated the loan, which could cause us to increase our provision for loan losses and adversely affect our financial condition and results of operations.

Secondary mortgage market conditions could have a material impact on our financial condition and results of operations.

Our mortgage banking operations provide a significant portion of our non-interest income. In addition to being affected by interest rates, the secondary mortgage markets are also subject to investor demand for residential mortgage loans and increased investor yield requirements for these loans. These conditions may fluctuate or worsen in the future. In light of current conditions, there is greater risk in retaining mortgage loans pending their sale to investors. We believe our ability to retain fixed-rate residential mortgage loans is limited. As a result, a prolonged period of secondary market illiquidity may reduce our loan production volumes and could have a material adverse effect on our financial condition and results of operations.

Changes in the programs offered by secondary market purchasers or our ability to qualify for their programs may reduce our mortgage banking revenues, which would negatively impact our non-interest income.

We generate mortgage revenues primarily from gains on the sale of single-family mortgage loans pursuant to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae and non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. Any future changes in these programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations.

If we are required to repurchase mortgage loans that we have previously sold, it would negatively affect our earnings

One of our primary business operations is our mortgage banking, which involves originating residential mortgage loans for sale in the secondary market under agreements that contain representations and warranties related to, among other things, the origination and characteristics of the mortgage loans. We may be required to repurchase mortgage loans that we have sold in cases of borrower default or breaches of these representations and warranties. If we are required to repurchase mortgage loans or provide indemnification or other recourse, this could increase our costs and thereby affect our future earnings.

Recent regulations could restrict our ability to originate and sell loans.

The Consumer Financial Protection Bureau has issued a rule designed to clarify for lenders how they can avoid legal liability under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower's ability to repay a mortgage. Loans that meet this "qualified mortgage" definition will be presumed to have complied with the new ability-to-repay standard. Under the Consumer Financial Protection Bureau's rule, a "qualified mortgage" loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less "bona fide discount points" for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years

Also, to qualify as a "qualified mortgage," a borrower's total monthly debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments.

In addition, the Dodd-Frank Act requires the regulatory agencies to issue regulations that require securitizers of loans to retain not less than 5% of the credit risk for any asset that is not a "qualified residential mortgage."

Furthermore, the Dodd-Frank Act requires the Consumer Finance Protection Bureau to adopt rules and publish forms that combine certain disclosures that consumers receive in connection with applying for and closing on certain mortgage loans under the Truth in Lending Act and the Real Estate Settlement Procedures Act. The Consumer Financial Protection Bureau has implemented a final rule to implement this requirement, and the final rule was effective in October 2015.

We currently sell in the secondary market the significant majority of the one- to four-family residential real estate loans that we originate. These final rules could have a significant effect on the secondary market for loans and the types of loans we originate, and restrict our ability to make loans, any of which could limit our growth or profitability.

Changes in economic conditions could adversely affect our earnings, as our borrowers' ability to repay loans and the value of the collateral securing our loans decline.

Economic conditions have an impact, to some extent, on our overall performance. Conditions such as an economic recession, rising unemployment, changes in interest rates, money supply and other factors beyond our control may adversely affect our asset quality, deposit levels and loan demand and, therefore, our earnings. Because a majority of our loans are secured by real estate, decreases in real estate values could adversely affect the value of property used as collateral. Adverse changes in the economy may also have a negative effect on the ability of our borrowers to make timely repayments of their loans, which could have an adverse impact on our earnings. Consequently, declines in the economy in our market area could have a material adverse effect on our financial condition and results of operations.

If our allowance for loan losses is not sufficient to cover actual loan losses, our results of operations would be negatively affected.

In determining the amount of the allowance for loan losses, we analyze our loss and delinquency experience by loan categories and we consider the effect of existing economic conditions. In addition, we make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. If the results of our analyses are incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, which would require additions to our allowance and would decrease our net income. Our emphasis on loan growth and on increasing our portfolio of commercial real estate loans, as well as any future credit deterioration, could require us to increase our allowance further in the future.

The Financial Accounting Standards Board has adopted a new accounting standard that will be effective for us for our first fiscal year after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for loan losses. This will change the current method of providing allowances for loan losses that are probable, which may require us to increase our allowance for loan losses, and to greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for loan losses. Any resulting increase in our allowance for loan losses or expenses incurred to determine the appropriate level of the allowance for loan losses may have a material adverse effect on our results of operations and financial condition.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities may have a material adverse effect on our results of operations and financial condition.

Because most of our borrowers are located in the Milwaukee, Wisconsin metropolitan area, a prolonged downturn in the local economy, or a decline in local real estate values, could cause an increase in nonperforming loans or a decrease in loan demand, which would reduce our profits.

Substantially all of our loans are secured by real estate located in our primary market area. Weakness in our local economy and our local real estate markets could adversely affect the ability of our borrowers to repay their loans and the value of the collateral securing our loans, which could adversely affect our results of operations. Real estate values are affected by various factors, including supply and demand, changes in general or regional economic conditions, interest rates, governmental rules or policies and natural disasters. Weakness in economic conditions also could result in reduced loan demand and a decline in loan originations. In particular, a significant decline in real estate values would likely lead to a decrease in new loan originations and increased delinquencies and defaults by our borrowers.

Strong competition within our market areas may limit our growth and profitability.

Competition in the banking and financial services industry is intense. In our market areas, we compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, money market funds, insurance companies, and brokerage firms operating locally and elsewhere. Some of our competitors have greater name recognition and market presence and offer certain services that we do not or cannot provide, all of which benefit them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than we do.

Financial reform legislation is expected to increase our costs of operations.

The Dodd-Frank Act has significantly changed the regulation of banks and savings institutions and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies have been given significant discretion in drafting the implementing rules and regulations, many of which are not in final form. As a result, we cannot at this time predict the extent to which the Dodd-Frank Act will impact our business, operations or financial condition. However, compliance with the Dodd-Frank Act and its implementing regulations and policies has already resulted in changes to our business and operations, as well as additional costs, and diverted management's time from other business activities, which adversely affects our financial condition and results of operations.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions.

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions. During the last year, several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, these policies and procedures may not be effective in preventing violations of these laws and regulations.

Changes in our accounting policies or in accounting standards could materially affect how we report our financial condition and results of operations.

Our accounting policies are essential to understanding our financial condition and results of operations. Some of these policies require the use of estimates and assumptions that may affect the value of our assets or liabilities and financial results. Some of our accounting policies are critical because they require management to make difficult, subjective, and complex judgments about matters that are inherently uncertain, and because it is likely that materially different amounts would be reported under different conditions or using different assumptions. If such estimates or assumptions underlying our financial statements are incorrect, we may experience material losses.

From time to time, the Financial Accounting Standards Board and the Securities and Exchange Commission change the financial accounting and reporting standards or the interpretation of those standards that govern the preparation of our financial statements. These changes are beyond our control, can be hard to predict and could materially affect how we report our financial condition and results of operations. We could also be required to apply a new or revised standard retroactively, which may result in our restating our prior period financial statements.

The need to account for certain assets at estimated fair value may adversely affect our results of operations.

We report certain assets, such as loans held for sale, at estimated fair value. Generally, for assets that are reported at fair value, we use quoted market prices or valuation models that utilize observable market inputs to estimate fair value. Because we carry these assets on our books at their estimated fair value, we may incur losses even if the asset in question presents minimal credit risk.

Changes in the valuation of our securities portfolio could adversely affect our profits.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. Fluctuations in market value may be caused by changes in market interest rates, lower market prices for securities and limited investor demand. Management evaluates securities for other-than-temporary impairment on a monthly basis, with more frequent evaluation for selected issues. In analyzing a debt issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, industry analysts' reports and, to a lesser extent given the relatively insignificant levels of depreciation in our debt portfolio, spread differentials between the effective rates on instruments in the portfolio compared to risk-free rates. In analyzing an equity issuer's financial condition, management considers industry analysts' reports, financial performance and projected target prices of investment analysts within a one-year time frame. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. Changes in interest rates can also have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. We increase or decrease our stockholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. The declines in market value could result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

Because the nature of the financial services business involves a high volume of transactions, we face significant operational risks.

We operate in diverse markets and rely on the ability of our employees and systems to process a high number of transactions. Operational risk is the risk of loss resulting from our operations, including but not limited to, the risk of fraud by employees or persons outside our company, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system and compliance requirements, and business continuation and disaster recovery. Insurance coverage may not be available for such losses, or where available, such losses may exceed insurance limits. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation, and customer attrition due to potential negative publicity. In the event of a breakdown in the internal control system, improper operation of systems or improper employee actions, we could suffer financial loss, face regulatory action, and suffer damage to our reputation.

Risks associated with system failures, interruptions, or breaches of security could negatively affect our earnings.

Information technology systems are critical to our business. We use various technology systems to manage our customer relationships, general ledger, securities investments, deposits and loans. We have established policies and procedures to prevent or limit the effect of system failures, interruptions, and security breaches, but such events may still occur or may not be adequately addressed if they do occur. In addition, any compromise of our systems could deter customers from using our products and services. Although we rely on security systems to provide security and authentication necessary to effect the secure transmission of data, these precautions may not protect our systems from security breaches.

In addition, we outsource a majority of our data processing to certain third-party providers. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

The occurrence of any system failures, interruption, or breach of security could damage our reputation and result in a loss of customers and business thereby subjecting us to additional regulatory scrutiny, or could expose us to litigation and possible financial liability. Any of these events could have a material adverse effect on our financial condition and results of operations.

Our risk management framework may not be effective in mitigating risk and reducing the potential for significant losses.

Our risk management framework is designed to minimize risk and loss to us. We seek to identify, measure, monitor, report and control our exposure to risk, including strategic, market, liquidity, compliance and operational risks. While we use a broad and diversified set of risk monitoring and mitigation techniques, these techniques are inherently limited because they cannot anticipate the existence or future development of currently unanticipated or unknown risks. Recent economic conditions and heightened legislative and regulatory scrutiny of the financial services industry, among other developments, have increased our level of risk. Accordingly, we could suffer losses as a result of our failure to properly anticipate and manage these risks.

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.

Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. We have experienced losses due to apparent fraud and other financial crimes. While we have policies and procedures designed to prevent such losses, losses may still occur.

Acquisitions may disrupt our business and dilute stockholder value.

We regularly evaluate merger and acquisition opportunities with other financial institutions and financial services companies. As a result, negotiations may take place and future mergers or acquisitions involving cash, debt, or equity securities may occur at any time. We would seek acquisition partners that offer us either significant market presence or the potential to expand our market footprint and improve profitability through economies of scale or expanded services.

Acquiring other banks, businesses, or branches may have an adverse effect on our financial results and may involve various other risks commonly associated with acquisitions, including, among other things:

- difficulty in estimating the value of the target company;

- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent tax or other liabilities of the target company;
- exposure to potential asset quality problems of the target company;
- potential volatility in reported income associated with goodwill impairment losses;
- difficulty and expense of integrating the operations and personnel of the target company;
- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits;
- potential disruption to our business;
- potential diversion of our management's time and attention;
- the possible loss of key employees and customers of the target company; and
- potential changes in banking or tax laws or regulations that may affect the target company.

Various factors may make takeover attempts more difficult to achieve.

Our articles of incorporation and bylaws, federal regulations, Maryland law, shares of restricted stock and stock options that we have granted or may grant to employees and directors and stock ownership by our management and directors, and various other factors may make it more difficult for companies or persons to acquire control of Waterstone Financial without the consent of our board of directors. A shareholder may want a takeover attempt to succeed because, for example, a potential acquiror could offer a premium over the then prevailing price of our common stock.

Legal and regulatory proceedings and related matters could adversely affect us or the financial services industry in general.

We, and other participants in the financial services industry upon whom we rely to operate, have been and may in the future become involved in legal and regulatory proceedings. Most of the proceedings we consider to be in the normal course of our business or typical for the industry; however, it is inherently difficult to assess the outcome of these matters, and other participants in the financial services industry or we may not prevail in any proceeding or litigation. There could be substantial cost and management diversion in such litigation and proceedings, and any adverse determination could have a materially adverse effect on our business, brand or image, or our financial condition and results of our operations.

Our funding sources may prove insufficient to replace deposits at maturity and support our future growth.

We must maintain sufficient funds to respond to the needs of depositors and borrowers. As a part of our liquidity management, we use a number of funding sources in addition to core deposit growth and repayments and maturities of loans and investments. As we continue to grow, we are likely to become more dependent on these sources, which may include Federal Home Loan Bank advances, proceeds from the sale of loans, federal funds purchased and brokered certificates of deposit. Adverse operating results or changes in industry conditions could lead to difficulty or an inability to access these additional funding sources. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. If we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our operating margins and profitability would be adversely affected.

We are subject to environmental liability risk associated with lending activities

A significant portion of our loan portfolio is secured by real estate, and we could become subject to environmental liabilities with respect to one or more of these properties. During the ordinary course of business, we may foreclose on and take title to properties securing defaulted loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous conditions or toxic substances are found on these properties, we may be liable for remediation costs, as well as for personal injury and property damage, civil fines and criminal penalties regardless of when the hazardous conditions or toxic substances first affected any particular property. Environmental laws may require us to incur substantial expenses to address unknown liabilities and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on nonresidential real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on us.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

We operate from our corporate center, our 11 full-service banking offices, our drive-through office and 11 automated teller machines, located in Milwaukee, Washington and Waukesha Counties, Wisconsin. In addition, we operate a loan production office in Minneapolis, Minnesota. The net book value of our premises, land, equipment and leasehold improvements was $23.7 million at December 31, 2016. The following table sets forth information with respect to our corporate center and our full-service banking offices as of February 28, 2017.

Corporate Center 11200 West Plank Court Wauwatosa, Wisconsin 53226	Wauwatosa 7500 West State Street Wauwatosa, Wisconsin 53213	Brookfield (1) 17495 W Capitol Dr. Brookfield, WI 53045
Franklin/Hales Corners 6555 South 108th Street Franklin, Wisconsin 53132	Germantown/Menomonee Falls W188N9820 Appleton Avenue Germantown, Wisconsin 53022	Oak Creek 6560 South 27th Street Oak Creek, Wisconsin 53154
Oconomowoc/Lake Country (1) 1233 Corporate Center Drive Oconomowoc, Wisconsin 53066	Pewaukee 1230 George Towne Drive Pewaukee, Wisconsin 53072	Waukesha/Brookfield 21505 East Moreland Blvd. Waukesha, Wisconsin 53186
West Allis 10101 West Greenfield Avenue West Allis, Wisconsin 53214	Fox Point 8607 North Port Washington Road Fox Point, WI 53217	Greenfield 5000 West Loomis Road Greenfield, WI 53220
Commercial Real Estate Loan Production Office (1) 701 Washington Avenue N Suite 525 Minneapolis, MN 55401		

(1) Leased property

In addition to our banking offices, as of December 31, 2016, our mortgage banking operation had 15 offices in Wisconsin, 13 offices in Florida, nine offices in Pennsylvania, six offices in Minnesota, five offices in Indiana, Ohio, and Texas, two offices in each of Arizona, California, Maryland, and Virginia, and one office in each of Colorado, Georgia, Idaho, Illinois, Iowa, Maine, Massachusetts, New Hampshire, Oregon, Tennessee, and Washington.

Item 3. Legal Proceedings

WaterStone Bank and its wholly owned subsidiary, Waterstone Mortgage Corporation are involved in various legal actions arising in the normal course of business, including the proceeding specifically discussed below. While the ultimate outcome of pending proceedings cannot be predicted with certainty, it is the opinion of management, after consultation with counsel representing us in such proceedings, that the resolution of these proceedings will not have a material adverse effect on our consolidated financial position or results of operation.

Herrington, et al. v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a lawsuit that was filed in the Federal District Court for the Western District of Wisconsin and has been transferred to arbitration alleging that Waterstone Mortgage Corporation violated the Fair Labor Standards Act and failed to pay loan officers consistent with their various contracts. Waterstone Mortgage Corporation is and will continue to vigorously defend its interests in this matter.
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Item 4. Mine Safety Disclosures

Not applicable

Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchase of Equity Securities

Our shares of common stock are traded on the NASDAQ Global Select Market® under the symbol WSBF. The approximate number of shareholders of record of Waterstone common stock as of February 28, 2017 was 1,691. On that same date there were 29,446,462 shares of common stock issued and outstanding.

The Company did not make any monthly common stock purchases during the fourth quarter of 2016.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares that May Yet Be Purchased Under the Plan[(a)]
October 1, 2016 - October 31, 2016	-	$ -	-	989,500
November 1, 2016 - November 30, 2016	-	-	-	989,500
December 1, 2016 - December 31, 2016	-	-	-	989,500
Total	-	$ -	-	989,500

(a) On September 4, 2015, the Board of Directors terminated the existing plan and authorized the repurchase of 1,500,000 shares of common stock.

The following table presents the high and low quarterly trading prices and dividends declared for Waterstone Financial's common stock for the years ended December 31, 2016 and 2015.

	2016		
	High	Low	Dividends Declared
1st Quarter	$14.12	$13.42	$ 0.05
2nd Quarter	15.33	13.69	0.08
3rd Quarter	17.08	15.15	0.08
4th Quarter	19.20	16.50	0.12

		2015	
	High	Low	Dividends Declared
1st Quarter	$13.24	$12.67	$ 0.05
2nd Quarter	13.28	12.70	0.05
3rd Quarter	13.60	12.43	0.05
4th Quarter	14.44	13.14	0.05

The plan governing the conversion of Lamplighter Financial, MHC (the "MHC") to stock form provided for the establishment of special "liquidation accounts" for the benefit of certain depositors of WaterStone Bank in an amount equal to the greater of the MHC's ownership interest in the retained earnings of the Company as of the date of the latest balance sheet contained in the prospectus utilized in the 2014 stock offering or the retained earnings of Waterstone Bank at the time it reorganized into the MHC. Following the completion of the conversion, under the rules of the Board of Governors of the Federal Reserve System, WaterStone Bank is not permitted to pay dividends on its capital stock to Waterstone Financial, its sole shareholder, if WaterStone Bank's shareholder's equity would be reduced below the amount of the liquidation accounts. The liquidation accounts will be reduced annually to the extent that eligible account holders have reduced their qualifying deposits. Subsequent increases will not restore an eligible account holder's interest in the liquidation accounts.

The future payment of dividends will depend upon a number of factors, including capital requirements, our financial condition and results of operations, tax considerations, statutory and regulatory limitations and general economic conditions and regulatory restrictions that affect our ability to pay dividends. We cannot assure you that any dividends will not be reduced or eliminated in the future. Special cash or stock dividends, to the extent permitted by applicable policy and regulation, may be paid in addition to, or in lieu of, regular cash dividends.

PERFORMANCE GRAPH

Set forth below is a line graph comparing the cumulative total shareholder return on Waterstone Financial common stock, based on the market price of the common stock and assuming reinvestment of cash dividends, with the cumulative total return of companies on the SNL Thrift NASDAQ Index and the Russell 2000. The graph assumes $100 was invested on December 31, 2011, in Waterstone Financial, Inc. common stock and each of those indices.

Waterstone Financial, Inc.

Index	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Waterstone Financial, Inc.	100.00	412.70	587.30	773.86	842.48	1,118.36
SNL Thrift NASDAQ index	100.00	119.34	151.33	167.60	191.52	243.50
Russell 2000	100.00	116.35	161.52	169.43	161.95	196.45

Item 6. Selected Financial Data

SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

The summary financial information presented below is derived in part from the Company's audited financial statements, although the table itself is not audited. The following data should be read together with the Company's consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" later in this report. The Company's subscription offering related to its second-step conversion closed on December 17, 2013. As a result, cash and cash equivalents and deposits at December 31, 2013 include $388.7 million in proceeds from the offering. Upon completion of the offering on January 22, 2014, $253.0 million of the proceeds were used to purchase shares by shareholders and the remaining oversubscribed funds were returned to subscribers. The result has a significant impact on certain comparative balance sheet totals and on ratios that are based on those numbers.

	At or for the Year Ended December 31,				
	2016	2015	2014	2013	2012
	(In Thousands, except per share amounts)				
Selected Financial Condition Data:					
Total assets	$1,790,619	$1,762,729	$1,783,380	$1,947,039	$1,661,076
Cash and cash equivalents	47,217	100,471	172,820	429,169	71,469
Securities available for sale	226,795	269,658	273,443	213,418	205,017
Loans held for sale	225,248	166,516	125,073	97,021	133,613
Loans receivable	1,177,884	1,114,934	1,094,990	1,092,676	1,133,672
Allowance for loan losses	16,029	16,185	18,706	24,264	31,043
Loans receivable, net	1,161,855	1,098,749	1,076,284	1,068,412	1,102,629
Real estate owned, net	6,118	9,190	18,706	22,663	35,974
Deposits	949,411	893,361	863,960	1,244,741	939,513
Borrowings	387,155	441,203	434,000	455,197	479,888
Total shareholders' equity	410,690	391,930	450,237	214,472	202,634
Selected Operating Data:					
Interest income	$63,736	$61,963	$63,634	$62,864	$69,846
Interest expense	20,292	23,119	22,327	23,658	27,901
Net interest income	43,444	38,844	41,307	39,206	41,945
Provision for loan losses	380	1,965	1,150	4,532	8,300
Net interest income after provision for loan losses	43,064	36,879	40,157	34,674	33,645
Noninterest income	126,365	104,474	84,568	87,799	91,203
Noninterest expense	127,435	115,534	104,818	99,144	102,138
Income before income taxes	41,994	25,819	19,907	23,329	22,710
Provision for income taxes (benefit)	16,462	9,249	7,175	8,621	(12,204)
Net income	$25,532	$16,570	$12,732	$14,708	$34,914
Per common share:					
Income per share - basic	$0.94	$0.57	$0.38	$0.43	$1.02
Income per share - diluted	$0.93	$0.56	$0.38	$0.43	$1.02
Book value	$13.95	$13.33	$13.08	$6.84	$6.52
Dividends declared	$0.33	$0.20	$0.20	N/A	N/A

	At or for the Year Ended December 31,				
	2016	2015	2014	2013	2012
Selected Financial Ratios and Other Data:					
Performance Ratios:					
Return on average assets	1.45 %	0.94 %	0.71 %	0.90%	2.07%
Return on average equity	6.33	3.99	2.89	7.01	18.89
Interest rate spread (1)	2.26	1.91	2.03	2.36	2.45
Net interest margin (2)	2.64	2.36	2.44	2.56	2.62
Noninterest expense to average assets	7.24	6.58	5.82	6.05	6.04
Efficiency ratio (3)	75.05	80.61	83.27	78.31	76.71
Average interest-earning assets to average interest-bearing liabilities	130.56	131.54	139.98	113.96	109.84
Dividend payout ratio (4)	27.66	35.20	52.48	N/A	N/A
Capital Ratios:					
Waterstone Financial, Inc.:					
Equity to total assets at end of period	22.94 %	22.23 %	25.25 %	11.02 %	12.20 %
Average equity to average assets	22.90	23.62	24.51	12.82	10.94
Total capital to risk-weighted assets	32.23	33.41	41.25	N/A	N/A
Tier 1 capital to risk-weighted assets	31.02	32.16	39.99	N/A	N/A
Common equity tier 1 capital to risk-weighted assets	31.02	32.16	N/A	N/A	N/A
Tier 1 capital to average assets	23.20	22.20	24.80	N/A	N/A
WaterStone Bank:					
Total capital to risk-weighted assets	29.50	30.92	31.98	21.67	17.34
Tier I capital to risk-weighted assets	28.29	29.67	30.73	20.41	16.07
Common equity tier 1 capital to risk-weighted assets	28.29	29.67	N/A	N/A	N/A
Tier I capital to average assets	21.17	20.45	19.04	12.48	11.13
Asset Quality Ratios:					
Allowance for loan losses as a percent of total loans	1.36 %	1.45 %	1.71 %	2.22 %	2.74 %
Allowance for loan losses as a percent of non-performing loans	162.62	91.94	49.21	47.61	41.58
Net charge-offs to average outstanding loans during the period	0.05	0.37	0.55	0.94	0.76
Non-performing loans as a percent of total loans	0.84	1.58	3.47	4.66	6.59
Non-performing assets as a percent of total assets	0.89	1.52	3.18	3.78	6.66
Other Data:					
Number of full-service banking offices	11	11	9	8	8
Number of full-time equivalent employees	895	770	731	849	726

(1) Represents the difference between the weighted average yield on average interest-earning assets and the weighted average cost of interest-bearing liabilities.
(2) Represents net interest income as a percent of average interest-earning assets.
(3) Represents non-interest expense divided by the sum of net interest income and noninterest income.
(4) Represents dividends paid per share divided by basic earnings per share.
N/A - Not applicable

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The following discussion and analysis is presented to assist the reader in understanding and evaluating of the Company's financial condition and results of operations. It is intended to complement the consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Form 10-K and should be read in conjunction therewith. The detailed discussion in the sections below focuses on the results of operations for the years ended December 31, 2016, 2015, and 2014 and the financial condition as of December 31, 2016 compared to the financial condition as of December 31, 2015.

As described in the notes to consolidated financial statements, we have two reportable segments: community banking and mortgage banking. The community banking segment provides consumer and business banking products and services to customers. Consumer products include loan products, deposit products, and personal investment services. Business banking products include loans for working capital, inventory and general corporate use, commercial real estate construction loans, and deposit accounts. The mortgage banking segment, which is conducted through Waterstone Mortgage Corporation, consists of originating residential mortgage loans primarily for sale in the secondary market.

Our community banking segment generates the significant majority of our consolidated net interest income and requires the significant majority of our provision for loan losses. Our mortgage banking segment generates the significant majority of our noninterest income and a majority of our noninterest expenses. We have provided below a discussion of the material results of operations for each segment on a separate basis for the years ended December 31, 2016, 2015, and 2014, which focuses on noninterest income and noninterest expenses. We have also provided a discussion of the consolidated operations of Waterstone Financial, which includes the consolidated operations of WaterStone Bank and Waterstone Mortgage Corporation, for the same periods.

Critical Accounting Policies

Critical accounting policies are those that involve significant judgments and assumptions by management and that have, or could have, a material impact on our income or the carrying value of our assets.

Allowance for Loan Losses. WaterStone Bank establishes valuation allowances on loans deemed to be impaired. A loan is considered impaired when, based on current information and events, it is probable that WaterStone Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. A valuation allowance is established for an amount equal to the impairment when the carrying amount of the loan exceeds the present value of the expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral (specific component). The Company recognizes the change in present value of expected future cash flows on impaired loans attributable to the passage of time as bad debt expense. On an ongoing basis, at least quarterly for financial reporting purposes, the fair value of collateral dependent impaired loans and real estate owned is determined or reaffirmed by the following procedures:

- Obtaining updated real estate appraisals or performing updated discounted cash flow analysis;
- Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;
- Comparing the estimated current book value to that of updated sales values experienced on similar real estate owned;
- Comparing the estimated current book value to that of updated values seen on more current appraisals of similar properties; and
- Comparing the estimated current book value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

WaterStone Bank also establishes valuation allowances based on an evaluation of the various risk components that are inherent in the credit portfolio (general component). The risk components that are evaluated include past loan loss experience; the level of non-performing and classified assets; current economic conditions; volume, growth, and composition of the loan portfolio; adverse situations that may affect the borrower's ability to repay; the estimated value of any underlying collateral; regulatory guidance; and other relevant factors. The allowance is increased by provisions charged to earnings and recoveries of previously charged-off loans and reduced by charge-offs. Charge-offs approximate the amount by which the outstanding principal balance exceeds the estimated net realizable value of the underlying collateral. The appropriateness of the allowance for loan losses is reviewed and approved quarterly by the WaterStone Bank Board of Directors. The allowance reflects management's best estimate of the amount needed to provide for the probable loss on impaired loans and other inherent losses in the loan portfolio, and is based on a risk model developed and implemented by management and approved by the WaterStone Bank Board of Directors.

Actual results could differ from this estimate, and future additions to the allowance may be necessary based on unforeseen changes in loan quality and economic conditions. More specifically, if our future charge-off experience increases substantially from our past experience, or if the value of underlying loan collateral, in our case mostly real estate, declines in value by a substantial amount, or if unemployment in our primary market area increases significantly, our allowance for loan losses may be inadequate and we will incur higher provisions for loan losses and lower net income in the future.

In addition, state and federal regulators periodically review the WaterStone Bank allowance for loan losses. Such regulators have the authority to require WaterStone Bank to recognize additions to the allowance at the time of their examination.

Income Taxes. The Company and its subsidiaries file consolidated federal, combined state income tax, and separate state income tax returns. The provision for income taxes is based upon income in the consolidated financial statements, rather than amounts reported on the income tax return. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as for net operating loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, the forecasts of future income, applicable tax planning strategies, and assessments of current and future economic and business conditions. Examples of positive evidence may include the existence of taxes paid in available carry-back years as well as the probability that taxable income will be generated in future periods. Examples of negative evidence may include cumulative losses in a current year and prior two years and general business and economic trends.

Positions taken in the Company's tax returns are subject to challenge by the taxing authorities upon examination. The benefit of uncertain tax positions are initially recognized in the financial statements only when it is more likely than not that the position will be sustained upon examination by the tax authorities. Such tax positions are both initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with the tax authority, assuming full knowledge of the position and all relevant facts. Interest and penalties on income tax uncertainties are classified within income tax expense in the income statement.

Fair Value Measurements. The Company determines the fair value of its assets and liabilities in accordance with ASC 820. ASC 820 establishes a standard framework for measuring and disclosing fair value under generally accepted accounting principles. A number of valuation techniques are used to determine the fair value of assets and liabilities in the Company's financial statements. The valuation techniques include quoted market prices for investment securities, appraisals of real estate from independent licensed appraisers and other valuation techniques. Fair value measurements for assets and liabilities where limited or no observable market data exists are based primarily upon estimates, and are often calculated based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the valuation results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there are inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values. Significant changes in the aggregate fair value of assets and liabilities required to be measured at fair value or for impairment are recognized in the income statement under the framework established by generally accepted accounting principles.

Recent Accounting Pronouncements. Refer to Note 1 of our consolidated financial statements for a description of recent accounting pronouncements including the respective dates of adoption and effects on results of operations and financial condition.

Comparison of Consolidated Waterstone Financial, Inc. Financial Condition at December 31, 2016 and at December 31, 2015

Total Assets. Total assets increased by $27.9 million, or 1.6%, to $1.79 billion at December 31, 2016 from $1.76 billion at December 31, 2015. The increase in total assets primarily reflects an increase in loans and loans held for sale offset by a reduction in cash and cash equivalents and securities available for sale. Funding needed for the loans receivable and loans held for sale was provided by a reduction of cash and cash equivalents and paydowns in securities available for sale.

Cash and Cash Equivalents. Cash and cash equivalents decreased $53.3 million to $47.2 million at December 31, 2016 from $100.5 million at December 31, 2015. The decrease in cash and cash equivalents primarily reflects the increase in loans receivable and loans held for sale. In addition, cash was used to pay down borrowings, purchase bank owned life insurance, and repurchase shares since December 31, 2015.

Securities Available for Sale. Securities available for sale decreased by $42.9 million to $226.8 million at December 31, 2016 from $269.7 million at December 31, 2015. The decrease was due to paydowns in mortgage related securities and maturities of debt securities exceeding security purchases for the year.

Loans Held for Sale. Loans held for sale increased $58.7 million, or 35.3%, to $225.2 million at December 31, 2016 from $166.5 million at December 31, 2015. The increase related to increased fourth quarter funding volumes at our mortgage subsidiary compared to the fourth quarter of 2015. During the quarter ended December 31, 2016, $622.5 million in residential loans were funded compared to $441.0 million the fourth quarter of 2015.

Loans Receivable. Loans receivable held for investment increased $63.0 million to $1.18 billion at December 31, 2016. The increase in total loans receivable was primarily attributable to increases in the one- to four-family, multi-family, commercial real estate, and commercial loan categories. Offsetting those increases, the home equity, construction and land, and consumer categories decreased slightly.

Allowance for Loan Losses. The allowance for loan losses decreased $156,000 to $16.0 million at December 31, 2016 from $16.2 million at December 31, 2015. The decrease resulted from the charge-off of specific reserves and improvement of key loan quality metrics decreasing the allowance related to the loans collectively reviewed. The overall decrease was primarily related to the one- to four-family, multi-family, and home equity categories. Offsetting those decreases, the allowance for loan losses increased for the commercial loan category along with the commercial real estate and construction and land categories.

Federal Home Loan Bank stock. Total Federal Home Loan Bank stock decreased $6.2 million from December 31, 2015. During the year ended December 31, 2016, $12.5 million of stock was sold as $220.0 million Federal Home Loan Bank borrowings matured. A total of $6.3 million of stock was purchased when $100.0 million of new long-term borrowings along with new short term borrowings were entered into with the Federal Home Loan Bank.

Cash Surrender Value of Life Insurance. Total cash surrender value of life insurance increased $11.9 million, or 24.1%, from December 31, 2015. During the year ended December 31, 2016, the Company purchased a $10.0 million bank owned life insurance policy, along with continued earnings aiding in increasing the policy values.

Real Estate Owned. Total real estate owned decreased by $3.1 million, or 33.4%, to $6.1 million at December 31, 2016, compared to $9.2 million at December 31, 2015. During the year ended December 31, 2016, $4.6 million was transferred from loans to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled $7.0 million. Write-downs totaled $656,000 during the year ended December 31, 2016.

Deposits. Deposits increased by $56.1 million to $949.4 million at December 31, 2016, from $893.4 million at December 31, 2015. The increase was driven by an increase in more cost effective transaction accounts along with an increase in time deposits to help fund loan and loans held for sale growth and reduce our reliance on wholesale funding.

Borrowings. Total borrowings decreased $54.0 million to $387.2 million at December 31, 2016, from $441.2 million at December 31, 2015. A total of $220.0 million of fixed rate borrowings matured and were paid off during the current year. These were replaced with $100.0 million of new fixed rate long-term borrowings with the Federal Home Loan Bank and with funds raised through our retail delivery channels. Short term borrowings increased $66.0 million at December 31, 2016 from December 31, 2015 for both the community banking and mortgage banking segment to fund loans held for sale.

Other Liabilities. Other liabilities increased $6.0 million at December 31, 2016 compared to December 31, 2015. The increase related to an increased dividend payable from a dividend rate increase and increased accrued salaries at the mortgage banking segment with more fundings.

Shareholders' Equity. Shareholders' equity increased by $18.8 million, or 4.8%, to $410.7 million at December 31, 2016 from $391.9 million at December 31, 2015. The increase in shareholders' equity was primarily due to net income, additional paid in capital as stock options were exercised, and the vesting of ESOP shares. These increases were offset by the repurchase of stock, dividends declared, along with accumulated other comprehensive income decreasing as the fair value of the security portfolio decreased.

Comparison of Community Banking Segment Operations for the Years Ended December 31, 2016 and 2015

Net income from our community banking segment for the year ended December 31, 2016 totaled $14.0 million compared to net income of $8.3 million for the year ended December 31, 2015. Net interest income increased $5.2 million to $42.9 million for the year ended December 31, 2016 compared to $37.7 million for the year ended December 31, 2015 due to an increase in average loan balances and a reduction in our overall cost of fundings. The long-term borrowings that matured were replaced with a lower cost mix of funding, including long and short-term borrowings and deposits raised through our retail network. The provision for loan losses decreased $1.4 million compared to the prior year.

Noninterest income increased $1.1 million to $4.6 million for the year ended December 31, 2016. The increase was mostly due to an increase in fees earned on loans, driven primarily by pre-payment activity.

Compensation, payroll taxes, and other employee benefits expense increased $730,000 to $17.2 million due to increases in health insurance costs and ESOP expense offset from the immediate vesting of 94,100 restricted share awards that amounted to $1.2 million in additional compensation expense in the prior year. Other non-interest expenses increased from the prior year. Occupancy, office furniture, and equipment remained consistent to the prior year. FDIC insurance premiums and real estate owned expenses decreased from the prior year as a direct result of improved asset quality metrics.

Comparison of Mortgage Banking Segment Operations for the Years Ended December 31, 2016 and 2015

Net income from our mortgage banking segment for the year ended December 31, 2016 totaled $12.3 million compared to net income of $8.3 million for the year ended December 31, 2015. We originated $2.38 billion in mortgage loans held for sale during the year ended December 31, 2016, which was an increase of $392.8 million, or 19.8%, from the $1.99 billion originated during the year ended December 31, 2015, which was primarily responsible for an increase in total mortgage banking income of $21.8 million, or 21.9%, to $121.1 million during the year ended December 31, 2016 compared to $99.3 million during the year ended December 31, 2015. The increase in loan production volume was driven by a 20.1% increase in mortgage purchase products and a 27.4% increase in refinance products. In addition, margins increased for the year ended December 31, 2016 compared to December 31, 2015. We sell loans on both a servicing-released and a servicing retained basis. Waterstone Mortgage Corporation has contracted with a third party to service the loans for which we retain servicing.

Our overall margin can be affected by the mix of both loan type (conventional loans versus governmental) and loan purpose (purchase versus refinance). Conventional loans include loans that conform to Fannie Mae and Freddie Mac standards, whereas governmental loans are those loans guaranteed by the federal government, such as a Federal Housing Authority or U.S. Department of Agriculture loan. Loans originated for the purchase of a residential property, which generally yield a higher margin than loans originated for refinancing existing loans, comprised 82.9% of total originations during the year ended December 31, 2016, compared to 83.7% of total originations during the year ended December 31, 2015. The mix of loan type trended slightly towards more conventional loans and less governmental loans comprising 65.1% and 34.9% of all loan originations, respectively, during the year ended December 31, 2016, compared 66.4% and 33.6% of all loan originations, respectively, during the year ended December 31, 2015.

During the year ended December 31, 2016, no mortgage servicing rights were sold. During the year ended December 31, 2015, mortgage servicing rights related to $580.2 million in loans receivable with a book value of $4.4 million were sold at a gain of $901,000.

Total compensation, payroll taxes and other employee benefits increased $12.6 million, or 19.1%, to $78.3 million for the year ended December 31, 2016 compared to $65.7 million for the year ended December 31, 2015. The increase in compensation expense was primarily a result of the increase in mortgage banking income, given our commission-based loan officer compensation model. Other noninterest expense increased $1.4 million to $17.5 million as fundings increased driving more volume-based expenses.

Comparison of Consolidated Waterstone Financial, Inc. Results of Operations for the Years Ended December 31, 2016 and 2015

	Years Ended December 31, 2016	2015
	(Dollars in Thousands, except per share amounts)	
Net income	$25,532	16,570
Earnings per share - basic	0.94	0.57
Earnings per share - diluted	0.93	0.56
Return on assets	1.45 %	0.94 %
Return on equity	6.33 %	3.99 %

Average Balance Sheets, Interest and Yields/Costs

The following table set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans were included in the computation of the average balances of loans receivable and held for sale. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense. Yields on interest-earning assets are computed on a fully tax-equivalent yield, where applicable.

	Years Ended December 31,								
	2016			2015			2014		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
	(Dollars in Thousands)								
Interest-earning assets:									
Loans receivable and held for sale (1)	$1,291,955	57,185	4.43%	$1,214,691	55,175	4.54%	$1,215,051	57,316	4.72%
Mortgage related securities (2)	153,980	3,048	1.98%	169,182	3,229	1.91%	164,468	2,996	1.82%
Debt securities, federal funds sold and short-term investments (2)(3)	198,475	4,317	2.18%	264,398	4,489	1.70%	311,548	4,192	1.35%
Total interest-earning assets	1,644,410	64,550	3.93%	1,648,271	62,893	3.82%	1,691,067	64,504	3.81%
Noninterest-earning assets	116,826			107,954			108,621		
Total assets	$1,761,236			$1,756,225			$1,799,688		
Interest-bearing liabilities:									
Demand accounts	$34,659	19	0.05%	$31,295	20	0.06%	$41,544	16	0.04%
Money market and savings accounts	168,775	392	0.23%	143,174	197	0.14%	160,575	113	0.07%
Certificates of deposit	674,310	6,953	1.03%	640,640	5,662	0.88%	640,858	4,797	0.75%
Total interest-bearing deposits	877,744	7,364	0.84%	815,109	5,879	0.72%	842,977	4,926	0.58%
Borrowings	381,803	12,928	3.39%	437,964	17,240	3.94%	442,731	17,401	3.93%
Total interest-bearing liabilities	1,259,547	20,292	1.61%	1,253,073	23,119	1.84%	1,285,708	22,327	1.74%
Noninterest-bearing liabilities									
Non-interest bearing deposits	76,016			65,965			50,212		
	22,426			22,282			22,739		

Other non-interest bearing liabilities									
Total non-interest bearing liabilities	98,442			88,247			72,951		
Total liabilities	1,357,989			1,341,320			1,358,659		
Equity	403,247			414,905			441,029		
Total liabilities and equity	$1,761,236			$1,756,225			$1,799,688		
Net interest income / Net interest rate spread [4]		44,258	2.32%		39,774	1.98%		42,177	2.08%
Less: taxable equivalent adjustment		814	0.05%		930	0.07%		870	0.05%
Net interest income / Net interest rate spread, as reported		43,444	2.37%		38,844	1.91%		41,307	2.03%
Net interest-earning assets [5]	$384,863			$395,198			$405,359		
Net interest margin [6]			2.64%			2.36%			2.44%
Tax equivalent effect			0.05%			0.05%			0.05%
Net interest margin on a fully tax equivalent basis			2.69%			2.41%			2.49%
Average interest-earning assets to average interest-bearing liabilities	130.56 %			131.54 %			139.98 %		

(1) Includes net deferred loan fee amortization income of $720,000, $573,000 and $627,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

(2) Average balance of available for sale securities is based on amortized historical cost.

(3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 1.76%, 1.35%, and 1.07% for the years ended December 31, 2016, 2015, and 2014, respectively.

(4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis..

(5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.

(6) Net interest margin represents net interest income divided by average total interest-earning assets.

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

	Years Ended December 31, 2016 versus 2015 Increase (Decrease) due to			Years Ended December 31, 2015 versus 2014 Increase (Decrease) due to		
	Volume	Rate	Net	Volume	Rate	Net
	(In Thousands)					
Interest and dividend income:						
Loans receivable and held for sale[1] [2]	$3,446	$ (1,436)	$2,010	$ (17)	$ (2,124)	$ (2,141)
Mortgage related securities[3]	(298)	117	(181)	87	146	233
Other interest-earning assets[3] [4]	(1,267)	1,095	(172)	(695)	992	297
Total interest-earning assets	1,881	(224)	1,657	(625)	(986)	(1,611)