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Sound Financial Bancorp, Inc.  
Form 10-K  
March 31, 2015  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2014

OR

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

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

COMMISSION FILE NUMBER 001-35633

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

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

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

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

Securities Registered Pursuant to Section 12(b) of the Act:  
Common Stock, par value \$.01 per share

Securities Registered Pursuant to Section 12(g) of the Act:  
Title of each class  
None

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
YES  NO

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES  NO

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

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and

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post such files). YES  NO

Indicate by checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting Company <input checked="" type="checkbox"/>
(Do not check if smaller reporting Company)			

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2014, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$38.8 million. (The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the registrant that such person is an affiliate of the registrant.)

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

As of March 30, 2015, there were 2,528,451 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

PART III of Form 10-K – Portions of the Registrant's Proxy Statement for its 2015 Annual Meeting of Shareholders.

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## PART I

### Item 1. Business

#### Special Note Regarding Forward-Looking Statements

Certain matters discussed in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to:

- changes in economic conditions, either nationally or in our market area;
- fluctuations in interest rates;
- the risks of lending and investing activities, including changes in the level and direction of loan delinquencies and write-offs and changes in estimates of the adequacy of our allowance for loan losses;
- the possibility of other-than-temporary impairments of securities held in our securities portfolio;
- our ability to access cost-effective funding;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values and both residential and commercial and multifamily real estate market conditions in our market area;
- secondary market conditions for loans and our ability to sell loans in the secondary market;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all including in particular, our recent acquisition of three branches from Columbia State Bank;
- legislative or regulatory changes such as the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including changes related to Basel III;
- monetary and fiscal policies of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the U.S. Government and other governmental initiatives affecting the financial services industry;
- results of examinations of Sound Financial Bancorp and Sound Community Bank by their regulators, including the possibility that the regulators may, among other things, require us to increase our allowance for loan losses or to write-down assets, change Sound Community Bank's regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;
- increases in premiums for deposit insurance;
- our ability to control operating costs and expenses;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- difficulties in reducing risks associated with the loans on our balance sheet;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;

- computer systems on which we depend could fail or experience a security breach;
  - our ability to retain key members of our senior management team;
  - costs and effects of litigation, including settlements and judgments;
  - our ability to implement our business strategies;
  - increased competitive pressures among financial services companies;
  - changes in consumer spending, borrowing and savings habits;
  - the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
  - our ability to pay dividends on our common stock;
  - adverse changes in the securities markets;
  - the inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described from time to time in this Form 10-K and our other filings with the U.S. Securities and Exchange Commission (the "SEC").

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

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

#### General

References in this document to Sound Financial Bancorp or the Company refer to Sound Financial Bancorp, Inc. and its predecessor, Sound Financial, Inc., a federal corporation, and references to the "Bank" refer to Sound Community Bank. References to "we," "us," and "our" means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank, unless the context otherwise requires.

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

Sound Community Bank's deposits are insured up to applicable limits by the FDIC. At December 31, 2014, Sound Financial Bancorp had total consolidated assets of \$495.2 million, net loans of \$426.0 million, deposits of \$407.8 million and stockholders' equity of \$50.6 million. The shares of Sound Financial Bancorp are traded on The NASDAQ Capital Market under the symbol "SFBC." Our executive offices are located at 2005 5<sup>th</sup> Avenue, Suite 200, Seattle, Washington, 98121.

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

## Market Area

We serve the Seattle Metropolitan Statistical Area ("MSA"), which includes the city of Seattle, King County, Snohomish County, and Pierce County within the Puget Sound region, and Clallam and Jefferson Counties, Washington. We serve these markets through our main office in Seattle, five branch offices, two of which are located in the Seattle MSA, two that are located in Clallam County and one that is located in Jefferson County, and a loan production office located in the Madison Park neighborhood of Seattle. Based on the most recent branch deposit data provided by the FDIC, our share of deposits in the Seattle-Tacoma-Bellevue MSA was approximately 0.21%, in King County approximately 0.15%, in Pierce County approximately 0.44% and in Snohomish County approximately 0.36%. In Clallam County and Jefferson County, we have approximately 13.67% and 4.04%, respectively, of the deposits in those markets. See "– Competition."

Our market area includes a diverse population of management, professional and sales personnel, office employees, manufacturing and transportation workers, service industry workers and government employees, as well as retired and self-employed individuals. The population has a skilled work force with a wide range of education levels and ethnic backgrounds. Major employment sectors include information and communications technology, financial services, manufacturing, maritime, biotechnology, education, health and social services, retail trades, transportation and professional services. The largest employers headquartered in our market area include Boeing, U.S. Joint Base Lewis-McChord, Navy Region Northwest, Microsoft, University of Washington, and Providence Health. Other significant employers include Costco, Nordstrom, Amazon.com, Inc., Starbucks, Alaska Air Group and Weyerhaeuser.

Weak economic conditions and ongoing strains in the financial and housing markets which began in 2008, generally started to improve in 2012 in portions of the United States, including our market area. While the effects during this period presented an unusually challenging environment for banks and their holding companies, including us, trends in housing prices and unemployment are generally improving. For the month of December 2014, the Seattle MSA reported an unemployment rate of 4.8%, as compared to the national average of 5.6%, according to the latest available information from the Bureau of Labor Statistics. Home prices in our markets also improved over the past year. Based on information from Case-Shiller, the average home price in the Seattle MSA increased 6.6% in 2014 from 2013. This compares favorably to the national average home price index increase in 2014 of 4.6%.

King County has the largest population of any county in the state of Washington, covers approximately 2,100 square miles, and is located on the Puget Sound. It has approximately 2.0 million residents and a median household income of approximately \$71,000. King County has a diversified economic base with many industries including shipping and transportation (Port of Seattle, Paccar, Inc. and Expeditors International of Washington, Inc.), retail (Amazon.com, Inc., Starbucks Corp. and Nordstrom, Inc.) aerospace (the Boeing Company) and computer technology (Microsoft Corp.) and biotech industries. Based on information from the Northwest Multiple Listing Service ("MLS"), the median sales price in King County in December 2014 was \$391,000, a 5.1% increase from December 2013's median sale price of \$372,000.

Pierce County has the second largest population of any county in the State of Washington, covers approximately 1,700 square miles and is located along western Puget Sound. It has approximately 811,000 residents and a median household income of approximately \$59,000. The Pierce County economy is diversified with the presence of military related government employment (Fort Lewis Army Base and McChord Air Force Base), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). Based on information from the MLS, the median sale price in Pierce County in December 2014 was \$230,000, a 3.6% increase from December 2013's median sales price of \$222,000.

Snohomish County has the third largest population of any county in the state of Washington, covers approximately 2,100 square miles and is located on Puget Sound touching the northern border of King County. It has approximately 733,000 residents and a median household income of approximately \$68,000. The economy of Snohomish County is diversified with the presence of military related government employment (Everett Homeport Naval Base), aerospace related employment (Boeing) and retail trade. Based on information from the MLS, the median sales price in Snohomish County as of December 31, 2014 was \$300,000, a 1.4% increase from December 2013's median sales price of \$296,000.

Clallam County, with a population of approximately 71,000, is ranked 18th among the counties in the state of Washington. It is bordered by the Pacific Ocean and the Strait of Juan de Fuca and covers 1,700 square miles, including the westernmost portion of the continental United States. It has approximately 36,000 households and median household income of approximately \$46,000. The economy of Clallam County is primarily manufacturing and shipping. The Sequim Dungeness Valley continues to be a growing retirement location. Our offices are in Port Angeles and Sequim, the two largest cities in the county. Based on information from the MLS, the median sales price in Clallam County in December 2014 was \$199,000, a 12.4% increase from 2013's median sales price of \$177,000.

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Jefferson County, with a population of approximately 30,000, is the 27<sup>th</sup> largest county in the state of Washington. It is bordered by Clallam County and the Strait of Juan de Fuca to the north and the Hood Canal on the west and covers 2,200 square miles. The majority of the population of the county lives in the northwestern portion of the county. Our office is located in Port Ludlow which is the third largest community in the county. Port Ludlow ranks 16<sup>th</sup> of 522 ranked areas in the state of Washington and is the most affluent area of Jefferson County. The economy of Jefferson County is primarily based on tourism, agriculture, lumber, fish processing and ship repair and maintenance. Port Ludlow is a popular retirement community and is a well-known port of call for leisure craft sailing between Puget Sound and the San Juan Islands. Based on information from the MLS, the average home price in Jefferson County as of December 2014 was \$147,000, a 3.3% decrease from 2013's median price of \$152,000.

There have been indications over the last several years that the U.S. job market, including the job market in our market area, is improving, however the unemployment rate in certain of our market areas remain relatively high.. According to the latest available information from the Bureau of Labor Statistics, King and Snohomish Counties reported an unemployment rate of 4.1% and 4.5%, respectively, as of December 2014, which are lower than the state and national unemployment rates of 6.3% and 5.6%, respectively. The unemployment rates for Clallam and Pierce Counties are above the state and national rates as of December 2014. The unemployment rate in Clallam County increased from 9.0% as of December 2013 to 9.3% as of December 2014, while the unemployment rate in Pierce County decreased from 7.3% as of December 2013 to 7.2% as of December 2014. The unemployment rate in Jefferson County increased from 8.4% as of December 2013 to 8.6% as of December 2014.

#### Lending Activities

The following table presents information concerning the composition of our loan portfolio, excluding loans held-for-sale by the type of loan for the dates indicated (dollars in thousands):

	December 31,		2013		2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Real estate loans:										
One- to four-family	\$133,031	30.80 %	\$117,739	30.02 %	\$94,059	28.71 %	\$94,498	31.45 %	\$98,314	32.81 %
Home equity	34,675	8.03	35,155	8.96	35,364	10.80	39,656	13.20	44,829	14.96
Commercial and multifamily	168,952	39.12	157,516	40.17	133,620	40.79	106,016	35.28	93,053	31.05
Construction and land	46,279	10.72	44,300	11.30	25,458	7.77	17,805	5.93	16,650	5.56
Total real estate loans	382,937	88.67	354,710	90.45	288,501	88.07	257,975	85.85	252,846	84.37
Consumer loans:										
Manufactured homes	12,539	2.90	13,496	3.44	16,232	4.96	18,444	6.14	20,043	6.69
Other consumer	16,875	3.91	10,284	2.62	8,650	2.64	10,920	3.63	12,110	4.04
Total consumer loans	29,414	6.81	23,780	6.06	24,882	7.60	29,364	9.77	32,153	10.73
Commercial business loans	19,525	4.52	13,668	3.49	14,193	4.33	13,163	4.38	14,678	4.90

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Total loans	431,876	100.00%	392,158	100.00%	327,576	100.00%	300,502	100.00%	299,677	100.00%
Less:										
Deferred fees and discounts	1,516		1,232		832		406		431	
Allowance for loan losses	4,387		4,177		4,248		4,455		4,436	
Total loans, net	\$425,973		\$386,749		\$322,496		\$295,641		\$294,810	

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The following table shows the composition of our loan portfolio in dollar amounts and in percentages by fixed and adjustable rate loans for the dates indicated (dollars in thousands):

	December 31, 2014		2013		2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Fixed- rate loans:										
Real estate loans:										
One- to four-family	\$ 118,083	27.34 %	\$ 103,756	26.46 %	\$ 79,020	24.12 %	\$ 78,145	26.00 %	\$ 79,930	26.67 %
Home equity	12,003	2.78	13,530	3.45	9,605	2.93	9,276	3.09	10,294	3.44
Commercial and multifamily	103,303	23.92	100,031	25.51	76,957	23.49	45,034	14.99	40,491	13.51
Construction and land	39,147	9.07	37,668	9.61	22,346	6.82	17,458	5.81	10,907	3.64
Total real estate loans	272,536	63.11	254,985	65.03	187,928	57.37	149,913	49.89	141,622	47.26
Manufactured homes	12,539	2.90	13,496	3.44	16,232	4.96	18,444	6.14	20,043	6.69
Other consumer	16,129	3.74	9,495	2.42	7,767	2.37	9,730	3.24	10,772	3.59
Commercial business	11,024	2.55	5,603	1.43	9,268	2.83	8,041	2.68	8,293	2.77
Total fixed-rate loans	312,226	72.30	283,579	72.32	221,195	67.52	186,128	61.94	180,730	60.31
Adjustable- rate loans:										
Real estate loans:										
One- to four-family	14,948	3.46	13,983	3.57	15,039	4.59	16,353	5.44	18,384	6.13
Home equity	22,672	5.25	21,625	5.51	25,759	7.86	30,380	10.11	34,535	11.52
Commercial and multifamily	65,649	15.20	57,485	14.66	56,663	17.30	60,982	20.29	52,562	17.54
Construction and land	7,132	1.65	6,632	1.69	3,112	0.95	347	0.12	5,743	1.92
Total real estate loans	110,401	25.56	99,725	25.43	100,573	30.70	108,062	35.96	111,224	37.11
Other consumer	746	0.17	789	0.20	883	0.27	1,190	0.40	1,338	0.45
Commercial business	8,501	1.97	8,065	2.05	4,925	1.50	5,122	1.70	6,385	2.13
Total adjustable-rate loans	119,648	27.70	108,579	27.68	106,381	32.48	114,374	38.06	118,947	39.69
Total loans	431,876	100.00%	392,158	100.00%	327,576	100.00%	300,502	100.00%	299,677	100.00%
Less:										

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Deferred fees and discounts	1,516	1,232	832	406	431
Allowance for loan losses	4,387	4,177	4,248	4,455	4,436
Total loans, net	\$425,973	\$386,749	\$322,496	\$295,641	\$294,810

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The following table illustrates the contractual maturity of our loan portfolio at December 31, 2014 (dollars in thousands). Mortgages that have adjustable or renegotiable interest rates are shown as maturing in the period during which the contract is due. The total amount of loans due after December 31, 2015, which have predetermined interest rates, is \$266.8 million, while the total amount of loans due after such date, which have floating or adjustable interest rates, is \$105.1 million. The table does not reflect the effects of possible prepayments or enforcement of due-on-sale clauses.

	Real Estate Mortgages											
	One- to Four- Family		Home Equity Loans		Commercial and Multifamily		Construction and Land		Manufactured Homes		Other Consumer	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
2015 <sup>(2)</sup>	\$4,041	4.29%	\$800	5.36%	\$12,324	5.07%	\$30,643	5.52%	\$155	7.31%	\$3,830	6.59%
2016	8,531	5.50	900	5.05	9,761	4.64	6,329	5.65	53	7.88	815	6.04
2017	3,134	4.40	2,701	5.15	6,185	5.11	1,389	7.24	112	7.61	403	6.10
2018	5,284	4.52	2,119	4.99	4,348	4.30	1,625	6.52	263	8.40	456	6.47
2019 to 2021	29,883	4.71	14,963	5.44	26,775	5.50	1,727	7.34	2,252	8.44	1,819	5.68
2022 to 2025	19,848	4.18	3,985	4.99	90,291	4.80	2,732	6.64	3,850	8.55	,511	5.44
2026 to 2029	17,768	4.24	2,492	6.17	9,783	4.98	2,732	6.17	5,043	7.76	6,406	4.80
2030 and following	44,542	4.63	6,715	4.93	9,485	4.88	137	6.15	811	6.54	1,63	5.88
Total <sup>(1)</sup>	\$133,031	4.56%	\$34,675	5.28%	\$168,952	4.94%	\$46,279	5.79%	\$12,539	8.05%	\$16,875	5.60%

(1) Excludes deferred fees and discounts of \$1.5 million.

(2) Includes demand loans, loans having no stated maturity and overdraft loans.

**Lending Authority.** Our President and Chief Executive Officer may approve unsecured loans up to \$1,000,000 and all types of secured loans up to 30% of our legal lending limit, or approximately \$3.2 million as of December 31, 2014. Our Executive Vice President and Chief Credit Officer may approve unsecured loans up to \$400,000 and secured loans up to 15% of our legal lending limit, or approximately \$2.1 million as of December 31, 2014. Any loans over the President and Chief Executive Officer's lending authority or loans otherwise outside our general underwriting guidelines must be approved by the Board Loan Committee. Lending authority is also granted to certain other bank officers at lower amounts, generally up to 7.5% of our legal lending limit for real estate secured loans and \$50,000 for unsecured loans provided the loan has no policy exceptions.

**Largest Borrowing Relationships.** At December 31, 2014, the maximum amount under federal law that we could lend to any one borrower and the borrower's related entities was approximately \$10.5 million. Our five largest relationships totaled \$18.7 million in the aggregate, or 4.3% of our \$430.4 million gross loan portfolio, at December 31, 2014. The largest relationship was for \$7.7 million in loans to businesses with common ownership collateralized by commercial real estate. The second largest relationship consists of a \$7.5 million line of credit to a business collateralized by the borrower's real estate collateral pool and assignment of specific promissory notes and underlying deeds of trust. There was \$1.7 million outstanding on the line at December 31, 2014. The total credit facility to this borrower is \$15.0 million and there is another participating financial institution. The next three largest lending relationships at December 31, 2014, were: \$7.2 million in loans to businesses with common ownership collateralized by multifamily real estate; a \$6.4 million loan collateralized by commercial real estate; and \$5.2 million in loans to businesses with common ownership collateralized by multifamily real estate. At December 31, 2014, we had five other lending relationships that exceeded \$4.0 million. All of the loans in these relationships were performing in accordance with their repayment terms as of December 31, 2014.

**One- to Four-Family Real Estate Lending.** One of our primary lending activities is the origination of loans secured by first mortgages on one- to four-family residences, substantially all of which are secured by property located in our geographic lending area. We originate both fixed-rate and adjustable-rate loans. Over the past two years, the overwhelming majority of our one- to four-family loan originations were fixed rate.

Most of our loans are underwritten using secondary market generally-accepted underwriting guidelines, and are readily saleable to Fannie Mae or other private investors. A portion of the one- to four-family loans we originate are retained in our portfolio while the majority are sold into the secondary market to Fannie Mae, with servicing retained for continued customer contact, relationship building and to increase noninterest income. The sale of mortgage loans provides a source of non-interest income through the gain on sale, reduces our interest rate risk, provides a stream of servicing income, enhances liquidity and enables us to originate more loans at our current capital level than if we held them in portfolio. We are currently selling all our conforming fixed-rate loans, on a servicing retained basis. Our pricing strategy for mortgage loans includes establishing interest rates that are competitive with other local financial institutions and consistent with our internal asset and liability management objectives. During the year ended December 31, 2014, we originated \$81.1 million of one- to four-family fixed-rate mortgage loans and \$1.2 million one- to four-family adjustable rate mortgage ("ARM") loans. See "- Loan Originations, Purchases, Sales, Repayments and Servicing." At December 31, 2014, one- to four-family residential mortgage loans (excluding loans held-for-sale) totaled \$133.0 million, or 30.8%, of our gross loan portfolio, of which \$118.1 million were fixed-rate loans and \$14.9 million were ARM loans, compared to \$117.7 million (excluding loans held-for-sale), or 30.0% of our gross loan portfolio as of December 31, 2013, of which \$103.8 million were fixed-rate loans and \$13.5 million were ARM loans.

Substantially all of the one- to four-family residential mortgage loans we retain in our portfolio consist of loans that are "non-conforming" because they do not satisfy acreage limits, income, credit, conforming loan limits (i.e., jumbo mortgages) or various other requirements imposed by Fannie Mae. Some of these loans are also originated to meet the needs of borrowers who cannot otherwise satisfy Fannie Mae credit requirements because of personal and financial reasons (i.e., divorce, bankruptcy, length of time employed, etc.), and other aspects, which do not conform to Fannie Mae's guidelines. Such borrowers may have higher debt-to-income ratios, or the loans are secured by unique properties in rural markets for which there are no sales of comparable properties to support the value according to

secondary market requirements. We may require additional collateral or lower loan-to-value ratios to reduce the risk of these loans. We believe that these loans satisfy the needs of borrowers in our market area. As a result, subject to market conditions, we intend to continue to originate these types of loans.

We generally underwrite our one- to four-family loans based on the applicant's employment and credit history and the appraised value of the subject property. We generally lend up to 80% of the lesser of the appraised value or purchase price for one- to four-family first mortgage loans and non-owner occupied first mortgage loans. For first mortgage loans with a loan-to-value ratio in excess of 80%, we generally require private mortgage insurance in order to reduce our exposure to 80% or we charge a higher interest rate. Properties securing our one- to four-family loans are generally appraised by independent fee appraisers who are selected in accordance with criteria approved by the Board of Directors. For loans that are less than \$250,000, we may use an automated valuation model developed by Freddie Mac, called the Home Value Estimator, in lieu of an appraisal. We typically require title insurance policies on all first mortgage real estate loans originated. Homeowners, liability, fire and, if required, flood insurance policies are also required for one-to four-family loans. Our real estate loans generally contain a "due on sale" clause allowing us to declare the unpaid principal balance due and payable upon the sale of the security property. The average size of our one- to four-family residential loans was approximately \$252,000 at December 31, 2014.

Fixed-rate loans secured by one- to four-family residences have contractual maturities of up to 30 years; however, at December 31, 2014 we had \$1.9 million of one- to four-family loans with an original contractual maturity of 40 years which were originated prior to 2009. All of these loans are fully amortizing, with payments due monthly. Our portfolio of fixed-rate loans also includes \$17.2 million of loans with an initial seven year term and a 30-year amortization period with a borrower refinancing option at a fixed rate at the end of the initial term as long as the loan has met certain performance criterion. In addition, we had \$23.7 million of one- to four- family loans with a five-year call option at December 31, 2014. Prior to 2012, we originated for portfolio five and seven year balloon reset loans (which are loans that are originated with a fixed interest rate for the initial five or seven years, and thereafter incur one interest rate change based on current market interest rates in which the new rate remains in effect for the remainder of the loan term) based on a 30-year amortization period.

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ARM loans are offered with annual adjustments and life-time rate caps that vary based on the product, generally with a maximum annual rate change of 2.0% and a maximum overall rate change of 6.0%. We generally use the rate on one-year Treasury Bills to re-price our ARM loans, however, \$5.2 million of our ARM loans are to employees that re-price annually based on a margin of 1% over our average 12 month cost of funds. As a consequence of using caps, the interest rates on ARM loans may not be as rate sensitive as our cost of funds. Furthermore, because loan indexes may not respond perfectly to changes in market interest rates, upward adjustments on loans may occur more slowly than increases in our cost of interest-bearing liabilities, especially during periods of rapidly increasing interest rates. Because of these characteristics, yields on ARM loans may not be sufficient to offset increases in our cost of funds. ARM loans generally pose different credit risks than fixed-rate loans, primarily because as interest rates rise, the borrower's payment rises, which increases the potential for default. The majority of these loans have been originated within the past several years, when rates were historically low. We continued to expand our fully amortizing ARM loans, by offering ARM loans with a fixed interest rate for the first one, three, five, or seven years, followed by a periodic adjustable interest rate for the remaining term. Given the recent market environment, however, the production of ARM loans has been substantially reduced because borrowers favor fixed rate mortgages.

**Home Equity Lending.** We originate home equity loans that consist of fixed-rate loans and variable-rate lines of credit. We originate home equity loans in amounts of up to 80% of the value of the collateral, minus any senior liens on the property; however, prior to 2010 we originated home equity loans in amounts of up to 100% of the value of the collateral, minus any senior liens on the property. Home equity lines of credit are typically originated for up to \$250,000 with an adjustable rate of interest, based on the one-year Treasury Bill rate plus a margin. Home equity lines of credit generally have up to a twelve-year draw period, during which time the funds may be paid down and redrawn up to the committed amount. Once the draw period has lapsed, the payment is amortized over a twelve-year period based on the loan balance at that time. We charge a \$50 annual fee on each home equity line of credit and require monthly interest-only payments on the entire drawn amount during the draw period. At December 31, 2014, home equity loans totaled \$34.7 million, or 8.0% of our gross loan portfolio compared to \$35.2 million, or 9.0% of our gross loan portfolio at December 31, 2013. Variable-rate home equity lines of credit at December 31, 2014 totaled \$22.7 million, or 5.3% of our gross loan portfolio, compared to \$21.6 million, or 5.5% of our gross loan portfolio as of December 31, 2013. At December 31, 2014, unfunded commitments on home equity lines of credit totaled \$10.3 million.

Our fixed-rate home equity loans are originated in amounts, together with the amount of the existing first mortgage, of up to 80% of the appraised value of the subject property. These loans may have terms of up to 20 years and are fully amortizing. At December 31, 2014, fixed-rate home equity loans totaled \$12.0 million, or 2.8% of our gross loan portfolio, compared to \$13.5 million, or 3.5% of our gross loan portfolio as of December 31, 2013.

**Commercial and Multifamily Real Estate Lending.** We offer a variety of commercial and multifamily loans. Most of these loans are secured by commercial income producing properties, including retail centers, multifamily apartment buildings, warehouses, and office buildings located in our market area. At December 31, 2014, commercial and multifamily loans totaled \$169.0 million, or 39.1% of our gross loan portfolio, compared to \$157.5 million, or 40.2% of our gross loan portfolio as of December 31, 2013.

Loans secured by commercial and multifamily real estate are generally originated with a variable interest rate, fixed for a five to ten-year term and a 20- to 25-year amortization period. At the end of the initial term, there is a balloon payment or the loan re-prices based on an independent index plus a margin of 1% to 4% for another five years.

Loan-to-value ratios on our commercial and multifamily loans typically do not exceed 80% of the lower of cost or appraised value of the property securing the loan at origination.

Loans secured by commercial and multifamily real estate are generally underwritten based on the net operating income of the property, quality and location of the real estate, the credit history and financial strength of the borrower and the quality of management involved with the property. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt plus an additional coverage requirement. We generally impose a minimum debt coverage ratio of approximately 1.20 for originated loans secured by income producing commercial properties. If the borrower is other than an individual, we generally require the personal guaranty of the borrower. We also generally require an

assignment of rents or leases in order to be assured that the cash flow from the project will be used to repay the debt. Appraisals on properties securing commercial and multifamily loans are performed by independent state certified licensed fee appraisers and approved by the Board Loan Committee. In order to monitor the adequacy of cash flows on income-producing properties, the borrower is required to provide, at a minimum, annual financial information. From time to time we also acquire participation interests in commercial and multifamily loans originated by other financial institutions secured by properties located in our market area. On a case by case basis, we will consider loan participations where the collateral is located outside of our market area. At December 31, 2014, we held one commercial business loan participation totaling \$1.2 million where the collateral is located outside of our market area. Historically, loans secured by commercial and multifamily properties generally involve different credit risks than one-to four-family properties. These loans typically involve larger balances to single borrowers or groups of related borrowers. Because payments on loans secured by commercial and multifamily properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial and multifamily loans also expose a lender to greater credit risk than loans secured by one-to four-family because the collateral securing these loans typically cannot be sold as easily as one-to four-family. In addition, most of our commercial and multifamily loans are not fully amortizing and contain large balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. Our largest single commercial and multifamily borrowing relationship at December 31, 2014, totaled \$7.7 million and is collateralized by five commercial real estate notes. At December 31, 2014, these loans were performing in accordance with their repayment terms.

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The following table displays information on commercial and multifamily real estate loans by type at December 31, 2014 and 2013 (dollars in thousands):

	2014		2013	
	Amount	Percent	Amount	Percent
Multifamily residential	\$48,799	28.88 %	\$53,042	33.67 %
Warehouses	23,648	14.00	22,113	14.04
Office buildings	8,792	5.20	9,756	6.19
Mobile Home Parks	4,734	2.80	6,865	4.36
Gas station / Convenience store	9,688	5.73	7,555	4.80
Other non-owner occupied commercial real estate	46,555	27.56	34,094	21.64
Other owner-occupied commercial real estate	26,736	15.83	24,091	15.29
Total	\$168,952	100.00%	\$157,516	100.00%

**Construction and Land Lending.** We originate construction loans secured by single-family residences and commercial and multifamily real estate. We also originate land and lot loans, which are secured by raw land or developed lots on which the borrower intends to build a residence, and land acquisition and development loans. At December 31, 2014, our construction and land loans totaled \$46.3 million, or 10.7% of our gross loan portfolio, compared to \$44.3 million, or 11.3% of our gross loan portfolio at December 31, 2013. At December 31, 2014, unfunded construction loan commitments totaled \$37.3 million.

Construction loans to individuals and contractors for the construction and acquisition of personal residences totaled \$6.5 million, or 14.1% of our construction and land portfolio at December 31, 2014. We originate these loans whether or not the collateral property underlying the loan is under contract for sale. At December 31, 2014, construction loans to contractors for homes that were considered speculative totaled \$9.0 million, or 19.6% of our construction and land portfolio.

The composition of, and location of underlying collateral securing, our construction and land loan portfolio, excluding loan commitments, at December 31, 2014 was as follows (in thousands):

	Olympic	Puget	Other	Total
	Peninsula	Sound		
Commercial and multifamily construction	\$ -	\$19,935	\$-	\$19,935
Residential construction	248	6,637	-	6,885
Land and lot loans	2,942	4,558	2,418	9,918
Speculative residential construction	-	9,054	-	9,054
Commercial land developments	487	-	-	487
Total	\$ 3,677	\$40,184	\$2,418	\$46,279

Our residential construction loans generally provide for the payment of interest only during the construction phase, which is typically up to nine months. At the end of the construction phase, the construction loan generally either converts to a longer term mortgage loan or is paid off through a permanent loan from another lender. Residential construction loans are made up to the lesser of a maximum loan-to-value ratio of 100% of cost or 80% of appraised value at completion; however, we generally do not originate construction loans which exceed these limits without securing adequate private mortgage insurance or other form of credit enhancement to mitigate the higher loan to value.

At December 31, 2014, our largest residential construction loan commitment was for \$2.2 million, all of which had been disbursed. This loan was performing according to its repayment terms. The average outstanding residential construction loan balance was approximately \$653,000 at December 31, 2014. Before making a commitment to fund a residential construction loan, we require an appraisal of the subject property by an independent licensed appraiser. During the construction phase, we make periodic inspections of the construction site and loan proceeds are disbursed directly to the contractors or borrowers as construction progresses. Typically, disbursements are made in monthly



draws during the construction period. Loan proceeds are disbursed after inspection based on the percentage of completion method. We also require general liability, builder's risk hazard insurance, title insurance, and flood insurance (as applicable, for properties located or to be built in a designated flood hazard area) on all construction loans.

We also originate developed lot and land loans to individuals intending to construct in the future a residence on the property. We will generally originate these loans in an amount up to 75% of the lower of the purchase price or appraisal. These lot and land loans are secured by a first lien on the property and have a fixed rate of interest with a maximum amortization of 20 years. At December 31, 2014, lot and land loans totaled \$10.4 million, or 22.5% of our construction and land portfolio.

We make land acquisition and development loans to experienced builders or residential lot developers in our market area. The maximum loan-to-value limit applicable to these loans is generally 75% of the appraised market value upon completion of the project. We do not require any cash equity from the borrower if there is sufficient equity in the land being used as collateral. Development plans are required from developers prior to making the loan. Our loan officers are required to personally visit the proposed site of the development and the sites of competing developments. We require that developers maintain adequate insurance coverage. Land acquisition and development loans generally are originated with a loan term up to 24 months, have adjustable rates of interest based on the Wall Street Journal Prime Rate or three or five- year Seattle Federal Home Loan Bank ("FHLB") Rate and require interest only payment during the term of the loan. Land acquisition and development loan proceeds are disbursed periodically in increments as construction progresses and as inspection by our approved inspectors warrant. We also require these loans to be paid on an accelerated basis as the lots are sold, so that we are repaid before all the lots are sold. At December 31, 2014, we had a single \$487,000 land acquisition and development loan secured by 9.1 acres of undeveloped land zoned for residential lot development. At December 31, 2014, this loan was performing in accordance with its repayment terms.

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We also offer commercial and multifamily construction loans. These loans are underwritten with terms similar to our permanent commercial real estate loans with special construction financing for up to 18 months under terms similar to our residential construction loans. At December 31, 2014, commercial and multifamily construction loans totaled \$19.9 million, or 43.1% of our construction and land portfolio.

Construction and land financing is generally considered to involve a higher degree of credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction costs is inaccurate, we may be required to advance funds beyond the amount originally committed in order to protect the value of the property and may have to hold the property for an indeterminate period of time. Additionally, if the estimate of value is inaccurate, we may be confronted with a project that, when completed, has a value that is insufficient to generate full payment. Land loans also pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. The value of the lots securing our loans may be affected by the success of the development in which they are located. As a result, construction loans and land loans often involve the disbursement of funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness, rather than the ability of the borrower or guarantor to repay principal and interest. The nature of these loans is also such that they are generally more difficult to monitor. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences.

**Consumer Lending.** We offer a variety of secured and unsecured consumer loans, including new and used manufactured homes, floating homes, automobiles, boats and recreational vehicle loans, and loans secured by deposit accounts. We also offer unsecured consumer loans. We originate our consumer loans primarily in our market area. All of our consumer loans are originated on a direct basis. At December 31, 2014, our consumer loans totaled \$29.4 million, or 6.4% of our gross loan portfolio, compared to \$23.8 million, or 6.1% of our gross loan portfolio at December 31, 2013.

We originate new and used manufactured home loans to borrowers who intend to use the home as a primary residence. The yields on these loans are higher than that on our other residential lending products and the portfolio has performed reasonably well with an acceptable level of risk and loss in exchange for the higher yield. Our weighted average yield on manufactured home loans at December 31, 2014 was 8.1%, compared to 4.6% for one- to four-family mortgages, excluding loans held-for-sale. At December 31, 2014, these loans totaled \$12.5 million, or 42.6% of our consumer loans and 2.9% of our gross loan portfolio. For used manufactured homes, loans are generally made for up to 90% of the lesser of the appraised value or purchase price up to \$200,000, and with terms typically up to 20 years. On new manufactured homes, loans are generally made for up to 80% of the lesser of the appraised value or purchase price up to \$200,000, and with terms typically up to 20 years. We generally charge a 1% fee at origination. We underwrite these loans based on our review of creditworthiness of the borrower, including credit scores, and the value of the collateral, for which we hold a security interest under Washington law.

Manufactured home loans are higher risk than loans secured by residential real property, though this risk is reduced if the owner also owns the land on which the home is located. A small portion of our manufactured home loans involve properties on which we also have financed the land for the owner. The primary additional risk in manufactured home loans is the difficulty in obtaining adequate value for the collateral due to the cost and limited ability to move the collateral. These loans tend to be made to retired individuals and first-time homebuyers. First-time homebuyers of manufactured homes tend to be a higher credit risk than first-time homebuyers of single family residences, due to more limited financial resources. As a result, these loans have a higher probability of default, higher delinquency rates and greater servicing and collateral recovery costs than single family residential loans and other types of consumer loans. We take into account this additional risk as a component of our allowance for loan losses methodology. We attempt to work out delinquent loans with the borrower and, if that is not successful, any repossessed manufactured homes are repossessed and sold. At December 31, 2014, there were five nonperforming manufactured home loan totaling \$195,000 and we held three manufactured homes valued at \$54,000 in our other real estate owned ("OREO") and repossessed assets portfolio.

We originate floating home, houseboat and house barge loans typically located on cooperative or condominium moorages. Terms vary from five to 20 years and have a fixed rate of interest. We lend up to 80% of the lesser of the appraised value or purchase price. At December 31, 2014, floating home loans totaled \$11.7 million, or 39.7% of our consumer loan portfolio and 2.7% of our gross loan portfolio.

The balance of our consumer loans include loans secured by new and used automobiles, new and used boats, motorcycles and recreational vehicles, loans secured by deposits and unsecured consumer loans, all of which, at December 31, 2014, totaled \$5.2 million or 17.7% of our consumer loan portfolio and 3.9% of our gross loan portfolio. Our automobile loan portfolio totaled \$545,000 at December 31, 2014, or 1.9% of our consumer loan portfolio and 0.1% of our gross loan portfolio. Automobile loans may be written for a term up to 72 months and have fixed rates of interest. Loan-to-value ratios are up to 100% of the lesser of the purchase price or the National Automobile Dealers Association value for auto loans, including tax, licenses, title and mechanical breakdown and gap insurance.

Loans secured by boats, motorcycles and recreational vehicles typically have terms from five to twenty years depending on the collateral and loan-to-value ratios up to 90%. These loans may be made with fixed or adjustable interest rates. Our unsecured consumer loans have either a fixed rate of interest generally for a maximum term of 48 months, or are revolving lines of credit of generally up to \$25,000. At December 31, 2014, unsecured consumer loans totaled \$1.5 million and unfunded commitments on our unsecured consumer lines of credit totaled \$1.5 million. At that date, the average outstanding balance on these lines was less than \$1,000.

Consumer loans (other than our manufactured and floating homes) generally have shorter terms to maturity, which reduces our exposure to changes in interest rates. In addition, management believes that offering consumer loan products helps to expand and create stronger ties to our existing customer base by increasing the number of customer relationships and providing cross-marketing opportunities.

Consumer loans generally entail greater risk than do one- to four-family residential mortgage loans, particularly in the case of consumer loans that are secured by rapidly depreciable assets, such as manufactured homes, automobiles, boats and recreational vehicles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower's continuing financial stability and, thus, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

**Commercial Business Lending.** At December 31, 2014, commercial business loans totaled \$19.5 million, or 4.5% of our gross loan portfolio, compared to \$13.7 million, or 3.5% of our gross loan portfolio at December 31, 2013. Substantially all of our commercial business loans have been to borrowers in our market area. Our commercial business lending activities encompass loans with a variety of purposes and security, including loans to finance commercial vehicles and equipment. Approximately \$2.1 million of our commercial business loans at December 31, 2014 were unsecured. Our commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of our credit analysis. We generally require personal guarantees on both our secured and unsecured commercial business loans. Nonetheless, commercial business loans are believed to carry higher credit risk than residential mortgage loans.

Our interest rates on commercial business loans are dependent on the type of loan. Our secured commercial business loans typically have a loan to value ratio of up to 80% and are term loans ranging from three to seven years. Secured commercial business term loans generally have a fixed rate based on the commensurate FHLB amortizing rate or prime rate as reported in the West Coast edition of the Wall Street Journal plus 1% to 3%. In addition, we typically charge loan fees of 1% to 2% of the principal amount at origination, depending on the credit quality and account relationships of the borrower. Business lines of credit are usually adjustable-rate and are based on the prime rate plus 1% to 3%, and are generally originated with both a floor and ceiling to the interest rate. Our business lines of credit generally have terms ranging from 12 months to 24 months and provide for interest-only monthly payments during the term.

Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise, may be illiquid and may fluctuate in value based on the specific type of business and equipment used. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself (which, in turn, is often dependent in part upon general economic conditions).

#### Loan Originations, Purchases, Sales, Repayments and Servicing

We originate both fixed-rate and adjustable-rate loans. Our ability to originate loans, however, is dependent upon customer demand for loans in our market area. Over the past few years, we have continued to originate residential and consumer loans, and increased our emphasis on commercial and multifamily, construction and land, and commercial business lending. Demand is affected by competition and the interest rate environment. During the past few years, we, like many other financial institutions, have experienced significant prepayments on loans due to the low interest rate environment prevailing in the United States. In periods of economic uncertainty, the ability of financial institutions, including us, to originate large dollar volumes of real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income. As a result, from time to time we will purchase whole loans or enter into loan participations with other financial institutions. In 2014, 2013 and 2012, we engaged in commercial loan participations with other financial institutions in the amount of \$11.3 million, \$8.4 million and \$4.5 million, respectively and purchased no whole loans during these years. We underwrite loan purchases and participations to the same standards as an internally-originated loan.

We do not actively engage in originating "alt A" loans, option adjustable rate or subprime loans and have no established program to originate or purchase these loans. We do offer interest-only one- to four- family loans to

well-qualified borrowers and at December 31, 2014, we held \$10.3 million of such loans in our loan portfolio, representing 2.4% of our gross loan portfolio. Subprime loans are defined by regulators as loans that at the time of loan origination had a FICO credit score of less than 660. Of the \$82.3 million in one- to four- family loans originated in 2014, only \$2.4 million, or 2.9%, were to borrowers with a credit score under 660. We obtain updated FICO scores on all of our borrowers periodically and based on the most recently updated score, \$21.1 million, or 4.9% of our gross loan portfolio would be deemed subprime at December 31, 2014. Based on the FICO score as of December 31, 2014, our subprime portfolio, included approximately \$13.1 million in one- to four-family mortgage loans, \$4.8 million in home equity loans, \$2.0 million in manufactured home loans, \$622,000 in construction and land loans, and \$252,000 in other consumer loans.

In addition to interest earned on loans and loan origination fees, we receive fees for loan commitments, late payments and other miscellaneous services.

We also sell whole one-to four-family loans without recourse to Fannie Mae, subject to a provision for repurchase upon breach of representation, warranty or covenant. These loans are fixed-rate mortgages, which primarily are sold to improve our interest rate risk. These loans are generally sold for cash in amounts equal to the unpaid principal amount of the loans determined using present value yields to the buyer. These sales allow for a servicing fee on loans when the servicing is retained by us. Most one- to four-family loans sold by us are sold with servicing retained. Three loans were repurchased from Fannie Mae totaling \$453,000 in 2014 and two were repurchased from Fannie Mae totaling \$431,000 in 2013. We earned mortgage servicing income of \$509,000, \$457,000 and \$550,000, respectively, for the years ended December 31, 2014, 2013 and 2012. In November 2009, we acquired a \$340.1 million loan servicing portfolio from Leader Financial Services. These loans are 100% owned by Fannie Mae and are subserviced under an agreement with a third party loan servicer who performs all servicing including payment processing, reporting and collections. At December 31, 2014, we were servicing a \$357.8 million portfolio of residential mortgage loans for Fannie Mae.

These mortgage servicing rights are carried at fair value and had a value at December 31, 2014 of \$3.0 million. See Note 6 to the Consolidated Financial Statements.

Sales of whole real estate loans can be beneficial to us since these sales generally generate income at the time of sale, produce future servicing income on loans where servicing is retained, provide funds for additional lending, and increase liquidity. We sold \$50.5 million, \$104.3 million and \$95.1 million of one- to four- family loans during the years ended December 31, 2014, 2013 and 2012, respectively. Gains, losses and transfer fees on sales of one-to four-family loans and participations are recognized at the time of the sale. Our net gain on sales of residential loans for all of 2014, 2013 and 2012 was \$624,000, \$967,000 and \$2.1 million, respectively. If a proposed loan exceeds our internal lending limits, we may originate the loan on a participation basis with another financial institution. We also from time to time participate with other financial institutions on loans they originate.

The following table shows our loan origination, sale and repayment activities, including loans held-for-sale, for the periods indicated (in thousands):

	For the year ended December		
	31,		
	2014	2013	2012
Originations by type:			
Fixed-rate:			
One- to four-family	\$81,130	\$118,217	\$143,189
Home equity	2,812	8,450	4,130
Commercial and multifamily	25,342	35,468	50,202
Construction and land	48,490	55,591	24,417
Manufactured homes	2,068	1,198	1,305
Other consumer	9,652	3,804	1,961
Commercial business	5,146	8,530	5,866
Total fixed-rate	174,640	231,258	231,070
Adjustable rate:			
One- to four-family	1,199	552	-
Home equity	3,550	294	-
Commercial and multifamily	25,789	14,524	22,821
Construction and land	8,228	1,478	2,280
Other consumer	264	280	24
Commercial business	4,193	5,226	1,979
Total adjustable-rate	43,223	22,354	27,104
Total loans originated	217,863	253,612	258,174
Purchases by type:			
Commercial and multifamily participations	-	983	-
Commercial business participations	166	4,325	4,500
Total loan participations purchased	166	5,308	4,500
Sales, repayments and participations sold:			
One- to four-family	52,696	108,870	95,055
Commercial and multifamily	5,445	2,676	-
Total loans sold and loan participations	58,141	111,546	95,055
Total principal repayments	119,774	79,479	140,764
Total reductions	177,915	191,025	235,819
Net increase	\$40,114	\$62,587	\$26,855

The decrease in originations in 2014 compared to 2013 and 2012 was due to a modest increase in interest rates in 2014 compared to 2013 and 2012 which reduced demand for refinancing. One- to four- family home purchases continued to be strong in our market area due to the economic environment and the rate of unemployment in our markets although it has somewhat been hampered due to the lack of overall supply, especially in the Seattle area. Demand for multi-family and construction loans continued to be strong in our markets due to demand for new homes and

apartments.

#### Asset Quality

When a borrower fails to make a required payment on a one-to four-family loan, we attempt to cure the delinquency by contacting the borrower. In the case of loans secured by a one-to four-family property, a late notice typically is sent 15 days after the due date, and the borrower is contacted by phone within 30 days after the due date. Generally, a delinquency letter is mailed to the borrower. All delinquent accounts are reviewed by a loan officer or branch manager who attempts to cure the delinquency by contacting the borrower once the loan is 30 days past due. If the account becomes 60 days delinquent and an acceptable repayment plan has not been agreed upon, we generally refer the account to legal counsel with instructions to prepare a notice of intent to foreclose. The notice of intent to foreclose allows the borrower up to 30 days to bring the account current. If foreclosed, typically we take title to the property and sell it directly through a real estate broker.

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Delinquent consumer loans, as well as delinquent home equity loans and lines of credit, are handled in a similar manner to one-to four-family loans, except that appropriate action may be taken to collect any loan payment that is delinquent for more than 15 days. Once the loan is 90 days past due, it is classified as nonaccrual. Generally, credits are charged-off at 120 days past due, unless the Loss Mitigation Department provides support for continuing its collection efforts. Our procedures for repossession and sale of consumer collateral are subject to various requirements under the applicable consumer protection laws as well as other applicable laws and the determination by us that it would be beneficial from a cost basis.

Delinquent loans are initially handled by the loan officer in charge of the loan, who is responsible for contacting the borrower. The Loss Mitigation Department also works with the loan officers to see that the necessary steps are taken to collect delinquent loans. In addition, management meets with all of the loan officers weekly and reviews past due and classified loans, as well as other loans that management feels may present possible collection problems, which are reported to the board on a quarterly basis. If an acceptable workout of a delinquent loan cannot be agreed upon, we generally initiate foreclosure or repossession proceedings on any collateral securing the loan.

Delinquent Loans. The following table sets forth our loan delinquencies by type, by amount and by percentage of type at December 31, 2014 (dollars in thousands):

Loans Delinquent For:

	60-89 Days			90 Days and Over			90+ Days and accruing			Total Delinquent Loans		
	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category
One- to four-family	3	\$ 167	0.13 %	11	\$ 720	0.54 %	-	\$ -	-	14	\$ 887	0.67 %
Home equity	1	109	0.31	5	203	0.59	-	-	-	6	312	0.90
Construction and land	-	-	-	1	81	0.18	-	-	-	1	81	0.18
Manufactured homes	3	42	0.33	1	27	0.22	1	114	0.91	5	183	1.24
Other consumer	4	7	0.04	-	-	-	-	-	-	4	7	0.20
Total	11	\$ 325	0.08 %	18	\$ 1,031	0.24 %	1	\$ 114	0.03 %	30	\$ 1,470	0.34 %



Nonperforming Assets. The table below sets forth the amounts and categories of nonperforming assets in our loan portfolio (in thousands). Loans are placed on nonaccrual status when the collection of principal and/or interest become doubtful or when the loan is more than 90 days past due. OREO and repossessed assets include assets acquired in settlement of loans. We had one accruing loan 90 days or more delinquent for the 2014 period reported totaling \$114,000.

	December 31,				
	2014	2013	2012	2011	2010
Nonperforming loans <sup>(1)</sup> :					
One- to four- family	\$ 1,512	\$ 772	\$ 1,143	\$ 4,401	\$ 2,729
Home equity	386	222	717	873	517
Commercial and multifamily	1,639	820	1,347	1,219	-
Construction and land	81	-	471	80	-
Manufactured homes	195	106	29		
Other consumer	29	1	8	64	-
Commercial business	-	-	197	-	-
Total nonperforming loans	\$3,842	\$ 1,921	3,912	6,637	3,246
OREO and repossessed assets:					
One- to four-family	\$269	\$ 1,086	\$ 1,318	\$478	\$ 1,102
Commercial and multifamily	-	-	1,073	2,225	1,302
Construction and land	-	-	-	-	70
Manufactured homes	54	92	112	118	
Other consumer	-	-	-	-	151
Total OREO and repossessed assets	323	1,178	2,503	2,821	2,625
Total nonperforming assets	\$4,165	\$3,099	\$6,415	\$9,458	\$5,871
Nonperforming assets as a percentage of total assets	0.84 %	0.70 %	1.68 %	2.78 %	1.75 %
Performing restructured loans:					
One- to four- family	\$2,619	\$3,195	\$3,198	\$2,508	\$2,836
Home equity	679	704	356	812	967
Commercial and multifamily	1,317	761	776	785	-
Construction and land	99	106	100	-	230
Manufactured homes	279	496	602	-	-
Other consumer	1	9	19	4	15
Commercial business	123	133	564	26	-
Total performing restructured loans	\$5,117	\$5,404	\$5,615	\$4,135	\$4,048

<sup>(1)</sup> Nonperforming loans include \$2.5 million, \$1.0 million, \$828,000, \$2.8 million and \$348,000 in nonperforming troubled debt restructurings as of December 31, 2014, 2013, 2012, 2011 and 2010, respectively.

Nonperforming commercial and multifamily estate loans increased \$819,000 to \$1.6 million at December 31, 2014 from \$820,000 at December 31, 2013 and is primarily comprised of a \$1.5 million commercial real estate loan which was restructured during the third quarter of 2014, and as of December 31, 2014, was performing as agreed under the new loan repayment terms. Nonperforming one- to four- family loans increased \$740,000 to \$1.5 million at December 31, 2014 from \$772,000 at December 31, 2013 due primarily to a \$1.2 million increase in nonperforming one- to four- family TDRs. Our largest nonperforming loan at December 31, 2014 was the commercial real estate loan discussed above totaling \$1.5 million. The balance in nonperforming one- to four- family loans at December 31, 2014 consisted of 12 loans to different borrowers with an average loan balance of \$126,000. The balance in nonperforming one- to four- family loans at December 31, 2013 consisted of eight loans to different borrowers with an average loan balance of \$96,000.



For the year ended December 31, 2014, gross interest income that would have been recorded had the nonaccrual loans been current in accordance with their original terms amounted to \$78,000, all of which was excluded from interest income for the year ended December 31, 2014. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition at December 31, 2014 Compared to December 31, 2013 -- Delinquencies and Nonperforming Assets" for more information on troubled assets.

**Troubled Debt Restructured Loans.** Troubled debt restructurings ("TDRs), which are accounted for under Accounting Codification Standard ("ASC") 310-40, are loans which have renegotiated loan terms to assist borrowers who are unable to meet the original terms of their loans. Such modifications to loan terms may include a lower interest rate, a reduction in principal, or a longer term to maturity. All TDRs are initially classified as impaired, regardless of whether the loan was performing at the time it was restructured. Once a troubled debt restructuring has performed according to its modified terms for six months and the collection of principal and interest under the revised terms is deemed probable, we remove the TDR from nonperforming status. At December 31, 2014, we had \$5.1 million of loans that were classified as performing TDRs and still on accrual. Included in nonperforming loans at December 31, 2014 and 2013 were troubled debt restructured loans of \$2.3 million and \$1.0 million, respectively.

**OREO and Repossessed Assets.** OREO and repossessed assets include assets acquired in settlement of loans. At December 31, 2014 OREO and repossessed assets consisted of three single family residences totaling \$269,000 and three manufactured homes totaling \$54,000.

**Other Loans of Concern.** In addition to the nonperforming assets set forth in the table above, as of December 31, 2014, there were 18 loans totaling \$916,000 with respect to which known information about the possible credit problems of the borrowers have caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items in the nonperforming asset categories. The majority of these loans have been considered individually in management's determination of our allowance for loan losses. The largest loans of concern at December 31, 2014, were a \$187,000 loan secured by residential property in Snohomish County, Washington and a \$163,000 loan secured by residential property in King County, Washington. Other loans of concern included \$515,000 in residential first mortgages, \$296,000 in home equity loans, \$47,000 in manufactured home loans, \$33,000 in construction and land loans, and \$25,000 in other consumer loans. Loans of concern had specific loan loss reserves of \$3,000 at December 31, 2014.

**Classified Assets.** Federal regulations provide for the classification of lower quality loans and other assets (such as OREO and repossessed assets), debt and equity securities considered, as "substandard," "doubtful" or "loss." An asset is considered "substandard" if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. "Substandard" assets include those characterized by the "distinct possibility" that the insured institution will sustain "some loss" if the deficiencies are not corrected. Assets classified as "doubtful" have all of the weaknesses in those classified "substandard," with the added characteristic that the weaknesses present make "collection or liquidation in full," on the basis of currently existing facts, conditions and values, "highly questionable and improbable." Assets classified as "loss" are those considered "uncollectible" and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When we classify problem assets as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address specific impairments. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge off those assets in the period in which they are deemed uncollectible. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the FDIC and, since our conversion to a Washington chartered commercial bank, the WDFI, which can order the establishment of additional loss allowances. Assets which do not currently expose us to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be

designated as special mention. At December 31, 2014, special mention assets, consisting solely of one loan, totaled \$24,000.

We regularly review the problem assets in our portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of management's review of our assets, at December 31, 2014, we had classified \$6.1 million of our assets as substandard, of which \$3.4 million represented a variety of outstanding loans, \$2.3 million represented non-agency mortgage backed securities, and the remaining balance OREO and repossessed assets. At that date, we had no assets classified as doubtful or loss. This total amount of classified assets represented 12.0% of our equity capital and 1.2% of our assets at December 31, 2014. Classified assets totaled \$7.2 million, or 15.5% of our equity capital and 1.6% of our assets at December 31, 2013.

**Allowance for Loan Losses.** We maintain an allowance for loan losses to absorb probable loan losses in the loan portfolio. The allowance is based on ongoing, monthly assessments of the estimated probable incurred losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, peer group information, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as one-to four-family, small commercial and multifamily, home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. More complex loans, such as commercial and multifamily loans and commercial business loans, are evaluated individually for impairment, primarily through the evaluation of the borrower's net operating income and available cash flow and their possible impact on collateral values.

At December 31, 2014, our allowance for loan losses was \$4.4 million, or 1.02% of our gross loan portfolio, compared to \$4.2 million, or 1.1% of our gross loan portfolio in 2013. Specific valuation reserves totaled \$367,000 and \$709,000 at December 31, 2014 and 2013, respectively.

Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, properly reflects estimated probable loan losses in our loan portfolio. See Notes 1 and 5 of the Notes to Consolidated Financial Statements. The following table sets forth an analysis of our allowance for loan losses at the dates indicated (dollars in thousands):

	December 31,				
	2014	2013	2012	2011	2010
Balance at beginning of period	\$4,177	\$4,248	\$4,455	\$4,436	\$3,468
Charge-offs:					
One-to four-family	127	560	2,740	834	843
Home equity	295	593	1,084	1,652	1,291
Commercial and multifamily	47	194	503	1,353	940
Construction and land		7	222	159	-
Manufactured homes	197	143	152	239	-
Other consumer	77	41	286	255	649
Commercial business	-	46	44	310	221
Total charge-offs	743	1,584	5,031	4,802	3,944
Recoveries:					
One-to four-family	64	-	4	11	-
Home equity	52	19	158	10	222
Commercial and multifamily	2	32	83	96	-
Construction and land	-	-	-	-	-
Manufactured homes	14	3	11	8	-
Other consumer	21	31	33	53	38
Commercial business	-	78	10	43	2
Total recoveries	153	163	299	221	262
Net charge-offs	590	1,421	4,732	4,581	3,682
Additions charged to operations	800	1,350	4,525	4,600	4,650
Balance at end of period	\$4,387	\$4,177	\$4,248	\$4,455	\$4,436
Net charge-offs during the period as a percentage of average loans outstanding during the period	0.14 %	0.40 %	1.55 %	1.53 %	1.22 %
Net charge-offs during the period as a percentage of average nonperforming assets	18.65 %	41.16 %	35.15 %	48.04 %	31.22 %
Allowance as a percentage of nonperforming loans	114.19 %	217.44 %	110.88 %	67.12 %	136.66 %
Allowance as a percentage of total loans (end of period)	1.02 %	1.07 %	1.30 %	1.47 %	1.48 %

Weak economic conditions and strains in the financial and housing markets which began in 2008, generally started to improve in 2012 in most major regions of the United States, and have steadily continued to improve, including in our market areas. While the effects during this period presented an unusually challenging environment for banks and their holding companies, including us, during 2013 and 2014 housing prices and unemployment rates generally started improving. Prior to 2012, our market area had experienced substantial home price declines, historically low levels of existing home sale activity, high levels of foreclosures and above average unemployment rates negatively affecting the values of real estate collateral supporting our loans and resulting in increased loan delinquencies and defaults and net charge-offs during these periods.

The decrease in our allowance for loan losses as a percentage of nonperforming loans ratio was a result of an increase in nonperforming loans during the period. The allowance for loan losses as a percentage of total loans ratio was 1.02% and 1.07% as of December 31, 2014 and 2013, respectively.



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The distribution of our allowance for losses on loans at the dates indicated is summarized as follows (dollars in thousands):

	December 31, 2014		2013		2012		2011		2010	
	Percent of loans in each category to total		Percent of loans in each category to total		Percent of loans in each category to total		Percent of loans in each category to total		Percent of loans in each category to total	
	Amount	loans	Amount	loans	Amount	loans	Amount	loans	Amount	loans
Allocated at end of period to:										
One- to four- family	\$1,442	30.80 %	\$1,915	30.02 %	\$1,417	28.71 %	\$1,117	31.45 %	\$909	32.81 %
Home equity	601	8.03	781	8.96	997	10.80	1,426	13.20	1,380	14.96
Commercial and multifamily	1,244	39.12	300	40.17	492	40.79	969	35.28	659	31.05
Construction and land	399	10.72	318	11.30	217	7.77	105	5.93	205	5.56
Manufactured homes	193	2.90	209	3.44	260	4.96	290	6.14	321	6.69
Other consumer	167	3.91	109	2.62	146	2.64	213	3.63	381	4.04
Commercial business	108	4.52	102	3.49	218	4.33	254	4.38	163	4.90
Unallocated	233	-	443	-	501	-	81	-	418	-
Total	\$4,387	100.00 %	\$4,177	100.00 %	\$4,248	100.00 %	\$4,455	100.00 %	\$4,436	100.00 %

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### Investment Activities

State commercial banks have the authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, including callable agency securities, certain certificates of deposit of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements and federal funds. Subject to various restrictions, state commercial banks may also invest their assets in investment grade commercial paper and corporate debt securities and mutual funds whose assets conform to the investments that the institution is otherwise authorized to make directly. See "- How We Are Regulated – Sound Community Bank" for a discussion of additional restrictions on our investment activities.

Our Chief Executive Officer and Chief Financial Officer have the responsibility for the management of our investment portfolio, subject to the direction and guidance of the Board of Directors. These officers consider various factors when making decisions, including the marketability, maturity and tax consequences of the proposed investment. The maturity structure of investments will be affected by various market conditions, including the current and anticipated slope of the yield curve, the level of interest rates, the trend of new deposit inflows, and the anticipated demand for funds via deposit withdrawals and loan originations and purchases.

The general objectives of our investment portfolio will be to provide liquidity when loan demand is high, to assist in maintaining earnings when loan demand is low and to maximize earnings while satisfactorily managing risk, including credit risk, reinvestment risk, liquidity risk and interest rate risk. Our investment quality will emphasize safer investments with the yield on those investments secondary to not taking unnecessary risk with the available funds. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Asset/Liability Management."

At December 31, 2014, we owned \$2.2 million in Federal Home Loan Bank of Seattle stock. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock.

Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB of Seattle. Our FHLB stock has a par value of \$100, is carried at cost, and is subject to recoverability testing. Management periodically evaluates FHLB stock for other-than-temporary or permanent impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than be recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, the impact of legislative and regulatory changes on financial institutions (i.e. the customer base of the FHLB, and the liquidity position of the FHLB). As of December 31, 2014, our management determined that our FHLB stock was not impaired. On September 25, 2014 the FHLB of Seattle and the FHLB of Des Moines announced a proposed merger. Under this proposal, Sound Community Bank would become a member of the FHLB of Des Moines and all shares of our FHLB of Seattle stock would convert to equal shares of FHLB of Des Moines stock. If the merger is terminated by either the FHLB of Des Moines or the FHLB of Seattle, the terminating FHLB must pay \$57 million in termination fees. If the FHLB of Seattle were to terminate the agreement, this could result in significant impairment to our investment in the FHLB of Seattle, potentially decreasing our earnings and shareholders' equity.

The following table sets forth the composition of our securities portfolio and other investments at the dates indicated. At December 31, 2014, our securities portfolio did not contain securities of any issuer with an aggregate book value in excess of 10% of our equity capital.

	December 31, 2014		2013		2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<u>Securities available for sale</u>						
Municipal bonds	\$1,911	\$2,083	\$1,911	\$1,931	\$-	\$-
Agency mortgage-backed securities	7,024	7,096	11,228	11,071	20,378	20,127
Non-agency mortgage-backed securities <sup>(1)</sup>	2,312	2,345	2,689	2,419	3,273	2,773



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Total available for sale securities	11,247	11,524	15,828	15,421	23,651	22,900
FHLB stock	2,224	2,224	2,314	2,314	2,401	2,401
Total securities	\$13,471	\$13,748	\$18,142	\$17,735	\$26,052	\$25,301

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One non-agency mortgage backed securities had an unrealized loss of \$50,000 as of December 31, 2014. All of the (1) non-agency securities were purchased at a discount in 2008 and 2009. Each of these securities has performed and paid principal and interest each month as contractually committed.

The composition and maturities of our investment securities portfolio at December 31, 2014, excluding FHLB stock, are as follows: Municipal bonds with an amortized cost of \$1.9 million and a fair value of \$2.1 million and a final maturity in five to ten years, federal agency mortgage-backed securities with an amortized cost of \$7.0 million and a fair value of \$7.1 million and a final maturity greater than ten years and non-agency mortgage-backed securities with an amortized cost of \$2.3 million and a fair value of \$2.3 million and a final maturity greater than ten years.

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We review investment securities on an ongoing basis for the presence of other-than-temporary impairment ("OTTI") taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend to sell a security or if it is likely that we will be required to sell the security before recovery of our amortized cost basis of the investment, which may be maturity, and other factors. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not more likely than not that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected.

Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and the fair value, is recognized as a charge to other comprehensive income. Impairment losses related to all other factors are presented as separate categories within other comprehensive income.

During the year ended December 31, 2014, we recognized no non-cash OTTI charges on our non-agency mortgage-backed securities. One non-agency mortgage-backed security had an unrealized loss but management determined the decline in value was not related to specific credit deterioration. We do not intend to sell these securities and it is more likely than not that we will not be required to sell the securities before anticipated recovery of the remaining amortized cost basis. We closely monitor our investment securities for changes in credit risk. The current market environment significantly limits our ability to mitigate our exposure to valuation changes in these securities by selling them. Accordingly, if market conditions deteriorate further and we determine our holdings of these or other investment securities are OTTI, our future earnings, shareholders' equity, regulatory capital and continuing operations could be materially adversely affected.

#### Sources of Funds

**General.** Our sources of funds are primarily deposits (including deposits from public entities), borrowings, payments of principal and interest on loans and investments and funds provided from operations.

**Deposits.** We offer a variety of deposit accounts to both consumers and businesses having a wide range of interest rates and terms. Our deposits consist of savings accounts, money market deposit accounts, demand accounts and certificates of deposit. We solicit deposits primarily in our market area; however, at December 31, 2014, approximately 3.4% of our deposits were from persons outside the State of Washington. As of December 31, 2014, core deposits, which we define as our non-time deposit accounts and time deposit accounts less than \$250,000, represented approximately 86.9% of total deposits, compared to 87.0% and 86.5% as of December 31, 2013 and December 31, 2012, respectively. We primarily rely on competitive pricing policies, marketing and customer service to attract and retain these deposits and we expect to continue these practices in the future.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and prevailing interest rates and competition. The variety of deposit accounts we offer has allowed us to be competitive in obtaining funds and to respond with flexibility to changes in consumer demand. We have become more susceptible to short-term fluctuations in deposit flows as customers have become more interest rate sensitive. We manage the pricing of our deposits in keeping with our asset/liability management, liquidity and profitability objectives, subject to competitive factors. Based on our experience, we believe that our deposits are relatively stable sources of funds.

Despite this stability, our ability to attract and maintain these deposits and the rates paid on them has been and will continue to be significantly affected by market conditions.

The following table sets forth our deposit flows during the periods indicated (dollars in thousands):

	For the year ended December 31,		
	2014	2013	2012
Opening balance	\$348,339	\$312,083	\$299,997
Net deposits	57,201	34,160	9,951
Interest credited	2,269	2,096	2,135
Ending balance	\$407,809	\$348,339	\$312,083

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Net increase	\$59,470	\$36,256	\$12,086
Percent increase	17.1 %	11.6 %	4.0 %

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The following table sets forth the dollar amount of deposits in the various types of deposit programs offered by us at the dates indicated (dollars in thousands):

	December 31, 2014		2013		2012	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
Noninterest-bearing demand	\$41,773	10.24 %	\$31,877	9.15 %	\$31,427	10.07 %
Interest-bearing demand	103,048	25.27	70,639	20.28	28,540	9.15
Savings	33,233	8.15	26,509	7.61	27,174	8.71
Money market	55,236	13.54	59,069	16.96	86,149	27.60
Escrow	2,580	0.63	2,717	0.78	3,807	1.22
Total non-maturity deposits	235,870	57.83	190,811	54.78	177,097	56.75
Certificates of deposit:						
1.99% or below	156,690	38.43	140,139	40.23	114,165	36.58
2.00 - 3.99	15,217	3.73	17,300	4.97	17,522	5.61
4.00 - 5.99	32	0.01	89	0.02	3,299	1.06
Total certificates of deposit	171,939	42.17	157,528	45.22	134,986	43.25
Total deposits	\$407,809	100.00 %	\$348,339	100.00 %	\$312,083	100.00 %

Interest-bearing demand accounts increased primarily as a result of a continued marketing emphasis on our rewards checking product as well as the introduction of a new interest-bearing demand account. This product is priced and marketed similarly to a money market account, however it does not have the monthly withdrawal and outgoing transfer restrictions like savings and money market accounts. The increase in noninterest-bearing demand accounts was primarily a result of our continued emphasis on attracting relatively low-cost core deposit accounts from small businesses. In addition, the acquisition of three retail branches on the North Olympic Peninsula was a primary factor in deposit growth. We acquired \$21.6 million in deposits in the acquisition and retained \$19.3 million as of December 31, 2014. The increase in certificates was primarily a result of several targeted marketing initiatives conducted in 2014 at slightly above market rates. The decrease in money market accounts was primarily the result of customers placing these funds in higher yielding certificate or interest-bearing demand accounts.

We are a public funds depository and as of December 31, 2014, we had \$39.3 million in public funds. These funds consisted of \$38.8 million in certificates of deposit, \$141,000 in money market accounts and \$296,000 in checking accounts at December 31, 2014. These accounts must be 100% collateralized. We use letters of credit from the FHLB as collateral for these funds.

The following table shows rate and maturity information for our certificates of deposit at December 31, 2014 (dollars in thousands):

	0.00-1.99%	2.00-3.99%	4.00-5.99%	Total	Percent of Total
Certificate accounts maturing in quarter ending:					
March 31, 2015	\$33,695	\$495	\$-	\$34,190	19.88 %
June 30, 2015	16,064	196	-	16,260	9.46
September 30, 2015	22,883	201	22	23,106	13.44
December 31, 2015	14,038	520	10	14,568	8.47

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March 31, 2016	10,942	1,997	-	12,939	7.52
June 30, 2016	17,152	1,561	-	18,713	10.88
September 30, 2016	4,644	1,321	-	5,965	3.47
December 31, 2016	20,356	1,360	-	21,716	12.63
March 31, 2017	4,393	1,625	-	6,018	3.50
June 30, 2017	245	4,378	-	4,623	2.69
September 30, 2017	1,388	1,496	-	2,884	1.68
December 31, 2017	2,830	-	-	2,830	1.65
Thereafter	8,060	67	-	8,127	4.73
Total	\$156,690	\$15,217	\$32	\$171,939	100.00%
Percent of total	91.13	% 8.85	% 0.02	% 100.00	%

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The following table indicates the amount of our certificates of deposit and other deposits by time remaining until maturity as of December 31, 2014 (in thousands):

	Maturity				Total
	3 months or less	Over 3 to 6 months	Over 6 to 12 months	Over 12 months	
Certificates of deposit less than \$100,000	\$13,247	\$6,926	\$11,098	\$24,876	\$56,147
Certificates of deposit of \$100,000 or more	20,942	9,335	26,576	58,939	115,792
Total certificates of deposit	\$34,189	\$16,261	\$37,674	\$83,815	\$171,939

Borrowings. Although deposits are our primary source of funds, we may utilize borrowings as a cost-effective source of funds when they can be invested at a positive interest rate spread, for additional capacity to fund loan demand, or to meet our asset/liability management goals. Our borrowings currently consist of advances from the FHLB. See Note 10 of the Notes to Consolidated Financial Statements.

We are a member of and obtain advances from the FHLB, which is part of the Federal Home Loan Bank System. The twelve regional Federal Home Loan Banks provide a central credit facility for their member institutions. These advances are provided upon the security of certain of our mortgage loans and mortgage-backed securities. These advances may be made pursuant to several different credit programs, each of which has its own interest rate, range of maturities and call features, and all long-term advances are required to provide funds for residential home financing. We have entered into a loan agreement with the FHLB pursuant to which Sound Community Bank may borrow up to approximately 35% of its total assets, secured by a blanket pledge on a portion of our residential mortgage portfolio including one- to four family first and second mortgage loans, and commercial and multifamily loans. Based on eligible collateral, the total amount available under this agreement as of December 31, 2014 was \$133.3 million. At the same date, we had \$30.6 million in FHLB advances outstanding with maturities between zero and three years. We also had outstanding letters of credit from the FHLB with a notional amount of \$42.5 million at December 31, 2014. We plan to rely in part on long-term FHLB advances to fund asset and loan growth. We also use short-term advances to meet short term liquidity needs. We are required to own stock in the FHLB based on the amount of our advances. We also from time to time may borrow from the Federal Reserve Bank of San Francisco's "discount window" for overnight liquidity needs. In 2014, 2013 and 2012, we did not borrow from the discount window.

The following table sets forth the maximum balance and average balance of borrowings for the periods indicated (dollars in thousands):

	For the year ended December 31,		
	2014	2013	2012
Maximum balance:			
FHLB advances	\$47,006	\$63,489	\$21,864
Average balances:			
FHLB advances	\$26,384	\$33,697	\$8,901
Weighted average interest rate:			
FHLB advances	0.58 %	0.53 %	2.02 %

The following table sets forth certain information about our borrowings at the dates indicated (dollars in thousands):

	December 31,		
	2014	2013	2012
FHLB advances	\$30,578	\$43,221	\$21,864
Weighted average interest rate:			
FHLB advances	0.38 %	0.36 %	1.12 %

Subsidiary and Other Activities

Sound Financial Bancorp has one subsidiary, Sound Community Bank. Sound Community Bank has one subsidiary, which is currently inactive. Our capital investment in the inactive subsidiary as of December 31, 2014 was \$2,000.

Competition

We face competition in attracting deposits and originating loans. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions, life insurance companies and mortgage brokers. Other savings institutions, commercial banks, credit unions and finance companies provide vigorous competition in consumer lending. Commercial business competition is primarily from local commercial banks, but other savings banks and credit unions also compete for this business. We compete by consistently delivering high-quality, personal service to our customers which results in a high level of customer satisfaction.

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Our market area has a high concentration of financial institutions, many of which are branches of large money center and regional banks that have resulted from the consolidation of the banking industry in Washington and other western states. These include such large national lenders as US Bank, JP Morgan Chase, Wells Fargo, Bank of America, Key Bank and others in our market area that have greater resources than we do and offer services that we do not provide. Customers who seek "one-stop shopping" may be drawn to institutions that offer services that we do not.

We attract our deposits through our branch office system. Competition for those deposits is principally from savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. We compete for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent data provided by the FDIC, there are approximately 57 other commercial banks and savings institutions operating in the Seattle MSA. Based on the most recent branch deposit data provided by the FDIC, our share of deposits in the Seattle MSA was approximately 0.2%. The five largest financial institutions in that area have 70.9% of those deposits. In Clallam County there are 11 other commercial banks and savings institutions. Our share of deposits in Clallam County was the second highest in the county at 13.7%, with the five largest institutions in that county having 72.3% of the deposits. In Jefferson County there are seven other commercial banks and savings institutions. Our share of deposits in Jefferson County is estimated to be 3.4% but due to the timing of our branch acquisition in Jefferson County, which occurred during the third quarter of 2014, official figures from the FDIC are unavailable. The five largest institutions in that county have 77.2% of those deposits.

#### How We Are Regulated

**General.** On December 28, 2012 Sound Community Bank converted from a federally chartered savings bank to a Washington state-chartered commercial bank. As a Washington commercial bank, Sound Community Bank's regulators are the WDFI and the FDIC, rather than the OCC. The Federal Reserve is the primary federal regulator for Sound Financial Bancorp. Set forth below is a brief description of certain laws and regulations that are applicable to Sound Financial Bancorp and Sound Community Bank. The description of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations. Legislation is introduced from time to time in the United States Congress or the Washington State Legislature that may affect the operations of Sound Financial Bancorp and Sound Community Bank. In addition, the regulations governing us may be amended from time to time. Any such legislation or regulatory changes in the future could adversely affect our operations and financial condition.

The WDFI and FDIC have extensive enforcement authority over Sound Community Bank. The Federal Reserve has the same type of authority over Sound Financial Bancorp. This enforcement authority includes, among other things, the ability to assess civil money penalties, issue cease-and-desist orders and removal orders and initiate injunctive actions. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with the regulators.

**Regulatory Reform.** On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. The following discussion summarizes significant aspects of the Dodd-Frank Act that will affect us. Regulations implementing many of these changes have not been promulgated, so we cannot determine the full impact of the Dodd-Frank Act on our business and operations at this time.

The following aspects of the Dodd-Frank Act are related to our operations:

The Consumer Financial Protection Bureau (the "CFPB"), an independent consumer compliance regulatory agency within the Federal Reserve, has been established. The CFPB is empowered to exercise broad regulatory, supervisory and enforcement authority over financial institutions with total assets over \$10 billion with respect to both new and existing consumer financial protection laws. Smaller financial institutions, like Sound Community Bank, will be subject to supervision and enforcement by their primary federal banking regulator with respect to federal consumer financial protection laws and regulations. The CFPB also has authority to promulgate new consumer financial protection regulations and amend existing consumer financial protection regulations.



The Federal Deposit Insurance Act was amended to direct federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries.

The prohibition on payment of interest on demand deposits was repealed.

Deposit insurance increased to \$250,000.

The deposit insurance assessment base for FDIC insurance is the depository institution's average consolidated total assets less average tangible equity during the assessment period.

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The minimum reserve ratio of the Deposit Insurance Fund increased to 1.35 percent of estimated annual insured deposits or the comparable percentage of the assessment base; however, the FDIC is directed to "offset the effect" of the increased reserve ratio for insured depository institutions with total consolidated assets of less than \$10 billion. Pursuant to the Dodd-Frank Act, the FDIC issued a rule setting a designated reserve ratio at 2.0% of insured deposits. Tier 1 capital treatment for "hybrid" capital items like trust preferred securities is eliminated subject to various grandfathering and transition rules. The federal banking agencies have promulgated new rules on regulatory capital for both depository institutions and their holding companies, to include leverage capital and risk-based capital measures at least as stringent as those now applicable to Sound Community Bank under the prompt corrective action regulations. See "-New Capital Rules"

A separate, non-binding shareholder vote is required regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments.

Securities exchanges are required to prohibit brokers from using their own discretion to vote shares not beneficially owned by them for certain "significant" matters, which include votes on the election of directors, executive compensation matters, and any other matter determined to be significant.

Stock exchanges, not including the OTC Bulletin Board, are prohibited from listing the securities of any issuer that does not have a policy providing for (i) disclosure of its policy on incentive compensation that is based on financial information required to be reported under the securities laws, and (ii) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid erroneously during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information.

#### Regulation of Sound Community Bank

General. Sound Community Bank, as a state-chartered commercial bank, is subject to applicable provisions of Washington law and to regulations and examinations of the WDFI. As an insured institution, it also is subject to examination and regulation by the FDIC, which insures the deposits of Sound Community Bank to the maximum permitted by law. During these state or federal regulatory examinations, the examiners may require Sound Community Bank to provide for higher general or specific loan loss reserves, which can impact our capital and earnings. This regulation of Sound Community Bank is intended for the protection of depositors and the Deposit Insurance Fund of the FDIC and not for the purpose of protecting shareholders of Sound Community Bank or Sound Financial Bancorp. Sound Community Bank is required to maintain minimum levels of regulatory capital and is subject to certain limitations on the payment of dividends to Sound Financial Bancorp. See "- Capital Requirements for Sound Community Bank" and "-Limitations on Dividends and Other Capital Distributions."

Federal and State Enforcement Authority and Actions. As part of its supervisory authority over Washington-chartered commercial banks, the WDFI may initiate enforcement proceedings to obtain a cease-and-desist order against an institution believed to have engaged in unsafe and unsound practices or to have violated a law, regulation, or other regulatory limit, including a written agreement. The FDIC also has the authority to initiate enforcement actions against insured institutions for similar reasons and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition. Both these agencies may utilize less formal supervisory tools to address their concerns about the condition, operations of compliance status of a commercial bank.

Regulation by the Washington Department of Financial Institutions and the FDIC. State law and regulations govern Sound Community Bank's ability to take deposits and pay interest, to make loans on or invest in residential and other real estate, to make other loans, to invest in securities, to offer various banking services to its customers, and to establish branch offices. As a state commercial bank, Sound Community Bank must pay semi-annual assessments, examination costs and certain other charges to the WDFI.

Washington law generally provides the same powers for Washington commercial banks as federally and other-state chartered savings institutions and banks with branches in Washington. Washington law allows Washington commercial banks to charge the maximum interest rates on loans and other extensions of credit to Washington residents which are allowable for a national bank in another state if higher than Washington limits. In addition, the

WDFI may approve applications by Washington commercial banks to engage in an otherwise unauthorized activity, if it determines that the activity is closely related to banking, and Sound Community Bank is otherwise qualified under the statute.

Federal law generally limits the activities, subsidiary investments and activities, and equity investments of Sound Community Bank, as principal, to those that are permissible for national banks, unless approved by the FDIC. Our relationship with our depositors and borrowers is regulated to a great extent by federal laws and regulations, especially with respect to disclosure requirements.

The FDIC has adopted regulatory guidelines establishing safety and soundness standards on such matters as loan underwriting and documentation, asset quality, earnings standards, internal controls and information systems, audit systems, interest rate risk exposure and compensation and other benefits. If the FDIC determines that Sound Community Bank fails to meet any standard prescribed by these guidelines, it may require Sound Community Bank to submit an acceptable plan to achieve compliance with the standard.

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Among these safety and soundness standards are FDIC regulations that require Sound Community Bank to adopt and maintain written policies that establish appropriate limits and standards for real estate loans. These standards, which must be consistent with safe and sound banking practices, establish loan portfolio diversification standards, prudent underwriting standards (including loan-to-value ratio limits) that are clear and measurable, loan administration procedures, and documentation, approval and reporting requirements. Sound Community Bank is obligated to monitor conditions in its real estate markets to ensure that its standards continue to be appropriate for current market conditions. Sound Community Bank's board of directors is required to review and approve Sound Community Bank's standards at least annually. The FDIC has published guidelines for compliance with these regulations, including supervisory limitations on loan-to-value ratios for different categories of real estate loans. Under the guidelines, the aggregate level of all loans in excess of the supervisory loan-to-value ratios should not exceed an aggregate limit of 100% of total capital, and within the aggregate limit, the total of all loans for commercial, agricultural, multifamily or other non-one-to-four-family residential properties should not exceed 30% of total capital.

Loans in excess of the supervisory loan-to-value ratio limitations must be identified in Sound Community Bank's records and reported at least quarterly to Sound Community Bank's board of directors. Sound Community Bank is in compliance with the record and reporting requirements. As of December 31, 2014, Sound Community Bank's aggregate loans in excess of the supervisory loan-to-value ratios were \$15.5 million.

The FDIC and the WDFI must approve any merger transaction involving Sound Community Bank as the acquirer, including an assumption of deposits from another depository institution. The FDIC generally is authorized to approve interstate merger transactions without regard to whether the transaction is prohibited by the law of any state. Interstate acquisitions of branches are permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions will also be subject to the nationwide and statewide insured deposit concentration amounts described below. The Dodd-Frank Act permits interstate branching for banks by establishing de novo branches.

**Insurance of Accounts.** The Deposit Insurance Fund ("DIF") of the FDIC insures deposit accounts in Sound Community Bank up to \$250,000 per separately insured depositor.

The FDIC assesses deposit insurance premiums on each FDIC-insured institution quarterly based on annualized rates for one of four risk categories applied to its deposits, subject to certain adjustments. Each institution with less than \$10 billion in assets is assigned to one of four risk categories based on its capital levels, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF.

Under the FDIC's regulations for deposit insurance assessments, the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately 5 basis points to 35 basis points, subject to applicable adjustments for unsecured debt issued by an institution, brokered deposits and unsecured debt of other FDIC-insured institutions, until such time as the FDIC's reserve ratio equals 1.15%. When the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from 3 basis points to 30 basis points (subject to adjustments as described above). When the reserve ratio for the prior assessment period is equal to or greater than 2.0% and less than 2.5%, the assessment rates may range from 2 basis points to 28 basis points and if the reserve ratio for prior assessment period is greater than 2.5%, the assessment rates may range from 1 basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

**Transactions with Related Parties.** Transactions between Sound Community Bank and its affiliates are required to be on terms as favorable to Sound Community Bank as transactions with non-affiliates, and certain of these transactions, such as loans to an affiliate, are restricted to a percentage of Sound Community Bank's capital and require eligible collateral in specified amounts. Sound Financial Bancorp is an affiliate of Sound Community Bank.

The Sarbanes-Oxley Act of 2002 generally prohibits loans by Sound Financial Bancorp to its executive officers and directors. However, the law contains a specific exception for loans by a depository institution to its executive officers and directors in compliance with federal banking laws. Under such laws, Sound Community Bank's authority to extend credit to executive officers, directors and 10% shareholders ("insiders"), as well as entities such persons control, is limited. The laws limit both the individual and aggregate amount of loans that Sound Community Bank

may make to insiders based, in part, on Sound Community Bank's capital level and requires that certain board approval procedures be followed. Such loans are required to be made on terms substantially the same as those offered to unaffiliated borrowers and not involve more than the normal risk of repayment. There is an exception for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees. Loans to executive officers are subject to additional limitations based on the type of loan involved.

Capital Requirements for Sound Community Bank. The following describes regulatory capital and prompt corrective action requirements under FDIC regulations that were in effect until December 31, 2014. See "New Capital Rules" below regarding changes to these requirement effective January 1, 2015. Sound Community Bank is required to maintain minimum levels of regulatory capital consisting of core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100 percent of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50 percent of Tier 1 capital.

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The FDIC measures an institution's capital using a leverage ratio together with certain risk-based ratios. The FDIC's minimum leverage ratio for a bank to be considered adequately capitalized is a ratio of Tier 1 capital to average total assets of 4%. At December 31, 2014, Sound Community Bank had a Tier 1 leverage ratio of 10.00%. The leverage ratio is also referred to as the Tier 1 capital ratio. An institution is deemed "well capitalized" if it has at least a 5% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. Institutions that are not well capitalized are subject to certain restrictions on brokered deposits and interest rates on deposits. At December 31, 2014, Sound Community Bank was considered a "well capitalized" institution. The FDIC retains the right to require a particular institution to maintain higher capital levels based on its particular risk profile.

FDIC regulations also measure capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. For a bank to be considered adequately capitalized the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets (the total risk-based capital ratio) must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets (the Tier 1 risk-based capital ratio) must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition, such as interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks.

Under prompt corrective action requirements under federal law and regulations, the FDIC as the primary federal banking regulator of an institution such as Sound Community Bank is authorized and, under certain circumstances, required to take certain actions against insured that fail to meet certain designated capital levels. The agency generally is required to take action to restrict the activities of an "undercapitalized institution," which is an institution with less than a 4.0% Tier 1 capital ratio, a 4.0% Tier 1 risk-based capital ratio or an 8.0% total risk-based capital ratio. Any such institution must submit a capital restoration plan and until such plan is approved by the FDIC may not increase its assets, acquire another institution, establish a branch or engage in any new activities, and generally may not make capital distributions. The FDIC is authorized to impose the additional restrictions on undercapitalized institutions. In connection with a capital restoration plan, each holding company of the institution submitting a plan must guarantee the institution's performance of the plan until it has been adequately capitalized during four consecutive quarters. The liability on this guarantee is limited to the lesser of 5% of the institution's assets when it became undercapitalized or the amount necessary for the institution to meet the capital standards when it fails to comply with the plan. Any institution that fails to comply with its capital plan or has Tier 1 or Tier 1 risk-based capital ratios of less than 3.0% or a total risk-based capital ratio of less than 6.0% is considered "significantly undercapitalized" and must be made subject to one or more additional specified actions and operating restrictions that may cover all aspects of its operations and may include a forced merger or acquisition of the institution. The holding company of such an institution must obtain prior approval of any dividend to its shareholders. An institution with a ratio of tangible equity to total assets of less than 2.0% is "critically undercapitalized" and becomes subject to further mandatory restrictions on its operations. In general, the FDIC must be appointed receiver for a critically undercapitalized institution whose capital is not restored within the time provided. When the FDIC as receiver liquidates an institution, the claims of depositors and the FDIC as their successor (for deposits covered by the FDIC insurance) have priority over other unsecured claims against the institution.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. The imposition by the FDIC of any of these measures on Sound Community Bank may have a substantial adverse effect on its operations and profitability. In connection with the new capital rules discussed below, there will be changes to the prompt corrective action regulations.

**New Capital Rules.** Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), Sound Financial Bancorp and Sound Community Bank will be subject to new capital regulations adopted by the Federal Reserve and the FDIC, which create a new required ratio for common equity Tier 1 ("CET1") capital, increase the minimum leverage and Tier 1 capital ratios, change the risk-weightings of certain assets for purposes of

the risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios, and change what qualifies as capital for purposes of meeting the capital requirements.

Under the new capital regulations, the minimum capital ratios are: (1) a CETI capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total capital ratio of 8.0% of risk-weighted assets, and (4) a leverage ratio (the ratio of Tier 1 capital to average total adjusted assets) of 4.0%. CETI generally consists of common stock, retained earnings, accumulated other comprehensive income ("AOCI") unless we elect to exclude AOCI from regulatory capital, as discussed below, and certain minority interests, all subject to applicable regulatory adjustments and deductions.

There are a number of changes in what constitutes regulatory capital, subject to transition periods. These changes include the phasing-out of certain instruments as qualifying capital. Mortgage servicing and deferred tax assets over designated percentages of CETI will be deducted from capital. In addition, Tier 1 capital will include AOCI, which includes all unrealized gains and losses on available for sale debt and equity securities. Because of our assets size, we have the one-time option of deciding in the first quarter of 2015 whether to permanently opt-out of the inclusion of unrealized gains and losses on available for sale debt and equity securities in our capital calculations. We are considering whether to elect this option.

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

In addition to the minimum CETI, Tier 1 and total capital ratios, Sound Financial Bancorp and Sound Community Bank will have to maintain a capital conservation buffer consisting of additional CETI capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses. The new capital conservation buffer requirement is to be phased in beginning on January 1, 2016 when a buffer greater than 0.625% of risk-weighted assets will be required which amount will increase each year until the buffer requirement is fully implemented on January 1, 2019.

The FDIC's prompt corrective action standards change when these new capital regulations become effective. Under the new standards, in order to be considered well-capitalized, a bank must have a ratio of CETI capital to risk-weighted assets of 6.5% (new), a ratio of Tier 1 capital to risk-weighted assets of 8% (increased from 6%), a ratio of total capital to risk-weighted assets of 10% (unchanged), and a leverage ratio of 5% (unchanged), and in order to be considered adequately capitalized, it must have the minimum capital ratios described above.

Although we continue to evaluate the impact that the new capital rules will have on Sound Financial Bancorp and Sound Community Bank, we anticipate that Sound Financial Bancorp and Sound Community Bank will remain well-capitalized under the new capital rules and will meet the capital conservation buffer requirement.

**Volcker Rule Regulations.** Regulations were adopted by the federal banking agencies to implement the provisions of the Dodd Frank Act commonly referred to as the Volcker Rule. The regulations contain prohibitions and restrictions on the ability of banks and their holding companies and the affiliates to engage in proprietary trading and to hold certain interests in, or to have certain relationships with, various types of investment funds, including hedge funds and private equity funds, and certain other investments, including certain collateralized mortgage obligations, collateralized debt obligations, collateralized loan obligations and others.

**Community Reinvestment and Consumer Protection Laws.** In connection with its lending and other activities, Sound Community Bank is subject to a number of federal laws designed to protect customers and promote lending to various sectors of the economy and population. These include, among others, the Equal Credit Opportunity Act, the Truth-in-Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Community Reinvestment Act ("CRA"). Among other things, these laws:

- require lenders to disclose credit terms in meaningful and consistent ways;
- prohibit discrimination against an applicant in a credit transaction;
- prohibit discrimination in housing-related lending activities;
- require certain lenders to collect and report applicant and borrower data regarding home;
- require lenders to provide borrowers with information regarding the nature and cost of real estate settlements;
- prohibit certain lending practices and limit escrow account amounts with respect to real estate loan transactions;
- require financial institutions to implement identity theft prevention programs and measures to protect the confidentiality of consumer financial information; and
- prescribe possible penalties for violations of the requirements of consumer protection statutes and regulations.

The CFPB has been given authority for amending existing consumer compliance regulations and implementing new such regulations. In addition, the Bureau is charged with examining the compliance of financial institutions with assets in excess of \$10 billion with these consumer protection rules. Sound Community Bank's compliance with consumer protection rules are examined by the WDFI and the FDIC since it does not meet this \$10 billion asset level threshold.

In addition, federal banking regulators, pursuant to the Gramm-Leach-Bliley Act, have enacted regulations limiting the ability of banks and other financial institutions to disclose nonpublic consumer information to non-affiliated third parties. The regulations require disclosure of privacy policies and allow consumers to prevent certain personal information from being shared with non-affiliated parties.





The CRA requires the appropriate federal banking agency, in connection with its examination of a bank, to assess the bank's record in meeting the credit needs of the communities served by the bank, including low and moderate income neighborhoods. The FDIC examines Sound Community Bank for compliance with its CRA obligations. Under the CRA, institutions are assigned a rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance" and the appropriate federal banking agency is to take this rating into account in the evaluation of certain applications of the institution, such as an application relating to a merger or the establishment of a branch. An unsatisfactory rating may be used as the basis for the denial of such an application. The CRA also requires that all institutions make public disclosures of their CRA ratings. Sound Community Bank received a "satisfactory" rating in its most recent CRA evaluation. Under the law of the state of Washington, Sound Community Bank has a similar obligation to meet the credit needs of the communities it serves, and is subject to examination by the WDFI for this purpose, including assignment of a rating. An unsatisfactory rating may be the basis for denial of certain applications. Bank Secrecy Act / Anti-Money Laundering Laws. Sound Community Bank is subject to the Bank Secrecy Act and other anti-money laundering laws and regulations, including the USA PATRIOT Act of 2001. These laws and regulations require Sound Community Bank to implement policies, procedures, and controls to detect, prevent, and report money laundering and terrorist financing and to verify the identity of their customers. Violations of these requirements can result in substantial civil and criminal sanctions. In addition, provisions of the USA PATRIOT Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing mergers and acquisitions.

Federal Home Loan Bank System. Sound Community Bank is a member of the Federal Home Loan Bank of Seattle, one of the 12 regional Federal Home Loan Banks in the Federal Home Loan Bank System. The Federal Home Loan Bank System provides a central credit facility for member institutions. As a member of the Federal Home Loan Bank of Seattle, Sound Community Bank is required to hold shares of capital stock in that Federal Home Loan Bank. At December 31, 2014, Sound Community Bank had \$2.2 million in Federal Home Loan Bank stock, which was in compliance with this requirement. Sound Community Bank received \$2,000 in dividends from the Federal Home Loan Bank of Seattle for the year ended December 31, 2014. The Federal Finance Housing Agency has approved the proposed merger of the Federal Home Loan Bank of Seattle with the Federal Home Loan Bank of Des Moines. If the members of each of these Federal Home Loan Banks approve the merger, the merger is anticipated to be completed on May 31, 2015.

The Federal Home Loan Banks have continued to contribute to low- and moderately-priced housing programs through direct loans or interest subsidies on advances targeted for community investment and low- and moderate-income housing projects. These contributions have affected adversely the level of Federal Home Loan Bank dividends paid and could continue to do so in the future. These contributions could also have an adverse effect on the value of Federal Home Loan Bank stock in the future. A reduction in value of Sound Community Bank's Federal Home Loan Bank stock may result in a corresponding reduction in its capital.

#### Regulation of Sound Financial Bancorp

General. Sound Financial Bancorp, as the sole shareholder of Sound Community Bank, is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations promulgated thereunder. This regulation and oversight is generally intended to ensure that Sound Financial Bancorp limits its activities to those allowed by law and that it operates in a safe and sound manner without endangering the financial health of Sound Community Bank.

As a bank holding company, Sound Financial Bancorp is required to file quarterly and annual reports with the Federal Reserve and any additional information required by the Federal Reserve and is subject to regular examinations by the Federal Reserve and to examination by the WDFI. The Federal Reserve also has extensive enforcement authority over bank holding companies, including the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices.

A merger or acquisition of Sound Financial Bancorp, or an acquisition of control of Sound Financial Bancorp, is generally subject to approval by the Federal Reserve and WDFI. In general, control for this purpose means 25% of voting stock, but such approval can be required in other circumstances, including but not limited to an acquisition of

as low as 5% of voting stock.

The Dodd-Frank Act requires a bank holding company to serve as a source of financial strength to its subsidiary banks, with the ability to provide financial assistance to a subsidiary bank in financial distress. Regulations to implement this provision are required, but to date, none have been promulgated.

Permissible Activities. Under the Bank Holding Company Act, the Federal Reserve may approve the ownership of shares by a bank holding company in any company the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. These activities generally include, among others, operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. The Bank Holding Company Act prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. A bank holding company that meets certain supervisory and financial standards and elects to be designed as a financial holding company may also engage in certain securities, insurance and merchant banking activities and other activities determined to be financial in nature or incidental to financial activities.

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The Federal Reserve must approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank, and may approve an acquisition located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state, but may not approve the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the law of the host state, or an application where the applicant controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

**Capital Requirements for Sound Financial Bancorp.** The Federal Reserve has adopted capital guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company and in analyzing applications under the Bank Holding Company Act. These guidelines apply on a consolidated basis to bank holding companies that have a material amount of debt or equity securities outstanding that are registered with the SEC, or meet other criteria. These bank holding company capital adequacy guidelines are similar to the FDIC's standards for a bank to be considered adequately capitalized. The Federal Reserve expects a holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. In addition, a bank holding company must serve as a source of financial strength for its depository institution subsidiaries. Effective January 1, 2015, Sound Financial Bancorp is subject to the capital rules described under the caption "New Capital Rules" above.

**Federal Securities Law.** The stock of Sound Financial Bancorp is registered with the SEC under the Securities Exchange Act of 1934, as amended. Sound Financial Bancorp is subject to the information, proxy solicitation, insider trading restrictions and other requirements of the SEC under the Securities Exchange Act of 1934.

Sound Financial Bancorp stock held by persons who are affiliates of Sound Financial Bancorp may not be resold without registration unless sold in accordance with certain resale restrictions. For this purpose, affiliates are generally considered to be officers, directors and principal shareholders. If Sound Financial Bancorp meets specified current public information requirements, each affiliate of Sound Financial Bancorp will be able to sell in the public market, without registration, a limited number of shares in any three-month period.

The SEC has adopted regulations and policies under the Sarbanes-Oxley Act of 2002 that apply to Sound Financial Bancorp as a registered company under the Securities Exchange Act of 1934. The stated goals of these requirements are to increase corporate responsibility, provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SEC and Sarbanes-Oxley-related regulations and policies include very specific additional disclosure requirements and corporate governance rules.

#### Limitations on Dividends and Stock Repurchases

**Sound Financial Bancorp.** Sound Financial Bancorp's ability to declare and pay dividends is subject to the Federal Reserve's limits, including the new capital conservation buffer requirement, and Maryland law, and it may depend on its ability to receive dividends received from Sound Community Bank.

A policy of the Federal Reserve limits the payment of a cash dividend by a bank holding company if the holding company's net income for the past year is not sufficient to cover both the cash dividend and a rate of earnings retention that is consistent with capital needs, asset quality and overall financial condition. A bank holding company that does not meet any applicable capital standard would not be able to pay any cash dividends under this policy. A bank holding company subject to the Small Bank Holding Company Policy Statement is expected not to pay dividends unless its debt-to-equity ratio is less than 1:1 and it meets certain additional criteria. The Federal Reserve also has indicated that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends.

Except for a company that meets the well-capitalized standard for bank holding companies, is well managed, and is not subject to any unresolved supervisory issues, a bank holding company is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve may

disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation or regulatory order, condition, or written agreement with the Federal Reserve. Regardless of its asset size, a bank holding company is considered well-capitalized if on a consolidated basis it has a total risk-based capital ratio of at least 10.0% and a Tier 1 risk-based capital ratio of 6.0% or more, and is not subject to an agreement, order, or directive to maintain a specific level for any capital measure.

Sound Financial Bancorp, pursuant to federal regulations and policies, is prohibited from engaging in a return of capital during the three year term of the business plan submitted by Sound Financial Bancorp in connection with its recently completed stock offering. Under Maryland corporate law, Sound Financial Bancorp generally may not pay dividends if after that payment it would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than the sum of its total liabilities.

Sound Community Bank. The amount of dividends payable by Sound Community Bank to Sound Financial Bancorp depends upon Sound Community Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies, including the new capital conservation buffer requirement. Sound Community Bank may not declare or pay a cash dividend on its capital stock if the payment would cause its net worth to be reduced below the amount required for its liquidation account. Dividends on Sound Community Bank's capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of Sound Community Bank without the approval of the WDFI.

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The amount of dividends actually paid during any one period will be strongly affected by Sound Community Bank's policy of maintaining a strong capital position. Federal law further provides that without prior approval no insured depository institution may pay a cash dividend if it would cause the institution to be less than adequately capitalized as defined in the prompt corrective action regulations. Moreover, the FDIC also has the general authority to limit the dividends paid by insured banks if such payments are deemed to constitute an unsafe and unsound practice. In addition, dividends may not be declared or paid if Sound Community Bank is in default in payment of any assessment due the FDIC.

#### Federal Taxation

General. We are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to Sound Financial Bancorp or Sound Community Bank. Our federal income tax returns have never been audited by the Internal Revenue Service.

We had no unrecognized tax benefits at December 31, 2014 and at December 31, 2013.

Method of Accounting. For federal income tax purposes, we currently report our income and expenses on the accrual method of accounting and use a fiscal year ending on December 31 for filing our federal income tax return.

Minimum Tax. The Internal Revenue Code imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain items of tax preference and adjustment, called alternative minimum taxable income. Net operating losses can offset no more than 90% of alternative minimum taxable income. The alternative minimum tax is payable to the extent that the taxpayer's alternative minimum tax is in excess of the taxpayer's regular tax. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. We have not been subject to the alternative minimum tax in prior years, nor do we have any such amounts available as credits for carryover.

Corporate Dividends-Received Deduction. Sound Financial Bancorp has elected to file a consolidated return with Sound Community Bank. Therefore any dividends Sound Financial Bancorp receives from Sound Community Bank will not be included as income to Sound Financial Bancorp.

#### State Taxation

We are subject to a business and occupation tax imposed under Washington law at the rate of 1.5% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties and certain investment securities are exempt from this tax.

#### Employees

At December 31, 2014, we had a total of 81 full-time employees and 16 part-time employees. Our employees are not represented by any collective bargaining group. Management considers its employee relations to be good.

#### Executive Officers of Sound Financial Bancorp and Sound Community Bank

Officers are elected annually to serve for a one year term. There are no arrangements or understandings between the officers and any other person pursuant to which he or she was or is to be selected as an officer.

Laura Lee Stewart. Ms. Stewart, age 65, is currently President and Chief Executive Officer of Sound Community Bank and Sound Financial Bancorp. Prior to joining Sound Community Bank as its President in 1989, when it was a credit union, Ms. Stewart was Senior Vice President/Retail Banking at Great Western Bank. Ms. Stewart was selected as an inaugural member of the FDIC Community Bank Advisory Board and completed her term in 2013. In 2014, she was appointed Governmental Relations chairwoman of the American Bankers Association. Ms. Stewart chaired the Washington Bankers Association from 2012 to 2014. Ms. Stewart also is a member of the National Arthritis Foundation's board of directors as well as serving as a member of the board of directors of various local community and charitable organizations. Her many years of service in all areas of the financial institution operations and duties

as President and Chief Executive Officer of Sound Community Bank bring a special knowledge of the financial, economic and regulatory challenges we face and she is well suited to educating the Board on these matters.

Matthew P. Deines. Mr. Deines, age 41, has served as Chief Financial Officer of Sound Community Bank since 2002 and was appointed Executive Vice President in January 2005. Mr. Deines has also served as Chief Financial Officer and Executive Vice President of Sound Financial Bancorp (and its predecessor company) since its incorporation in 2008. Mr. Deines currently is responsible for management of our accounting, financial reporting, operations and information technology functions and is chair of Sound Community Bank's asset-liability management committee. Prior to joining Sound Community Bank, Mr. Deines was an Audit Supervisor with McGladrey and Pullen, LLP and received his Washington CPA certificate in 2000. Mr. Deines received a Bachelor's of Science Degree from Loyola Marymount University. He received a Masters of Business Administration Degree from the University of Washington in June 2010.

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Kelli Nielsen. Ms. Nielsen, age 43, is Senior Vice President of Retail Banking and Marketing. Ms. Nielsen is responsible for Training and Development and Business Development as well. Ms. Nielsen joined the Sound Community Bank in August 2012. Prior to joining the Bank, Ms. Nielsen was Vice President of Relationship Strategies at Opus Bank (formerly Cascade Bank). She joined Cascade Bank in 2002 as Vice President and Sales and Service Manager for Retail Banking. She also oversaw Training while directing 23 branches, which grew from \$250 Million to over \$1 Billion in a 10-year timeframe. Kelli has over 22 years of banking experience and has served 11 years on the WBA (Washington Bankers Association) Education Committee, authored and published a children's book, is a Certified Life Coach from the Life Coach Institute of Orange County, and holds three certificates from the Ritz Carlton Leadership Training Center. She is the 2014/2015 Chair of the WBA Retail Leadership Committee and a 2014-2016 Task Force Committee Member at the American Bankers Association Stonier School of Banking.

Internet Website

We maintain a website, [www.soundcb.com](http://www.soundcb.com). Information pertaining to us, including SEC filings, can be found by clicking the link on our site called "Investor Relations." This Annual Report on Form 10-K and our other reports, proxy statements and other information filed with the SEC are available on that website within the Investor Relations webpage by clicking the link called "SEC Filings." The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. For more information regarding access to these filings on our website, please contact our Corporate Secretary, Sound Financial Bancorp, Inc., 2005 5th Avenue, Suite 200, Seattle, Washington, 98121 or by calling (206) 448-0884.

Item 1A. Risk Factors

Not required; we are a smaller reporting company.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Five of our seven offices are leased. The operating leases contain renewal options and require us to pay property taxes and operating expenses on the properties. Our total rental expense for each of the years ended December 31, 2014 and 2013 was \$873,000 and \$847,000, respectively. The aggregate net book value of our leasehold improvements, furniture and equipment was \$5.6 million at December 31, 2014. See also Note 7 of the Notes to Consolidated Financial Statements. In the opinion of management, the facilities are adequate and suitable for our current needs. We may open additional banking offices to better serve current customers and to attract new customers in subsequent years.

The following table sets forth certain information concerning our main office, our branch offices and our loan production office at December 31, 2014:

Location	Year opened	Owned or leased	Lease expiration date
Main office: 2005 5th Avenue Seattle, WA 98121	1993	Leased	2017 <sup>(1)</sup>
Branch offices:			
Cedar Plaza Branch 22807 44th Avenue West Mountlake Terrace, WA 98043	2004	Leased	2015 <sup>(2)</sup>
Tacoma Branch 2941 S. 38th Street Tacoma, WA 98409	2009	Leased	2019 <sup>(5)</sup>
Port Ludlow Branch 9500 Oak Bay Road, Ste A.	2014	Owned	



Port Ludlow, WA 98365

Sequim Branch 645 W. Washington Street Sequim, WA 98382	1997	Owned
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Port Angeles Branch 110 N. Alder Street Port Angeles, WA 98682 31	2010	Leased	2028 <sup>(3)</sup>
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Loan Production Office:

Madison Park Loan Office 2013 Leased 2015<sup>(4)</sup>  
3101 E. Madison Street  
Seattle, WA 98112

- (1) Lease contains no renewal option.  
(2) Lease provides for four five-year renewals.  
(3) Lease provides for two ten-year renewals.  
(4) Lease provides for two three-year renewals.  
(5) -Lease provides for two five-year renewals.

We maintain depositor and borrower customer files on an online basis, utilizing a telecommunications network, portions of which are leased. Management has a disaster recovery plan in place with respect to the data processing system, as well as our operations as a whole.

Item 3. Legal Proceedings

From time to time we are involved as plaintiff or defendant in various legal actions arising in the normal course of business. We do not anticipate incurring any material legal fees or other liability as a result of such litigation.

Item 4. Mine Safety Disclosures

Not applicable.

## PART II

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

The common stock of Sound Financial Bancorp, which began trading on August 23, 2012, is traded on The NASDAQ Capital Market under the symbol "SFBC." The table below shows the high and low closing prices and quarterly dividends for our common stock for the periods indicated.

<u>2014 Quarters</u>	Stock Price		Dividends Per Share
	High	Low	
First Quarter (ended 3/31/2014)	\$17.58	\$16.55	\$ 0.05
Second Quarter (ended 6/30/2014)	\$17.51	\$16.55	\$ 0.05
Third Quarter (ended 9/30/2014)	\$18.75	\$17.09	\$ 0.05
Fourth Quarter (ended 12/31/2014)	\$18.93	\$17.48	\$ 0.05

<u>2013 Quarters</u>	Stock Price		Dividends Per Share
	High	Low	
First Quarter (ended 3/31/2013)	\$13.37	\$10.40	\$ 0.00
Second Quarter (ended 6/30/2013)	\$13.99	\$12.46	\$ 0.05
Third Quarter (ended 9/30/2013)	\$15.64	\$13.50	\$ 0.05
Fourth Quarter (ended 12/31/2013)	\$17.22	\$15.09	\$ 0.05

At December 31, 2014, there were 2,524,645 shares outstanding and the closing price of our common stock on that date was \$18.85. On that date, we had approximately 263 shareholders of record.

Our cash dividend payout policy is reviewed continually by management and the Board of Directors. Any dividends declared and paid in the future would depend upon a number of factors, including capital requirements, our financial condition and results of operations, tax considerations, statutory and regulatory limitations, and general economic conditions. No assurances can be given that any dividends will be paid or that, if paid, will not be reduced or

eliminated in future periods. Our future payment of dividends may depend, in part, upon receipt of dividends from Sound Community Bank, which are restricted by federal regulations.

Information regarding our equity compensation plan is included in Item 12 of this Form 10-K.

Stock Repurchases

There were no stock repurchases by the Company during the quarter ended December 31, 2014.

## Item 6. Selected Financial Data

## SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

The following table sets forth certain information concerning the Company's consolidated financial position and results of operations at and for the dates indicated and have been derived from the audited consolidated financial statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with Item 7., "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8., "Financial Statements and Supplementary Data." (In thousands)

	At December 31,		
	2014	2013	2012
Selected Financial Condition Data:			
Total assets	\$495,187	\$442,611	\$381,044
Total loans, net	425,973	386,749	322,496
Loans held-for-sale	810	130	1,725
Available for sale securities, at fair value	11,524	15,421	22,900
Bank-owned life insurance, net	11,408	11,068	7,220
Other real estate owned and repossessed assets, net	323	1,178	2,503
Federal Home Loan Bank stock, at cost	2,224	2,314	2,401
Total deposits	407,809	348,339	312,083
Borrowings	30,578	43,221	21,864
Stockholders' equity	50,644	46,504	43,457

	For the years ended December 31,		
	2014	2013	2012
Selected Operations Data:			
Total interest income	\$21,356	\$19,626	\$18,175
Total interest expense	2,423	2,312	2,360
Net interest income	18,933	17,314	15,815
Provision for loan losses	800	1,350	4,525
Net interest income after provision for loan losses	18,133	15,964	11,290
Service charges and fee income	2,571	2,270	2,219
Gain on sale of loans	624	967	2,063
Mortgage servicing income	509	457	550
Other-than-temporary impairment losses on securities	-	(30 )	(164 )
Fair value adjustment on mortgage servicing rights	328	900	53
Earnings on cash surrender value of BOLI	340	348	238
Total noninterest income	4,372	4,912	4,959
Salaries and benefits	8,278	7,206	6,011
Operations expense	4,045	3,950	2,787
Occupancy expense	1,359	1,316	1,218
Net losses on OREO and repossessed assets	208	1,036	921
Other noninterest expense	2,037	1,613	1,441
Total noninterest expense	15,927	15,121	12,378
Income before provision for income taxes	6,578	5,755	3,871
Provision for income taxes	2,338	1,815	1,231
Net income	\$4,240	\$3,940	\$2,640

	For the years ended		
	December 31,		
	2014	2013	2012
Selected Financial Ratios and Other Data:			
Performance ratios:			
Return on assets (ratio of net income to average total assets)	0.93 %	0.96 %	0.74 %
Return on equity (ratio of net income to average equity)	8.76	8.68	7.64
Dividend payout ratio	11.89	9.85	-
Interest rate spread information:			
Average during period	4.45	4.44	4.92
End of period	4.33	4.06	4.40
Net interest margin <sup>(1)</sup>	4.49	4.55	5.00
Noninterest income to total net revenue <sup>(2)</sup>	18.76	22.10	23.87
Noninterest expense to average total assets	3.48	3.68	3.46
Average interest-earning assets to average interest-bearing liabilities	117.53	116.97	110.75
Efficiency ratio <sup>(3)</sup>	66.97	63.29	55.15
Asset quality ratios:			
Nonperforming assets to total assets at end of period	0.84	0.70	1.68
Nonperforming loans to gross loans	0.89	0.49	1.20
Allowance for loan losses to nonperforming loans	114.19	217.44	110.59
Allowance for loan losses to total loans	1.02	1.07	1.30
Net charge-offs to average loans outstanding	0.14	0.40	1.55
Capital ratios:			
Equity to total assets at end of period	10.24	10.51	11.40
Average equity to average assets	10.57	11.04	9.66
Other data:			
Number of full service offices	6	5	5

(1) Net interest income divided by average interest earning assets.

(2) Noninterest income divided by the sum of noninterest income and net interest income.

(3) Noninterest expense, excluding other real estate owned and repossessed property expense, as a percentage of net interest income and total noninterest income, excluding net securities transactions.

Item 7.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis reviews our consolidated financial statements and other relevant statistical data and is intended to enhance your understanding of our financial condition and results of operations. The information in this section has been derived from the Consolidated Financial Statements and footnotes thereto that appear in Item 8 of this Form 10-K. The information contained in this section should be read in conjunction with these Consolidated Financial Statements and footnotes and the business and financial information provided in this Form 10-K.

### Overview

Our principal business consists of attracting retail deposits from the general public and investing those funds, along with borrowed funds, in loans secured by first and second mortgages on one- to four-family residences (including home equity loans and lines of credit), commercial and multifamily, consumer and commercial business loans and construction and land loans. We offer a wide variety of secured and unsecured consumer loan products, including manufactured home loans, floating home loans, automobile loans, boat loans and recreational vehicle loans. We intend to continue emphasizing our residential mortgage, commercial and multifamily and commercial business lending, while continuing to originate home equity and consumer loans. As part of our business, we focus on residential mortgage loan originations, many of which we sell to Fannie Mae. We typically sell these loans with servicing retained to maintain the direct customer relationship and promote our emphasis on strong customer service. We originated \$82.3 million, \$118.8 million and \$107.2 million of one- to four-family residential mortgage loans during the years ended December 31, 2014, 2013 and 2012, respectively. During these same periods, we sold \$52.7 million, \$108.9 million and \$95.1 million, respectively, of one- to four-family residential mortgage loans.

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

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

Our strategic plan targets consumers, small and medium size businesses, and professionals in our market area for loans and deposits. In pursuit of these goals, and while managing the size of our loan portfolio, we focus on including a significant amount of commercial business and commercial and multifamily loans in our portfolio. A significant portion of these commercial and multifamily and commercial business loans have adjustable rates, higher yields or shorter terms and higher credit risk than traditional fixed-rate mortgages. Our commercial loan portfolio (commercial and multifamily and commercial business loans) increased to \$188.4 million or 43.6% of our loan portfolio at December 31, 2014, from \$171.2 million or 43.7% of our loan portfolio at December 31, 2013, and \$147.8 million or 44.9% of our loan portfolio at December 31, 2012. In addition to higher balances in commercial lending, we also benefit from additional lending opportunities in our construction and land development portfolio. Our construction and land development portfolio increased to \$46.3 million or 10.7% of our loan portfolio at December 31, 2014, from \$44.3 million or 11.3% of our loan portfolio as of December 31, 2013 and \$25.5 million or 7.8% as of December 31, 2012. The impact of additional commercial and multifamily and construction and land loans has had a positive impact on our net interest income and has helped to further diversify our loan portfolio mix.

Our provision for loan losses expense was significantly lower in 2014 and 2013 than during the three previous years and reflects decreased levels of delinquencies, classified loans and net charge-offs

### Recent Accounting Standards

For a discussion of recent accounting standards, please see Note 2 - Accounting Pronouncements Recently Issued or Adopted in the Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

### Critical Accounting Policies

Certain of our accounting policies are important to an understanding of our financial condition, since they require management to make difficult, complex or subjective judgments, which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances that could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, accounting for other-than-temporary impairment of securities, accounting for mortgage servicing rights, accounting for other real estate owned, and accounting for deferred income taxes. For additional information on our accounting policies see "Note 1 - Organization and Significant Accounting Principles" in the Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

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**Allowance for Loan Loss.** The allowance for loan losses is the amount estimated by management as necessary to cover losses inherent in the loan portfolio as of the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. Determining the amount of the allowance for loan losses necessarily involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of historical and current loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. To strengthen our loan review and classification process, we engage an independent consultant to review our classified loans and a significant sample of recently originated non-classified loans on a regular basis. We also enhanced our credit administration policies and procedures to improve our maintenance of updated financial data on commercial borrowers. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of our allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

**Other-than-temporary impairment of securities.** Management reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment ("OTTI"), taking into consideration current market conditions; fair value in relationship to cost; extent and nature of the change in fair value; issuer rating changes and trends; whether management intends to sell a security or if it is likely that we will be required to sell the security before recovery of the amortized cost basis of the investment, which may be upon maturity; and other factors. For debt securities, if management intends to sell the security or it is likely that we will be required to sell the security before recovering our cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If management does not intend to sell the security and it is not more likely than not that we will be required to sell the security, but management does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, i.e., the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive loss. Impairment losses related to all other factors are presented as separate categories within other comprehensive income (loss).

**Mortgage Servicing Rights.** We record mortgage servicing rights on loans sold to Fannie Mae with servicing retained as well as for acquired servicing rights. We stratify our capitalized mortgage servicing rights based on the type, term and interest rates of the underlying loans. Mortgage servicing rights are carried at fair value. The value is determined through a discounted cash flow analysis, which uses interest rates, prepayment speeds and delinquency rate assumptions as inputs. All of these assumptions require a significant degree of management judgment. If our assumptions prove to be incorrect, the value of our mortgage servicing rights could be negatively impacted. We use a third party to assist us in the preparation of the analysis of the market value each quarter.

**Other Real Estate Owned.** Other real estate owned ("OREO") represents real estate that we have taken control of in partial or full satisfaction of significantly delinquent loans. At the time of foreclosure, OREO is recorded at the fair value less costs to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan and lease losses. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell. Subsequent valuation adjustments are recognized within net (loss) gain on OREO. Revenue and



expenses from operations and subsequent adjustments to the carrying amount of the property are included in other non-interest expense in the consolidated statements of income. In some instances, we may make loans to facilitate the sales of OREO. Management reviews all sales for which it is the lending institution for compliance with sales treatment under provisions established by ASC Topic 360, "Accounting for Sales of Real Estate". Any gains related to sales of OREO are deferred until the buyer has a sufficient initial and continuing investment in the property.

**Income Taxes.** Income taxes are reflected in our financial statements to show the tax effects of the operations and transactions reported in the financial statements and consist of taxes currently payable plus deferred taxes. ASC Topic 740, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating our deferred tax asset, we are required to estimate our income and taxes in the jurisdiction in which we operate. This process involves estimating our actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes. Valuation allowances are established to reduce the net carrying amount of deferred tax assets if it is determined to be more likely than not all or some portion of the potential deferred tax asset will not be realized.

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### Business and Operating Strategies and Goals

Our goal is to deliver returns to shareholders by increasing higher-yielding assets (in particular commercial and multifamily and commercial business loans), increasing core deposit balances, reducing expenses, managing problem assets and exploring expansion opportunities. We seek to achieve these results by focusing on the following objectives:

**Focusing on Asset Quality.** Our goal is to maintain or improve upon our level of nonperforming assets by managing credit risk on the current loan portfolio and new originations. We are focused on actively monitoring and managing all segments of our loan portfolio in order to proactively identify and mitigate risk. We continue to devote significant efforts and resources to reduce our problem assets. Despite these efforts, nonperforming assets recently increased to \$4.2 million at December 31, 2014, compared to \$3.1 million at December 31, 2013 and decreased from \$6.4 million at December 31, 2012. The increase since December 31, 2013, can be attributed to an increase in nonperforming loans from a year ago primarily due to a \$1.5 million commercial real estate loan which was restructured during the third quarter of 2014 and as of December 31, 2014, was performing as agreed under the new loan repayment terms and a \$740,000 increase in nonperforming one- to four- family loans due to an increase in nonperforming TDRs.

**Improving Earnings by Expanding Product Offerings.** We intend to prudently maintain the percentage of our assets consisting of higher-yielding commercial real estate and commercial business loans, which offer higher risk-adjusted returns, shorter maturities and more sensitivity to interest rate fluctuations than one-to four- family mortgage loans while maintaining our focus on residential lending. We also intend to selectively add additional products to further diversify revenue sources and to capture more of each customer's banking relationship by cross selling loan and deposit products and additional services to our customers. We intend to further build relationships with small businesses through new and existing product offerings including merchant services, remote deposit capture, online and mobile cash management, and online tools for wires, ACH and bill payment. We also believe the continuing changes in the secondary market as a result of the uncertainty that is surrounding Fannie Mae and Freddie Mac will result in increased opportunities in the coming years to originate high quality residential loans with more attractive pricing for our loan portfolio. With our long experience and expertise in residential lending we believe we can be effective in capturing the opportunities of these market changes in residential lending. We are also exploring correspondent relationships to sell some mortgage loans servicing-released.

**Emphasizing lower cost core deposits to manage the funding costs of our loan growth.** Our strategic focus is to emphasize total relationship banking with our customers to internally fund our loan growth. We are also focused on reducing wholesale funding sources, including FHLB advances, through the continued growth of core customer deposits. We believe that a continued focus on customer relationships will help to increase the level of core deposits and locally-based retail certificates of deposit. We intend to increase demand deposits by growing retail and business banking relationships. New technology and services are generally reviewed for business development and cost saving opportunities. We continue to experience growth in customer use of our online and mobile banking services, which allows customers to conduct a full range of services on a real-time basis, including balance inquiries, transfers and electronic bill paying while providing our customers greater flexibility and convenience in conducting their banking. In addition to our retail branches, we maintain state of the art technology-based products, such as business cash management, business remote deposit products and an online personal financial management and consumer remote deposit product. Total deposits increased to \$407.8 million at December 31, 2014, from \$348.3 million at December 31, 2013, and \$312.1 million at December 31, 2012. At December 31, 2014, core deposits, which we define as our non-time deposit accounts and time deposit accounts less than \$250,000, increased \$52.2 million to \$354.6 million while FHLB advances decreased \$12.6 million to \$30.6 million from December 31, 2013.

**Maintaining Our Customer Service Focus.** Exceptional service, local involvement (including volunteering and contributing to the communities where we are located) and timely decision-making are integral parts of our business strategy. We emphasize to our employees the importance of delivering exemplary customer service and seeking opportunities to build further relationships with our customers to enhance our market position and add profitable growth opportunities. The goal is to compete with other financial service providers by relying on the strength of our customer service and relationship banking approach. We believe that one of our strengths is that our employees are also significant shareholders through our employee stock ownership ("ESOP") and 401(k) plans. We also offer incentives that are designed to reward employees for balanced and high quality growth.

Expanding our presence within our existing and contiguous market areas and by capturing business opportunities resulting from changes in the competitive environment. We believe that opportunities currently exist within our market area to grow our franchise. We anticipate organic growth as the local economy and loan demand strengthens, through our marketing efforts and as a result of the opportunities being created as a result of the consolidation of financial institutions that is occurring in our market area. In addition, by delivering high quality, customer-focused products and services, we expect to attract additional borrowers and depositors and thus increase our market share and revenue generation. We opened a loan production office in Seattle in March 2013 and acquired three branches in August 2014. Following completion of the transaction, we closed our Sequim branch location and consolidated it into the acquired Sequim branch location and closed the acquired branch office located in Port Angeles and consolidated those operations into the Bank's existing Port Angeles branch. We continue to be disciplined as it pertains to future expansion, acquisitions and de novo branching focusing on the markets in Western Washington, which we know and understand.

Comparison of Financial Condition at December 31, 2014 and December 31, 2013

General. Total assets increased by \$52.6 million, or 11.9%, to \$495.2 million at December 31, 2014 from \$442.6 million at December 31, 2013. This increase was primarily the result of a \$39.2 million, or 10.1%, increase in our net loan portfolio, a \$14.0 million, or 91.0%, increase in cash and cash equivalents and a \$3.4 million, or 159.8%, increase in premises and equipment offset partially by a \$3.9 million, or 25.3%, decrease in available for sale securities, an \$855,000, or 72.6%, decrease in OREO and repossessed assets and a \$373,000, or 9.5% decrease in other assets. Asset growth was funded by a \$59.5 million, or 17.1%, increase in deposits.

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Cash and Securities. We increased our on-balance sheet liquidity in 2014 in order to manage liquidity and interest rate risk. Cash, cash equivalents and our available-for-sale securities increased by \$10.1 million, or 32.7%, to \$40.8 million at December 31, 2014. Cash and cash equivalents increased by \$14.0 million, or 91.0%, to \$29.3 million at December 31, 2014. Available-for-sale securities, which consist primarily of agency mortgage-backed securities, decreased by \$3.9 million, or 25.3%, from \$15.4 million at December 31, 2013 to \$11.5 million at December 31, 2014 as a result of pay downs.

At December 31, 2014, our securities portfolio consisted of 15 agency mortgage-backed securities, five non-agency mortgage-backed securities and five municipal securities with a fair value of \$11.5 million. At December 31, 2013, our securities portfolio consisted of 17 agency mortgage-backed securities, five non-agency mortgage-backed securities and five municipal bonds with a fair value of \$15.4 million. At December 31, 2014, three of the 15 agency mortgage-backed securities were in an unrealized loss position compared to 11 of the 17 agency mortgage-backed securities at December 31, 2013. All of the agency mortgage-backed securities in an unrealized loss position at December 31, 2014 and December 31, 2013 were issued or guaranteed by U.S. governmental agencies. The unrealized losses were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities, and not related to the underlying credit of the issuers or the underlying collateral. It is expected that these securities will not be settled at a price less than the amortized cost of each investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because we do not intend to sell the securities in this class and it is not likely that we will be required to sell these securities before recovery of their amortized cost basis, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered an other-than-temporary impairment ("OTTI").

As of December 31, 2014, one of the five non-agency mortgage-backed securities was in an unrealized loss position compared to two of the five non-agency mortgage-backed securities in an unrealized loss position at December 31, 2013. The unrealized loss was caused by changes in interest rates and market illiquidity causing a decline in the fair value subsequent to the purchase. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. While management does not intend to sell the non-agency mortgage-backed securities, and it is unlikely that we will be required to sell these securities before recovery of our amortized cost basis, management's impairment evaluation indicates that certain securities possess qualitative and quantitative factors that suggest an OTTI. These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. In addition to the qualitative factors, management's evaluation includes an assessment of quantitative evidence that involves the use of cash flow modeling and present value calculations as determined by considering the applicable OTTI accounting guidance. We compare the present value of the current estimated cash flows to the present value of the previously estimated cash flows. Accordingly, if the present value of the current estimated cash flows is less than the present value of the previous period's present value, an adverse change is considered to exist and the security is considered OTTI. The associated "credit loss" is the amount by which the security's amortized cost exceeds the present value of the current estimated cash flows. Based upon the results of the cash flow modeling, no security reflected OTTI during the year ended December 31, 2014. Estimating the expected cash flows and determining the present values of the cash flows involves the use of a variety of assumptions and complex modeling. In developing our assumptions, we consider all available information relevant to the collectability of the applicable security, including information about past events, current conditions, and reasonable and supportable forecasts. Furthermore, we believe that the cash flows used in the determination of OTTI are the "best estimate" of cash flows.

Loans. Our total loan portfolio, excluding loans held-for-sale, increased \$39.7 million, or 10.1%, from \$392.2 million at December 31, 2013 to \$431.9 million at December 31, 2014. Loans held-for-sale increased from \$130,000 at December 31, 2013 to \$810,000 at December 31, 2014, reflecting primarily the timing of transactions in late 2014, as compared to late 2013.

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The following table reflects the changes in the types of loans in our portfolio at the end of 2014, as compared to the end of 2013 (dollars in thousands):

	December 31,		Amount Change	Percent Change	
	2014	2013			
One-to-four-family	\$133,031	\$117,739	\$15,292	13.0	%
Home equity	34,675	35,155	(480 )	(1.4 )	
Commercial and multifamily	168,952	157,516	11,436	7.3	
Construction and land	46,279	44,300	1,979	4.5	
Manufactured homes	12,539	13,496	(957 )	(7.1 )	
Other consumer	16,875	10,284	6,591	64.1	
Commercial business	19,525	13,668	5,857	42.9	
Total loans	\$431,876	\$392,158	\$39,718	10.1	%

The most significant change in our loan portfolio was a result of increases in one- to four- family mortgage loans which was primarily a result of increases in higher yielding jumbo mortgage and non-conforming one- to four- family mortgage loans which we maintain in our portfolio. Commercial and multifamily loans increased primarily as a result of continued efforts to expand and diversify our lending portfolio. Other consumer loans increased primarily as a result of expansion of our floating home loan portfolio. Commercial business loans increased primarily as a result of a participation loan entered into with another financial institution. Manufactured home loans decreased as repayments exceeded loan originations as a result of a lack of demand for these types of loans by well-qualified borrowers. The loan portfolio remains well-diversified with commercial and multifamily real estate loans accounting for 39.1% of the portfolio, residential real estate loan 30.8% of the portfolio and home equity, manufactured and other consumer loans 14.8% of the portfolio. Construction and land loans account for 10.7% of the portfolio and commercial business loans account for the remaining 4.5% of the portfolio. At December 31, 2013, commercial and multifamily real estate loans accounted for 40.1% of the portfolio, residential real estate loan accounted for 30.0% of the portfolio and home equity, manufactured and other consumer loans 15.1% of the portfolio, construction and land loans 11.3% of the portfolio and commercial business loans accounted for the remaining 3.5% of the portfolio.

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**Mortgage Servicing Rights.** At December 31, 2014 and 2013, we had \$3.0 million in mortgage servicing rights recorded at fair value. We record mortgage servicing rights on loans sold to Fannie Mae with servicing retained and upon acquisition of a servicing portfolio. We stratify our capitalized mortgage servicing rights based on the type, term and interest rates of the underlying loans. Mortgage servicing rights are carried at fair value. If the fair value of our mortgage servicing rights fluctuates significantly, our financial results could be materially impacted.

**Nonperforming Assets.** At December 31, 2014, our nonperforming assets totaled \$4.2 million, or 0.84% of total assets, compared to \$3.1 million, or 0.70% of total assets at December 31, 2013.

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

	Nonperforming Assets at December 31,			
	2014	2013	Amount Change	Percent Change
Nonaccrual loans	\$1,464	\$558	\$ 906	162.4 %
Accruing loans 90 days or more delinquent	114	321	(207 )	(64.5 )
Nonperforming TDRs	2,264	1,042	1,222	117.3
OREO and repossessed assets	323	1,178	(855 )	(72.6 )
Total	\$4,165	\$3,099	\$ 1,066	34.4 %

Nonperforming loans to total loans increased to \$4.2 million, or 0.89%, of total loans at December 31, 2014 from \$3.1 million, or 0.49%, at December 31, 2013. Nonperforming commercial and multifamily real estate loans increased \$819,000 to \$1.6 million at December 31, 2014 from \$820,000 at December 31, 2013 and is primarily comprised of a \$1.5 million commercial real estate loan which was restructured during the third quarter of 2014, and as of December 31, 2014, was performing as agreed under the new loan repayment terms. Nonperforming one- to four- family real estate loans increased \$740,000 to \$1.5 million at December 31, 2014 from \$772,000 at December 31, 2013 due primarily to a \$1.2 million increase in nonperforming TDRs. Our largest nonperforming loan at December 31, 2014 was the commercial real estate loan discussed above totaling \$1.5 million.

OREO and repossessed assets decreased 72.6% during 2014 primarily due to improving economic conditions in our market and our continued focus on credit administration. During 2014, we repossessed six personal residences and 10 manufactured homes. We sold 13 personal residences and 11 manufactured homes at an aggregate loss of \$28,000. Our largest OREO at December 31, 2013, consisted of an \$122,000 loan secured by a personal residence in Clallam County, Washington, a \$105,000 loan secured by a personal residence in San Juan County, Washington and a \$42,000 loan secured by a personal residence in Clallam County, Washington.

**Allowance for Loan Losses.** The allowance for loan losses is maintained to cover losses that are probable and can be estimated on the date of evaluation in accordance with generally accepted accounting principles in the United States. It is our best estimate of probable incurred credit losses in our loan portfolio.

The following table reflects the adjustments in our allowance during 2014 and 2013 (dollars in thousands):

	Year Ended	
	December 31, 2014	December 31, 2013
Balance at beginning of period	\$4,177	\$4,248
Charge-offs	(743 )	(1,584 )
Recoveries	153	163
Net charge-offs	(590 )	(1,421 )
Provisions charged to operations	800	1,350

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Balance at end of period	\$4,387		\$4,177	
Ratio of net charge-offs during the period to average loans outstanding during the period	0.14	%	0.40	%
Allowance as a percentage of nonperforming loans	114.19	%	217.44	%
Allowance as a percentage of total loans (end of period)	1.02	%	1.07	%

Specific loan loss reserves decreased \$342,000, while general loan loss reserves increased \$552,000 at December 31, 2014, compared to the prior year end. Net charge-offs for 2014 were \$590,000, or 0.14% of average loans, compared to \$1.4 million, or 0.40% of average loans for 2013. The decrease in net charge-offs was primarily due to the improved economic conditions in our market area and continued efforts in credit administration and collections. As of December 31, 2014, the allowance for loan losses as a percentage of loans receivable and nonperforming loans was 1.02% and 114.19%, respectively, compared to 1.07% and 271.44%, respectively, at December 31, 2013. Allowance for loan losses as a percentage of loans receivable decreased primarily as a result of improved credit metrics related to both specific and general reserves. This includes a decrease in expected losses on loans individually evaluated for impairment as a percentage of these loans and an increase in expected losses on loans collectively evaluated for impairment. The decrease in loans individually evaluated is due to lower past due and impaired loans as a percentage of the overall loan portfolio and improving values for real estate in the markets where we lend. The increase in the allowance attributed to collectively evaluated loans is due to an increase in loans receivable and an evaluation by management of a longer look-back period in calculating the historical loss ratios. Management will continue to evaluate the appropriate loss periods given changes in the economic environment and nature of the risks within the loan portfolio. The allowance for loan losses as a percentage of nonperforming loans decreased due to an increase in nonperforming loans from \$1.9 million at December 31, 2013 to \$3.8 million at December 31, 2014.

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Deposits. Total deposits increased by \$59.5 million, or 17.1%, to \$407.8 million at December 31, 2014 from \$348.3 million at December 31, 2013. Interest-bearing demand accounts increased \$32.4 million, or 45.9%, certificates increased \$14.4 million, or 9.1%, and noninterest-bearing demand accounts increased \$9.9 million, or 31.0% and savings accounts increased \$6.7 million, or 25.4%. These increases were partially offset by a \$3.8 million, or 6.5%, decrease in money market accounts. The acquisition of three retail branches on the North Olympic Peninsula was a primary factor in deposit growth. We acquired \$21.6 million in deposits in the acquisition and retained \$19.3 million as of December 31, 2014. The increase in interest-bearing demand accounts was primarily a result of a continued marketing emphasis on our rewards checking product as well as the introduction of a new interest-bearing demand account in 2014. The increase in noninterest-bearing demand accounts was primarily a result of our continued emphasis on attracting relatively low-cost core deposit accounts from small businesses. The increase in certificates was primarily a result of several targeted marketing initiatives conducted in 2014 at slightly above market rates. The decrease in money market accounts was primarily the result of customers placing these funds in higher yielding certificate or interest-bearing demand accounts. Escrow accounts decreased by \$137,000, or 5.0%, and were primarily a result of lower balances in our custodial accounts for our loan servicing portfolio. At December 31, 2014, brokered deposits were \$5.0 million compared to \$4.3 million at December 31, 2013.

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

	As of December 31, 2014	Wtd. Avg.	As of December 31, 2013	Wtd. Avg.
	Amount	Rate	Amount	Rate
Noninterest-bearing demand	\$41,773	0.00 %	\$31,877	0.00 %
Interest-bearing demand	103,048	0.43	70,639	0.37
Savings	33,233	0.16	26,509	0.14
Money market	55,236	0.27	59,069	0.30
Certificates	171,939	1.03	157,528	1.13
Escrow	2,580	0.00	2,717	0.00
Total	\$407,809	0.60 %	\$348,339	0.64 %

Borrowings. FHLB advances decreased \$12.6 million, or 29.3%, to \$30.6 million at December 31, 2014, with a weighted-average cost of 0.38%, from \$43.2 million at December 31, 2013, with a weighted –average cost of 0.53% due to maturities. This decrease in borrowings was a result of the acquisition of deposits from our branch acquisition coupled with deposit growth among our existing branches. We rely on FHLB advances to fund interest-earning assets when deposits alone cannot fully fund interest-earning asset growth. This reliance on borrowings, rather than deposits, may increase our overall cost of funds.

Stockholders' Equity. Total stockholders' equity increased \$4.2 million, or 9.0%, to \$50.7 million at December 31, 2014. This primarily reflects net income of \$4.2 million, ESOP share allocations of \$441,000 and other comprehensive income of \$452,000, partially offset by \$904,000 in stock repurchases and cash dividends of \$504,000.



Average Balances, Net Interest Income, Yields Earned and Rates Paid

The following table presents for the periods indicated the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates. Income and yields on tax-exempt obligations have not been computed on a tax equivalent basis. All average balances are daily average balances. Nonaccruing loans have been included in the table as loans carrying a zero yield for the period they have been on non-accrual (dollars in thousands).

	December 31, 2014			2013			2012		
	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
Interest-earning assets:									
Loans receivable <sup>(1)</sup>	\$408,283	\$21,143	5.18 %	\$358,029	\$19,329	5.40 %	\$307,231	\$17,794	5.79 %
Investments and interest bearing accounts	13,792	213	1.54	22,902	297	1.30	10,614	381	3.59
Total interest-earning assets <sup>(1)</sup>	422,075	21,356	5.06	380,931	19,626	5.15	317,845	18,149	5.72
Interest-bearing liabilities:									
Savings and money market accounts	85,192	201	0.24	99,799	253	0.25	115,371	314	0.27
Demand and NOW accounts	125,166	378	0.30	44,009	162	0.37	60,143	24	0.04
Certificate accounts	163,527	1,691	1.03	148,154	1,681	1.13	105,475	1,796	1.70
Borrowings	26,318	153	0.58	33,697	216	0.64	8,901	225	2.54
Total interest-bearing liabilities	400,349	2,423	0.61	325,659	2,312	0.71	289,890	2,360	0.81
Net interest income		\$18,978			\$17,314			\$15,815	
Net interest rate spread			4.47 %			4.44 %			4.90 %
Net earning assets	\$21,872			\$55,272			\$27,955		
Net interest margin			4.49 %			4.55 %			5.00 %
Average interest-earning assets to average interest-bearing liabilities									
		105.47 %			116.97 %			109.64 %	

<sup>(1)</sup> Calculated net of deferred loan fees, loan discounts and loans in process.

## Rate/Volume Analysis

The following schedule presents the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. It distinguishes between the changes related to outstanding balances and that due to the changes in interest rates. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (i.e., changes in volume multiplied by old rate) and (ii) changes in rate (i.e., changes in rate multiplied by old volume). For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the change due to volume and the change due to rate (dollars in thousands).

	Year ended December 31, 2014 vs. 2013			Year ended December 31, 2013 vs. 2012		
	Increase (decrease) due to Volume	Rate	Total Increase (decrease)	Increase (decrease) due to Volume	Rate	Total Increase (decrease)
Interest-earning assets:						
Loans receivable	\$2,713	\$(899)	\$ 1,814	\$2,942	\$(1,407)	\$ 1,535
Investments and interest bearing accounts	(118 )	34	(84 )	441	(525 )	(84 )
Total interest-earning assets	2,595	(865)	1,774	3,383	(1,932)	1,451
Interest-bearing liabilities:						
Savings and Money Market accounts	(37 )	(15 )	(52 )	(42 )	(19 )	(61 )
Demand and NOW accounts	299	(83 )	216	(6 )	144	138
Certificate accounts	174	(165)	9	727	(842 )	(115 )
Borrowings	(47 )	(16 )	(63 )	630	(640 )	(10 )
Total interest-bearing liabilities	\$389	\$(279)	\$ 110	\$1,307	\$(1,355)	\$ (48 )
Change in net interest income			\$ 1,664			\$ 1,499

## Comparison of Results of Operation for the Years Ended December 31, 2014 and 2013

General. Net income increased \$301,000 to \$4.2 million, or \$1.63 per diluted common share for the year ended December 31, 2014, from \$3.9 million, or \$1.49 per diluted common share for the year ended December 31, 2013. The primary reasons for the improvement were an increase in net interest income and decrease in the provision for loan losses, partially offset by higher noninterest expense and lower noninterest income.

Interest Income. Interest income increased by \$1.7 million, or 9.0%, to \$21.4 million for the year ended December 31, 2014, from \$19.6 million for the year ended December 31, 2013. The increase in interest income for the year primarily reflected the increase in the average balance of interest-earning assets, in particular our average balance of loans receivable which outpaced the decline in the weighted average yield on our interest-earning assets during the year ended December 31, 2014 as compared to the prior year.

Our weighted average yield on interest-earning assets was 5.00% for the year ended December 31, 2014, compared to 5.15% for the year ended December 31, 2013. The weighted average yield on loans decreased from 5.40% for the year ended December 31, 2013, to 5.18% for the year ended December 31, 2014. The average balance of gross loans receivable increased \$50.3 million, or 14.0%, for the year ended December 31, 2014 as compared to the prior year. The weighted average yield on available for sale securities (including OTTI) was 1.54% for the year ended December 31, 2014 compared to 1.48% for the year ended December 31, 2013. While we maintained a similar mix of investments year over year, there was no OTTI in 2014 which increased the yield slightly. The average balance of available for sale securities decreased \$9.1 million, or 39.8%, for the year ended December 31, 2014 as compared to the prior year.

Interest Expense. Interest expense increased \$110,000, or 4.8%, to \$2.4 million for the year ended December 31, 2014, from \$2.3 million for the year ended December 31, 2013. This increase reflects primarily overall higher balances of deposits partially offset by a decrease in the average balance of FHLB advances and a lower weighted average cost of interest-bearing deposits during the year. Our weighted average cost of interest-bearing liabilities was

0.58% for the year ended December 31, 2014, compared to 0.71% for the year ended December 31, 2013.

Interest paid on deposits increased \$173,000, or 8.3%, to \$2.3 million for the year ended December 31, 2014, from \$2.1 million for the year ended December 31, 2013. This increase resulted from a \$48.5 million increase in the average balances of deposits, which was partially offset by a lower weighted average cost of deposits during the year. We experienced a four basis point decrease in the average rate paid on deposits during the year ended December 31, 2014 compared to 2013. This decrease in average rates was a result of the re-pricing of matured certificates of deposit, most of which we were able to retain at lower rates as well as higher balances of noninterest-bearing deposits.

Interest expense on borrowings decreased \$63,000, or 29.2%, to \$153,000 for the year ended December 31, 2014 from \$216,000 for the year ended December 31, 2013. The decrease was a result of a six basis point decrease in our cost of borrowings to 0.58% for the year ended December 31, 2014 from 0.64% for the year ended December 31, 2013 and a \$7.4 million decrease in the average balance of borrowings outstanding during the year.

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Net Interest Income. Net interest income increased \$1.7 million, or 9.6%, to \$19.0 million for the year ended December 31, 2014, from \$17.3 million for the year ended December 31, 2013. The increase primarily resulted from increased interest income due to higher average loan balances and lower average balances and cost of borrowings. This was partially offset by higher average balances of interest-bearing deposits during 2014 as compared to 2013. Our average yield on loans receivable decreased during the year ended December 31, 2014 as compared to the prior year as new loan originations and re-pricing adjustable rate loans reflect the continued low rate environment. Our net interest margin was 4.43% for the year ended December 31, 2014, compared to 4.55% for the year ended December 31, 2013.

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

A provision of \$800,000 was made during the year ended December 31, 2014, compared to a provision of \$1.4 million during the year ended December 31, 2013. The reduced provision primarily reflects declines in loan charge-offs and improving values for real estate in the markets where we lend offset by increases to the provision related to higher average loan balances and changes in the composition of our loan portfolio.

For the year ended December 31, 2014, the annualized percentage of net charge-offs to average loans decreased 26 basis points to 0.14% from 0.40% for the year ended December 31, 2013. The ratio of nonperforming loans to total loans increased from 0.49% at December 31, 2013 to 0.89% at December 31, 2014. See "- Comparison of Financial Condition at December 31, 2014 and December 31, 2013 – Delinquencies and Nonperforming Assets" for more information on nonperforming loans in 2014.

Noninterest Income. Noninterest income decreased \$540,000, or 11.0%, to \$4.4 million for the year ended December 31, 2014, as compared to \$4.9 million for the year ended December 31, 2013 as reflected below (dollars in thousands):

	Year Ended			
	December 31, 2014	December 31, 2013	Amount Change	Percent Change
Service charges and fee income	\$2,571	\$2,270	\$ 301	13.3 %
Earnings on cash surrender value of bank owned life insurance	340	348	(8 )	(2.3 )
Mortgage servicing income	509	457	52	11.4
Fair value adjustment on mortgage servicing rights	328	900	(572 )	(63.6 )
Other-than-temporary impairment losses	-	(30 )	30	(100.0 )
Net gain on sale of loans	624	967	(343 )	(35.5 )
Total noninterest income	\$4,372	\$4,912	\$ (540 )	(11.0 )%

The increase in service charges and fee income was primarily the result of increased deposit service fees from new accounts acquired in our recent branch acquisitions as well as higher loan fees. The increase in mortgage servicing income was primarily a result of reduced expenses in the loan servicing portfolio some of which represented Fannie Mae reimbursements received in 2014. In addition, the purchase price premium paid for the servicing portfolio that was purchased in 2009 was fully amortized as of August 2014. The fair value adjustment on mortgage servicing rights was negatively impacted primarily due to faster prepayment speeds. The increase in mortgage servicing income

was primarily a result of decreased expenses related to our third party subservicing loan portfolio. The decreased net gain on sale of loans was primarily reflective of the curtailed refinance activity as a result of higher mortgage rates this year as compared to last year partially offset by higher average premiums on loans sold, including a few loans that were sold servicing-released.. The decrease in OTTI was a result of improving credit trends in our non-agency mortgage-backed securities portfolio.

Noninterest Expense. Noninterest expense increased \$806,000, or 5.3%, to \$15.9 million during 2014 compared to \$15.1 million during 2013, as reflected below (dollars in thousands):

	Year Ended		Amount Change	Percent Change
	December 31, 2014	2013		
Salaries and benefits	\$8,278	\$7,206	\$ 1,072	14.9 %
Operations	4,045	3,950	95	2.4
Regulatory assessments	267	326	(59 )	(18.1 )
Occupancy	1,359	1,316	43	3.3
Data processing	1,770	1,287	483	37.5
Losses and expenses on OREO and repossessed assets	208	1,036	(828 )	(79.9 )
Total noninterest expense	\$15,927	\$15,121	\$ 806	5.3 %

Noninterest expense was higher primarily as a result of higher operating and data processing expenses as a result of conversion costs associated with our recent branch acquisitions and higher salaries and benefit expenses due to an increase in staffing additional branch locations, partially offset by lower losses and expenses related to OREO and other repossessed assets.

Income Tax Expense. For the year ended December 31, 2014, we had income tax expense of \$2.3 million on our pre-tax income as compared to \$1.8 million for the year ended December 31, 2013. The effective tax rates for the years ended December 31, 2014 and 2013 were 35.5% and 31.5%, respectively.

## Liquidity

Liquidity management is both a daily and longer-term function of management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and federal funds. On a longer term basis, we maintain a strategy of investing in various lending products and investment securities, including mortgage-backed securities. We use our sources of funds primarily to meet ongoing commitments, pay maturing deposits, fund deposit withdrawals and fund loan commitments.

We maintain cash and investments that qualify as liquid assets to maintain adequate liquidity to ensure safe and sound operation and meet demands for customer funds (particularly withdrawals of deposits). At December 31, 2014, we had \$40.8 million in cash and investment securities available for sale and \$810,000 in loans held-for-sale. We can also obtain funds from borrowings, primarily FHLB advances. At December 31, 2014, we had the ability to borrow an additional \$60.3 million in FHLB advances, subject to certain collateral requirements. We have access to additional borrowings of \$21.8 million through the Federal Reserve's Discount Window, subject to certain collateral requirements, \$2.0 million through an unsecured line of credit at Pacific Coast Banker's Bank and up to \$9.0 million through a Fed Funds Sweep and Line Agreement established with Zions Bank.

We are required to have enough cash and investments that qualify as liquid assets in order to maintain sufficient liquidity to ensure safe and sound operations. Liquidity may increase or decrease depending upon the availability of funds and comparative yields on investments in relation to the return on loans. Historically, we have maintained liquid assets above levels believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. Cash flow projections are regularly reviewed and updated to assure that adequate liquidity is maintained.

Liquidity management involves the matching of cash flow requirements of customers, who may be either depositors desiring to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs and our ability to manage those requirements. We strive to maintain an adequate liquidity position by managing the balances and maturities of interest-earning assets and interest-bearing liabilities so that the balance we have in short-term investments at any given time will cover adequately any reasonably anticipated, immediate need for funds. Additionally, we maintain relationships with correspondent banks, which could provide funds on short-term notice if needed. Our liquidity, represented by cash and cash-equivalents, is a product of our operating, investing and financing activities.

As disclosed in our Consolidated Statements of Cash Flows in Item 8 of this Annual Report on Form 10-K, cash and cash equivalents increased \$14.0 million to \$29.3 million as of December 31, 2014, from \$15.3 million as of December 31, 2013. Net cash provided by operating activities was \$6.8 million for the year ended December 31, 2014. Net cash of \$38.9 million was used in investing activities during the year ended December 31, 2014 and consisted principally of loan originations, net of principal repayments and purchases of premises and equipment related to our branch acquisitions completed during the third quarter of 2014. There was \$46.1 million of cash provided by financing activities during the year ended December 31, 2014 and primarily consisted of a \$59.5 million net increase in deposits partially offset by a \$12.6 million net decrease in FHLB advances.

Sound Financial Bancorp is a separate legal entity from Sound Community Bank and must provide for its own liquidity. In addition to its own operating expenses (many of which are paid to Sound Community Bank), Sound Financial Bancorp is responsible for paying any dividends declared to its shareholders, and interest and principal on outstanding debt. Sound Financial Bancorp's primary source of funds is dividends from Sound Community Bank, which are subject to regulatory limits. At December 31, 2014, Sound Financial Bancorp, on an unconsolidated basis, had \$413,000 in cash, noninterest-bearing deposits and liquid investments generally available for its cash needs. Our liquidity, represented by cash and cash equivalents and investment securities, is a product of our operating, investing and financing activities. Our primary sources of funds are deposits, amortization, prepayments and maturities of outstanding loans and mortgage-backed securities, maturities of investment securities and other short-term investments and funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed securities and maturing investment securities and short-term investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, which provide liquidity to meet lending requirements. We also generate cash through borrowings. We utilize FHLB advances to leverage our capital base and provide funds for our lending and investment activities, and to enhance our

interest rate risk management.

We use our sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At December 31, 2014, the approved outstanding loan commitments, including unused lines and letters of credit, amounted to \$73.6 million. Certificates of deposit scheduled to mature in one year or less at December 31, 2014, totaled \$88.1 million. It is management's policy to manage deposit rates that are competitive with other local financial institutions. Based on this management strategy, we believe that a majority of maturing deposits will remain with us. See also the Consolidated Statements of Cash Flows, included in Item 8., "financial Statements and Supplementary Data," of this Form 10-K, for further information.

#### Off-Balance Sheet Activities

In the normal course of operations, we engage in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit. For the year ended December 31, 2014, we engaged in no off-balance sheet transactions likely to have a material effect on our financial condition, results of operations or cash flows.

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A summary of our off-balance sheet loan commitments at December 31, 2014, is as follows (in thousands):

Off-balance sheet loan commitments:

Residential mortgage commitments	\$5,615
Undisbursed portion of loans closed	37,337
Unused lines of credit	30,615
Irrevocable letters of credit	65
Total loan commitments	\$73,632

#### Capital

Sound Community Bank was subject to minimum capital requirements imposed by regulations of the FDIC. Based on its capital levels at December 31, 2014, Sound Community Bank exceeded these requirements as of that date.

Consistent with our goals to operate a sound and profitable organization, our policy is for Sound Community Bank to maintain a "well-capitalized" status under the regulatory capital categories of the FDIC. Based on capital levels at December 31, 2014, Sound Community Bank was considered to be well-capitalized. Management monitors the capital levels to provide for current and future business opportunities and to maintain Sound Community Bank's "well-capitalized" status. See "Business - How We Are Regulated -- Regulation of Sound Community Bank -- New Capital Rules" in Part I, Item 1 of this Form 10-K for revised capital rules that Sound Community Bank became subject to as of January 1, 2015.

The following table shows the capital ratios of Sound Community Bank at December 31, 2014 (dollars in thousands):

	Actual		Minimum Capital Requirements		Minimum Required to Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 Capital to total adjusted assets <sup>(1)</sup>	\$48,343	10.19%	\$18,973	≥ 4.0 %	\$23,716	≥ 5.0 %
Tier 1 Capital to risk-weighted assets <sup>(2)</sup>	\$48,343	12.44%	\$15,540	≥ 4.0 %	\$23,310	≥ 6.0 %
Total Capital to risk-weighted assets <sup>(2)</sup>	\$52,730	13.57%	\$31,080	≥ 8.0 %	\$38,850	≥ 10.0 %

(1)Based on total adjusted assets of \$474.3 million.

(2)Based on risk-weighted assets of \$388.5 million.

#### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

##### Asset/Liability Management

**Our Risk When Interest Rates Change.** The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market rates change over time. Like other financial institutions, our results of operations are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

**How We Measure Our Risk of Interest Rate Changes.** As part of efforts to manage our exposure to changes in interest rates and comply with applicable regulations, we monitor our interest rate risk. In doing so, we analyze and manage assets and liabilities based on their interest rates and payment streams, timing of maturities, re-pricing opportunities, and sensitivity to actual or potential changes in market interest rates.

We are subject to interest rate risk to the extent that our interest-bearing liabilities, primarily deposits and FHLB advances, re-price more rapidly or at different rates than our interest-earning assets. In order to minimize the potential



for adverse effects of material prolonged increases or decreases in interest rates on our results of operations, we have adopted an asset and liability management policy. Our board of directors sets the asset and liability policy, which is implemented by the asset/liability committee.

The purpose of the asset/liability committee is to communicate, coordinate, and control asset/liability management consistent with our business plan and board-approved policies. The committee establishes and monitors the volume and mix of assets and funding sources, taking into account relative costs and spreads, interest rate sensitivity and liquidity needs. The objectives are to manage assets and funding sources to produce results that are consistent with liquidity, capital adequacy, growth, risk and profitability goals.

The committee generally meets monthly to, among other things, protect capital through earnings stability over the interest rate cycle; maintain our well-capitalized status; and provide a reasonable return on investment. The committee recommends appropriate strategy changes based on this review. The committee is responsible for reviewing and reporting the effects of the policy implementations and strategies to the board of directors at least quarterly. Senior managers oversee the process on a daily basis.

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A key element of our asset/liability management plan is to protect net earnings by managing the maturity or re-pricing mismatch between our interest-earning assets and our rate-sensitive liabilities. We seek to reduce exposure to earnings by extending funding maturities through the use of FHLB advances, through the use of adjustable rate loans and through the sale of certain fixed rate loans in the secondary market.

As part of our efforts to monitor and manage interest rate risk, we maintain our own interest rate risk model and utilize software and resources provided by a third party. The model contains several assumptions that are based upon a combination of proprietary and market data that reflect historical results and current market conditions. These assumptions relate to interest rates, prepayments, deposit decay rates and the market value of certain assets under the various interest rate scenarios. The model's capital at risk measure, also known as the Economic Value of Equity "EVE", evaluates the change in the projected EVE over a two-year period given an immediate increase or decrease in interest rates. It considers both the absolute dollar change in EVE and also the percentage change in EVE.

Management and the board of directors review these measurements on a quarterly basis to determine whether our interest rate exposure is within the limits established by the board of directors.

Our asset/liability management strategy dictates acceptable limits on the amounts of change in given changes in interest rates. For interest rate increases of 100, 200, and 300 basis points, our policy dictates that our EVE percentage change should not decrease greater than 20%, 30% and 40%, respectively and that our EVE ratio not fall below 10%, 8%, and 6%, respectively. As illustrated in the table below, we were in compliance with this aspect of our asset/liability management policy at December 31, 2014.

The table presented below, as of December 31, 2014 (the latest available information), is an internal analysis of our interest rate risk as measured by changes in EVE for instantaneous and sustained parallel shifts in the yield curve, in 100 basis point increments, up 300 basis points and down 100 basis points as any further decline in rates is impossible given the Federal Funds Rate of 0.25%.

As illustrated in the table below (dollars in thousands), our EVE would be negatively impacted by an increase or decrease in interest rates. Our EVE is impacted as a result of deposit accounts re-pricing more rapidly than loans and securities due to the fixed rate nature of a large portion of our loan and security portfolios. As interest rates rise, the market value of our fixed rate assets decline due to both rate increases and slowing prepayments.

December 31, 2014

Change  
in  
Interest  
Rates

in Basis Points	Economic Value of Equity			EVE Ratio %
	\$ Amount	\$ Change	% Change	
+300bp	\$45,966	\$(14,128)	(23.5 )%	10.05 %
+200bp	50,341	(9,753 )	(16.2 )	10.73
+100bp	56,344	(3,750 )	(6.2 )	11.69
0 bp	60,094	-	0.0	12.17
-100 bp	58,948	(1,146 )	(1.9 )	11.68

In addition to monitoring selected measures of EVE, management also monitors effects on net interest income resulting from increases or decrease in rates. This process is used in conjunction with EVE measures to identify excessive interest rate risk. In managing our assets/liability mix, depending on the relationship between long and short term interest rates, market conditions and consumer preference, we may place somewhat greater emphasis on maximizing its net interest margin than on strictly matching the interest rate sensitivity of its assets and liabilities. Management also believes that the increased net income which may result from an acceptable mismatch in the actual maturity or re-pricing of its asset and liability portfolios can, during periods of declining or stable interest rates, provide sufficient returns to justify the increased exposure to sudden and unexpected increases in interest rates which may result from such a mismatch. Management believes that our level of interest rate risk is acceptable under this approach.

In evaluating our exposure to interest rate movements, certain shortcomings inherent in the method of analysis presented in the foregoing table must be considered. For example, although certain assets and liabilities may have similar maturities or re-pricing periods, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in interest rates. Additionally, certain assets, such as adjustable rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed above. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. We consider all of these factors in monitoring our exposure to interest rate risk.

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Item 8. Financial Statements and Supplementary Data  
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors  
Sound Financial Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of Sound Financial Bancorp, Inc. and Subsidiary (the Company) as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sound Financial Bancorp, Inc. and Subsidiary as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Moss Adams LLP

Everett, Washington  
March 31, 2015

## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Consolidated Balance Sheets

(In thousands, except share and per share amounts)

	December 31,	
	2014	2013
<b>ASSETS</b>		
Cash and cash equivalents	\$29,289	\$15,334
Available-for-sale securities, at fair value	11,524	15,421
Loans held-for-sale	810	130
Loans	430,360	390,926
Allowance for loan losses	(4,387 )	(4,177 )
Total loans, net	425,973	386,749
Accrued interest receivable	1,497	1,366
Bank-owned life insurance, net	11,408	11,068
Other real estate owned ("OREO") and repossessed assets, net	323	1,178
Mortgage servicing rights, at fair value	3,028	2,984
Federal Home Loan Bank ("FHLB") stock, at cost	2,224	2,314
Premises and equipment, net	5,555	2,138
Other assets	3,556	3,929
Total assets	\$495,187	\$442,611
<b>LIABILITIES</b>		
Deposits		
Interest-bearing	363,456	313,745
Noninterest-bearing demand	44,353	34,594
Total deposits	407,809	348,339
Borrowings		
Accrued interest payable	76	82
Other liabilities	5,606	4,103
Advance payments from borrowers for taxes and insurance	474	362
Total liabilities	444,543	396,107
<b>COMMITMENTS AND CONTINGENCIES (NOTE 18)</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none issued or outstanding	-	-
Common stock, \$0.01 par value, 40,000,000 shares authorized, 2,524,645 and 2,510,810 issued and outstanding as of December 31, 2014 and 2013, respectively	25	25
Additional paid-in capital	23,552	23,829
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(1,140 )	(1,369 )
Retained earnings	28,024	24,288
Accumulated other comprehensive income (loss), net of tax	183	(269 )
Total stockholders' equity	50,644	46,504
Total liabilities and stockholders' equity	\$495,187	\$442,611

See notes to consolidated financial statements

## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Consolidated Statements of Income

(In thousands, except share and per share amounts)

	Years Ended December	
	31,	
	2014	2013
<b>INTEREST INCOME</b>		
Loans, including fees	\$21,143	\$19,329
Interest and dividends on investments, cash and cash equivalents	213	297
Total interest income	21,356	19,626
<b>INTEREST EXPENSE</b>		
Deposits	2,269	2,096
Borrowings	154	216
Total interest expense	2,423	2,312
Net interest income	18,933	17,314
<b>PROVISION FOR LOAN LOSSES</b>	800	1,350
Net interest income after provision for loan losses	18,133	15,964
<b>NONINTEREST INCOME</b>		
Service charges and fee income	2,571	2,270
Earnings on cash surrender value of bank-owned life insurance	340	348
Mortgage servicing income	509	457
Fair value adjustment on mortgage servicing rights	328	900
Other-than-temporary impairment losses on securities	-	(30)
Net gain on sale of loans	624	967
Total noninterest income	4,372	4,912
<b>NONINTEREST EXPENSE</b>		
Salaries and benefits	8,278	7,206
Operations	4,045	3,950
Regulatory assessments	267	326
Occupancy	1,359	1,316
Data processing	1,770	1,287
Net loss and expenses on OREO and repossessed assets	208	1,036
Total noninterest expense	15,927	15,121
Income before provision for income taxes	6,578	5,755
Provision for income taxes	2,338	1,815
Net income	\$4,240	\$3,940
Earnings per common share:		
Basic	\$1.69	\$1.52
Diluted	\$1.63	\$1.49
Weighted average number of common shares outstanding:		
Basic	2,513,069	2,570,671
Diluted	2,602,146	2,625,696

See notes to consolidated financial statements

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

	Years Ended December 31,	
	2014	2013
Net income	\$4,240	\$3,940
Available for sale securities:		
Unrealized gains arising during the year, net of taxes of \$233 and \$107, respectively	452	207
Reclassification adjustments for other-than-temporary impairment, net of taxes of \$0 and \$10, respectively	-	20
Other comprehensive income, net of tax	452	227
Comprehensive income	\$4,692	\$4,167

See notes to consolidated financial statements

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Consolidated Statements of Stockholders' Equity

(In thousands, except number of shares)

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net of tax	Total Stockholders' Equity
Balances at December 31, 2012	2,587,544	\$ 26	\$ 24,789	\$ (1,598 )	\$ 20,736	\$ (496 )	\$ 43,457
Net income					3,940		3,940
Other comprehensive income, net of tax						227	227
Share-based compensation			168				168
Restricted stock forfeited and retired	(734 )						
Cash dividends on common stock (\$0.15 per share)					(388 )		(388 )
Common stock repurchased	(76,000 )	(1 )	(1,201 )				(1,202 )
Allocation of ESOP shares			73	229			302
Balances at December 31, 2013	2,510,810	\$ 25	\$ 23,829	\$ (1,369 )	\$ 24,288	\$ (269 )	\$ 46,504

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net of tax	Total Stockholders' Equity
Balances at December 31, 2013	2,510,810	\$ 25	\$ 23,829	\$ (1,369 )	\$ 24,288	\$ (269 )	\$ 46,504
Net income					4,240		4,240
Other comprehensive income, net of tax						452	452
Share-based compensation			333				333
Restricted stock awards	45,565	-					-
Cash dividends on common stock (\$0.20 per share)					(504 )		(504 )
Common stock repurchased	(53,340 )		(904 )				(904 )
Stock options exercised	21,610		81				81
Excess tax benefits of stock compensation			39				39