

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Waterstone Financial, Inc.
Form 10-Q
July 31, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-Q

T Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2017

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

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) (IRS Employer Identification No.)

11200 W. Plank Court Wauwatosa, Wisconsin 53226
(Address of principal executive offices) (Zip Code)

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

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

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

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

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

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

Yes No T

The number of shares outstanding of the issuer's common stock, \$0.01 par value per share, was 29,555,466 at July 28, 2017.

WATERSTONE FINANCIAL, INC.

10-Q INDEX

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Consolidated Statements of Financial Condition as of June 30, 2017 (unaudited) and December 31, 2016</u>	3
<u>Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016 (unaudited)</u>	4
<u>Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2017 and 2016 (unaudited)</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2017 and 2016 (unaudited)</u>	6
<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016 (unaudited)</u>	7
<u>Notes to Consolidated Financial Statements (unaudited)</u>	8 - 34
	35 -
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	53
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	54
<u>Item 4. Controls and Procedures</u>	55
<u>PART II. OTHER INFORMATION</u>	55
<u>Item 1. Legal Proceedings</u>	55
<u>Item 1A. Risk Factors</u>	55
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	55
<u>Item 3. Defaults Upon Senior Securities</u>	56
<u>Item 4. Mine Safety Disclosures</u>	56
<u>Item 5. Other Information</u>	56
<u>Item 6. Exhibits</u>	56
<u>Signatures</u>	56

PART I — FINANCIAL INFORMATION

Item 1. Financial StatementsWATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	(Unaudited)	
	June 30, 2017	December 31, 2016
	(Dollars In Thousands, except share and per share data)	
Assets		
Cash	\$84,013	\$7,878
Federal funds sold	29,382	26,828
Interest-earning deposits in other financial institutions and other short term investments	16,165	12,511
Cash and cash equivalents	129,560	47,217
Securities available for sale (at fair value)	209,079	226,795
Loans held for sale (at fair value)	196,644	225,248
Loans receivable	1,225,762	1,177,884
Less: Allowance for loan losses	14,612	16,029
Loans receivable, net	1,211,150	1,161,855
Office properties and equipment, net	23,170	23,655
Federal Home Loan Bank stock (at cost)	18,675	13,275
Cash surrender value of life insurance	64,978	61,509
Real estate owned, net	4,784	6,118
Prepaid expenses and other assets	28,270	24,947
Total assets	\$1,886,310	\$1,790,619
Liabilities and Shareholders' Equity		
Liabilities:		
Demand deposits	\$119,585	\$120,371
Money market and savings deposits	153,743	162,456
Time deposits	664,065	666,584
Total deposits	937,393	949,411
Borrowings	498,103	387,155
Advance payments by borrowers for taxes	18,842	4,716
Other liabilities	23,965	38,647
Total liabilities	1,478,303	1,379,929
Shareholders' equity:		
Preferred stock (par value \$.01 per share)		
Authorized - 50,000,000 shares in 2017 and in 2016, no shares issued	-	-
Common stock (par value \$.01 per share)		
Authorized - 100,000,000 shares in 2017 and in 2016		
Issued - 29,554,466 in 2017 and 29,430,123 in 2016		
Outstanding - 29,554,466 in 2017 and 29,430,123 in 2016	296	294
Additional paid-in capital	325,003	322,934
Retained earnings	179,512	184,565

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Unearned ESOP shares	(19,584)	(20,178)
Accumulated other comprehensive income (loss), net of taxes	237	(378)
Cost of shares repurchased (5,957,833 shares at June 30, 2017 and 5,908,150 shares at December 31, 2016)	(77,457)	(76,547)
Total shareholders' equity	408,007	410,690
Total liabilities and shareholders' equity	\$1,886,310	\$1,790,619

See Accompanying Notes to Unaudited Consolidated Financial Statements.

- 3 -

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	(In Thousands, except per share amounts)			
Interest income:				
Loans	\$14,985	\$14,073	\$29,223	\$27,857
Mortgage-related securities	678	790	1,374	1,628
Debt securities, federal funds sold and short-term investments	877	885	1,729	1,859
Total interest income	16,540	15,748	32,326	31,344
Interest expense:				
Deposits	1,838	1,835	3,633	3,554
Borrowings	2,221	3,748	4,317	7,642
Total interest expense	4,059	5,583	7,950	11,196
Net interest income	12,481	10,165	24,376	20,148
Provision for loan losses	25	-	(1,186)	205
Net interest income after provision for loan losses	12,456	10,165	25,562	19,943
Noninterest income:				
Service charges on loans and deposits	481	616	848	953
Increase in cash surrender value of life insurance	470	471	788	712
Loss on sale of securities	(107)	-	(107)	-
Mortgage banking income	36,224	34,980	60,911	55,594
Other	173	284	738	537
Total noninterest income	37,241	36,351	63,178	57,796
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	27,584	25,709	47,579	43,395
Occupancy, office furniture, and equipment	2,527	2,419	5,054	4,755
Advertising	869	655	1,593	1,313
Data processing	633	638	1,231	1,281
Communications	397	372	776	714
Professional fees	717	489	1,324	1,012
Real estate owned	(133)	163	278	307
FDIC insurance premiums	117	155	237	360
Other	3,476	3,631	7,173	6,316
Total noninterest expenses	36,187	34,231	65,245	59,453
Income before income taxes	13,510	12,285	23,495	18,286
Income tax expense	4,622	4,518	8,035	6,658
Net income	\$8,888	\$7,767	\$15,460	\$11,628
Income per share:				
Basic	\$0.32	\$0.29	\$0.56	\$0.43
Diluted	\$0.32	\$0.29	\$0.55	\$0.43
Weighted average shares outstanding:				
Basic	27,487	26,919	27,406	26,942
Diluted	27,955	27,204	27,913	27,243

See Accompanying Notes to Unaudited Consolidated Financial Statements.

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	(In Thousands)			
Net income	\$8,888	\$7,767	\$15,460	\$11,628
Other comprehensive income, net of tax:				
Net unrealized holding gain on available for sale securities:				
Net unrealized holding gain arising during the period, net of tax expense of (\$204), (\$528), (\$356), (\$1,728), respectively	316	815	550	2,675
Reclassification adjustment for net loss included in net income during the period, net of tax benefit of (\$42), \$0, (\$42), \$0, respectively	65	-	65	-
Total other comprehensive income	381	815	615	2,675
Comprehensive income	\$9,269	\$8,582	\$16,075	\$14,303

See Accompanying Notes to Unaudited Consolidated Financial Statements.

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

	Common Shares	Stock Amount	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Cost of Shares Repurchased	Total Shareholders' Equity
(Dollars In Thousands, except per share amounts)								
Balances at December 31, 2015	29,407	\$ \$294	\$ 317,022	\$ 168,089	\$ (21,365)	\$ 582	\$ (72,692)	\$ 391,930
Comprehensive income:								
Net income	-	-	-	11,628	-	-	-	11,628
Other comprehensive income	-	-	-	-	-	2,675	-	2,675
Total comprehensive income								14,303
ESOP shares committed to be released to Plan participants	-	-	145	-	594	-	-	739
Cash dividend, \$0.13 per share	-	-	-	(3,554)	-	-	-	(3,554)
Stock compensation activity, net of tax	40	-	78	-	-	-	-	78
Stock compensation expense	-	-	942	-	-	-	-	942
Repurchase of common stock returned to authorized but unissued	(284)	(2)	-	-	-	-	(3,855)	(3,857)
Balances at June 30, 2016	29,163	\$ \$292	\$ 318,187	\$ 176,163	\$ (20,771)	\$ 3,257	\$ (76,547)	\$ 400,581
Balances at December 31, 2016	29,430	\$ \$294	\$ 322,934	\$ 184,565	\$ (20,178)	\$ (378)	\$ (76,547)	\$ 410,690
Comprehensive income:								
Net income	-	-	-	15,460	-	-	-	15,460
Other comprehensive income	-	-	-	-	-	615	-	615
Total comprehensive income								16,075

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

ESOP shares committed to be released to Plan participants	-	-	315	-	594	-	-	909
Cash dividend, \$0.74 per share	-	-	-	(20,513)	-	-	-	(20,513)
Stock based compensation activity	174	2	806	-	-	-	-	808
Stock compensation expense	-	-	948	-	-	-	-	948
Repurchase of common stock returned to authorized but unissued	(50)	-	-	-	-	-	(910)	(910)
Balances at June 30, 2017	29,554	\$ \$296	\$ 325,003	\$ 179,512	\$ (19,584)	\$ 237	\$ (77,457)	\$ 408,007

See Accompanying Notes to Unaudited Consolidated Financial Statements.

- 6 -

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six months ended June 30,	
	2017	2016
	(In Thousands)	
Operating activities:		
Net income	\$ 15,460	\$ 11,628
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	(1,186)	205
Provision for depreciation	1,043	1,447
Stock based compensation	948	942
Net amortization of premium/discount on debt and mortgage related securities	365	510
Amortization of unearned ESOP shares	909	739
Amortization and impairment of mortgage servicing rights	49	389
Gain on sale of loans held for sale	(60,277)	(54,929)
Loans originated for sale	(1,219,226)	(1,046,354)
Proceeds on sales of loans originated for sale	1,308,107	1,058,992
Increase in accrued interest receivable	(153)	(21)
Increase in cash surrender value of life insurance	(788)	(712)
Increase (decrease) in accrued interest on deposits and borrowings	70	(211)
(Decrease) increase in other liabilities	(560)	4,149
Increase in accrued tax receivable	(1,132)	(367)
Loss on sale of securities	107	-
Net loss related to real estate owned	102	3
Gain on sale of mortgage servicing rights	(308)	-
Other	(1,899)	(9,447)
Net cash provided by (used in) operating activities	41,524	(33,037)
Investing activities:		
Net increase in loans receivable	(49,033)	(18,910)
Net change in FHLB stock	(5,400)	4,650
Purchases of:		
Mortgage related securities	(4,976)	(5,236)
Premises and equipment, net	(695)	(689)
Bank owned life insurance	(2,680)	(10,180)
Proceeds from:		
Principal repayments on mortgage-related securities	16,940	19,115
Maturities of debt securities	5,845	5,945
Sale of debt securities	448	-
Sales of real estate owned	2,119	3,712
Net cash used in investing activities	(37,432)	(1,593)
Financing activities:		
Net (decrease) increase in deposits	(12,018)	49,348
Net change in short term borrowings	34,948	(6,458)
Repayment of long term debt	(24,000)	(70,000)
Proceeds from long term debt	100,000	50,000
Net change in advance payments by borrowers for taxes	(241)	175

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Cash dividends on common stock	(20,336)	(2,671)
Purchase of common stock returned to authorized but unissued	(910)	(3,857)
Proceeds from stock option exercises	808	78
Net cash provided by financing activities	78,251	16,615
Increase (decrease) in cash and cash equivalents	82,343	(18,015)
Cash and cash equivalents at beginning of period	47,217	100,471
Cash and cash equivalents at end of period	\$129,560	\$82,456

Supplemental information:

Cash paid or credited during the period for:

Income tax payments	\$9,332	\$6,545
Interest payments	7,880	11,407

Noncash activities:

Loans receivable transferred to real estate owned	923	3,123
Dividends declared but not paid in other liabilities	3,514	2,304

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Note 1 — Basis of Presentation

The unaudited interim consolidated financial statements include the accounts of Waterstone Financial, Inc. (the "Company") and the Company's subsidiaries.

WaterStone Bank SSB (the "Bank") is a community bank that has served the banking needs of its customers since 1921. WaterStone Bank also has an active mortgage banking segment, Waterstone Mortgage Corporation.

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, multi-family residential real estate, and commercial real estate loans for retention in its portfolio. WaterStone Bank also offers home equity loans and lines of credit, construction and land loans, 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 and municipal obligations.

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.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information, Rule 10-01 of Regulation S-X and the instructions to Form 10-Q. The financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the financial position, results of operations, changes in shareholders' equity, and cash flows of the Company for the periods presented.

The accompanying unaudited consolidated financial statements and related notes should be read in conjunction with the Company's December 31, 2016 Annual Report on Form 10-K. Operating results for the six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017 or for any other period.

The preparation of the unaudited consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include the allowance for loan losses, deferred income taxes and real estate owned. Actual results could differ from those estimates.

Certain prior period amounts have been reclassified to conform to current period presentation. These reclassifications did not result in any changes to previously reported net income or shareholders' equity.

Impact of Recent Accounting Pronouncements

Accounting Standards Codification (ASC) Topic 606 "Revenue from Contracts with Customers." New authoritative accounting guidance under ASC Topic 606, "Revenue from Contracts with Customers" amended prior guidance to require an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount

that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services and to provide clarification on identifying performance obligations and licensing implementation guidance. The new authoritative guidance was initially effective for reporting periods after January 1, 2017 but was deferred to January 1, 2018. The Company is evaluating the new guidance but does not expect it to have a material impact on the Company's statements of operations or financial condition.

ASC Topic 825 "Financial Instruments." New authoritative accounting guidance under ASC Topic 825, "Financial Instruments" amended prior guidance to require equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. An entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. The new guidance simplifies the impairment assessment of equity investments without readily determinable fair values, requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from changes in the instrument-specific credit risk when the entity has selected the fair value option for financial instruments and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset. The new authoritative guidance will be effective for reporting periods after January 1, 2018 and is not expected to have a material impact on the Company's statements of operations or financial condition.

ASC Topic 842 "Leases." New authoritative accounting guidance under ASC Topic 842, "Leases" amended prior guidance to require lessees to recognize the assets and liabilities arising from all leases on the balance sheet. The new authoritative guidance defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. In addition, the qualifications for a sale and leaseback transaction have been amended. The new authoritative guidance also requires qualitative and quantitative disclosures by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The new authoritative guidance will be effective for reporting periods after January 1, 2019. The Company is evaluating the new guidance and its impact on the Company's statements of operations and financial condition.

ASC Topic 718 "Compensation - Stock Compensation." New authoritative accounting guidance under ASC Topic 718, "Compensation - Stock Compensation" amended prior guidance on several aspects, including the income tax consequences, classification of awards as either equity or liability, and classification on the statement of cash flows. The new authoritative guidance allows for all excess tax benefits and tax deficiencies to be recognized as income tax benefit or expense in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. For earnings per share, anticipated excess tax benefits will not be included in assumed proceeds when applying the treasury method for computing dilutive shares. For the statement of cash flows, excess tax benefits should be classified along with other income tax cash flows as an operating activity, and cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. The new authoritative guidance also allows an entity to make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. In addition, the threshold to qualify for equity classification permits withholding up to the maximum statutory tax rates in the applicable jurisdictions. The Company adopted this standard on January 1, 2017 and the standard did not have a material impact on its consolidated financial statements.

ASC Topic 326 "Financial Instruments - Credit Losses." New authoritative accounting guidance under ASC Topic 326, "Financial Instruments - Credit Losses" amended the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information for credit loss estimates. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The new authoritative guidance also requires a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected (net of the allowance for credit losses). In addition, the credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses rather than a write-down. The new authoritative guidance will be effective for reporting periods after January 1, 2020. The Company is evaluating the new guidance and its impact on the Company's statements of operations and financial condition.

Note 2— Securities Available for Sale

The amortized cost and fair values of the Company's investment in securities available for sale follow:

	June 30, 2017			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In Thousands)			
Mortgage-backed securities	\$66,297	\$ 612	\$ (163)	) \$66,746
Collateralized mortgage obligations:				
Government sponsored enterprise issued	56,695	64	(319)	) 56,440
Mortgage-related securities	122,992	676	(482)	) 123,186
Government sponsored enterprise bonds	2,500	1	(2)	) 2,499
Municipal securities	63,747	1,590	(8)	) 65,329
Other debt securities	17,397	52	(612)	) 16,837
Debt securities	83,644	1,643	(622)	) 84,665
Certificates of deposit	1,225	4	(1)	) 1,228
	\$207,861	\$ 2,323	\$ (1,105)	) \$209,079
	December 31, 2016			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In Thousands)			
Mortgage-backed securities	\$72,858	\$ 798	\$ (243)	) \$73,413
Collateralized mortgage obligations:				
Government sponsored enterprise issued	62,297	70	(365)	) 62,002
Mortgage-related securities	135,155	868	(608)	) 135,415
Government sponsored enterprise bonds	2,500	4	(1)	) 2,503
Municipal securities	70,311	685	(300)	) 70,696
Other debt securities	17,399	154	(603)	) 16,950
Debt securities	90,210	843	(904)	) 90,149
Certificates of deposit	1,225	7	(1)	) 1,231
	\$226,590	\$ 1,718	\$ (1,513)	) \$226,795

The Company's mortgage-backed securities and collateralized mortgage obligations issued by government sponsored enterprises are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. At June 30, 2017, \$63.9 million of the Company's mortgage related securities were pledged as collateral to secure repurchase agreement obligations of the Company. As of June 30, 2017, \$2.9 million of the Company's mortgage related securities were pledged as collateral to secure mortgage banking related activities. At December 31, 2016, \$93.2 million of the Company's government sponsored enterprise bonds and \$2.4 million of the Company's mortgage related securities were pledged as collateral to secure mortgage banking related activities, respectively.

The amortized cost and fair values of investment securities by contractual maturity at June 30, 2017 are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Fair	
	Cost	Value
	(In Thousands)	
Debt and other securities		
Due within one year	\$9,486	\$9,484
Due after one year through five years	20,358	20,504
Due after five years through ten years	38,150	39,470
Due after ten years	16,875	16,435
Mortgage-related securities	122,992	123,186
	\$207,861	\$209,079

- 10 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Gross unrealized losses on securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position were as follows:

	June 30, 2017					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
	(In Thousands)					
Mortgage-backed securities	\$10,436	\$ (144)	\$1,054	\$ (19)	\$11,490	\$ (163)
Collateralized mortgage obligations:						
Government sponsored enterprise issued	37,476	(319)	-	-	37,476	(319)
Government sponsored enterprise bonds	1,998	(2)	-	-	1,998	(2)
Municipal securities	9,322	(8)	-	-	9,322	(8)
Other debt securities	-	-	9,388	(612)	9,388	(612)
Certificates of deposit	489	(1)	-	-	489	(1)
	\$59,721	\$ (474)	\$10,442	\$ (631)	\$70,163	\$ (1,105)

	December 31, 2016					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
	(In Thousands)					
Mortgage-backed securities	\$23,433	\$ (222)	\$1,068	\$ (21)	\$24,501	\$ (243)
Collateralized mortgage obligations:						
Government sponsored enterprise issued	39,395	(365)	-	-	39,395	(365)
Government sponsored enterprise bonds	2,000	(1)	-	-	2,000	(1)
Municipal securities	32,141	(300)	-	-	32,141	(300)
Other debt securities	-	-	9,397	(603)	9,397	(603)
Certificates of deposit	489	(1)	-	-	489	(1)
	\$97,458	\$ (889)	\$10,465	\$ (624)	\$107,923	\$ (1,513)

The Company reviews the investment securities portfolio on a quarterly basis to monitor its exposure to other-than-temporary impairment. In evaluating whether a security's decline in market value is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition of the issuer and the underlying obligors, quality of credit enhancements, volatility of the fair value of the security, the expected recovery period of the security and ratings agency evaluations. In addition, the Company may also evaluate payment structure, whether there are defaulted payments or expected defaults, prepayment speeds and the value of any underlying collateral.

The following table presents the change in other-than-temporary credit related impairment charges on securities available for sale for which a portion of the other-than-temporary impairments related to other factors was recognized in other comprehensive loss.

Credit-related impairments on securities as of December 31, 2015	(In Thousands) \$ 117
Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized	-
Decrease in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized	(23)

Credit-related impairments on securities as of December 31, 2016	94
Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized	-
Increase in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized	-
Credit-related impairments on securities as of June 30, 2017	\$ 94

As of June 30, 2017, the Company held one municipal security that had previously been deemed to be other-than-temporarily impaired. The security was issued by a tax incremental district in a municipality located in Wisconsin. During the year ended December 31, 2012, the Company received audited financial statements with respect to the municipal issuer that called into question the ability of the underlying taxing district that issued the security to operate as a going concern. During the year ended December 31, 2012, the Company's analysis of this security resulted in \$77,000 in credit losses charged to earnings with respect to this municipal security. An additional \$17,000 credit loss was charged to earnings during the year ended December 31, 2014 with respect to this security as a sale occurred at a discounted price. As of June 30, 2017, this security had a combined amortized cost of \$116,000 and total life-to-date impairment of \$94,000.

As of June 30, 2017, the Company had one mortgage-backed security and one other debt security which had been in an unrealized loss position for twelve months or longer. These securities were determined not to be other-than-temporarily impaired as of June 30, 2017. The Company has determined that the decline in fair value of these securities is primarily attributable to an increase in market interest rates compared to the stated rates on these securities and is not attributable to credit deterioration. As the Company does not intend to sell nor is it more likely than not that it will be required to sell these securities before recovery of the amortized cost basis, these securities are not considered other-than-temporarily impaired.

Deterioration of general economic market conditions could result in the recognition of future other than temporary impairment losses within the investment portfolio and such amounts could be material to our consolidated financial statements.

During the six months ended June 30, 2017, proceeds from the sale of securities totaled \$448,000 and resulted in losses totaling \$107,000. The \$107,000 included in loss on sale of available for sale securities in the consolidated statements of income during the six months ended June 30, 2017 was reclassified from accumulated other comprehensive income. There were no sales of securities during the six months ended June 30, 2016.

Note 3 - Loans Receivable

Loans receivable at June 30, 2017 and December 31, 2016 are summarized as follows:

	June 30, 2017	December 31, 2016
	(In Thousands)	
Mortgage loans:		
Residential real estate:		
One- to four-family	\$412,139	\$392,817
Multi-family	574,468	558,592
Home equity	21,046	21,778
Construction and land	14,906	18,179
Commercial real estate	176,934	159,401
Consumer	291	319
Commercial loans	25,978	26,798
	\$1,225,762	\$1,177,884

The Company provides several types of loans to its customers, including residential, construction, commercial and consumer loans. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to one borrower or to multiple borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. While the Company's credit risks are geographically concentrated in the Milwaukee metropolitan area, there are no concentrations with individual or groups of related borrowers.

Qualifying loans receivable totaling \$933.3 million and \$911.9 million at June 30, 2017 and December 31, 2016, respectively, are pledged as collateral against \$415.0 million in outstanding Federal Home Loan Bank of Chicago (FHLBC) advances under a blanket security agreement.

Certain of the Company's executive officers, directors, employees, and their related interests have loans with the Bank. As of June 30, 2017 and December 31, 2016, loans aggregating approximately \$4.6 million and \$5.1 million, respectively, were outstanding to such parties. None of these loans were considered impaired as of June 30, 2017 or December 31, 2016.

As of June 30, 2017 and December 31, 2016, there were no loans 90 or more days past due and still accruing interest.

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

An analysis of past due loans receivable as of June 30, 2017 and December 31, 2016 follows:

As of June 30, 2017						
	1-59 Days Past Due ⁽¹⁾	60-89 Days Past Due ⁽²⁾	90 Days or Greater	Total Past Due	Current ⁽³⁾	Total Loans
(In Thousands)						
Mortgage loans:						
Residential real estate:						
One- to four-family	\$1,924	\$1,057	\$4,317	\$7,298	\$404,841	\$412,139
Multi-family	129	-	763	892	573,576	574,468
Home equity	155	-	56	211	20,835	21,046
Construction and land	-	-	37	37	14,869	14,906
Commercial real estate	164	212	186	562	176,372	176,934
Consumer	-	-	-	-	291	291
Commercial loans	-	-	26	26	25,952	25,978
Total	\$2,372	\$1,269	\$5,385	\$9,026	\$1,216,736	\$1,225,762

As of December 31, 2016						
	1-59 Days Past Due ⁽¹⁾	60-89 Days Past Due ⁽²⁾	90 Days or Greater	Total Past Due	Current ⁽³⁾	Total Loans
(In Thousands)						
Mortgage loans:						
Residential real estate:						
One- to four-family	\$2,403	\$ 7	\$4,623	\$7,033	\$385,784	\$392,817
Multi-family	376	-	401	777	557,815	558,592
Home equity	82	-	35	117	21,661	21,778
Construction and land	-	-	-	-	18,179	18,179
Commercial real estate	-	-	203	203	159,198	159,401
Consumer	-	-	-	-	319	319
Commercial loans	42	-	27	69	26,729	26,798
Total	\$2,903	\$ 7	\$5,289	\$8,199	\$1,169,685	\$1,177,884

⁽¹⁾ Includes \$59,000 and \$148,000 at June 30, 2017 and December 31, 2016, respectively, which are on non-accrual status.

⁽²⁾ Includes \$1.3 million and \$- at June 30, 2017 and December 31, 2016, respectively, which are on non-accrual status.

⁽³⁾ Includes \$1.9 million and \$4.4 million at June 30, 2017 and December 31, 2016, respectively, which are on non-accrual status.

A summary of the activity for the six months ended June 30, 2017 and 2016 in the allowance for loan losses follows:

One- to Four- Family	Home Multi-Family Equity	Construction and Land	Commercial Real Estate	Consumer Commercial	Total
(In Thousands)					

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Six months ended June 30, 2017

Balance at beginning of period	\$7,164	\$ 4,809	\$ 364	\$ 1,016	\$ 1,951	\$ 12	\$ 713	\$16,029
Provision (credit) for loan losses	(187)	(376)	1	(310)	(166)	(1)	(147)	(1,186)
Charge-offs	(392)	(44)	-	(14)	-	-	-	(450)
Recoveries	119	43	17	40	-	-	-	219
Balance at end of period	\$6,704	\$ 4,432	\$ 382	\$ 732	\$ 1,785	\$ 11	\$ 566	\$14,612

Six months ended June 30, 2016

Balance at beginning of period	\$7,763	\$5,000	\$433	\$904	\$1,680	\$9	\$396	\$16,185
Provision (credit) for loan losses	(103)	(5)	(2)	(13)	52	1	275	205
Charge-offs	(464)	(445)	(62)	(3)	-	-	-	(974)
Recoveries	178	59	19	33	-	-	-	289
Balance at end of period	\$7,374	\$4,609	\$388	\$921	\$1,732	\$10	\$671	\$15,705

- 13 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of June 30, 2017 follows:

	One- to Four- Family (In Thousands)	Multi- Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
Allowance related to loans individually evaluated for impairment	\$986	\$45	\$85	\$ -	\$ 58	\$ -	\$ -	\$1,174
Allowance related to loans collectively evaluated for impairment	5,718	4,387	297	732	1,727	11	566	13,438
Balance at end of period	\$6,704	\$4,432	\$382	\$ 732	\$ 1,785	\$ 11	\$ 566	\$14,612
Loans individually evaluated for impairment	\$10,024	\$3,686	\$273	\$ 37	\$ 691	\$ -	\$ 26	\$14,737
Loans collectively evaluated for impairment	402,115	570,782	20,773	14,869	176,243	291	25,952	1,211,025
Total gross loans	\$412,139	\$574,468	\$21,046	\$ 14,906	\$ 176,934	\$ 291	\$ 25,978	\$1,225,762

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of December 31, 2016 follows:

	One- to Four- Family (In Thousands)	Multi- Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
Allowance related to loans individually evaluated for impairment	\$499	\$-	\$79	\$ -	\$ 83	\$ -	\$ 1	\$662
Allowance related to loans collectively evaluated for impairment	6,665	4,809	285	1,016	1,868	12	712	15,367
Balance at end of period	\$7,164	\$4,809	\$364	\$ 1,016	\$ 1,951	\$ 12	\$ 713	\$16,029
Loans individually evaluated for impairment	\$10,920	\$3,941	\$442	\$ -	\$ 718	\$ -	\$ 41	\$16,062
Loans collectively evaluated for impairment	381,897	554,651	21,336	18,179	158,683	319	26,757	1,161,822
Total gross loans	\$392,817	\$558,592	\$21,778	\$ 18,179	\$ 159,401	\$ 319	\$ 26,798	\$1,177,884

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

The following table presents information relating to the Company's internal risk ratings of its loans receivable as of June 30, 2017 and December 31, 2016:

	One to Four- Family (In Thousands)	Multi-Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
At June 30, 2017								
Substandard	\$9,647	\$ 1,198	\$242	\$ 37	\$ 691	\$ -	\$ 906	\$12,721
Watch	9,702	2,989	53	-	598	-	1,372	14,714
Pass	392,790	570,281	20,751	14,869	175,645	291	23,700	1,198,327
	\$412,139	\$ 574,468	\$21,046	\$ 14,906	\$ 176,934	\$ 291	\$ 25,978	\$1,225,762
At December 31, 2016								
Substandard	\$12,845	\$ 1,427	\$428	\$ -	\$ 717	\$ -	\$ 41	\$15,458
Watch	10,509	3,975	149	436	1,389	-	3,671	20,129
Pass	369,463	553,190	21,201	17,743	157,295	319	23,086	1,142,297
	\$392,817	\$ 558,592	\$21,778	\$ 18,179	\$ 159,401	\$ 319	\$ 26,798	\$1,177,884

- 14 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Factors that are important to managing overall credit quality include sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an allowance for loan losses, and sound non-accrual and charge-off policies. Our underwriting policies require an officers' loan committee review and approval of all loans in excess of \$500,000. In addition, we utilize an independent loan review function for all loans. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we maintain a loan review system under which our credit management personnel review non-owner occupied one- to four-family, multi-family, construction and land, commercial real estate and commercial loans that individually, or as part of an overall borrower relationship exceed \$1.0 million in potential exposure. Loans meeting these criteria are reviewed on an annual basis, or more frequently, if the loan renewal is less than one year. With respect to this review process, management has determined that pass loans include loans that exhibit acceptable financial statements, cash flow and leverage. Watch loans have potential weaknesses that deserve management's attention, and if left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit. Substandard loans are considered inadequately protected by the current net worth and paying capacity of the obligor or the collateral pledged. These loans generally have a well-defined weakness that may jeopardize liquidation of the debt and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Finally, a loan is considered to be impaired when it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management has determined that all non-accrual loans and loans modified under troubled debt restructurings meet the definition of an impaired loan.

The Company's procedures dictate that an updated valuation must be obtained with respect to underlying collateral at the time a loan is deemed impaired. Updated valuations may also be obtained upon transfer from loans receivable to real estate owned based upon the age of the prior appraisal, changes in market conditions or known changes to the physical condition of the property.

Estimated fair values are reduced to account for sales commissions, broker fees, unpaid property taxes and additional selling expenses to arrive at an estimated net realizable value. The adjustment factor is based upon the Company's actual experience with respect to sales of real estate owned over the prior two years. In situations in which we are placing reliance on an appraisal that is more than one year old, an additional adjustment factor is applied to account for downward market pressure since the date of appraisal. The additional adjustment factor is based upon relevant sales data available for our general operating market as well as company-specific historical net realizable values as compared to the most recent appraisal prior to disposition.

With respect to multi-family income-producing real estate, appraisals are reviewed and estimated collateral values are adjusted by updating significant appraisal assumptions to reflect current real estate market conditions. Significant assumptions reviewed and updated include the capitalization rate, rental income and operating expenses. These adjusted assumptions are based upon recent appraisals received on similar properties as well as on actual experience related to real estate owned and currently under Company management.

The following tables present data on impaired loans at June 30, 2017 and December 31, 2016.

	As of or for the Six Months Ended June 30, 2017					
	Recorded Unpaid		Reserve	Cumulative Charge-Offs	Average	Interest Paid
	Investment	Principal			Recorded Investment	
	(In Thousands)					
Total Impaired with Reserve						
One- to four-family	\$3,384	\$3,384	\$986	\$ -	\$ 3,410	\$ 65
Multi-family	373	373	45	-	374	-
Home equity	163	163	85	-	167	6
Construction and land	-	-	-	-	-	-

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Commercial real estate	255	664	58	409	263	5
Consumer	-	-	-	-	-	-
Commercial	-	-	-	-	-	-
	4,175	4,584	1,174	409	4,214	76
Total Impaired with no Reserve						
One- to four-family	6,640	7,612	-	972	6,778	144
Multi-family	3,313	4,188	-	875	3,344	95
Home equity	110	110	-	-	114	2
Construction and land	37	51	-	14	49	-
Commercial real estate	436	436	-	-	437	7
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	10,562	12,423	-	1,861	10,748	248
Total Impaired						
One- to four-family	10,024	10,996	986	972	10,188	209
Multi-family	3,686	4,561	45	875	3,718	95
Home equity	273	273	85	-	281	8
Construction and land	37	51	-	14	49	-
Commercial real estate	691	1,100	58	409	700	12
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	\$14,737	\$17,007	\$1,174	\$2,270	\$14,962	\$324

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

As of or for the Year Ended December 31, 2016

	Recorded Unpaid		Reserve	Cumulative	Average	Interest
	Investment	Principal	Charge-Offs	Recorded	Investment	Paid
	(In Thousands)					
Total Impaired with Reserve						
One- to four-family	\$3,007	\$3,007	\$ 499	\$ -	\$ 3,063	\$ 88
Multi-family	-	-	-	-	-	-
Home equity	188	188	79	-	198	15
Construction and land	-	-	-	-	-	-
Commercial real estate	280	689	83	409	295	15
Consumer	-	-	-	-	-	-
Commercial	1	1	1	-	2	-
	3,476	3,885	662	409	3,558	118
Total Impaired with no Reserve						
One- to four-family	7,913	9,245	-	1,332	8,150	401
Multi-family	3,941	4,952	-	1,011	4,005	230
Home equity	254	254	-	-	258	9
Construction and land	-	-	-	-	-	-
Commercial real estate	438	438	-	-	442	13
Consumer	-	-	-	-	-	-
Commercial	40	40	-	-	46	2
	12,586	14,929	-	2,343	12,901	655
Total Impaired						
One- to four-family	10,920	12,252	499	1,332	11,213	489
Multi-family	3,941	4,952	-	1,011	4,005	230
Home equity	442	442	79	-	456	24
Construction and land	-	-	-	-	-	-
Commercial real estate	718	1,127	83	409	737	28
Consumer	-	-	-	-	-	-
Commercial	41	41	1	-	48	2
	\$16,062	\$18,814	\$ 662	\$ 2,752	\$ 16,459	\$ 773

The difference between a loan's recorded investment and the unpaid principal balance represents a partial charge-off resulting from a confirmed loss when the value of the collateral securing the loan is below the loan balance and management's assessment that the full collection of the loan balance is not likely.

When a loan is considered impaired, 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.

The determination as to whether an allowance is required with respect to impaired loans is based upon an analysis of the value of the underlying collateral and/or the borrower's intent and ability to make all principal and interest payments in accordance with contractual terms. The evaluation process is subject to the use of significant estimates and actual results could differ from estimates. This analysis is primarily based upon third party appraisals and/or a discounted cash flow analysis. In those cases in which no allowance has been provided for an impaired loan, the Company has determined that the estimated value of the underlying collateral exceeds the remaining outstanding balance of the loan. Of the total \$10.6 million of impaired loans as of June 30, 2017 for which no allowance has been

provided, \$1.9 million in net charge-offs have been recorded to reduce the unpaid principal balance to an amount that is commensurate with the loans' net realizable value, using the estimated fair value of the underlying collateral. To the extent that further deterioration in property values continues, the Company may have to reevaluate the sufficiency of the collateral servicing these impaired loans resulting in additional provisions to the allowance for loans losses or charge-offs.

At June 30, 2017, total impaired loans included \$8.2 million of troubled debt restructurings. Troubled debt restructurings involve granting concessions to a borrower experiencing financial difficulty by modifying the terms of the loan in an effort to avoid foreclosure. The vast majority of debt restructurings include a modification of terms to allow for an interest only payment and/or reduction in interest rate. The restructured terms are typically in place for six to twelve months. At December 31, 2016, total impaired loans included \$10.1 million of troubled debt restructurings.

- 16 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

The following presents data on troubled debt restructurings:

	As of June 30, 2017					
	Accruing Amount	Non-accruing Number	Accruing Amount	Non-accruing Number	Total Amount	Total Number
	(Dollars in Thousands)					
One- to four-family	\$3,291	3	\$1,224	7	\$4,515	10
Multi-family	2,489	1	825	3	3,314	4
Home Equity	48	1	-	-	48	1
Commercial real estate	292	1	42	1	334	2
	\$6,120	6	\$2,091	11	\$8,211	17

	As of December 31, 2016					
	Accruing Amount	Non-accruing Number	Accruing Amount	Non-accruing Number	Total Amount	Total Number
	(Dollars in Thousands)					
One- to four-family	\$3,296	3	\$2,399	34	\$5,695	37
Multi-family	2,514	1	1,427	5	3,941	6
Home equity	49	1	97	1	146	2
Commercial real estate	295	1	60	1	355	2
	\$6,154	6	\$3,983	41	\$10,137	47

At June 30, 2017, \$8.2 million in loans had been modified in troubled debt restructurings and \$2.1 million of these loans were included in the non-accrual loan total. The remaining \$6.1 million, while meeting the internal requirements for modification in a troubled debt restructuring, were current with respect to payments under their original loan terms at the time of the restructuring and, therefore, continued to be included with accruing loans. Provided these loans perform in accordance with the modified terms, they will continue to be accounted for on an accrual basis.

All loans that have been modified in a troubled debt restructuring are considered to be impaired. As such, an analysis has been performed with respect to all of these loans to determine the need for a valuation reserve. When a loan is expected to perform in accordance with the restructured terms and ultimately return to and perform under contract terms, a valuation allowance is established for an amount equal to the excess of the present value of the expected future cash flows under the original contract terms as compared with the modified terms, including an estimated default rate. When there is doubt as to the borrower's ability to perform under the restructured terms or ultimately return to and perform under market terms, a valuation allowance is established equal to the impairment when the carrying amount exceeds fair value of the underlying collateral. As a result of the impairment analysis, a \$242,000 valuation allowance has been established as of June 30, 2017 with respect to the \$8.2 million in troubled debt restructurings. As of December 31, 2016, a \$293,000 valuation allowance had been established with respect to the \$10.1 million in troubled debt restructurings.

After a troubled debt restructuring reverts to market terms, a minimum of six consecutive contractual payments must be received prior to consideration for a return to accrual status. If an updated credit department review indicates no other evidence of elevated credit risk, the loan is returned to accrual status at that time.

The following presents troubled debt restructurings by concession type:

	As of June 30, 2017		
	Performing in	In Default	Total

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

	accordance with modified terms					
	Amount	Number	Amount	Number	Amount	Number
	(dollars in thousands)					
Interest reduction and principal forbearance	\$7,090	11	\$714	2	\$7,804	13
Principal forbearance	48	1	-	-	48	1
Interest reduction	359	3	-	-	359	3
	\$7,497	15	\$714	2	\$8,211	17

As of December 31, 2016

	Performing in accordance with modified terms		In Default		Total	
	Amount	Number	Amount	Number	Amount	Number
	(dollars in thousands)					
Interest reduction and principal forbearance	\$8,221	22	\$761	2	\$8,982	24
Principal forbearance	49	1	-	-	49	1
Interest reduction	1,106	22	-	-	1,106	22
	\$9,376	45	\$761	2	\$10,137	47

- 17 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

There were no loans modified as troubled debt restructurings for the three months or six months ended June 30, 2017 and June 30, 2016.

There were no troubled debt restructurings within the past twelve months for which there was a default during the three or six months ended June 30, 2017 and June 30, 2016.

The following table presents data on non-accrual loans as of June 30, 2017 and December 31, 2016:

	June 30, 2017	December 31, 2016		
	(Dollars in Thousands)			
Non-accrual loans:				
Residential				
One- to four-family	\$6,732	\$ 7,623		
Multi-family	1,198	1,427		
Home equity	194	344		
Construction and land	37	-		
Commercial real estate	398	422		
Commercial	26	41		
Consumer	-	-		
Total non-accrual loans	\$8,585	\$ 9,857		
Total non-accrual loans to total loans receivable	0.70 %	0.84 %		
Total non-accrual loans to total assets	0.46 %	0.55 %		

Note 4— Real Estate Owned

Real estate owned is summarized as follows:

	June 30, 2017	December 31, 2016
	(In Thousands)	
One- to four-family	\$ 1,386	\$ 2,141
Multi-family	-	-
Construction and land	4,802	5,082
Commercial real estate	300	300
Total real estate owned	6,488	7,523
Valuation allowance at end of period	(1,704)	(1,405)
Total real estate owned, net	\$4,784	\$ 6,118

The following table presents the activity in the Company's real estate owned:

	Six months ended June 30, 2017 2016	
	(In Thousands)	
Real estate owned at beginning of the period	\$6,118	9,190
Transferred from loans receivable	923	3,123
Sales (net of gains / losses)	(1,792)	(3,325)
Write downs	(464)	(351)
Other	(1)	-
Real estate owned at the end of the period	\$4,784	8,637

Residential one- to four-family mortgage loans that were in the process of foreclosure were \$5.0 million and \$3.1 million at June 30, 2017 and December 31, 2016, respectively.

Note 5— Mortgage Servicing Rights

The following table presents the activity in the Company's mortgage servicing rights:

	Six months ended June 30,	
	2017	2016
	(In Thousands)	
Mortgage servicing rights at beginning of the period	\$2,260	\$1,422
Additions	568	972
Amortization	(49)	(239)
Sales	(2,264)	-
Mortgage servicing rights at end of the period	515	2,155
Valuation allowance at end of period	-	(150)
Mortgage servicing rights at end of the period, net	\$515	\$2,005

During the six months ended June 30, 2017, \$1.22 billion in residential loans were originated for sale. During the same period, sales of loans held for sale totaled \$1.31 billion, generating mortgage banking income of \$60.9 million. The unpaid principal balance of loans serviced for others was \$73.3 million and \$318.6 million at June 30, 2017 and December 31, 2016, respectively. These loans are not reflected in the consolidated statements of financial condition.

During the six months ended June 30, 2017, the Company sold mortgage servicing rights related to \$295.1 million in loans receivable with a book value of \$2.3 million for \$2.6 million resulting in a gain on sale of \$308,000. During the six months ended June 30, 2016, the Company did not sell any mortgage servicing rights.

The following table shows the estimated future amortization expense for mortgage servicing rights for the periods indicated:

Estimate for the period ending December 31:	(In Thousands)
2017	\$ 49
2018	73
2019	65
2020	58
2021	49
Thereafter	221
Total	\$ 515

Note 6— Deposits

At June 30, 2017 and December 31, 2016, time deposits with balances greater than \$250,000 amounted to \$40.4 million and \$44.5 million, respectively.

A summary of the contractual maturities of time deposits at June 30, 2017 is as follows:

	(In Thousands)
Within one year	\$ 557,711
More than one to two years	90,268

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

More than two to three years	13,027
More than three to four years	1,637
More than four through five years	1,422
	\$ 664,065

- 20 -

Note 7— Borrowings

Borrowings consist of the following:

	June 30, 2017		December 31, 2016		
	Balance	Weighted Average Rate	Balance	Weighted Average Rate	
(Dollars in Thousands)					
Short term:					
Repurchase agreement	\$23,103	3.98 %	\$8,155	3.52 %	
Federal Home Loan Bank, Chicago advances	85,000	1.14 %	65,000	0.61 %	
Long term:					
Federal Home Loan Bank, Chicago advances maturing:					
2017	65,000	3.19 %	65,000	3.19 %	
2018	65,000	2.97 %	65,000	2.97 %	
2021	100,000	0.78 %	100,000	0.78 %	
2027	100,000	1.24 %	-	0.00 %	
Repurchase agreements maturing	2017 60,000	3.87 %	84,000	3.96 %	
	\$498,103	2.05 %	\$387,155	2.27 %	

The short-term repurchase agreement represents the outstanding portion of a total \$35.0 million commitment with one unrelated bank. The short-term repurchase agreement is utilized by Waterstone Mortgage Corporation to finance loans originated for sale. This agreement is secured by the underlying loans being financed. Related interest rates are based upon the note rate associated with the loans being financed. The short-term repurchase agreement had a \$23.1 million balance at June 30, 2017 and a \$8.2 million balance at December 31, 2016.

The \$85.0 million in short-term advances consists of one \$35.0 million short-term advance that has a maturity date of March 15, 2018 and a fixed rate of 1.28% and one \$50.0 million short-term advance that has a maturity date of August 25, 2017 and a fixed rate of 1.05%.

The \$65.0 million in advances due in 2017 consists of three advances with fixed rates ranging from 3.09% to 3.46% callable quarterly until maturity.

The \$65.0 million in advances due in 2018 consists of three advances with fixed rates ranging from 2.73% to 3.11% callable quarterly until maturity.

The \$100.0 million in advances due in 2021 consists of two advances totaling \$50.0 million with fixed rates ranging from 0.67% to 0.73% with a FHLB quarterly call option beginning in June 2018 and one advance for \$50.0 million with a fixed rate of 0.85% with a FHLB quarterly call option beginning in September 2018.

The \$100.0 million in advances due in 2027 consists of one \$50.0 million advance with a fixed rate of 1.24% with a FHLB single call option in May 2019 and one \$50.0 million advance with a fixed rate of 1.23% with a FHLB single call option in June 2019.

The \$60.0 million in repurchase agreements have fixed rates ranging from 2.89% to 4.31% callable quarterly until their maturity in 2017. The repurchase agreements are collateralized by securities available for sale with an estimated fair value of \$63.9 million at June 30, 2017 and \$93.2 million at December 31, 2016.

The Company selects loans that meet underwriting criteria established by the FHLBC as collateral for outstanding advances. The Company's borrowings from the FHLBC are limited to 79% of the carrying value of unencumbered one- to four-family mortgage loans, 75% of the carrying value of home equity loans and 51% of the carrying value of multi-family loans. In addition, these advances were collateralized by FHLBC stock of \$18.7 million at June 30, 2017 and \$13.3 million at December 31, 2016. In the event of prepayment, the Company is obligated to pay all remaining contractual interest on the advance.

- 21 -

Note 8 – Regulatory Capital

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

The Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier I capital ratio, increase the minimum Tier 1 capital ratio requirements and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The Company and the Bank have made the election to retain the existing treatment for accumulated other comprehensive income. The final rules took effect for the Company and the Bank on January 1, 2015, subject to a transition period for certain parts of the rules.

The table below includes the new regulatory capital ratio requirements that became effective on January 1, 2015. Beginning in 2016, an additional capital conservation buffer was added to the minimum requirements for capital adequacy purposes, subject to a three year phase-in period. The capital conservation buffer will be fully phased-in on January 1, 2019 at 2.5%. A banking organization with a conservation buffer of less than 2.5% (or the required phase-in amount in years prior to 2019) will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At June 30, 2017, the ratios for the Company and the Bank are sufficient to meet the fully phased-in conservation buffer.

The actual and required capital amounts and ratios for the Bank as of June 30, 2017 and December 31, 2016 are presented in the table below:

	June 30, 2017							
	Actual		For Capital Adequacy Purposes		Minimum Capital Adequacy with Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars In Thousands)							
Total Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.	\$410,803	30.19%	\$108,841	8.00%	\$125,847	9.25%	\$N/A	N/A
WaterStone Bank	397,990	29.34%	108,513	8.00%	125,468	9.25%	135,642	10.00%
Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.	396,191	29.12%	81,630	6.00%	98,637	7.25%	N/A	N/A
WaterStone Bank	383,378	28.26%	81,385	6.00%	98,340	7.25%	108,513	8.00%

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Common Equity Tier 1 Capital (to risk-weighted assets)

Consolidated Waterstone

Financial, Inc.	396,191	29.12 %	61,223	4.50 %	78,229	5.75 %	N/A	N/A
WaterStone Bank	383,378	28.26 %	61,039	4.50 %	77,994	5.75 %	88,167	6.50 %

Tier 1 Capital (to average assets)

Consolidated Waterstone

Financial, Inc.	396,191	22.14 %	71,575	4.00 %	N/A	N/A	N/A	N/A
WaterStone Bank	383,378	21.47 %	71,413	4.00 %	N/A	N/A	89,266	5.00 %

State of Wisconsin (to total assets)

WaterStone Bank	383,378	20.39 %	112,838	6.00 %	N/A	N/A	N/A	N/A
-----------------	---------	---------	---------	--------	-----	-----	-----	-----

- 22 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

December 31, 2016
(Dollars In Thousands)

Total Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	\$426,496	32.23 %	\$105,870	8.00 %	\$114,141	8.625 %	\$N/A	N/A
WaterStone Bank								
	389,602	29.50 %	105,641	8.00 %	113,895	8.625 %	132,052	10.00 %
Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	410,467	31.02 %	79,402	6.00 %	87,673	6.625 %	N/A	N/A
WaterStone Bank								
	373,573	28.29 %	79,231	6.00 %	87,484	6.625 %	105,641	8.00 %
Common Equity Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	410,467	31.02 %	59,552	4.50 %	67,823	5.125 %	N/A	N/A
WaterStone Bank								
	373,573	28.29 %	59,423	4.50 %	67,676	5.125 %	85,834	6.50 %
Tier 1 Capital (to average assets)								
Consolidated Waterstone Financial, Inc.								
	410,467	23.20 %	70,760	4.00 %	N/A	N/A	N/A	N/A
WaterStone Bank								
	373,573	21.17 %	70,573	4.00 %	N/A	N/A	88,216	5.00 %
State of Wisconsin (to total assets)								
WaterStone Bank								
	373,573	20.90 %	107,247	6.00 %	N/A	N/A	N/A	N/A

Note 9 – Income Taxes

Income tax expense increased from \$6.7 million during the six months ended June 30, 2016 to \$8.0 million for the six months ended June 30, 2017. This increase was primarily due to the increase in our income before income taxes, which increased from \$18.3 million during the six months ended June 30, 2016 to \$23.5 million during the six months ended June 30, 2017. Income tax expense is recognized on the statement of income during the six months ended June 30, 2017 at an effective rate of 34.2% of pretax income compared to 36.4% during the six months ended June 30, 2016.

During six months ended June 30, 2017, the Company recognized a benefit of approximately \$806,000 related to stock awards exercised during the year as a result of adopting the new stock compensation accounting standard.

Note 10 – Offsetting of Assets and Liabilities

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. In addition, the Company enters into agreements under which it sells loans held for sale subject to an obligation to repurchase the same loans. Under these arrangements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of assets. The obligation to repurchase the assets is reflected as a liability in the Company's consolidated statements of financial condition, while the securities and loans held for sale underlying the repurchase agreements remain in the respective investment securities and loans held for sale asset accounts. In other words, there is no offsetting or netting of the investment securities or loans held for sale assets with the repurchase agreement liabilities. One of the Company's two short-term repurchase agreements and all of the Company's long-term repurchase agreements are subject to master netting agreements, which set forth the rights and obligations for repurchase and offset. Under the master netting agreement, the Company is entitled to set off the collateral placed with a single counterparty against obligations owed to that counterparty.

The following table presents the liabilities subject to an enforceable master netting agreement as of June 30, 2017 and December 31, 2016.

	Gross Recognized Liabilities (In Thousands)	Gross Amounts Offset	Net Amounts Presented	Gross Amounts Not Offset	Net Amount
June 30, 2017					
Repurchase Agreements					
Short-term	\$23,103	\$ -	\$ 23,103	\$23,103	\$ -
Long-term	60,000	-	60,000	60,000	-
	\$83,103	\$ -	\$ 83,103	\$83,103	\$ -
December 31, 2016					
Repurchase Agreements					
Short-term	\$8,155	\$ -	\$ 8,155	\$8,155	\$ -
Long-term	84,000	-	84,000	84,000	-
	\$92,155	\$ -	\$ 92,155	\$92,155	\$ -

Note 11– Commitments, Off-Balance Sheet Arrangements, and Contingent Liabilities

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated statements of financial condition. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

	June 30, 2017	December 31, 2016
	(In Thousands)	
Financial instruments whose contract amounts represent potential credit risk:		
Commitments to extend credit under amortizing loans (1)	\$33,719	\$ 30,903
Commitments to extend credit under home equity lines of credit (2)	14,467	14,367
Unused portion of construction loans (3)	25,690	21,137
Unused portion of business lines of credit	16,300	15,095
Standby letters of credit	259	333

(1) Commitments for loans are extended to customers for up to 90 days after which they expire. Excludes commitments to originate loans held for sale, which are discussed in the following footnote.

(2) Unused portions of home equity loans are available to the borrower for up to 10 years.

(3) Unused portions of construction loans are available to the borrower for up to one year.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements of the Company. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral obtained generally consists of mortgages on the underlying real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds mortgages on the underlying real estate as collateral supporting those commitments for which collateral is deemed necessary.

The Company has determined that there are no probable losses related to commitments to extend credit or the standby letters of credit as of June 30, 2017 and December 31, 2016.

In the normal course of business, the Company, or its subsidiaries, are involved in various legal proceedings. In the opinion of management, any liability resulting from pending proceedings would not be expected to have a material adverse effect on the Company's consolidated financial statements.

Herrington v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their various employment agreements. On July 5, 2017, the arbitrator issued a final award finding Waterstone Mortgage Corporation liable for unpaid minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. The arbitrator awarded

damages under the FLSA in the amount of \$7.3 million, and attorney's fees and costs in the amount of \$3.3 million. While a judgment confirming the arbitrator's award with respect to damages and fees has not yet been issued, if plaintiff prevails on her theories, the Company has estimated that the award, which includes attorney's fees and costs, could be as high as \$11.0 million. Waterstone Mortgage Corporation will continue to vigorously defend its interests in this matter, including challenging any findings regarding liability and damages through appropriate post-arbitration motions and appeal processes and seeking to vacate in its entirety any award against the Company. Given the pending legal strategies that are available, we do not believe that it is probable that the plaintiff will ultimately prevail in this litigation, and estimate the low end of the possible range of loss is \$0. In accordance with the authoritative guidance in evaluating contingencies, the Company has not recorded an accrual related to this matter.

Note 12 – Derivative Financial Instruments

In connection with its mortgage banking activities, the Company enters into derivative financial instruments as part of its strategy to manage its exposure to changes in interest rates. Mortgage banking derivatives include interest rate lock commitments provided to customers to fund mortgage loans to be sold in the secondary market and forward commitments for the future delivery of such loans to third party investors. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of future changes in interest rates on its commitments to fund the loans as well as on its portfolio of mortgage loans held for sale. The Company's mortgage banking derivatives have not been designated as hedge relationships. These instruments are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements of ASC 815. Changes in the fair value of derivatives not designated in hedging relationships are recorded as a component of mortgage banking income in the Company's consolidated statements of operations. The Company does not use derivatives for speculative purposes.

Forward commitments to sell mortgage loans represent commitments obtained by the Company from a secondary market agency to purchase mortgages from the Company at specified interest rates and within specified periods of time. Commitments to sell loans are made to mitigate interest rate risk on interest rate lock commitments to originate loans and loans held for sale. At June 30, 2017, the Company had forward commitments to sell mortgage loans with an aggregate notional amount of approximately \$417.2 million and interest rate lock commitments with an aggregate notional amount of approximately \$266.9 million. The fair value of the forward commitments to sell mortgage loans at June 30, 2017 included a gain of \$1.5 million that is reported as a component of other assets on the Company's consolidated statement of financial condition. The fair value of the interest rate locks at June 30, 2017 included a gain of \$2.5 million that is reported as a component of other assets on the Company's consolidated statements of financial condition.

In determining the fair value of its derivative loan commitments, the Company considers the value that would be generated by the loan arising from exercise of the loan commitment when sold in the secondary mortgage market. That value includes the price that the loan is expected to be sold for in the secondary mortgage market. The fair value of these commitments is recorded on the consolidated statements of financial condition with the changes in fair value recorded as a component of mortgage banking income.

Residential mortgage loans sold to others are predominantly conventional residential first lien mortgages. The Company's agreements to sell residential mortgage loans in the normal course of business usually require certain representations and warranties on the underlying loans sold related to credit information, loan documentation and collateral, which if subsequently are untrue or breached, could require the Company to repurchase certain loans affected. The Company has only been required to make insignificant repurchases as a result of breaches of these representations and warranties. The Company's agreements to sell residential mortgage loans also contain limited recourse provisions. The recourse provisions are limited in that the recourse provision ends after certain payment criteria have been met. With respect to these loans, repurchase could be required if defined delinquency issues arose during the limited recourse period. Given that the underlying loans delivered to buyers are predominantly conventional first lien mortgages and that historical experience shows negligible losses and insignificant repurchase activity, management believes that losses and repurchases under the limited recourse provisions will continue to be insignificant.

Note 13 – Earnings Per Share

Earnings per share are computed using the two-class method. Basic earnings per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the applicable period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares.

Presented below are the calculations for basic and diluted earnings per share:

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
	(In Thousands, except per share amounts)			
Net income	\$8,888	\$7,767	\$15,460	\$11,628
Net income available to unvested restricted shares	-	5	-	7
Net income available to common stockholders	\$8,888	\$7,762	\$15,460	\$11,621
Weighted average shares outstanding	27,487	26,919	27,406	26,942
Effect of dilutive potential common shares	468	285	507	301
Diluted weighted average shares outstanding	27,955	27,204	27,913	27,243
Basic earnings per share	\$0.32	\$0.29	\$0.56	\$0.43
Diluted earnings per share	\$0.32	\$0.29	\$0.55	\$0.43

Note 14 – Fair Value Measurements

ASC Topic 820, "Fair Value Measurements and Disclosures" defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This accounting standard applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements. The standard also emphasizes that fair value (i.e., the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date), among other things, is based on exit price versus entry price, should include assumptions about risk such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. When considering the assumptions that market participants would use in pricing the asset or liability, this accounting standard establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The fair value hierarchy prioritizes inputs used to measure fair value into three broad levels.

Level 1 inputs - In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2 inputs - Fair values determined by Level 2 inputs use inputs other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets where there are few transactions and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Level 3 inputs are unobservable inputs for the asset or liability and include situations where there is little, if any, market activity for the asset or liability.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

- 27 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

The following table presents information about our assets recorded in our consolidated statement of financial condition at their fair value on a recurring basis as of June 30, 2017 and December 31, 2016, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

	June 30, 2017 (In Thousands)	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Available for sale securities				
Mortgage-backed securities	\$66,746	\$-	\$66,746	\$-
Collateralized mortgage obligations				
Government sponsored enterprise issued	56,440	-	56,440	-
Government sponsored enterprise bonds	2,499	-	2,499	-
Municipal securities	65,329	-	65,329	-
Other debt securities	16,837	2,412	14,425	-
Certificates of deposit	1,228	-	1,228	-
Loans held for sale	196,644	-	196,644	-
Mortgage banking derivative assets	3,904	-	-	3,904

	December 31, 2016 (In Thousands)	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Available for sale securities				
Mortgage-backed securities	\$73,413	\$-	\$73,413	\$-
Collateralized mortgage obligations				
Government sponsored enterprise issued	62,002	-	62,002	-
Government sponsored enterprise bonds	2,503	-	2,503	-
Municipal securities	70,696	-	70,696	-
Other debt securities	16,950	2,541	14,409	-
Certificates of deposit	1,231	-	1,231	-
Loans held for sale	225,248	-	225,248	-
Mortgage banking derivative assets	3,403	-	-	3,403
Mortgage banking derivative liabilities	69	-	-	69

The following summarizes the valuation techniques for assets recorded in our consolidated statements of financial condition at their fair value on a recurring basis:

Available for sale securities – The Company's investment securities classified as available for sale include: mortgage-backed securities, collateralized mortgage obligations, government sponsored enterprise bonds, municipal securities and other debt securities. The fair value of mortgage-backed securities, collateralized mortgage obligations and government sponsored enterprise bonds are determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities, prepayment models and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. The fair value of municipal securities is determined by a third party valuation source using

observable market data utilizing a multi-dimensional relational pricing model. Standard inputs to this model include observable market data such as benchmark yields, reported trades, broker quotes, rating updates and issuer spreads. These model measurements are classified as Level 2 in the fair value hierarchy. The fair value of other debt securities, which includes a trust preferred security issued by a financial institution, is determined through quoted prices in active markets and is classified as Level 1 in the fair value hierarchy.

Loans held for sale – The Company carries loans held for sale at fair value under the fair value option model. Fair value is generally determined by estimating a gross premium or discount, which is derived from pricing currently observable in the secondary market, principally from observable prices for forward sale commitments. Loans held-for-sale are considered to be Level 2 in the fair value hierarchy of valuation techniques.

Mortgage banking derivatives - Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company utilizes a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment and then multiplying by quoted investor prices. The Company also utilizes a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. While there are Level 2 and 3 inputs used in the valuation models, the Company has determined that one or more of the inputs significant in the valuation of both of the mortgage banking derivatives fall within Level 3 of the fair value hierarchy.

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2017 and 2016.

	Mortgage banking derivatives, net (In Thousands)
Balance at December 31, 2015	\$ 2,188
Mortgage derivative gain, net	1,146
Balance at December 31, 2016	\$ 3,334
Mortgage derivative gain, net	570
Balance at June 30, 2017	\$ 3,904

There were no transfers in or out of Level 1, 2 or 3 measurements during the periods.

Assets Recorded at Fair Value on a Non-recurring Basis

The following tables present information about our assets recorded in our consolidated statement of financial condition at their fair value on a non-recurring basis as of June 30, 2017 and December 31, 2016, and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value.

	June 30, 2017 (In Thousands)	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Impaired loans, net (1)	\$3,001	\$-	\$-	\$3,001
Real estate owned	4,784	-	-	4,784

	December 31, 2016 (In Thousands)	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Impaired loans, net (1)	\$2,814	\$-	\$-	\$2,814
Real estate owned	6,118	-	-	6,118

(1) Represents collateral-dependent impaired loans, net, which are included in loans.

Loans – We do not record loans at fair value on a recurring basis. On a non-recurring basis, loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on

our consolidated statements of financial condition at net realizable value of the underlying collateral. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of impaired loans, loans that have been deemed to be impaired are considered to be Level 3 in the fair value hierarchy of valuation techniques. At June 30, 2017, loans determined to be impaired with an outstanding balance of \$4.2 million were carried net of specific reserves of \$1.2 million for a fair value of \$3.0 million. At December 31, 2016, loans determined to be impaired with an outstanding balance of \$3.5 million were carried net of specific reserves of \$662,000 for a fair value of \$2.8 million. Impaired loans collateralized by assets which are valued in excess of the net investment in the loan do not require any specific reserves.

Real estate owned – On a non-recurring basis, real estate owned, is recorded in our consolidated statements of financial condition at the lower of cost or fair value. Fair value is determined based on third party appraisals and, if less than the carrying value of the foreclosed loan, the carrying value of the real estate owned is adjusted to the fair value. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of the properties, real estate owned is considered to be Level 3 in the fair value hierarchy of valuation techniques. Changes in the value of real estate owned totaled \$464,000 and \$351,000 during the six months ended June 30, 2017 and 2016, respectively and are recorded in real estate owned expense. At June 30, 2017 and December 31, 2016, real estate owned totaled \$4.8 million and \$6.1 million, respectively.

Mortgage servicing rights – The Company utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of mortgage servicing rights. The model utilizes prepayment assumptions to project cash flows related to the mortgage servicing rights based upon the current interest rate environment, which is then discounted to estimate an expected fair value of the mortgage servicing rights. The model considers characteristics specific to the underlying mortgage portfolio, such as: contractually specified servicing fees, prepayment assumptions, delinquency rates, late charges and costs to service. Given the significance of the unobservable inputs utilized in the estimation process, mortgage servicing rights are classified as Level 3 within the fair value hierarchy. The Company records the mortgage servicing rights at the lower of amortized cost or fair value. At June 30, 2017 and December 31, 2016, there were no impairment identified for mortgage servicing rights.

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of June 30, 2017, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at June 30, 2017	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Value		
				Minimum Value	Maximum Value	
Mortgage banking derivatives	\$3,904	Pricing models	Pull through rate	33.6 %	99.8	%
Impaired loans	3,001	Market approach	Discount rates applied to appraisals	15.0 %	35.0	%
Real estate owned	4,784	Market approach	Discount rates applied to appraisals	14.8 %	85.7	%

The significant unobservable input used in the fair value measurement of the Company's mortgage banking derivatives, including interest rate lock commitments, is the loan pull through rate. This represents the percentage of loans currently in a lock position which the Company estimates will ultimately close. Generally, the fair value of an interest rate lock commitment will be positively (negatively) impacted when the prevailing interest rate is lower (higher) than the interest rate lock commitment. Generally, an increase in the pull through rate will result in the fair value of the interest rate lock increasing when in a gain position, or decreasing when in a loss position. The pull through rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. The pull through rate is computed using historical data and the ratio is periodically reviewed by the Company.

The significant unobservable inputs used in the fair value measurement of collateral for collateral-dependent impaired loans and real estate owned included in the above table primarily relate to discounting criteria applied to independent appraisals received with respect to the collateral. Discounts applied to the appraisals are dependent on the vintage of the appraisal as well as the marketability of the property. The discount factor is computed using actual realization rates on properties that have been foreclosed upon and liquidated in the open market.

The significant unobservable inputs used in the fair value measurement of mortgage servicing rights include the prepayment rate, discount rate and cost to service. The prepayment rate represents the assumed rate of prepayment of the outstanding principal balance of the underlying mortgage notes. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the prepayment rate and discount rate are not directly interrelated, they will generally move in opposite directions.

Fair value information about financial instruments follows, whether or not recognized in the consolidated statements of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company's financial instruments consist of the following:

June 30, 2017

December 31, 2016

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

	Carrying amount (In Thousands)	Fair Value Total	Level 1	Level 2	Level 3	Carrying amount	Fair Value Total	Level 1	Level 2	Level 3
Financial Assets										
and cash										
securities	\$ 129,560	\$ 129,560	\$ 113,660	\$ 15,900	\$ -	\$ 47,217	\$ 47,217	\$ 34,967	\$ 12,250	\$ -
available-for-sale securities held for	209,079	209,079	2,412	206,667	-	226,795	226,795	2,541	224,254	-
debt securities	196,644	196,644	-	196,644	-	225,248	225,248	-	225,248	-
equity securities	1,225,762	1,259,333	-	-	1,259,333	1,177,884	1,212,967	-	-	1,212,967
common stock	18,675	18,675	-	18,675	-	13,275	13,275	-	13,275	-
equity interest										
available	4,434	4,434	4,434	-	-	4,281	4,281	4,281	-	-
equity securities	515	655	-	-	655	2,260	3,232	-	-	3,232
equity securities										
equity securities	3,904	3,904	-	-	3,904	3,403	3,403	-	-	3,403
Financial Liabilities										
deposits	937,393	937,064	273,328	663,736	-	949,411	949,825	282,827	666,998	-
loans										
loans	18,842	18,842	18,842	-	-	4,716	4,716	4,716	-	-
loans	498,103	499,506	-	499,506	-	387,155	390,932	-	390,932	-
equity interest										
available	986	986	986	-	-	916	916	916	-	-
equity securities										
equity securities	-	-	-	-	-	69	69	-	-	69

The following methods and assumptions were used by the Company in determining its fair value disclosures for financial instruments.

Cash and Cash Equivalents

The carrying amount reported in the consolidated statements of financial condition for cash and cash equivalents is a reasonable estimate of fair value.

Securities

The fair value of securities is generally determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. Prepayment models are used for mortgage related securities with prepayment features.

Loans Held for Sale

Fair value is estimated using the prices of the Company's existing commitments to sell such loans and/or the quoted market price for commitments to sell similar loans.

Loans Receivable

Loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at fair value. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. With respect to loans that are not considered to be impaired, fair value is estimated by discounting the future contractual cash flows using discount rates that reflect a current rate offered to borrowers of similar credit standing for the remaining term to maturity. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820-10 and generally produces a higher fair value.

FHLB Stock

For FHLB stock, the carrying amount is the amount at which shares can be redeemed with the FHLB and is a reasonable estimate of fair value.

Deposits and Advance Payments by Borrowers for Taxes

The fair values for interest-bearing and noninterest-bearing negotiable order of withdrawal accounts, savings accounts, and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates of similar remaining maturities to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit. The advance payments by borrowers for taxes are equal to their carrying amounts at the reporting date.

Borrowings

Fair values for borrowings are estimated using a discounted cash flow calculation that applies current interest rates to estimated future cash flows of the borrowings.

Accrued Interest Payable and Accrued Interest Receivable

For accrued interest payable and accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would be generally established at market rates at the time of the draw. Fair values for the Company's commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the counterparty's credit standing, and discounted cash flow analyses. The fair value of the Company's commitments to extend credit was not material at June 30, 2017 and December 31, 2016.

Mortgage Banking Derivative Assets and Liabilities

Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company relies on a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment, and then multiplying by quoted investor prices. The Company also relies on a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. On the Company's Consolidated Statements of Condition, instruments that have a positive fair value are included in prepaid expenses and other assets, and those instruments that have a negative fair value are included in other liabilities.

- 31 -

Note 15 – Segment Reporting

Selected financial and descriptive information is required to be provided about reportable operating segments, considering a "management approach" concept as the basis for identifying reportable segments. The management approach is based on the way that management organizes the segments within the enterprise for making operating decisions, allocating resources, and assessing performance. Consequently, the segments are evident from the structure of the enterprise's internal organization, focusing on financial information that an enterprise's chief operating decision-makers use to make decisions about the enterprise's operating matters.

The Company has determined that it has two reportable segments: community banking and mortgage banking. The Company's operating segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Company and therefore, the financial results of the Company's business segments are not necessarily comparable with similar information for other financial institutions.

Community Banking

The community banking segment provides consumer and business banking products and services to customers primarily within Southeastern Wisconsin along with a loan production office in Minneapolis, Minnesota. Within this segment, the following products and services are provided: (1) lending solutions such as residential mortgages, home equity loans and lines of credit, personal and installment loans, real estate financing, business loans, and business lines of credit; (2) deposit and transactional solutions such as checking, credit, debit and pre-paid cards, online banking and bill pay, and money transfer services; (3) investable funds solutions such as savings, money market deposit accounts, IRA accounts, certificates of deposit, and (4) fixed and variable annuities, insurance as well as trust and investment management accounts.

Consumer products include loan and deposit products: mortgage, home equity loans and lines, personal term loans, demand deposit accounts, interest bearing transaction accounts and time deposits. Consumer products also include personal investment services. Business banking products include secured and unsecured lines and term loans for working capital, inventory and general corporate use, commercial real estate construction loans, demand deposit accounts, interest bearing transaction accounts and time deposits.

Mortgage Banking

The mortgage banking segment provides residential mortgage loans for the primary purpose of sale on the secondary market. Mortgage banking products and services are provided by offices in 24 states.

	As of or for the three months ended June 30, 2017			
			Holding Company	
	Community Banking	Mortgage Banking	and Other	Consolidated
	(In Thousands)			
Net interest income	\$12,433	\$24	\$24	\$12,481
Provision for loan losses	-	25	-	25
Net interest income (loss) after provision for loan losses	12,433	(1	) 24	12,456
Noninterest income	995	36,743	(497	) 37,241

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Noninterest expenses:

Compensation, payroll taxes, and other employee benefits	4,153	23,553	(122)	27,584
Occupancy, office furniture and equipment	782	1,745	-	2,527
FDIC insurance premiums	117	-	-	117
Real estate owned	(133)	-	-	(133)
Other	1,628	4,782	(318)	6,092
Total noninterest expenses	6,547	30,080	(440)	36,187
Income (loss) before income taxes	6,881	6,662	(33)	13,510
Income tax expense	1,902	2,715	5	4,622
Net income (loss)	\$4,979	\$3,947	\$(38)	\$ 8,888
Total assets	\$1,874,474	\$225,119	\$(213,283)	\$ 1,886,310

- 32 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

	As of or for the three months ended June 30, 2016			
	Community Banking (In Thousands)	Mortgage Banking	Holding Company and Other	Consolidated
Net interest income	\$9,962	\$132	\$71	\$ 10,165
Provision for loan losses	-	-	-	-
Net interest income after provision for loan losses	9,962	132	71	10,165
Noninterest income	1,203	35,400	(252)	36,351
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	4,037	21,787	(115)	25,709
Occupancy, office furniture and equipment	816	1,603	-	2,419
FDIC insurance premiums	155	-	-	155
Real estate owned	163	-	-	163
Other	1,264	4,615	(94)	5,785
Total noninterest expenses	6,435	28,005	(209)	34,231
Income before income taxes	4,730	7,527	28	12,285
Income tax expense	1,421	3,087	10	4,518
Net income	\$3,309	\$4,440	\$18	\$7,767
Total assets	\$1,793,197	\$246,295	\$(240,226)	\$1,799,266

	As of or for the six months ended June 30, 2017			
	Community Banking (In Thousands)	Mortgage Banking	Holding Company and Other	Consolidated
Net interest income	\$24,113	\$125	\$138	\$24,376
Provision for loan losses	(1,300)	114	-	(1,186)
Net interest income after provision for loan losses	25,413	11	138	25,562
Noninterest income	1,807	62,128	(757)	63,178
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	8,481	39,342	(244)	47,579
Occupancy, office furniture and equipment	1,623	3,431	-	5,054
FDIC insurance premiums	237	-	-	237
Real estate owned	278	-	-	278
Other	2,883	9,644	(430)	12,097
Total noninterest expenses	13,502	52,417	(674)	65,245
Income before income taxes	13,718	9,722	55	23,495
Income tax expense	4,061	3,949	25	8,035
Net income	\$9,657	\$5,773	\$30	\$15,460

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

As of or for the six months ended June 30,
2016

	Holding Company			
	Community Banking	Mortgage and Banking	Other	Consolidated
	(In Thousands)			
Net interest income	\$19,733	\$277	\$ 138	\$ 20,148
Provision for loan losses	100	105	-	205
Net interest income after provision for loan losses	19,633	172	138	19,943
Noninterest income	1,925	56,333	(462)	57,796
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	8,392	35,231	(228)	43,395
Occupancy, office furniture and equipment	1,648	3,107	-	4,755
FDIC insurance premiums	360	-	-	360
Real estate owned	307	-	-	307
Other	2,453	8,337	(154)	10,636
Total noninterest expenses	13,160	46,675	(382)	59,453
Income before income taxes	8,398	9,830	58	18,286
Income tax expense	2,604	4,030	24	6,658
Net income	\$5,794	\$5,800	\$ 34	\$ 11,628

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

Forward-Looking Information

This Quarterly Report on Form 10-Q may contain 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; and
- 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 worse 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, the fair value of financial instruments or 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 providers 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 referred to in reports filed by the Company with the Securities and Exchange Commission (particularly those under the caption "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016).

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 unaudited consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Quarterly Report on Form 10-Q and should be read in conjunction therewith. The detailed discussion in the sections below focuses on the results of operations for the three and six months ended June 30, 2017 and 2016 and the financial condition as of June 30, 2017 compared to the financial condition as of December 31, 2016.

As described in the notes to the unaudited 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 primarily within Southeastern Wisconsin along with a loan production office in Minneapolis, Minnesota. 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 by offices in 24 states through Waterstone Mortgage Corporation, consists of originating residential mortgage loans primarily for sale in the secondary market.

- 35 -

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 three and six months ended June 30, 2017 and 2016, which focuses on noninterest income and noninterest expenses. We have also provided a discussion of the consolidated operations of the Company, which includes the consolidated operations of the Bank and Waterstone Mortgage Corporation, for the same periods.

Comparison of Community Banking Segment Results of Operations for the Three Months Ended June 30, 2017 and 2016

Net income for the three months ended June 30, 2017 totaled \$5.0 million compared to net income of \$3.3 million for the three months ended June 30, 2016. Net interest income increased \$2.5 million to \$12.4 million for the three months ended June 30, 2017 compared to \$10.0 million for the three months ended June 30, 2016. Net interest income increased due primarily to a decrease of \$1.6 million in interest expense on borrowings as higher rate FHLB borrowings matured in 2016 along with an increase of \$856,000 in interest income as the average loan balance increased.

Compensation, payroll taxes, and other employee benefits expense increased \$116,000 due primarily to an increase in health insurance and ESOP expense partially offset by stock compensation expense. The Bank also reported an increase in other noninterest expense for the three months ended June 30, 2017 compared to the three months ended June 30, 2016. Occupancy, office furniture, and equipment expense, FDIC premiums, and real estate owned expense decreased for the three months ended June 30, 2017 compared to the three months ended June 30, 2016.

Comparison of Mortgage Banking Segment Results of Operations for the Three Months Ended June 30, 2017 and 2016

Net income totaled \$3.9 million for the three months ended June 30, 2017 compared to \$4.4 million for the three months ended June 30, 2016. Mortgage banking segment revenue increased \$1.3 million, or 3.8%, to \$36.7 million for the three months ended June 30, 2017 compared to \$35.4 million for the three months ended June 30, 2016. The increase in revenue was attributable to a \$62.8 million, or 9.3%, increase in origination volume partially offset by a decrease in margin. In addition to the decrease in margin, the value of the interest rate lock pipeline decreased \$580,000 compared to the prior year period.

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 91.7% of total originations during the three months ended June 30, 2017, compared to 88.5% of total originations during the three months ended June 30, 2016. The mix of loan type trended slightly towards more conventional loans and less governmental loans; with conventional loans and governmental loans comprising 64.8% and 35.2% of all loan originations, respectively, during the three months ended June 30, 2017, compared 61.0% and 39.0% of all loan originations, respectively, during the three months ended June 30, 2016.

Total compensation, payroll taxes and other employee benefits increased \$1.8 million, or 8.1%, to \$23.6 million for the three months ended June 30, 2017 compared to \$21.8 million for the three months ended June 30, 2016. The increase in compensation expense was primarily a result of the increase in mortgage banking income, given our commission-based loan officer compensation model. Occupancy, office furniture, and equipment expense and other noninterest expense increased \$309,000 to \$6.5 million as the number of branches increased and as fundings increased, driving more volume-based expenses.

Consolidated Waterstone Financial, Inc. Results of Operations

	Three months ended June 30, 2017 2016 (Dollars in Thousands, except per share amounts)	
Net income	\$8,888	7,767
Earnings per share - basic	0.32	0.29
Earnings per share - diluted	0.32	0.29
Annualized return on average assets	1.99 %	1.78 %
Annualized return on average equity	8.70 %	7.86 %

Net Interest Income

Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans are 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.

	Three months ended June 30,							
	2017			2016				
	Average	Interest	Yield/Cost	Average	Interest	Yield/Cost		
	Balance			Balance				
	(Dollars in Thousands)							
Assets								
Interest-earning assets:								
Loans receivable and held for sale (1)	\$1,346,784	\$14,985	4.46	% \$1,261,199	\$14,073	4.49	%	
Mortgage related securities (2)	128,207	678	2.12	% 160,613	790	1.98	%	
Debt securities, federal funds sold and short-term investments (2)(3)	195,313	1,081	2.22	% 212,545	1,110	2.10	%	
Total interest-earning assets	1,670,304	16,744	4.02	% 1,634,357	15,973	3.93	%	
Noninterest-earning assets	119,663			119,033				
Total assets	\$1,789,967			\$1,753,390				
Liabilities and equity								
Interest-bearing liabilities:								
Demand accounts	\$35,530	7	0.08	% \$33,681	5	0.06	%	
Money market and savings accounts	171,784	109	0.25	% 163,219	106	0.26	%	
Time deposits	662,428	1,722	1.04	% 675,306	1,724	1.03	%	
Total interest-bearing deposits	869,742	1,838	0.85	% 872,206	1,835	0.85	%	
Borrowings	393,470	2,221	2.26	% 388,933	3,748	3.88	%	
Total interest-bearing liabilities	1,263,212	4,059	1.29	% 1,261,139	5,583	1.78	%	
Noninterest-bearing liabilities								
Noninterest-bearing deposits	90,037			70,273				
Other noninterest-bearing liabilities	27,118			24,358				
Total noninterest-bearing liabilities	117,155			94,631				
Total liabilities	1,380,367			1,355,770				
Equity	409,600			397,620				
Total liabilities and equity	\$1,789,967			\$1,753,390				
Net interest income / Net interest rate spread (4)								
		12,685	2.73	%	10,390	2.15	%	
Less: taxable equivalent adjustment		204	0.05	%	225	0.06	%	
Net interest income / Net interest rate spread, as reported		\$12,481	2.68	%	\$10,165	2.09	%	
Net interest-earning assets (5)	\$407,092			\$373,218				
Net interest margin (6)			3.00	%		2.50	%	
Tax equivalent effect			0.05	%		0.06	%	
			3.05	%		2.56	%	

Net interest margin on a fully tax
equivalent basis (6)

Average interest-earning assets to average
interest-bearing liabilities

132.23 %

129.59 %

(1) Interest income includes net deferred loan fee amortization income of \$244,000 and \$190,000 for the three months ended June 30, 2017 and 2016, respectively.

(2) Average balance of mortgage related and debt securities are 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 1.80% and 1.67% for the three months ended June 30, 2017 and 2016, 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.

- 37 -

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.

	Three months ended June 30, 2017 versus 2016 Increase (Decrease) due to		
	Volume	Rate	Net
	(In Thousands)		
Interest income:			
Loans receivable and held for sale (1)(2)	\$994	\$(82)	\$912
Mortgage related securities (3)	(174)	62	(112)
Other earning assets (3)(4)	(92)	63	(29)
Total interest-earning assets	728	43	771
Interest expense:			
Demand accounts	-	2	2
Money market and savings accounts	6	(3)	3
Time deposits	(11)	9	(2)
Total interest-earning deposits	(5)	8	3
Borrowings	44	(1,571)	(1,527)
Total interest-bearing liabilities	39	(1,563)	(1,524)
Net change in net interest income	\$689	\$1,606	\$2,295

(1) Interest income includes net deferred loan fee amortization income of \$244,000 and \$190,000 for the three months ended June 30, 2017 and 2016, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

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

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income increased \$2.3 million, or 22.8%, to \$12.5 million during the three months ended June 30, 2017 compared to \$10.2 million during the three months ended June 30, 2016.

Interest income on loans increased \$912,000 due primarily to an increase of \$85.6 million in average loans partially offset by a three basis point decrease in average yield on loans. The increase in average loan balance was driven by a \$88.7 million increase in the average balance of loans held in portfolio partially offset by a decrease of \$3.1 million in the average balance of loans held for sale.

Interest income from mortgage-related securities decreased \$112,000 year over year as the average balance decreased \$32.4 million due to securities paying down in 2016 and into 2017 and less purchases occurring to replace those securities due to current market conditions. This was partially offset by an increase in rate.

Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) decreased \$8,000 due to a decrease of \$17.2 million in average balance, as municipal securities matured and were not replaced due to market conditions. This decrease in average balance was partially offset by a 13 basis point increase in the average yield. The increase in average yield was driven by a 25 basis point increase in the Federal Funds rate in December 2016 and another 25 basis point increase in June 2017, as well as an increase in the cash dividend paid by the FHLB on its stock.

Interest expense on time deposits decreased \$2,000 primarily due to a \$12.9 million decrease in the average balance of time deposits compared to the prior year period. Partially offsetting the decrease in average balance, the average cost of time deposits increased one basis point, as maturing time deposits have repriced or have been replaced at a slightly higher rate in the current competitive market.

Interest expense on money market and savings accounts increased \$3,000 due primarily to an increase in average balance of \$8.6 million partially offset by a one basis point decrease in rate. The increase in average volume reflects the Company's strategy to target this segment of retail funds for more aggressive growth.

Interest expense on borrowings decreased \$1.5 million due to a decrease in the average cost of borrowings that resulted from the maturity and replacement of fixed rate borrowings since the beginning of the prior year. The average cost of borrowings totaled 2.26% during the quarter ended June 30, 2017, compared to 3.88% during the quarter ended June 30, 2016.

Provision for Loan Losses

Our provision for loan losses increased \$25,000 as the mortgage banking segment had to reserve for additional loans during the three months ended June 30, 2017, compared to no provision during the three months ended June 30, 2016. The community banking segment recorded no provision during the current quarter due to the continued improvement in loan quality metrics including: non-accrual loans, loans rated substandard or watch, and loans past due.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Losses" section.

Noninterest Income

	Three months ended June 30,			
	2017	2016	\$ Change	% Change
	(Dollars in Thousands)			
Service charges on loans and deposits	\$481	\$616	\$ (135)	(21.9)%
Increase in cash surrender value of life insurance	470	471	(1)	-0.2 %
Loss on sale of securities	(107)	-	(107)	N/ M
Mortgage banking income	36,224	34,980	1,244	3.6 %
Other	173	284	(111)	(39.1)%
Total noninterest income	\$37,241	\$36,351	\$ 890	2.4 %

N/M - Not meaningful

Total noninterest income increased \$890,000, or 2.4%, to \$37.2 million during the three months ended June 30, 2017 compared to \$36.4 million during the three months ended June 30, 2016. The increase resulted primarily from an increase in mortgage banking income offset by decreases in the remaining other categories.

The increase in mortgage banking income was the result of an increase in origination volumes. The volume increased \$62.8 million, or 9.3%, to \$737.9 million during the three months ended June 30, 2017 compared to a \$675.1 million during the three months ended June 30, 2016. See "Comparison of Mortgage Banking Segment Operations for the Three Months Ended June 30, 2017 and 2016" above, for additional discussion of the increase in mortgage banking income.

Service charges on loans and deposits decreased primarily due to a decrease in loan prepayment fees.

The decrease in cash surrender value of life insurance was due to a decrease on one policy's annual dividend offset by a purchase of a \$2.5 million policy in June 2017.

The \$107,000 loss on sale of securities was due to a sale of a municipal bond in June 2017. There were no sales of securities in 2016.

The \$111,000 decrease in other noninterest income was due primarily to an decrease in servicing fee revenue on loans sold at the mortgage banking segment. The decrease results from a bulk sale of mortgage servicing rights in the first quarter of 2017.

Noninterest Expenses

	Three months ended June 30,			
	2017	2016	\$ Change	% Change
	(Dollars in Thousands)			
Compensation, payroll taxes, and other employee benefits	\$27,584	\$25,709	\$ 1,875	7.3 %
Occupancy, office furniture and equipment	2,527	2,419	108	4.5 %
Advertising	869	655	214	32.7 %
Data processing	633	638	(5)	(0.8)%
Communications	397	372	25	6.7 %
Professional fees	717	489	228	46.6 %
Real estate owned	(133)	163	(296)	(181.6)%
FDIC insurance premiums	117	155	(38)	(24.5)%
Other	3,476	3,631	(155)	(4.3)%
Total noninterest expenses	\$36,187	\$34,231	\$ 1,956	5.7 %

Total noninterest expenses increased \$2.0 million, or 5.7%, to \$36.2 million during the three months ended June 30, 2017 compared to \$34.2 million during the three months ended June 30, 2016.

Compensation, payroll taxes and other employee benefit expense at our mortgage banking segment increased \$1.8 million, or 8.1%, to \$23.6 million during the three months ended June 30, 2017. The increase in compensation within our mortgage banking segment correlates to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers.

Compensation, payroll taxes and other employee benefit expense increased \$116,000, or 2.9%, at the community banking segment during the three months ended June 30, 2017. This was primarily due to an increase in health insurance expense and higher ESOP expense, which increased due to the increased average stock price of the shares in the second quarter of 2017.

Advertising expense increased \$214,000, or 32.7%, to \$869,000 during the three months ended June 30, 2017. This was primarily due to marketing increases at the mortgage banking segment in an effort to increase volumes.

Professional fees increased \$228,000, or 46.6%, to \$717,000 during the three months ended June 30, 2017. This was primarily due to an increase in legal fees at the mortgage banking segment related to ongoing litigation.

Occupancy, office furniture and equipment expense increased, resulting from additional rent expense in the current year period compared to prior year period due to the addition of mortgage banking segment branches. Offsetting the rent increase, there was less depreciation expense at the mortgage banking segment in the quarter ended June 30, 2017 compared to the prior year period. The community banking segment had a slight decrease in expense year over year due to less depreciation and utilities expenses.

Net real estate owned expense decreased \$296,000, resulting in \$133,000 of income during the three months ended June 30, 2017, compared to \$163,000 of expense during the three months ended June 30, 2016. Property management expense (other than gains/losses) decreased \$61,000 during the three months ended June 30, 2017 compared to the three months ended June 30, 2016 due to a reduction in the number of properties under management. Net gains on sales of REO increased \$23,000 to \$222,000 for the three months ended June 30, 2017 compared to \$199,000 for the three months ended June 30, 2016. Real estate owned writedowns decreased \$211,000 to \$10,000 for the three months ended June 30, 2017 compared to \$221,000 for the three months ended June 30, 2016.

FDIC insurance expense decreased during the three months ended June 30, 2017 due to improved asset quality metrics.

Other noninterest expense decreased primarily at the mortgage banking segment which resulted from lower amortization of mortgage servicing rights and other various branch costs.

Income Taxes

Driven by an increase in pre-tax income, income tax expense increased \$104,000, or 2.3%, to \$4.6 million during the three months ended June 30, 2017, compared to \$4.5 million during the three months ended June 30, 2016. Income tax expense was recognized during the three months ended June 30, 2017 at an effective rate of 34.2% compared to an effective rate of 36.8% during the three months ended June 30, 2016. During the quarter ended June 30, 2017, the Company recognized a benefit of approximately \$456,000 related to stock awards exercised within the current period as a result of adopting the new stock compensation accounting standard.

- 40 -

Comparison of Community Banking Segment for the Six Months Ended June 30, 2017 and 2016

Net income for the six months ended June 30, 2017 totaled \$9.7 million compared to net income of \$5.8 million for the six months ended June 30, 2016. Net interest income increased \$4.4 million to \$24.1 million for the six months ended June 30, 2017 compared to \$19.7 million for the six months ended June 30, 2016. Provision for loan losses decreased \$1.4 million as asset quality metrics continued to improve. Noninterest income decreased \$118,000 as loan prepayment fees decreased and a \$107,000 loss on sale of securities occurred in 2017 partially offset by an increase in the cash surrender value of life insurance. Compensation, payroll taxes, and other employee benefits expense increased \$89,000 primarily due to increases in salary expense along with an increase in ESOP expense, offset by a decrease in health insurance cost. FDIC premiums and real estate owned expense decreased as asset quality improved and we experienced a reduction of foreclosed properties. Those decreases were partially offset by an increase in other noninterest expense for the six months ended June 30, 2017 compared to the six months ended June 30, 2016.

Comparison of Mortgage Banking Segment Operations for the Six Months Ended June 30, 2017 and 2016

Net income decreased \$27,000 to \$5.8 million for the six months ended June 30, 2017, compared to the six months ended June 30, 2016. Mortgage banking segment revenues increased \$5.8 million, or 10.3%, to \$62.1 million for the six months ended June 30, 2017 compared to \$56.3 million for the six months ended June 30, 2016. The increase in revenue was attributable to a 16.5% increase in volume origination to \$1.22 billion during the six months ended June 30, 2017 compared to \$1.05 billion during the six months ended June 30, 2016 offset by a decrease in margin. While revenue increased 10.3%, noninterest expenses increased \$5.7 million, or 12.3%, to \$52.4 million for the six months ended June 30, 2017 compared to \$46.7 million for the six months ended June 30, 2016.

Loans originated by the mortgage banking segment for the purpose of sale in the secondary market increased \$172.9 million, or 16.5%, to \$1.22 billion during the six months ended June 30, 2017, compared to \$1.05 billion for the six months ended June 30, 2016. The increase in originations was driven by an increase in the origination of loans made for the purpose of residential purchases, which yield a higher margin than refinance loans, along with an increase in the origination of mortgage refinance products. Our origination efforts continue to be focused on loans made for the purpose of residential purchases, as opposed to mortgage refinance. The percentage of origination volume related to purchase activity increased slightly to 89.4% from 87.4% of total originations for the six months ended June 30, 2017 and 2016, respectively.

Consolidated Waterstone Financial, Inc. Results of Operations

	Six months ended June 30,			
	2017	2016		
	(Dollars in Thousands, except per share amounts)			
Net income	\$15,460	\$11,628		
Earnings per share - basic	0.56	0.43		
Earnings per share - diluted	0.55	0.43		
Annualized return on average assets	1.77	%	1.34	%
Annualized return on average equity	7.56	%	5.89	%

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans are 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.

	Six months ended June 30,			2016				
	2017			Average				
	Average	Interest	Yield/Cost	Average	Interest	Yield/Cost		
	(Dollars in Thousands)							
Assets								
Interest-earning assets:								
Loans receivable and held for sale (1)	\$ 1,326,577	\$29,223	4.44	% \$ 1,244,431	\$27,857	4.50	%	
Mortgage related securities (2)	130,391	1,374	2.12	% 162,931	1,628	2.01	%	
Debt securities, federal funds sold and short-term investments (2)(3)	190,484	2,142	2.27	% 219,633	2,318	2.12	%	
Total interest-earning assets	1,647,452	32,739	4.01	% 1,626,995	31,803	3.93	%	
Noninterest-earning assets	114,945			113,314				
Total assets	\$1,762,397			\$1,740,309				
Liabilities and equity								
Interest-bearing liabilities:								
Demand accounts	\$37,032	13	0.07	% \$32,979	9	0.05	%	
Money market and savings accounts	169,622	210	0.25	% 156,962	197	0.25	%	
Time deposits	662,232	3,410	1.04	% 666,960	3,348	1.01	%	
Total interest-bearing deposits	868,886	3,633	0.84	% 856,901	3,554	0.83	%	
Borrowings	371,627	4,317	2.34	% 394,508	7,642	3.90	%	
Total interest-bearing liabilities	1,240,513	7,950	1.29	% 1,251,409	11,196	1.80	%	
Noninterest-bearing liabilities								
Noninterest-bearing deposits	86,798			70,502				
Other noninterest-bearing liabilities	22,742			21,400				
Total noninterest-bearing liabilities	109,540			91,902				
Total liabilities	1,350,053			1,343,311				
Equity	412,344			396,998				
Total liabilities and equity	\$1,762,397			\$1,740,309				
Net interest income / Net interest rate spread (4)								
		24,789	2.72	%	20,607	2.13	%	
Less: taxable equivalent adjustment		413	0.05	%	459	0.06	%	
Net interest income / Net interest rate spread, as reported		\$24,376	2.67	%	\$20,148	2.07	%	
Net interest-earning assets (5)	\$406,939			\$375,586				
Net interest margin (6)			2.98	%		2.49	%	
Tax equivalent effect			0.05	%		0.06	%	
Net interest margin on a fully tax equivalent basis (6)			3.03	%		2.55	%	
			132.80	%		130.01	%	

Average interest-earning assets to average
interest-bearing liabilities

- (1) Interest income includes net deferred loan fee amortization income of \$386,000 and \$367,000 for the six months ended June 30, 2017 and 2016, respectively.
- (2) Average balance of mortgage related and debt securities are 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 1.83% and 1.70% for the six months ended June 30, 2017 and 2016, 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.

	Six months ended June 30, 2017 versus 2016		
	Increase (Decrease) due to		Net
	Volume	Rate	
	(In Thousands)		
Interest income:			
Loans receivable and held for sale (1)(2)	\$1,754	\$(388)	\$1,366
Mortgage related securities (3)	(343)	89	(254)
Other earning assets (3) (4)	(327)	151	(176)
Total interest-earning assets	1,084	(148)	936
Interest expense:			
Demand accounts	1	3	4
Money market and savings accounts	15	(2)	13
Time deposits	(21)	83	62
Total interest-earning deposits	(5)	84	79
Borrowings	(477)	(2,848)	(3,325)
Total interest-bearing liabilities	(482)	(2,764)	(3,246)
Net change in net interest income	\$1,566	\$2,616	\$4,182

(1) Interest income includes net deferred loan fee amortization income of \$386,000 and \$376,000 for the six months ended June 30, 2017 and 2016, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

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

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income increased \$4.2 million, or 21.0%, to \$24.4 million during the six months ended June 30, 2017 compared to \$20.1 million during the six months ended June 30, 2016.

Interest income on loans increased \$1.4 million due to an increase in average balance of \$82.1 million partially offset by a six basis point decrease in average yield on loans. The increase in average loan balance was driven by an \$81.3 million increase in the average balance of loans held in portfolio and the average balance of loans held for sale increased \$839,000.

Interest income from mortgage related securities decreased as securities have paid down, and less purchases have occurred to replace those securities due to current market conditions.

Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) decreased due to a \$29.1 million decrease in average balance, as municipal securities matured and were

not replaced due to market conditions. This decrease in average balance was partially offset by a 13 basis point increase in the average yield. The increase in average yield was driven by a 25 basis point increase in the Federal Funds rate in December 2016 and another 25 basis point increase in June 2017, as well as an increase in the cash dividend paid by the FHLB on its stock.

Interest expense on time deposits increased \$62,000 primarily due to a three basis point increase in the average cost of funds, as maturing time deposits have repriced, or have been replaced at a higher rate in the current competitive market. Partially offsetting the increase in rate, the average balance of time deposits decreased \$4.7 million compared to the prior year period.

Interest expense on money market and savings accounts increased \$13,000 due to an increase in average balance partially offset by a slight decrease in rate. The increase in volume reflect the Company's strategy to aggressively grow this segment of retail funds.

Interest expense on borrowings decreased \$3.3 million due to a decrease in the average cost of borrowings that resulted from the maturity and replacement of fixed rate borrowings. The average cost of borrowings totaled 2.34% during the six months ended June 30, 2017, compared to 3.90% during the six months ended June 30, 2016.

Provision for Loan Losses

Our provision for loan losses decreased \$1.4 million, to a negative provision of \$1.2 million during the six months ended June 30, 2017, from \$205,000 during the six months ended June 30, 2016. The negative provision recorded during the current year period reflects the continued improvement in loan quality metrics including: non-accrual loans, loans rated substandard or watch, and loans past due.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Losses" section.

Noninterest Income

	Six months ended June 30,			
	2017	2016	\$ Change	% Change
	(Dollars in Thousands)			
Service charges on loans and deposits	\$848	\$953	\$(105)	(11.0)%
Increase in cash surrender value of life insurance	788	712	76	10.7 %
Loss on sale of securities	(107)	-	(107)	N/ M
Mortgage banking income	60,911	55,594	5,317	9.6 %
Other	738	537	201	37.4 %
Total noninterest income	\$63,178	\$57,796	\$ 5,382	9.3 %

N/M - Not meaningful

Total noninterest income increased \$5.4 million, or 9.3%, to \$63.2 million during the six months ended June 30, 2017 compared to \$57.8 million during the six months ended June 30, 2016. The increase resulted primarily from an increase in mortgage banking income.

The \$5.3 million increase in mortgage banking income was the result of an increase in origination volumes but partially offset by a decrease in margins. The volume increased \$172.9 million, or 16.5%, to \$1.22 billion during the six months ended June 30, 2017 compared to \$1.05 billion during the six months ended June 30, 2016. See "Comparison of Mortgage Banking Segment Operations for the Six Months Ended June 30, 2017 and 2016" above, for additional discussion of the increase in mortgage banking income.

The decrease in service charges on loans and deposits was related to an decrease in loan prepayment fees.

The increase in cash surrender value of life insurance was primarily due to the purchase of a \$10.0 million policy in March 2016 and a \$2.5 million policy in June 2017.

The \$107,000 loss on sale of securities was due to a sale of a municipal bond in June 2017. There were no sales of securities in 2016.

The \$201,000 increase in other noninterest income was primarily due to a gain on mortgage servicing rights as there was a bulk sale of mortgage servicing rights for \$308,000 during the six months ended June 30, 2017. There were no bulk sales of mortgage servicing rights during the six months ended June 30, 2016. Offsetting the gain on sale of mortgage servicing rights, servicing fee income on loans sold decreased from the bulk sale.

Noninterest Expenses

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

	Six months ended June 30,				
	2017	2016	\$ Change	% Change	
	(Dollars in Thousands)				
Compensation, payroll taxes, and other employee benefits	\$47,579	\$43,395	\$4,184	9.6	%
Occupancy, office furniture and equipment	5,054	4,755	299	6.3	%
Advertising	1,593	1,313	280	21.3	%
Data processing	1,231	1,281	(50)	(3.9)	%
Communications	776	714	62	8.7	%
Professional fees	1,324	1,012	312	30.8	%
Real estate owned	278	307	(29)	(9.4)	%
FDIC insurance premiums	237	360	(123)	(34.2)	%
Other	7,173	6,316	857	13.6	%
Total noninterest expenses	\$65,245	\$59,453	\$5,792	9.7	%

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Total noninterest expenses increased \$5.8 million, or 9.7%, to \$65.2 million during the six months ended June 30, 2017 compared to \$59.5 million during the six months ended June 30, 2016.

Compensation, payroll taxes and other employee benefit expense increased \$4.1 million, or 11.7%, to \$39.3 million at our mortgage banking segment. The increase in compensation within our mortgage banking segment correlated to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers.

Compensation, payroll taxes and other employee benefit expense increased \$89,000 within the community banking segment primarily due to salary expenses and ESOP expenses offset by a decrease in health insurance. Salaries expense increased due primarily to annual raises and higher ESOP expense, which increased due to the increased average stock price of the shares in the first half of 2017. Health insurance decreased as claims have been lower to start 2017 compared to 2016.

Occupancy, office furniture and equipment expense increased, resulting from additional rent expense in the current year compared to prior year due to the addition of mortgage banking segment branches. Offsetting the rent increase, there was less depreciation expense at the mortgage banking segment in the six months ended June 30, 2017 compared to the same period during the prior year. Additionally, the community banking segment had slightly lower expense year over year due to less depreciation expense.

Advertising expense increased as a result of increased advertising efforts to generate more volume at the mortgage banking segment branches.

Professional fees expense increased as a result of an increase in legal fees at the mortgage banking segment primarily related to ongoing litigation.

Net real estate owned expense decreased \$29,000, to \$278,000 during the six months ended June 30, 2017 compared to \$307,000 for the six months ended June 30, 2016. Property management expense (other than gains/losses) decreased \$128,000 to \$177,000 during the six months ended June 30, 2017 compared to the six months ended June 30, 2016 due to a reduction in the number of properties under management. Net gains on sales of real estate owned increased \$14,000 to \$362,000 for the six months ended June 30, 2017 compared to \$348,000 for the six months ended June 30, 2016. Real estate owned writedowns increased \$113,000 to \$464,000 for the six months ended June 30, 2017 compared to \$351,000 for the six months ended June 30, 2016.

FDIC insurance expense decreased during the six months ended June 30, 2017. This was driven by a decrease in the FDIC assessment rate due to improved asset quality metrics.

Other noninterest expense increased primarily due to increased expense at the mortgage banking segment. The mortgage banking segment increase was associated with the increase of loan origination activity.

Income Taxes

Driven by an increase in pre-tax income, income tax expense increased \$1.4 million, or 20.7%, to \$8.0 million during the six months ended June 30, 2017, compared to \$6.7 million during the six months ended June 30, 2016. Income tax expense was recognized during the six months ended June 30, 2017 at an effective rate of 34.2% compared to 36.4% for the six months ended June 30, 2016. During the six months ended June 30, 2017, the Company recognized a benefit of approximately \$806,000 related to stock awards exercised within the first two quarters of 2017 as a result of adopting the new stock compensation accounting standard.

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

Total Assets - Total assets increased by \$95.7 million, or 5.3%, to \$1.89 billion at June 30, 2017 from \$1.79 billion at December 31, 2016. The increase in total assets primarily reflects an increase in cash and cash equivalents and loans receivable, partially offset by a decrease in loans held for sale. Funding needed for the loans receivable increased through additional short-term and long-term FHLB debt in 2017.

Cash and Cash Equivalents – Cash and cash equivalents increased \$82.3 million, or 174.4%, to \$129.6 million at June 30, 2017, compared to \$47.2 million at December 31, 2016. The increase in cash and cash equivalents primarily reflects the increase in short-term and long-term FHLB borrowings to take advantage of the low interest rate environment in advance of wholesale borrowing maturities in the second half of 2017.

Securities Available for Sale – Securities available for sale decreased \$17.7 million at June 30, 2017 compared to December 31, 2016. 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 decreased at June 30, 2017 due to the timing of loans sold to investors.

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Loans Receivable - Loans receivable held for investment increased \$47.9 million to \$1.23 billion at June 30, 2017 from \$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, and commercial real estate categories. Offsetting those increases, the home equity, land and construction, consumer, and commercial loan categories decreased.

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

	As of or for the Six months ended June 30,		As of or for the Year Ended December 31, 2016
	2017	2016	
	(In Thousands)		
Total gross loans receivable and held for sale at beginning of period	\$ 1,403,132	\$ 1,281,450	\$ 1,281,450
Real estate loans originated for investment:			
Residential			
One- to four-family	57,651	34,757	78,045
Multi-family	61,429	55,763	118,072
Home equity	2,409	2,086	5,037
Construction and land	655	4,915	5,878
Commercial real estate	28,499	11,420	35,443
Total real estate loans originated for investment	150,643	108,941	242,475
Consumer loans originated for investment	-	-	-
Commercial business loans originated for investment	4,073	5,530	11,692
Total loans originated for investment	154,716	114,471	254,167
Principal repayments	(105,465)	(95,272)	(185,020)
Transfers to real estate owned	(923)	(3,123)	(4,590)
Loan principal charged-off	(450)	(974)	(1,607)
Net activity in loans held for investment	47,878	15,102	62,950
Loans originated for sale	1,219,226	1,046,354	2,378,926
Loans sold	(1,247,830)	(1,004,063)	(2,320,194)
Net activity in loans held for sale	(28,604)	42,291	58,732
Total gross loans receivable and held for sale at end of period	\$ 1,422,406	\$ 1,338,843	\$ 1,403,132

Allowance for Loan Losses - The allowance for loan losses decreased \$1.4 million June 30, 2017 from December 31, 2016. The decrease resulted from the negative provision due to improvement of key loan quality metrics decreasing the allowance related to the loans collectively and specifically reviewed. The overall decrease was primarily related to the one- to four-family, multi-family, construction and land, commercial real estate, consumer, and commercial categories. The home equity category increased compared to the balance at December 31, 2016.

Cash surrender value of life insurance – Total cash surrender value of life insurance increased \$3.5 million from December 31, 2016. During the six months ended June 30, 2017, the policy value increased due to continued earnings along with the annual premiums paid during the year. In addition, a \$2.5 million policy was purchased in June 2017.

Federal Home Loan Bank stock – Total Federal Home Loan Bank stock increased \$5.4 million from December 31, 2016. During the six months ended June 30, 2017, \$8.3 million of stock was purchased when entering into a total of \$161.0 million of new short-term and long-term FHLB borrowings. A total of \$2.9 million of stock was sold as \$65.0

million of short-term FHLB borrowings matured.

Real Estate Owned – Total real estate owned decreased \$1.3 million from December 31, 2016. During the six months ended June 30, 2017, \$923,000 was transferred from loans receivable to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled \$1.8 million and writedowns were \$464,000 in an effort to sell various aged properties.

Deposits – Total deposits decreased \$12.0 million to \$937.4 million at June 30, 2017 from December 31, 2016. The decrease was driven by a decrease of \$8.7 million in money market and savings deposits, \$2.5 million in time deposits and \$786,000 in demand deposits.

- 46 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Borrowings – Total borrowings increased \$110.9 million to \$498.1 million at June 30, 2017 from December 31, 2016. A total of \$75.0 million of short-term FHLB borrowings matured and were paid off during the current period. These were replaced with \$85.0 million of new fixed rate short-term and \$100.0 million of new fixed rate long-term FHLB borrowings. A total of \$24.0 million in repurchase agreements matured and were not replaced. External short term borrowings at the mortgage banking segment increased a total of \$14.9 million at June 30, 2017 from December 31, 2016 to fund loans held for sale.

Advance Payments by Borrowers for Taxes - Advance payments by borrowers for taxes increased \$14.1 million. The increase was the result of payments received from borrowers for their real estate taxes and is seasonally normal, as balances increase during the course of the calendar year until real estate tax obligations are paid out in the fourth quarter.

Other Liabilities - Other liabilities decreased \$14.7 million at June 30, 2017 compared to December 31, 2016. The decrease was primarily related to a seasonal decrease in outstanding checks related to advance payments by borrowers for taxes. The Company receives payments from borrowers for their real estate taxes during the course of the calendar year until real estate tax obligations are paid out in the fourth quarter. At the time at which the disbursements are made, the outstanding checks are classified as other liabilities. These amounts remain classified as other liabilities until settled.

Shareholders' Equity – Shareholders' equity decreased by \$2.7 million to \$408.0 million at June 30, 2017 from December 31, 2016. The decrease in shareholders' equity was primarily due to the regular dividends and special dividend declared and the repurchase of stock. Partially offsetting these decreases, shareholders' equity increased primarily due to net income, additional paid in capital as stock options were exercised, accumulated other comprehensive income increasing as the fair value of the security portfolio increased, and unearned ESOP shares as they continue to vest.

ASSET QUALITY

NONPERFORMING ASSETS

	At June 30, 2017	At December 31, 2016
	(Dollars in Thousands)	
Non-accrual loans:		
Residential		
One- to four-family	\$6,732	\$ 7,623
Multi-family	1,198	1,427
Home equity	194	344
Construction and land	37	-
Commercial real estate	398	422
Commercial	26	41
Consumer	-	-
Total non-accrual loans	8,585	9,857
Real estate owned		
One- to four-family	1,386	2,141

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Multi-family	-	-		
Construction and land	4,802	5,082		
Commercial real estate	300	300		
Total real estate owned	6,488	7,523		
Valuation allowance at end of period	(1,704)	(1,405)		
Total real estate owned, net	4,784	6,118		
Total nonperforming assets	\$13,369	\$ 15,975		
Total non-accrual loans to total loans, net	0.70	%	0.84	%
Total non-accrual loans to total assets	0.46	%	0.55	%
Total nonperforming assets to total assets	0.71	%	0.89	%

- 47 -

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

All loans that exceed 90 days past due with respect to principal and interest are recognized as non-accrual. Troubled debt restructurings that are non-accrual either due to being past due greater than 90 days 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 that 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 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 when a loan is contractually past due between 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, typically 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 periods indicated.

	As of or for the Six Months Ended June 30, 2017 2016 (In Thousands)	
Balance at beginning of period	\$9,857	17,604
Additions	2,340	1,927
Transfers to real estate owned	(923)	(3,123)
Charge-offs	(109)	(662)
Returned to accrual status	(2,084)	(3,559)
Principal paydowns and other	(496)	(808)
Balance at end of period	\$8,585	11,379

Total non-accrual loans decreased by \$1.3 million, or 12.9%, to \$8.6 million as of June 30, 2017 compared to \$9.9 million as of December 31, 2016. The ratio of non-accrual loans to total loans receivable was 0.70% at June 30, 2017 compared to 0.84% at December 31, 2016. During the six months ended June 30, 2017, \$923,000 in non-accrual loans were transferred to real estate owned, \$109,000 in loan principal was charged off, \$2.1 million in loans were returned to accrual status and approximately \$496,000 in principal payments were received. Offsetting this activity, \$2.3 million in loans were placed on non-accrual status during the six months ended June 30, 2017.

Of the \$8.6 million in total non-accrual loans as of June 30, 2017, \$8.2 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 \$1.6 million in cumulative partial net charge-offs have been recorded over the life of these loans as of June 30, 2017. 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 \$1.0 million have been recorded as of June 30, 2017. The remaining \$370,000 of non-accrual loans were reviewed on an aggregate basis and \$74,000 in general valuation allowance was deemed necessary related to those loans as of June 30, 2017. The \$74,000 in 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 June 30, 2017 totaled \$2.8 million, which represents 32.4% of total non-accrual loans as of that date. These five loans are carried net of cumulative life-to-date net charge-offs of \$15,000. Aggregate specific valuation allowances with respect to these five loans total \$680,000 as of June 30, 2017.

For the six months ended June 30, 2017, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was \$302,000. We received \$205,000 of interest payments on such loans during the six months ended June 30, 2017. 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 at June 30, 2017 or December 31, 2016.

TROUBLED DEBT RESTRUCTURINGS

The following table summarizes information with respect to the accrual status of our troubled debt restructurings:

	As of June 30, 2017		
	Accruing	Non-accruing	Total
	(In Thousands)		
One- to four-family	\$3,291	\$ 1,224	4,515
Multi-family	2,489	825	3,314
Home equity	48	-	48
Commercial real estate	292	42	334
	\$6,120	\$ 2,091	8,211
	As of December 31, 2016		
	Accruing	Non-accruing	Total
One- to four-family	\$3,296	\$ 2,399	5,695
Multi-family	2,514	1,427	3,941
Home equity	49	97	146
Commercial real estate	295	60	355
	\$6,154	\$ 3,983	10,137

All troubled debt restructurings are considered to be impaired, are risk rated as either substandard or watch and are included in the internal risk rating tables disclosed in the notes to the financial statements. Specific reserves have been established to the extent that collateral-based impairment analyses indicate that a collateral shortfall exists.

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.

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	At
June	December
30,	31,
2017	2016

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

(Dollars in
Thousands)

Loans past due less than 90 days	\$3,641	\$ 2,910
Loans past due 90 days or more	5,385	5,289
Total loans past due	\$9,026	\$ 8,199
Total loans past due to total loans receivable	0.74 %	0.70 %

Past due loans increased by \$827,000, or 10.1%, to \$9.0 million at June 30, 2017 from \$8.2 million at December 31, 2016. Loans past due less than 90 days increased by \$731,000, or 25.1%. Loans past due 90 days or more increased by \$96,000, or 1.8%, during the six months ended June 30, 2017. The \$731,000 increase in loans past due less than 90 days or more was primarily due to one relationship in the one-to four-family loan category.

- 49 -

REAL ESTATE OWNED

Total real estate owned decreased by \$1.3 million, or 21.8%, to \$4.8 million at June 30, 2017, compared to \$6.1 million at December 31, 2016. During the six months ended June 30, 2017, \$923,000 was transferred from loans to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled \$1.8 million. A total of \$464,000 in write downs occurred during the six months ended June 30, 2017. 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 (as described previously) 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).

Virtually all habitable real estate owned (both residential and commercial properties) is managed with the intent of attracting a lessee to generate revenue. Foreclosed properties are recorded at the lower of carrying value or fair value, less costs to sell, 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

	As of or for the Six Months Ended June 30, 2017 2016 (Dollars in Thousands)	
Balance at beginning of period	\$ 16,029	\$ 16,185
Provision for loan losses	(1,186)	205
Charge-offs:		
Mortgage		
One- to four-family	392	464
Multi-family	44	445
Home equity	-	62
Commercial real estate	-	-
Construction and land	14	3
Consumer	-	-
Commercial	-	-

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Total charge-offs	450	974
Recoveries:		
Mortgage		
One- to four-family	119	178
Multi-family	43	59
Home equity	17	19
Commercial real estate	-	-
Construction and land	40	33
Consumer	-	-
Commercial	-	-
Total recoveries	219	289
Net charge-offs	231	685
Allowance at end of period	\$14,612	\$15,705
Ratios:		
Allowance for loan losses to non-accrual loans at end of period	170.20 %	138.02 %
Allowance for loan losses to loans receivable at end of period	1.19 %	1.39 %
Net charge-offs to average loans outstanding (annualized)	0.04 %	0.12 %
Current period provision for loan losses to net charge-offs	(513.42)%	29.93 %
Net charge-offs (annualized) to beginning of the period allowance	2.91 %	8.51 %

At June 30, 2017, the allowance for loan losses decreased \$1.4 million to \$14.6 million compared to \$16.0 million at December 31, 2016. The decrease in allowance for loan losses reflects the negative provision. The negative provision recorded during the current quarter reflects the continued improvement in loan quality metrics including: non-accrual loans, loans rated substandard or watch, and loans past due.

Net charge-offs totaled \$231,000, or an annualized 0.04% of average loans for the six months ended June 30, 2017, compared to \$685,000, or an annualized 0.12% of average loans for the six months ended June 30, 2016. Of the \$231,000 in charge-offs during the six months ended June 30, 2017, a majority of the activity related to loans secured by single-family residential loans.

Our underwriting policies and procedures emphasize that credit decisions must rely on both the credit quality of the borrower and the estimated value of the underlying collateral. Credit quality is assured only when the estimated value of the collateral is objectively determined and is not subject to significant fluctuation.

The allowance for loan losses has been determined in accordance with GAAP. We are responsible for the timely and periodic determination of the amount of the allowance required. Any future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and the underlying collateral, trends in non-performing loans, current economic conditions and other relevant factors. To the best of management's knowledge, all probable losses have been provided for in the allowance for loan losses.

The establishment of the amount of the loan loss allowance inherently involves judgments by management as to the appropriateness of the allowance, which ultimately may or may not be correct. Higher than anticipated rates of loan default would likely result in a need to increase provisions in future years.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet our liquidity needs. We adjust our liquidity levels to fund loan commitments, repay our borrowings, fund deposit outflows and pay real estate taxes on mortgage loans. We also adjust liquidity as appropriate to meet asset and liability management objectives. The level of our liquidity position at any point in time is dependent upon the judgment of the senior management as supported by the Asset/Liability Committee. Liquidity is monitored on a daily, weekly and monthly basis using a variety of measurement tools and indicators.

Our primary sources of liquidity are deposits, amortization and repayment of loans, sales of loans held for sale, maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan repayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competitors. We set the interest rates on our deposits to maintain a desired level of total deposits. In addition, we invest excess funds in short-term, interest-earning assets, which provide liquidity to meet lending requirements. Additional sources of liquidity used for the purpose of managing long- and short-term cash flows include advances from the FHLB.

During the six months ended June 30, 2017 primary uses of cash and cash equivalents included: \$1.22 billion funding loans held for sale, \$49.0 million increase in loans receivable, \$24.0 decrease in repurchase agreements, \$12.0 million decrease in deposits, \$20.3 million for cash dividends paid, \$5.4 million in purchases of FHLB stock, and \$5.0 million in purchases of mortgage related securities.

During the six months ended June 30, 2017, primary sources of cash and cash equivalents included: \$1.31 billion in proceeds from the sale of loans held for sale, \$100.0 million in proceeds from long-term FHLB debt, \$34.9 million in proceeds from additional short-term borrowings, \$16.9 million in principal repayments on mortgage related securities, \$15.5 million in net income, and \$5.8 million from maturities of debt securities.

During the six months ended June 30, 2016 primary uses of cash and cash equivalents included: \$1.05 billion funding loans held for sale, \$70.0 million in the payment of long term debt, \$18.9 million increase in loans receivable, purchase of \$10.0 million in bank owned life insurance, \$3.9 million for the repurchase of common stock, \$5.2 million in purchases of mortgage related securities, \$6.5 million in short term borrowings, and \$2.7 million in dividends paid.

During the six months ended June 30, 2016, primary sources of cash and cash equivalents included: \$1.06 billion in proceeds from the sale of loans held for sale, \$49.3 million increase in deposits, \$50.0 million from long term borrowings, \$19.1 million in principal repayments on mortgage related securities, \$5.9 from maturities of debt securities, \$11.6 million in net income, and \$3.7 million from real estate owned sales.

A portion of our liquidity consists of cash and cash equivalents, which are a product of our operating, investing and financing activities. At June 30, 2017 and 2016, respectively, \$129.6 million and \$82.5 million of our assets were invested in cash and cash equivalents. At June 30, 2017, cash and cash equivalents are comprised of the following: \$29.4 million in cash held at the Federal Reserve Bank and other depository institutions and \$100.2 million in federal funds sold and short-term investments. Our primary sources of cash are principal repayments on loans, proceeds from the calls and maturities of debt and mortgage-related securities, increases in deposit accounts and advances from the FHLBC.

Liquidity management is both a daily and longer-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLBC which provide an additional source of funds. At June 30, 2017, we had \$85.0 million in short-term advances from the FHLBC. Of the \$85.0 million, a total of \$35.0 million has a contractual maturity date of March 15, 2018 and a total of \$50.0 million has a contractual maturity date of August 25, 2017. At June 30, 2017, we had \$390.0 million in long term advances from the FHLBC with contractual maturity dates in 2017, 2018, 2021, and 2027. The advances with maturity dates in 2017 and 2018 are callable quarterly until maturity. The 2021 advance maturities have quarterly call options beginning in June 2018 and September 2018. The 2027 advance maturities have a single call option in May 2019 and June 2019. As an additional source of funds, we also enter into repurchase agreements. At June 30, 2017, we had \$60.0 million in repurchase agreements. The repurchase agreements mature at various times in 2017, however, all are callable quarterly until maturity.

At June 30, 2017, we had outstanding commitments to originate loans receivable of \$33.7 million. In addition, at June 30, 2017, we had unfunded commitments under construction loans of \$25.7 million, unfunded commitments under business lines of credit of \$16.3 million and unfunded commitments under home equity lines of credit and standby letters of credit of \$14.7 million. At June 30, 2017, certificates of deposit scheduled to mature in one year or less totaled \$557.7 million. Based on prior experience, management believes that, subject to the Bank's funding needs, a significant portion of such deposits will remain with us, although there can be no assurance that this will be the case. In the event a significant portion of our deposits is not retained by us, we will have to utilize other funding sources, such as FHLBC advances, in order to maintain our level of assets. However, we cannot assure that such borrowings would be available on attractive terms, or at all, if and when needed. Alternatively, we could reduce our level of liquid assets, such as our cash and cash equivalents and securities available-for-sale in order to meet funding needs. In addition, the cost of such deposits may be significantly higher if market interest rates are higher or there is an increased amount of competition for deposits in our market area at the time of renewal.

Waterstone Financial, Inc. is a separate legal entity from WaterStone Bank and must provide for its own liquidity to pay dividends to its shareholders, repurchase shares of its common stock, and for other corporate purposes. The primary source of liquidity for Waterstone Financial, Inc. is dividend payments from WaterStone Bank. The ability of WaterStone Bank to pay dividends is subject to regulatory restrictions. At June 30, 2017, Waterstone Financial, Inc. (on an unconsolidated basis) had liquid assets totaling \$22.5 million.

Capital

Shareholders' equity decreased by \$2.7 million to \$408.0 million at June 30, 2017 from December 31, 2016. The decrease in shareholders' equity was primarily due to the regular dividends and special dividend declared and the repurchase of stock. Partially offsetting these decreases, shareholders' equity increased primarily due to net income, additional paid in capital as stock options were exercised, accumulated other comprehensive income increasing as the fair value of the security portfolio increased, and unearned ESOP shares as they continue to vest.

The Company's Board of Directors authorized a stock repurchase program in the first quarter of 2015. The Company authorized two stock repurchase programs in the second quarter of 2015. These first three programs have been either fulfilled or cancelled. The Company's Board of Directors authorized a fourth stock repurchase program in the third quarter of 2015. The timing of the repurchases will depend on certain factors, including but not limited to, market conditions and prices, available funds and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, negotiated private transactions and pursuant to a trading plan that will be adopted in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934. Repurchased shares are held by the Company as authorized but unissued shares.

As of June 30, 2017, the Company had repurchased 5,847,153 shares at an average price of \$12.96 under previously approved stock repurchase plans. As of June 30, 2017, the Company is authorized to purchase up to 989,500 additional shares under the current approved stock repurchase program.

WaterStone Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories. At June 30, 2017, WaterStone Bank exceeded all regulatory capital requirements and is considered "well capitalized" under regulatory guidelines. See "Notes to Consolidated Financial Statements - Note 8 Regulatory Capital."

Contractual Obligations, Commitments, Contingent Liabilities, and Off-balance Sheet Arrangements

The following tables present information indicating various contractual obligations and commitments of the Company as of June 30, 2017 and the respective maturity dates.

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

	Total	One Year	More than One Year	More than Three Years	Over Five Years
	(In Thousands)	or Less	Through Three Years	Through Five Years	
Demand deposits (4)	\$ 119,585	\$ 119,585	\$-	\$-	\$-
Money market and savings deposits (4)	153,743	153,743	-	-	-
Time deposit (4)	664,065	557,711	103,295	3,059	-
Bank lines of credit (4)	23,103	23,103	-	-	-
Federal Home Loan Bank advances (1)	415,000	215,000	-	100,000	100,000
Repurchase agreements (2)(4)	60,000	60,000	-	-	-
Operating leases (3)	8,840	2,818	3,396	1,430	1,196
	\$ 1,444,336	\$ 1,131,960	\$ 106,691	\$ 104,489	\$ 101,196

(1) Secured under a blanket security agreement on qualifying assets, principally, mortgage loans. Excludes interest which will accrue on the advances.

All Federal Home Loan Bank advances with maturities exceeding one year are callable on a quarterly basis.

(2) The repurchase agreements are callable on a quarterly basis until maturity.

(3) Represents non-cancelable operating leases for offices and equipment.

(4) Excludes interest.

Herrington v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their various employment agreements. On July 5, 2017, the arbitrator issued a final award finding Waterstone Mortgage Corporation liable for unpaid minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. The arbitrator awarded damages under the FLSA in the amount of \$7.3 million, and attorney's fees and costs in the amount of \$3.3 million. While a judgment confirming the arbitrator's award with respect to damages and fees has not yet been issued, if plaintiff prevails on her theories, the Company has estimated that the award, which includes attorney's fees and costs, could be as high as \$11.0 million. Waterstone Mortgage Corporation will continue to vigorously defend its interests in this matter, including challenging any findings regarding liability and damages through appropriate post-arbitration motions and appeal processes and seeking to vacate in its entirety any award against the Company. Given the pending legal strategies that are available, we do not believe that it is probable that the plaintiff will ultimately prevail in this litigation, and estimate the low end of the possible range of loss is \$0. In accordance with the authoritative guidance in evaluating contingencies, the Company has not recorded an accrual related to this matter.

Off-Balance Sheet Commitments

The following table details the amounts and expected maturities of significant off-balance sheet commitments as of June 30, 2017.

			More than One Year	More than Three Years	Over
		One Year	Through Three Years	Through Five Years	Five Years
	Total	or Less			
	(In Thousands)				
Real estate loan commitments (1)	\$33,719	\$33,719	\$ -	\$ -	\$ -
Unused portion of home equity lines of credit (2)	14,467	14,467	-	-	-
Unused portion of construction loans (3)	25,690	25,690	-	-	-
Unused portion of business lines of credit	16,300	16,300	-	-	-
Standby letters of credit	259	259	-	-	-
Total Other Commitments	\$90,435	\$90,435	\$ -	\$ -	\$ -

General: Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and generally have fixed expiration dates or other termination clauses.

- (1) Commitments for loans are extended to customers for up to 90 days after which they expire.
- (2) Unused portions of home equity loans are available to the borrower for up to 10 years.
- (3) Unused portions of construction loans are available to the borrower for up to one year.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Management of Market Risk

General. The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, WaterStone Bank's board of directors has established an Asset/Liability Committee which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the board of directors. Management monitors the level of interest rate risk on a regular basis and the Asset/Liability Committee meets at least weekly to review our asset/liability policies and interest rate risk position, which are evaluated quarterly.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. We have implemented the following strategies to manage our interest rate risk: (i) emphasizing variable rate loans including variable rate one- to four-family, and commercial real estate loans as well as three to five year commercial real estate balloon loans; (ii) reducing and shortening the expected average life of the investment portfolio; and (iii) whenever possible, lengthening the term structure of our deposit base and our borrowings from the FHLBC. These measures should reduce the volatility of our net interest income in different interest rate environments.

Income Simulation. Simulation analysis is an estimate of our interest rate risk exposure at a particular point in time. At least quarterly we review the potential effect changes in interest rates may have on the repayment or repricing of rate sensitive assets and funding requirements of rate sensitive liabilities. Our most recent simulation uses projected repricing of assets and liabilities at June 30, 2017 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rate assumptions may have a significant impact on interest income simulation results. Because of the large percentage of loans and mortgage-backed securities we hold, rising or falling interest rates may have a significant impact on the actual prepayment speeds of our mortgage related assets that may in turn affect our interest rate sensitivity position. When interest rates rise, prepayment speeds slow and the average expected lives of our assets would tend to lengthen more than the expected average lives of our liabilities and therefore would most likely have a positive impact on net interest income and earnings.

The following interest rate scenario displays the percentage change in net interest income over a one-year time horizon assuming increases of 100, 200 and 300 basis points and a decreases of 100 basis points. The results incorporate actual cash flows and repricing characteristics for balance sheet accounts following an instantaneous parallel change in market rates based upon a static (no growth balance sheet).

Analysis of Net Interest Income Sensitivity

	Immediate Change in Rates			
	+300	+200	+100	-100
	(Dollar Amounts in Thousands)			
As of March 31, 2017				
Dollar Change	\$3,804	2,573	1,299	(1,495)
Percentage Change	7.35 %	4.97	2.51	(2.89)

At June 30, 2017, a 100 basis point instantaneous increase in interest rates had the effect of increasing forecast net interest income over the next 12 months by 2.51% while a 100 basis point decrease in rates had the effect of decreasing net interest income by 2.89%.

Item 4. Controls and Procedures

Disclosure Controls and Procedures: Company management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

Internal Control Over Financial Reporting: There have been no material changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Other than as disclosed below, the Company is not involved in any pending legal proceedings as a defendant other than routine legal proceedings occurring in the ordinary course of business. At June 30, 2017, the Company believes that any liability arising from the resolution of any pending legal proceedings will not be material to its financial condition or results of operations.

Herrington v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their various employment agreements. On July 5, 2017, the arbitrator issued a final award finding Waterstone Mortgage Corporation liable for unpaid minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. The arbitrator awarded damages under the FLSA in the amount of \$7.3 million, and attorney's fees and costs in the amount of \$3.3 million. While a judgment confirming the arbitrator's award with respect to damages and fees has not yet been issued, if plaintiff prevails on her theories, the Company has estimated that the award, which includes attorney's fees and costs, could be as high as \$11.0 million. Waterstone Mortgage Corporation will continue to vigorously defend its interests in this matter, including challenging any findings regarding liability and damages through appropriate post-arbitration motions and appeal processes and seeking to vacate in its entirety any award against the Company. Given the pending legal strategies that are available, we do not believe that it is probable that the plaintiff will ultimately prevail in this litigation, and estimate the low end of the possible range of loss is \$0. In accordance with the authoritative guidance in evaluating contingencies, the Company has not recorded an accrual related to this matter.

Item 1A. Risk Factors

There have been no changes in risk factors applicable to the Company from those disclosed in "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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

Following are the Company's monthly common stock purchases during the second quarter of 2017:

Edgar Filing: Waterstone Financial, Inc. - Form 10-Q

Period	Total Number of Shares Purchased ^(b)	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)
April 1, 2017 - April 30, 2017	19,484	\$ 18.41	-	989,500
May 1, 2017 - May 31, 2017	-	-	-	989,500
June 1, 2017 - June 30, 2017	1,467	18.45	-	989,500
Total	20,951	\$ 18.41	-	989,500

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

(b) During the second quarter of 2017, the Company repurchased 20,951 shares for minimum tax withholding settlements on equity compensation. These purchases are included in the monthly common stock purchases table above but do not count against the maximum number of shares that may yet be purchased under the Board of Directors' authorization.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

(a) Exhibits: See Exhibit Index, which follows the signature page hereof.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

WATERSTONE FINANCIAL, INC.

(Registrant)

Date: July 31, 2017

/s/ Douglas S. Gordon
Douglas S. Gordon
Chief Executive Officer
Principal Executive Officer

Date: July 31, 2017

/s/ Mark R. Gerke
Mark R. Gerke
Chief Financial Officer
Principal Financial Officer

EXHIBIT INDEX

WATERSTONE FINANCIAL, INC.

Form 10-Q for Quarter Ended June 30, 2017

Exhibit No.	Description	Filed Herewith
<u>31.1</u>	Sarbanes-Oxley Act Section 302 Certification signed by the Chief Executive Officer of Waterstone Financial, Inc.	X
<u>31.2</u>	Sarbanes-Oxley Act Section 302 Certification signed by the Chief Financial Officer of Waterstone Financial, Inc.	X
<u>32.1</u>	Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer of Waterstone Financial, Inc.	X
<u>32.2</u>	Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer of Waterstone Financial, Inc.	X
101	The following financial statements from Waterstone Financial, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2017, formatted in Extensive Business Reporting Language (XBRL): (i) consolidated statements of financial condition, (ii) consolidated statements of income, (iii) consolidated statements of comprehensive income, (iv) consolidated statements of changes in shareholders' equity, (v) consolidated statements of cash flows and (vi) the notes to consolidated financial statements.	X