GUARANTY BANCSHARES INC /TX/
Form 10-K
March 15, 2001

**FINANCIAL INFORMATION**
**2000 Annual Report on Form 10-K**


**Part I**

| | |
|---|---|
| Item 1. Business | - 4- |
| Item 2. Properties | -15- |
| Item 3. Legal Proceedings | -15- |
| Item 4. Submission of Matters to Vote of Security Holders | -15- |

**Part II**

| | |
|---|---|
| Item 5. Market for Registrant s Common Equity and Related Shareholder Matters | -16- |
| Item 6. Selected Consolidated Annual Financial Data | -17- |
| Item 7. Management s Discussion and Analysis | -19- |
| Item 7A. Quantitative and Qualitative Disclosures | -39- |
| Item 8. Financial Statements and Supplementary Data | -41- |
| Item 9. Changes and Disagreements with Accountants | -41- |

**Part III**

| | |
|---|---|
| Item 10. Directors and Executive Officers | -41- |
| Item 11. Executive Compensation | -41- |
| Item 12. Security Ownership | -41- |
| Item 13. Related Transactions | -41- |

**Part IV**

| | |
|---|---|
| Item 14. Exhibits, Financial Statement Schedules | -42- |
| Independent Auditors Report | -F-2- |
| Consolidated Balance Sheets | -F-4- |
| Consolidated Statements of Earnings | -F-5- |
| Consolidated Statements of Shareholders Equity | -F-6- |

| | |
|---|---|
| Consolidated Statements of Cash Flows | -F-7- |
| Notes to Consolidated Financial Statements | -F-8- |


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

# FORM 10-K

(Mark One)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2000
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 0-23113

GUARANTY BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

| **Texas** | **75-1656431** |
|---|---|
| (State or other jurisdiction of Identification Number) | (I.R.S.Employer incorporation or organization) |
| **100 West Arkansas Mount Pleasant, Texas** | **75455** |
| (Address of principal executive offices) | (Zip Code) |

**Registrant s telephone number, including area code:**
**(903) 572-9881**

**Securities registered pursuant to Section 12(b) of the Act: None**

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

Common Stock, par value
$1.00 per share

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

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

As of February 16, 2001, the number of outstanding shares of Common Stock was 3,037,632. As of such date, the aggregate market value of the shares of Common Stock held by non-affiliates, based on the closing price of the Common Stock on the Nasdaq National Market System on such date, was approximately $32.3 million.

**Documents Incorporated by Reference:**

Portions of the Company s Proxy Statement relating to the 2001 Annual Meeting of Shareholders, which will be filed within 120 days after December 31, 2000, are incorporated by reference into Part III, Items 10-13 of this Form 10-K.

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**PART I**

**SPECIAL CAUTIONARY NOTICE REGARDING FORWARD LOOKING INFORMATION**

Statements and financial discussion and analysis contained in this Annual Report on Form 10-K that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements describe the Company s future plans, strategies and expectations, are based on assumptions and involve a number of risks and uncertainties, many of which are beyond the Company s control. The important factors that could cause actual results to differ materially from the forward-looking statements include, without limitation:

changes in interest rates and market prices, which could reduce the Company s net interest margins, asset valuations and expense expectations;

changes in the levels of loan prepayments and the resulting effects on the value of the Company s loan portfolio;

changes in local economic and business conditions which adversely affect the Company s customers and their ability to transact profitable business with the Company, including the ability of its borrowers to repay their loans according to their terms or a change in the value of the related collateral;

increased competition for deposits and loans adversely affecting rates and terms;

the timing, impact and other uncertainties of the Company s potential future acquisitions, including the Company s ability to identify suitable future acquisition candidates, the success or failure in the integration of their operations, and the Company s ability to enter new markets successfully and capitalize on growth opportunities;

increased credit risk in the Company s assets and increased operating risk caused by a material change in commercial, consumer and/or real estate loans as a percentage of the total loan portfolio;

the failure of assumptions underlying the establishment of and provisions made to the allowance for loan losses;

changes in the availability of funds resulting in increased costs or reduced liquidity;

changes in the Company s ability to pay dividends on its Common Stock;

increased asset levels and changes in the composition of assets and the resulting impact on the Company s capital levels and regulatory capital ratios;

the Company s ability to acquire, operate and maintain cost effective and efficient systems without incurring unexpectedly difficult or expensive but necessary technological changes;

the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels;

the effects of the Internal Revenue Service s examination regarding the Company s leveraged leasing transactions; and

changes in statutes and government regulations or their interpretations applicable to bank holding companies and the Company s present and future banking and other subsidiaries, including changes in tax requirements and tax rates.



All written or oral forward-looking statements attributable to the Company are expressly qualified in their entirety by these cautionary statements.

**Item 1.** ***Business***

**General**

Guaranty Bancshares, Inc. (the Company ) was incorporated as a business corporation under the laws of the State of Texas in 1980 to serve as a holding company for Guaranty Bank (the Bank ), which was chartered in 1913, and for Talco State Bank, which was chartered in 1912 and merged into the Bank in 1997. The Company s headquarters are located at 100 West Arkansas, Mount Pleasant, Texas 75455, and its telephone number is (903) 572-9881.

The Company has grown through a combination of internal growth, the acquisition of community banks and the opening of new community banking offices. In 1992, the Company established its Deport, Texas location by acquiring certain assets and liabilities of the First National Bank of Deport (the Deport Bank ). The Deport Bank also had a branch in Paris, Texas, which the Company acquired. To enhance its expansion into the Paris community, in 1994 the Company constructed a new facility to serve as its Paris location. In 2000, the Paris facility was expanded from approximately 5,400 square feet to approximately 9,700 square feet, again to service the expanded customer base. In 1993, the Company purchased a commercial bank in Bogata, Texas and in 1996 opened a second retail-service banking facility in Mount Pleasant. In 1997, the Company merged Talco State Bank into the Bank and opened a full-service location in Texarkana. Texarkana is the center of a trade area encompassing approximately 123,000 people. Management of the Company believes that this trade area provides opportunity for strong continued growth in loans and deposits. Texas Highway 59 (scheduled to become Interstate 69), which serves as the primary NAFTA Highway linking the interior United States and Mexico, is a main artery to Texarkana. The increased traffic along this NAFTA Highway is expected to enhance economic activity in this area and create more opportunities for growth. In 1998, the Company completed a new facility in Texarkana to enhance its expansion in the Texarkana market. In 1999, the Company opened a full-service location in Pittsburg, Texas, a community of approximately 4,500 people located 12 miles from Mount Pleasant. Also in 1999, the Company acquired the First American Financial Corporation, ( First American ), with locations in Sulphur Springs and Commerce, Texas. The Company also acquired First American s wholly owned mortgage company. In 2000, the operations of the mortgage subsidiary, which were being continued by the Company under the name Guaranty Mortgage Company, were merged into the Bank. Also in August 2000, the Company was granted approval by the Texas Department of Banking to open a loan production office in Fort Stockton, Texas. In December of 2000, the Company was granted approval by the Department to operate this facility as a full service bank location.

The Company has developed a community-banking network, with most of its offices located in separate communities. Lending and investment activities are funded from a strong core deposit base consisting of more than 37,000 deposit accounts. Each of the Company s offices has the authority and flexibility to make pricing decisions within overall ranges developed by the Company as a form of quality control. Management of the Company believes that its responsiveness to local customers and ability to adjust deposit rates and price loans at each location gives it a distinct competitive advantage. Employees are committed to personal service and developing long-term customer relationships, and adequate staffing is provided at each location to ensure that customer s needs are well addressed. The Company provides economic incentives to its officers to develop additional business for the Company and to cross-sell additional products and services to existing customers.

The Company continues to look for additional expansion opportunities, either through acquisitions of existing financial institutions or by establishing de novo offices. The Company intends to consider various strategic acquisitions of banks, banking assets or financial service entities related to banking in those areas that management believes would complement and help grow the Company s existing business. The Company is particularly optimistic about the growth potential in the Texarkana, Sulphur Springs, Paris, and Mount Pleasant market area.

The Bank owns interests in four entities which complement the Company s business: (i) Guaranty Leasing Company ( Guaranty Leasing ), which finances equipment leases and has engaged in certain transactions which have resulted in the recognition of federal income tax losses deductible by the Company, (ii) GB Com, Inc., a nominee company, (iii) BSC Securities, L.C. ( BSC ), which provides brokerage services and (iv) Independent Bank Services, L.C. ( IBS ), which performs compliance, loan review, internal audit and electronic data processing audit functions.

**Business**

The Company s guiding strategy is to increase shareholder value by providing customers with individualized, responsive, quality service and to augment its existing market share. The Company s main objective is to increase loans and deposits through additional expansion opportunities in Texas, while stressing efficiency and maximizing profitability. In furtherance of this objective, the Company has employed the following operating strategies:

*Focus On Community Banking*. The Company has developed a reputation of being a premier provider of financial services to small and medium-sized businesses, professionals and individuals in Northeast Texas. Management believes the Company s reputation for providing personal, professional and dependable service is well established in communities located in this area. Each of the Company s full-service branch locations is administered by a local President with knowledge of the community and lending expertise in the specific industries found in the community, whether it is agriculture, manufacturing and commerce or professional services. Decisions regarding loans are made at each location in a timely manner. Indicative of the Company s community banking expertise, the Small Business Administration honored the Company as the top rated small business lender in the State of Texas in 1995, 1996, 1997, and 1998 even though the Company did not participate in the Small Business Administration guaranteed loan program.

*Continue Strong Core Growth*. In recent years, the Company has increased its market share in each of the communities in which it maintains a full-service banking facility. In its principal location of Mount Pleasant, the Company s market share of financial institution deposits represent approximately 45.0% for the year ended December 31, 2000. Deposits at the Paris location grew 27.9% in 1999 and 24.1% in 2000. Deposits at the Texarkana location, which opened in August of 1997, grew 95.9% in 1999, and 9.6% in 2000. Deposits at the Pittsburg location, which opened in May 1999, grew $4.5 million in 1999 and $9.5 million in 2000 representing 8.2% of the market share in Camp County. Deposits at the Sulphur Springs location represent an approximate market share of 13.4%. The Company is well known in its geographic area as a result of its longevity and reputation for service. The Company intends to grow by continuing to seek strategic acquisitions and branching opportunities.

*Enhance Technology*. The Company has embraced technological change as a way to remain competitive, manage operational costs associated with growth and offer superior products to its customers. Recent technological implementations include end-user Internet Banking, electronic bill and note payment, check imaging, credit file imaging, optical report archival and an automated voice response system. Currently, the Company is evaluating several additional enhancements that will improve its ability to deliver information internally to improve productivity and externally to provide convenience and timeliness to its growing customer base. Such enhancements include high-speed wireless communications between all locations combining data and voice traffic, and on-line account reconciliation and internal transfers. The Company has made significant investments in technology, and has become a technological leader in its market.

*Offer Competitive Products*. The Company recognizes its competition is not solely banks, but brokerage houses, insurance companies, credit unions and various other competitors, and that in order to thrive it must be competitive in the products that it offers. The Company offers a full range of commercial loan products, including term loans, lines of credit, fixed asset loans and working capital loans. The Company also offers consumers a full range of personal loan products including automobile loans, home improvement loans, consumer loans and mortgage loans. The Company also has a wide variety of deposit products, including a Premier Money Market Account that pays a rate competitive with most brokerage investment accounts and has been very attractive to customers. This product, coupled with certificates of deposit, NOW accounts, savings accounts, Internet banking, free checking, debit cards and overdraft protection, gives the customer a full compliment of deposit products at competitive rates.



*Expand Revenue Sources*. In order to provide service to its customers and to augment revenues, the Company offers brokerage and trust services. BSC is a full-service brokerage company that offers a complete array of investment options including stocks, bonds, mutual funds, financial and retirement planning, tax advantaged investments and asset allocations.

BSC offers securities through Southwest Securities; a Texas based independent clearing firm. BSC is licensed and regulated through the National Association of Securities Dealers, the Securities and Exchange Commission and various state and federal banking authorities. The Company s Trust Department offers complete trust services, including estate administration, custody, trust and asset management services. Management believes that an aging affluent population will foster an increase in the need for professional estate administration services. The maturing of the baby boomer generation is creating a market for asset management services. The Trust Department is in a unique position since there is little competition for trust services in the Company s markets. Because of the Company s strong presence in its markets, management believes that banking relationships can be leveraged into growth for the Trust Department. Growth in trust assets and corresponding management fees will result from expanding estate administration, traditional trust services, asset management services and custodial services in the Company s markets.

*Improve Operating Efficiencies*. In order to control overhead expenses, the Company seeks to provide a full range of services as effectively as possible. Through BSC, the Company is able to provide its customers with full brokerage services without having to carry the entire cost itself due to a shared cost agreement with other banks. Similarly, the Company enjoys the compliance, loan review, internal audit and electronic data processing audit functions provided by IBS on a shared cost basis with a group of other banks participating in this arrangement. The Company has spent the last nine years and considerable revenue expanding its market and improving the delivery of its financial products, which has resulted in a higher than desired efficiency ratio. Beginning with the acquisition of the Deport Bank in 1992, the Company has added nine locations. As a result, it has taken longer for the Company to achieve the desired economies of scale, but with its growth rate, those economies are beginning to be realized and the efficiency ratio is expected to show declining trends in the future. The Company has the support staff and related fixed asset investments to accommodate additional growth and enjoy additional economies of scale.

**Recent Acquisition**

In August 2000, the Bank was granted approval by the Texas Department of Banking to open a loan production office in Fort Stockton, Texas. In December 2000 the Department approved operating this facility as a full service bank location.

**Competition**

The banking business is highly competitive, and the profitability of the Company depends principally on the Company s ability to compete in the market areas in which its banking operations are located. The Company competes with other commercial banks, savings banks, savings and loan associations, credit unions, finance companies, mutual funds, insurance companies, brokerage and investment banking firms, asset-based non-bank lenders and certain other non-financial entities, including retail stores which may maintain their own credit programs and certain governmental organizations which may offer more favorable financing than the Company. The Company has been able to compete effectively with other financial institutions by emphasizing customer service, technology and local office decision-making, by establishing long-term customer relationships and building customer loyalty, and by providing products and services designed to address the specific needs of its customers. Competition from both financial and non-financial institutions is expected to continue.

Under the Gramm-Leach-Bliley Act, effective March 11, 2000, securities firms and insurance companies that elect to become financial holding companies may acquire banks and other financial institutions. The Gramm-Leach-Bliley Act may significantly change the competitive environment in which the Company and its subsidiaries conduct business. See -Supervision and Regulation The Company . The financial services industry is also likely to become even more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.



**Leveraged Lease Transactions**

In a series of transactions in 1992, 1994 and 1995, Guaranty Leasing acquired limited partnership interests in certain partnerships (collectively, the Partnerships or individually, a Partnership ) engaged in the equipment leasing business. The investments were structured by TransCapital Corporation ( TransCapital ) through various subsidiaries and controlled partnerships.

Generally, in each of the transactions the Partnership became the lessee of equipment from an equipment owner (pursuant to a sale and leaseback transaction) and the sublessor of the equipment to the equipment user. Each Partnership receives note

payments from the equipment owner under a purchase money note given to purchase the equipment from that Partnership. The Partnership makes lease payments to the equipment owner pursuant to the master lease of the equipment. In most instances, payments under the purchase money note equals lease payments under the master lease. Rental payments from the equipment used under these equipment subleases were sold in advance subject to existing liens for purchase of the equipment.

The Partnership incurs a tax loss while the master lease/sublease structure is in place; primarily because deductions for rentals paid under the master lease exceed taxable interest income under the purchase money note. Consequently, Guaranty Leasing has reported tax losses as a result of its investments in the Partnerships, which were deductible by the Company. In November 1998, Guaranty Leasing was informed by the Internal Revenue Service (the Service ) that it has taken the position that certain losses taken by a Partnership during 1994, 1995 and 1996 of $302,000, $410,000 and $447,000, respectively, would be disallowed. The Company believes that it has correctly reported these transactions for tax purposes and that it has obtained appropriate legal, accounting and appraisal opinions and authority to support its positions. The Partnership plans to appeal the Service s determination with the Service s Appellate Division. If the appeal is unsuccessful, the Partnership plans to litigate the matter in Tax Court. Any final determination with respect to the Partnership will be binding on the Company. If the Service is ultimately successful in redetermining the Partnership s tax liability, the Company s tax deductions taken in 1994, 1995 and 1996 may be disallowed and its tax liability may be adjusted, which may have a material adverse affect on the Company. The Partnership is actively contesting the position of the Service in connection with this matter, and will take appropriate steps necessary to protect its legal position.

Also, there can be no assurance that the Service will not contest, and ultimately disallow, similar types of deductions and losses taken during these and other open tax years by this Partnership or other similar Partnerships (as discussed above) in which Guaranty Leasing has ownership. If the Service were to be successful, the potential tax liability to the Company could be material to its consolidated financial statements.

During the year ended December 31, 2000, Guaranty Leasing acquired for approximately $2.8 million, a 2.5% ownership in an Aircraft Finance Trust ( AFT ), a special purpose business trust formed to acquire, finance, refinance, own, lease, sublease, sell and maintain aircraft. AFT was created by General Electric Capital Corporation, and is a financing transaction through which airlines lease aircraft. AFT is a business trust formed in 1999 under the laws of the state of Delaware, and it leases aircraft to airlines around the world. The senior notes issued to AFT are rated AA by Standard and Poors and the notes are secured by the cash flow from the aircraft leases. The notes mature in 2024. The AFT has no material impact on the financials.



**Employees**

As of December 31, 2000, the Company had 198 full-time equivalent employees, 77 of whom were officers of the Bank. The Company provides medical and hospitalization insurance to its full-time employees. The Company considers its relations with employees to be excellent.

**Supervision and Regulation**

The supervision and regulation of bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds of the Federal Deposit Insurance Corporation ( FDIC ) and the banking system as a whole, and not for the protection of the bank holding company shareholders or creditors. The banking agencies have broad enforcement power over bank holding companies and banks including the power to impose substantial fines and other penalties for violations of laws and regulations.

The following description summarizes some of the laws to which the Company and the Bank are subject. References herein to applicable statutes and regulations are brief summaries thereof, do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations.

**The Company**. The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the BHC Act ), and it is subject to supervision, regulation and examination by the Board of Governors of the Federal Reserve System ( Federal Reserve ). The BHC Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

*Regulatory Restrictions on Dividends; Source of Strength*. It is the policy of the Federal Reserve that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization s expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its banking subsidiaries.

Under Federal Reserve policy, a bank holding company is expected to act as a source of financial strength to each of its banking subsidiaries and commit resources to their support. Such support may be required at times when, absent this Federal Reserve policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

In the event of a bank holding company s bankruptcy under Chapter 11 of the U.S. Bankruptcy Code, the trustee will be deemed to have assumed and is required to cure immediately any deficit under any commitment by the debtor holding company to any of the federal banking agencies to maintain the capital of an insured depository institution, and any claim for breach of such obligation will generally have priority over most other unsecured claims.

*Financial Modernization.*Under the BHC Act, bank holding companies generally may not acquire a direct or indirect interest in or control of more than 5% of the voting shares of any company that is not a bank or bank holding company or from engaging in activities other than those of banking, managing or controlling banks or furnishing services to or performing services for its subsidiaries, except that it may engage in, directly or indirectly, certain activities that the Federal Reserve determined to be closely related to banking or managing and controlling banks as to be a proper incident thereto.

However, on November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act that eliminated the barriers to affiliations among banks, securities firms, insurance companies and other financial service providers. The Gramm-Leach-Bliley Act permits bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. No regulatory approval will be required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activity s that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve.



Under the Gramm-Leach-Bliley Act, a bank holding company may become a financial holding company by filing a declaration with the Federal Reserve if each of its subsidiary banks is well capitalized under the Federal Deposit Insurance Corporation Improvement Act ( FDICIA ) prompt corrective action provisions, is well managed, and has at least a satisfactory rating under the Community Reinvestment Act of 1977 ( CRA ). The Gramm-Leach-Bliley Act defines financial in nature to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Federal Reserve has determined to be closely related to banking.

While the Federal Reserve will serve as the umbrella regulator for financial holding companies and has the power to examine banking organizations engaged in new activities, regulation and supervision of activities which are financial in nature or determined to be incidental to such financial activities will be handled along functional lines. Accordingly, activities of subsidiaries of a financial holding company will be regulated by the agency or authorities with the most experience regulating that activity as it is conducted in a financial holding company.

*Safe and Sound Banking Practices*. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve s Regulation Y, for example, generally requires a holding company to give the Federal Reserve prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company s consolidated net worth. The Federal Reserve may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The Federal Reserve has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1.0 million for each day the activity continues.

*Anti-Tying Restrictions.*Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates.

*Capital Adequacy Requirements*. The Federal Reserve has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum total risk-based capital ratio of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2000, the Company s ratio of Tier 1 capital to total risk-weighted assets was 11.79% and its ratio of total capital to total risk-weighted assets was 12.69%. **See Management s Discussion and Analysis of Financial Condition and Results of Operations .**

In addition to the risk-based capital guidelines, the Federal Reserve uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company s Tier 1 capital divided by its average total consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of up to 200 basis points above the regulatory minimum. As of December 31, 2000, the Company s leverage ratio was 8.60%.



The federal banking agencies risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

*Imposition of Liability for Undercapitalized Subsidiaries.* Bank regulators are required to take prompt corrective action to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes undercapitalized, it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution s holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution s assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior Federal Reserve approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

*Acquisitions by Bank Holding Companies.* The BHC Act requires every bank holding company to obtain the prior approval of the Federal Reserve before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the Federal Reserve is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served, and various competitive factors.

*Control Acquisitions.* The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company unless the Federal Reserve has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any company is required to obtain the approval of the Federal Reserve under the BHC Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the outstanding Common Stock of the Company, or

otherwise obtaining control or a controlling influence over the Company.

**The Bank**. The Bank is a Texas-chartered banking association, the deposits of which are insured by the Bank Insurance Fund ( BIF ) of the FDIC. The Bank is not a member of the Federal Reserve System; therefore, the Bank is subject to supervision and regulation by the FDIC and the Texas Department of Banking ( TDB ). Such supervision and regulation subjects the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC and the TDB. Because the Federal Reserve regulates the bank holding company parent of the Bank, the Federal Reserve also has supervisory authority, which directly affects the Bank.



*Equivalence to National Bank Powers.* The Texas Constitution, as amended in 1986, provides that a Texas-chartered bank has the same rights and privileges that are or may be granted to national banks domiciled in Texas. To the extent that the Texas laws and regulations may have allowed state-chartered banks to engage in a broader range of activities than national banks, the FDICIA has operated to limit this authority. FDICIA provides that no state bank or subsidiary thereof may engage as principal in any activity not permitted for national banks, unless the institution complies with applicable capital requirements and the FDIC determines that the activity poses no significant risk to the insurance fund. In general, statutory restrictions on the activities of banks are aimed at protecting the safety and soundness of depository institutions.

*Financial Modernization.* Under the Gramm-Leach-Bliley Act, a national bank may establish a financial subsidiary and engage, subject to limitations on investment, in activities that are financial in nature, other than insurance underwriting as principal, insurance company portfolio investment, real estate development, real estate investment and annuity issuance. To do so, a bank must be well capitalized, well managed and have a CRA rating of satisfactory or better. Subsidiary banks of a financial holding company or national banks with financial subsidiaries must remain well capitalized and well managed in order to continue to engage in activities that are financial in nature without regulatory actions or restrictions, which could include divestiture of the financial in nature subsidiary or subsidiaries. In addition, a financial holding company or a bank may not acquire a company that is engaged in activities that are financial in nature unless each of the subsidiary banks of the financial holding company or the bank has a CRA rating of satisfactory or better.

Although the powers of state chartered banks with respect to engaging in financial activities are not specifically addressed in the Gramm-Leach-Bliley Act, state banks such as the Bank, will have the same if not greater powers as national banks through the parity provision contained in the Texas Constitution.

*Branching.* Texas law provides that a Texas-chartered bank can establish a branch anywhere in Texas provided that the branch is approved in advance by the TDB. The branch must also be approved by the FDIC, which considers a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate powers.

*Restrictions on Transactions With Affiliates and Insiders.* Transactions between the Bank and its nonbanking subsidiaries, including the Company, are subject to Section 23A of the Federal Reserve Act. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties, which are collateralized by the securities, or obligations of the Company or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act which generally requires that certain transactions between the Bank and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as insiders ) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution s total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

*Restrictions on Distribution of Subsidiary Bank Dividends and Assets.* Dividends paid by the Bank have provided a substantial part of the Company s operating funds and it is anticipated that dividends paid by the Bank to the Company will continue to be the Company s principal source of operating funds. Capital adequacy requirements serve to limit the amount of

dividends that may be paid by the Bank. Under federal law, the Bank cannot pay a dividend if, after paying the dividend, the Bank will be undercapitalized. The FDIC may declare a dividend payment to be unsafe and unsound even though the Bank would continue to meet its capital requirements after the dividend.



Because the Company is a legal entity separate and distinct from its subsidiaries, its right to participate in the distribution of assets of any subsidiary upon the subsidiary s liquidation or reorganization will be subject to the prior claims of the subsidiary s creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository institution holding company (such as the Company) or any shareholder or creditor thereof.

*Examinations.* The FDIC periodically examines and evaluates insured banks. Based upon such an evaluation, the FDIC may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between the FDIC-determined value and the book value of such assets. The TDB also conducts examinations of state banks but may accept the results of a federal examination in lieu of conducting an independent examination.

*Audit Reports.* Insured institutions with total assets of $500 million or more must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution s holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial statements prepared in accordance with generally accepted accounting principles, management s certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. For institutions with total assets of more than $3 billion, independent auditors may be required to review quarterly financial statements. FDICIA requires that independent audit committees be formed, consisting of outside directors only. The committees of such institutions must include members with experience in banking or financial management, must have access to outside counsel, and must not include representatives of large customers.

*Capital Adequacy Requirements.* The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk.

The FDIC s risk-based capital guidelines generally require state banks to have a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0% and a ratio of total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Bank as for the Company. As of December 31, 2000, the Bank s ratio of Tier 1 capital to total risk-weighted assets was 10.93% and its ratio of total capital to total risk-weighted assets was 11.84%. **See Management s Discussion and Analysis of Financial Condition and Results of Operations .**

The FDIC s leverage guidelines require state banks to maintain Tier 1 capital of no less than 5.0% of average total assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. The TDB has issued a policy, which generally requires state chartered banks to maintain a leverage ratio (defined in accordance with federal capital guidelines) of 6.0%. As of December 31, 2000, the Bank s ratio of Tier 1 capital to average total assets (leverage ratio) was 7.88%. **See Management s Discussion and Analysis of Financial Condition and Results of Operations .**

*Corrective Measures for Capital Deficiencies.* The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well capitalized, adequately capitalized, under capitalized, significantly under capitalized and critically under capitalized. A well capitalized bank has a total risk based capital ratio of 10.0% or higher; a Tier 1 risk based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk based capital ratio of 8.0% or higher; a Tier 1 risk based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well capitalized bank. A bank is under capitalized if it fails to meet any one of the ratios required to be adequately capitalized. The Bank is classified as well capitalized for purposes of the FDIC s prompt corrective action regulations.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment, and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution s capital decreases, the FDIC s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management, and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Management believes that the Company meets all capital adequacy requirements to which it is subject at December 31, 2000. The Bank s capital ratios exceeded the minimum requirements for well capitalized institutions under the regulatory framework for prompt corrective action at December 31, 2000. As a result, the Company does not believe that FDICIA s prompt corrective action regulations will have any material effect on the activities or operations of the Bank. It should be noted, however, that a bank s capital category is determined solely for the purpose of applying the FDIC s prompt corrective action regulations and that the capital category may not constitute an accurate representation of the Bank s overall financial condition or prospects.

*Deposit Insurance Assessments.* The Bank must pay assessments to the FDIC for federal deposit insurance protection. The FDIC has adopted a risk-based assessment system as required by FDICIA. Under this system, FDIC-insured depository institutions pay insurance premiums at rates based on their risk classification. Institutions assigned to higher-risk classifications (that is, institutions that pose a greater risk of loss to their respective deposit insurance funds) pay assessments at higher rates than institutions that pose a lower risk. An institution s risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators. In addition, the FDIC can impose special assessments in certain instances. The current range of BIF assessments is between 0% and 0.27% of deposits.

The FDIC established a process for raising or lowering all rates for insured institutions semi-annually if conditions warrant a change. Under this new system, the FDIC has the flexibility to adjust the assessment rate schedule twice a year without seeking prior public comment, but only within a range of five cents per $100 above or below the premium schedule adopted. Changes in the rate schedule outside the five-cent range above or below the current schedule can be made by the FDIC only after a full rulemaking with opportunity for public comment.

On September 30, 1996, President Clinton signed into law an act that contained a comprehensive approach to recapitalize the Savings Association Insurance Fund ( SAIF ) and assure the payment of the Financing Corporation s ( FICO ) bond obligations. Under this new act, banks insured under the BIF are required to pay a portion of the interest due on bonds that were issued by FICO to help shore up the ailing Federal Savings and Loan Insurance Corporation in 1987. The FDIC also applies an assessment against BIF-assessable deposits to be paid to the Financing Corporation ( FICO ) to assist in paying interest of FICO bonds, which financed the resolution of the thrift industry crisis. The FICO assessment is approximately 1.22 basis points, on an annual basis, on BIF-insured deposits.

*Enforcement Powers.* The FDIC and the other federal banking agencies have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or its banking subsidiaries, as well as officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties. The appropriate federal banking agency may appoint the FDIC as conservator or receiver for a banking institution (or the FDIC may appoint itself, under certain circumstances) if any one or more of a number of circumstances exist, including, without limitation, the fact that the banking institution is undercapitalized and has no reasonable prospect of becoming adequately capitalized; fails to become adequately capitalized when required to do so; fails to submit a timely and acceptable capital restoration plan; or materially fails to implement an accepted capital restoration plan. The TDB also has broad enforcement powers over the Bank, including the power to impose orders, remove officers and directors, impose fines and appoint supervisors and conservators.

-13-

*Brokered Deposit Restrictions.* Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew or roll over brokered deposits.

*Cross-Guarantee Provisions.* The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ( FIRREA ) contains a cross-guarantee provision which generally makes commonly controlled insured depository institutions liable to the FDIC for any losses incurred in connection with the failure of a commonly controlled depository institution.

*Community Reinvestment Act.* The CRA and the regulations issued there under are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank s record in meeting the needs of its service area when considering applications to establish branches, merger applications and applications to acquire the assets and assume the liabilities of another bank. FIRREA requires federal banking agencies to make public a rating of a bank s performance under the CRA. In the case of a bank holding company, the CRA performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction.

*Consumer Laws and Regulations.* In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, and the Fair Housing Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of their ongoing customer relations.

**Instability of Regulatory Structure.** Various legislation, such as the Gramm-Leach-Bliley Act, which expanded the powers of banking institutions and bank holding companies, and proposals to overhaul the bank regulatory system and limit the investments that a depository institution may make with insured funds, is from time to time introduced in Congress. Such legislation may change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways. The Company cannot determine the ultimate effect that the Gramm-Leach-Bliley Act will have or the effect that potential legislation, if enacted, or implementing regulations with respect thereto, would have, upon the financial condition or results of operations of the Company or its subsidiaries.

**Expanding Enforcement Authority.** One of the major additional burdens imposed on the banking industry by FDICIA is the increased ability of banking regulators to monitor the activities of banks and their holding companies. In addition, the Federal Reserve and FDIC are possessed of extensive authority to police unsafe or unsound practices and violations of applicable laws and regulations by depository institutions and their holding companies. For example, the FDIC may terminate the deposit insurance of any institution, which it determines has engaged in an unsafe or unsound practice. The agencies can also assess civil money penalties, issue cease and desist or removal orders, seek injunctions, and publicly disclose such actions. FDICIA, FIRREA and other laws have expanded the agencies authority in recent years, and the agencies have not yet fully tested the limits of their powers.

-14-

**Effect on Economic Environment.** The policies of regulatory authorities, including the monetary policy of the Federal Reserve, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the Federal Reserve to affect the money supply are open market operations in U.S. Government securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid for deposits.

Federal Reserve monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future. The nature of future monetary policies and the effect of such policies on the business and earnings of the Company and the Bank cannot be predicted.

**Item 2.** ***Properties***

The Company conducts business at eleven banking locations, two of which are located in Mount Pleasant, eight are located in the Northeast Texas communities of Bogata, Commerce, Deport, Paris, Pittsburg, Sulphur Springs, Talco, Texarkana and one location in the West Texas community of Fort Stockton. The Company s headquarters are located at 100 West Arkansas in Mount Pleasant in a two-story office building. The Company owns all of its locations except its Fort Stockton facility. The following table sets forth specific information on each of the Company s locations:

| Location | Address | Deposits at December 31, 2000 |
|---|---|---|
| | | (Dollars in thousands) |
| Bogata | 110 Halesboro St., Bogata, Texas 75417 | $ 14,576 |
| Commerce | 1108 Park St., Commerce, Texas 75429 | 17,100 |
| Deport | 111 Main St., Deport, Texas 75435 | 10,243 |
| Fort Stockton | # 1 Spring Drive, Fort Stockton, Texas 79735 | 0(1) |
| Mount Pleasant-Downtown | 100 W. Arkansas, Mount Pleasant, Texas 75455 | 155,953 |
| Mount Pleasant-South | 2317 S. Jefferson, Mount Pleasant, Texas 75455 | 3,551 |
| Paris | 3250 Lamar Ave., Paris, Texas 75460 | 57,937 |
| Pittsburg | 116 S. Greer Blvd., Pittsburg, Texas 75686 | 14,068 |
| Sulphur Springs | 919 Gilmer St., Sulphur Springs, Texas 75482 | 52,372 |
| Talco | 104 Broad St., Talco, Texas 75487 | 13,219 |
| Texarkana | 2202 St. Michael Dr., Texarkana, Texas 75503 | 19,246 |

(1) Opened for business as a loan production office in August 2000. Approved for branching in December 2000.

**Item 3.** ***Legal Proceedings***

Neither the Company nor the Bank is currently a party to any material legal proceeding. However, the Bank is involved in routine litigation in the normal course of its business, which, in the opinion of management, will not have a material adverse effect on the financial condition or results of operations of the Company or the Bank.

**Item 4.** ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of security holders during the fourth quarter of 2000.

**PART II**

**Item 5.** ***Market for Registrant s Common Equity and Related Shareholder Matters***

The Common Stock began trading on May 21, 1998 and is listed on the Nasdaq National Market System ( Nasdaq NMS ) under the symbol GNTY . Prior to that date, the Company s Common Stock was privately held and not listed on any public exchange or actively traded. The Company had a total of 3,250,016 shares outstanding at December 31, 2000. As of December 31, 2000, there were 418 registered shareholders of record. The number of beneficial shareholders is unknown to the Company at this time.

The following table presents the high and low Common Stock prices reported on the Nasdaq NMS by quarter during the two years ended December 31, 2000:

| | **2000** | | **1999** | |
|---|---|---|---|---|
| | **High** | **Low** | **High** | **Low** |
| Fourth quarter | $ 11.13 | $ 10.00 | $ 11.00 | $ 7.75 |
| Third quarter | 11.63 | 9.50 | 11.63 | 7.25 |
| Second quarter | 12.63 | 10.00 | 11.13 | 9.38 |
| First quarter | 10.25 | 8.75 | 10.63 | 8.75 |

Holders of Common Stock are entitled to receive dividends when, as and if declared by the Company s Board of Directors out of funds legally available therefore. While the Company has declared dividends on its Common Stock since 1980, and paid semi-annual dividends aggregating $0.25 per share per annum in 2000, there is no assurance that the Company will continue to pay dividends in the future.

The principal source of cash revenues to the Company is dividends paid by the Bank with respect to the Bank s capital stock. There are certain restrictions on the payment of such dividends imposed by federal and state banking laws, regulations and authorities. **See Management s Discussion and Analysis of Financial Condition and Results of Operations and Supervision and Regulation The Bank .**

The cash dividends paid per share by quarter were as follows:

| | **2000** | **1999** |
|---|---|---|
| Fourth quarter | $ 0.13 | $ 0.13 |
| Third quarter | | |
| Second quarter | 0.12 | 0.12 |
| First quarter | | |



***Item 6. Selected Financial Data***

**SELECTED CONSOLIDATED FINANCIAL DATA OF THE COMPANY**

The following selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements of the Company and the notes thereto, appearing elsewhere in this Annual Report on Form 10-K, and the information contained in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. The selected historical consolidated financial data as of and for the five years ended December 31, 2000 are derived from the Company s Consolidated Financial Statements, which have been audited by independent certified public accountants.

| | As of and for the Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2000** | **1999** | **1998** | **1997** | **1996** |
| | (Dollars in thousands, except per share data) | | | | |
| **Income Statement Data:** | | | | | |
| Interest income | $ 29,017 | $ 21,568 | $ 18,368 | $ 17,009 | $ 14,851 |
| Interest expense | 16,742 | 10,506 | 8,951 | 8,192 | 6,919 |
| Net interest income | 12,275 | 11,062 | 9,417 | 8,817 | 7,932 |
| Provision for loan losses | 595 | 310 | 540 | 355 | 206 |
| Net interest income after provision for loan losses | 11,680 | 10,752 | 8,877 | 8,462 | 7,726 |
| Noninterest income | 3,723 | 3,374 | 2,826 | 1,657 | 2,390 |
| Noninterest expense | 12,140 | 10,259 | 8,488 | 7,446 | 7,073 |
| Earnings before taxes | 3,263 | 3,867 | 3,215 | 2,673 | 3,043 |
| Provision for income tax expense | 755 | 745 | 541 | 273 | 165 |
| Net earnings | 2,508 | 3,122 | 2,674 | 2,400 | 2,878 |
| Preferred stock dividend | | | 37 | 74 | 74 |
| Net earnings available to common shareholders. | $ 2,508 | $ 3,122 | $ 2,637 | $ 2,326 | $ 2,804 |
| **Common Share Data:** (1) | | | | | |
| Net earnings (basic and diluted) (2) | $ 0.80 | $ 1.03 | $ 0.95 | $ 0.91 | $ 1.08 |
| Book value | 9.67 | 8.77 | 8.21 | 6.84 | 6.06 |
| Tangible book value | 8.85 | 7.81 | 8.14 | 6.74 | 5.95 |
| Cash dividends | 0.25 | 0.25 | 0.24 | 0.22 | 0.21 |
| Dividend payout ratio | 30.70% | 24.58% | 26.38% | 24.24% | 18.81% |
| Weighted average common shares outstanding | | | | | |
| (in thousands) | 3,126 | 3,045 | 2,782 | 2,547 | 2,592 |
| Period end shares outstanding (in thousands) | 3,044 | 3,232 | 2,898 | 2,548 | 2,545 |
| **Balance Sheet Data:** | | | | | |

| | As of and for the Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| Total assets | $411,031 | $370,438 | $272,906 | $244,157 | $213,932 |
| Securities | 81,620 | 79,761 | 51,367 | 58,139 | 30,382 |
| Loans | 287,335 | 255,209 | 185,886 | 157,395 | 139,289 |
| Allowance for loan losses | 2,578 | 2,491 | 1,512 | 1,129 | 1,055 |
| Total deposits | 358,265 | 328,637 | 242,325 | 222,961 | 194,855 |
| Total common shareholders equity | 29,425 | 28,496 | 23,796 | 17,426 | 15,423 |

(Table continues on next page.)



| | As of and for the Years Ended December 31 | | | | |
|---|---|---|---|---|---|
| | 2000 | 1999 | 1998 | 1997 | 1996 |
| | (Dollars in thousands, except per share data) | | | | |
| **Average Balance Sheet Data:** | | | | | |
| Total assets | $394,496 | $309,247 | $253,633 | $228,782 | $203,056 |
| Securities | 84,933 | 58,308 | 47,972 | 50,089 | 29,520 |
| Loans | 267,996 | 213,737 | 169,754 | 146,061 | 132,400 |
| Allowance for loan losses | 2,519 | 1,876 | 1,397 | 1,070 | 1,029 |
| Total deposits | 345,342 | 276,525 | 227,919 | 208,401 | 183,896 |
| Total common shareholders equity | 28,266 | 25,989 | 21,363 | 16,508 | 15,164 |
| **Performance Ratios:** | | | | | |
| Return on average assets | 0.64% | 1.01% | 1.05% | 1.05% | 1.42% |
| Return on average common equity | 8.87% | 12.01% | 12.34% | 14.09% | 18.49% |
| Net interest margin | 3.44% | 3.93% | 4.07% | 4.24% | 4.32% |
| Efficiency ratio (3) | 75.72% | 71.12% | 69.33% | 71.09% | 68.52% |
| **Asset Quality Ratios** (4): | | | | | |
| Nonperforming assets to total loans and other real estate | 1.73% | 0.43% | 0.67% | 1.22% | 1.49% |
| Net loan charge-offs to average loans | 0.19 | 0.08 | 0.09 | 0.19 | 0.12 |
| Allowance for loan losses to total loans | 0.90 | 0.98 | 0.81 | 0.72 | 0.76 |
| Allowance for loan losses to nonperforming loans (5) | 54.83 | 244.94 | 130.80 | 92.85 | 93.12 |
| **Capital Ratios** (4): | | | | | |

| | As of and for the Years Ended December 31 | | | | |
|---|---|---|---|---|---|
| Leverage ratio | 8.60% | 8.21% | 9.30% | 7.87% | 7.87% |
| Average shareholders equity to average total assets | 7.17 | 8.40 | 8.59 | 7.58 | 7.88 |
| Tier 1 risk-based capital ratio | 11.79 | 9.86 | 12.29 | 11.16 | 11.07 |
| Total risk-based capital ratio | 12.69 | 10.83 | 13.08 | 11.86 | 11.80 |

(1) Adjusted for a seven for one stock split effective March 24, 1998.

(2) Net earnings per share are based upon the weighted average number of common shares outstanding during the period.

(3) Calculated by dividing total noninterest expenses by net interest income plus noninterest income, excluding securities losses or gains.

(4) At period end, except net loan charge-offs to average loans, and average shareholders equity to average total assets.

(5) Nonperforming loans consist of nonaccrual loans, loans contractually past due 90 days or more and restructured loans.



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

Certain statements in this Annual Report on Form 10-K include forward-looking information within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, but are not limited to, the factors listed above and those described in this discussion and analysis. **See Special Cautionary Notice Regarding Forward Looking Information.** Management s Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of the Company s balance sheets and statements of earnings. This section should be read in conjunction with the Company s Consolidated Financial Statements and accompanying notes and other detailed information appearing elsewhere in this Annual Report on Form 10-K.

**Overview**

Net earnings available to common shareholders were $2.5 million, $3.1 million and $2.6 million for the years ended December 31, 2000, 1999 and 1998, respectively, and net earnings per common share were $0.80, $1.03 and $0.95 for these same periods. The decrease in earnings from 1999 to 2000 resulted primarily from an increase in interest expense caused by higher cost of funds and a growth in interest bearing liabilities and an increase in noninterest expenses offset by an increase in noninterest income. Average costing liabilities increased $77.9 million from $230.8 million in 1999 to $308.8 million in 2000. Average cost of funds were 4.55% for the twelve months ended December 31, 1999 compared to 5.42% for the same period in 2000, an increase of 19.1%. Noninterest income increased $349,000 or 10.3% from $3.4 million for the twelve months ended December 31, 1999 to $3.7 million for the same period in 2000. This increase was generated primarily from an increase in service charge income of $495,000 or 26.0% offset by a decrease in gain on sale of assets from $330,000 in 1999 to $38,000 in 2000. The increase in earnings from 1998 to 1999 resulted primarily from higher net interest income generated by a significant growth in average earning assets during the year. Average earning assets increased $50.0 million from $231.2 million in 1998 to $281.2 million in 1999. Noninterest income increased $548,000 in 1999 compared with 1998. Additional income was generated in 1999 by the sale of assets of $353,000 and an increase in service charge income of $565,000. The Company posted returns on average assets of 0.64%, 1.01% and 1.05% and returns on average common equity of 8.87%, 12.01% and 12.34% for the years ended December 31, 2000, 1999 and 1998, respectively.

Total assets at December 31, 2000, 1999 and 1998 were $411.0 million, $370.4 million and $272.9 million, respectively. Total deposits at December 31, 2000, 1999 and 1998 were $358.3 million, $328.6 million and $242.3 million, respectively. Deposits increased by $29.7 million or 9.0% in 2000 compared with fiscal 1999 and by $86.3 million or 35.6 % in 1999 compared with fiscal 1998. These increases were primarily attributable to the First American acquisition in September 1999

and the growth in public funds deposit monies, certificates of deposits, and the Premier Money Market Account. At December 31, 2000, 1999 and 1998, investment securities totaled $81.6 million, $79.8 million and $51.4 million, respectively. The increase of investment securities in 2000 was primarily attributable to the increase in unrealized gain on securities available for sale of $1.9 million from December 31, 1999 to December 31, 2000. The increase in 1999 compared with 1998 was primarily attributable to the investment of additional deposit funds and the deposits and investment securities acquired from First American. Common shareholders equity was $29.4 million, $28.5 million and $23.8 million at December 31, 2000, 1999 and 1998, respectively. The increase in common shareholder s equity for the year ended December 31, 2000 reflects earnings retention and an increase in the unrealized gain on securities available for sale offset by the purchase of treasury stock and payment of dividends.

-19-

**Results of Operation**

*Net Interest Income*

Net interest income represents the amount by which interest income on interest-earning assets, including securities and loans, exceeds interest expense incurred on interest-bearing liabilities, including deposits and other borrowed funds. Net interest income is the principal source of the Company s earnings. Interest rate fluctuations, as well as changes in the amount and type of earning assets and liabilities, combine to affect net interest income.

*2000 versus 1999.* Net interest income increased from $11.1 million in 1999 to $12.3 million in 2000, an increase of $1.2 million or 11.0%, primarily due to a growth in interest income of $7.4 million, or 34.5%, offset by an increase in interest expense of $6.2 million, or 59.4%. This resulted in net interest margins of 3.44% and 3.93% and net interest spreads of 2.72% and 3.12% for the years ended December 31, 2000 and 1999, respectively.

The increase in net interest income for 2000 was primarily due to growth in average loans of $54.3 million or 25.4% and growth in average investment securities of $26.6 million or 45.7%, which contributed $5.7 million and $2.0 million, respectively, to the increase in total interest income. Net interest income was negatively affected by lower yields on both loans and securities. The increase in interest expense was due primarily to an increase in average interest-bearing deposits of $64.0 million or 28.2%, along with an increase in cost of funds from 4.55% in 1999 to 5.42% in 2000. For the year ended December 31, 2000 the Company also had an increase in average other borrowed funds and long-term debt of $8.5 million and $5.4 million respectively.

*1999 versus 1998.* Net interest income increased from $9.4 million in 1998 to $11.1 million in 1999, an increase of $1.7 million or 17.5%, primarily due to growth in interest income of $3.2 million. This increase was partially offset by an increase in interest expense of $1.6 million. This resulted in net interest margins of 3.93% and 4.07% and net interest spreads of 3.12% and 3.18% for 1999 and 1998, respectively.

The increase in net interest income for 1999 was primarily due to growth in average loans of $44.0 million or 25.9% and growth in average investment securities of $10.3 million or 21.5%, which contributed $2.9 million and $522,000, respectively, to the increase in total interest income. Net interest income was negatively affected by lower yields on both loans and securities. The Company also decreased federal funds from an average $12.9 million in 1998 to $7.7 million in 1999, causing a decrease in federal funds interest income of $304,000.

-20-

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. No tax equivalent adjustments were made and all average balances are yearly average balances. Nonaccruing loans have been included in the tables as loans carrying a zero yield.

| | Years Ended December 31, |
|---|---|

| | Years Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2000 | | | 1999 | | | 1998 | | |
| | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Average Yield/ Rate |
| | (Dollars in thousands) | | | | | | | | |
| **Assets** | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans | $267,996 | $ 23,218 | 8.66% | $213,737 | $ 17,481 | 8.18% | $169,754 | $ 14,544 | 8.57% |
| Securities | 84,933 | 5,589 | 6.58 | 58,308 | 3,626 | 6.22 | 47,972 | 3,104 | 6.47 |
| Federal funds sold | 3,434 | 209 | 6.09 | 7,725 | 385 | 4.98 | 12,867 | 689 | 5.35 |
| Interest-bearing deposits in other financial institutions | 23 | 1 | 4.35 | 1,428 | 76 | 5.32 | 572 | 31 | 5.42 |
| Total interest-earning assets | 356,386 | 29,017 | 8.14% | 281,198 | 21,568 | 7.67% | 231,165 | 18,368 | 7.95% |
| Less allowance for loan losses | (2,519) | | | (1,876) | | | (1,397) | | |
| Total interest-earning assets, net of allowance | 353,867 | | | 279,322 | | | 229,768 | | |
| Non-earning assets: | | | | | | | | | |
| Cash and due from banks | 12,083 | | | 9,926 | | | 8,579 | | |
| Premises and equipment | 13,187 | | | 8,617 | | | 6,687 | | |
| Interest receivable and other assets | 15,066 | | | 11,230 | | | 8,209 | | |
| Other real estate owned | 293 | | | 152 | | | 390 | | |
| Total assets | $394,496 | | | $309,247 | | | $253,633 | | |
| **Liabilities and shareholders equity** | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| NOW, savings, and money market accounts | $ 97,328 | $ 4,039 | 4.15% | $ 74,898 | $ 2,569 | 3.43% | $ 59,276 | $ 2,013 | 3.40% |
| Time deposits | 193,475 | 11,291 | 5.84 | 151,924 | 7,723 | 5.08 | 127,472 | 6,913 | 5.42 |
| Total interest-bearing deposits | 290,803 | 15,330 | 5.27 | 226,822 | 10,292 | 4.54 | 186,748 | 8,926 | 4.78 |
| FHLB advances and federal funds purchased | 12,529 | 812 | 6.48 | 4,027 | 214 | 5.31 | 809 | 25 | 3.09 |
| Long-term debt | 5,423 | 600 | 11.06 | | | 0.00 | | 0.00 | |
| Total interest-bearing liabilities | 308,755 | 16,742 | 5.42% | 230,849 | 10,506 | 4.55% | 187,557 | 8,951 | 4.77% |
| Noninterest-bearing liabilities: | | | | | | | | | |
| Demand deposits | 54,539 | | | 49,702 | | | 41,171 | | |
| Accrued interest, taxes and other liabilities | 2,936 | | | 2,707 | | | 3,129 | | |
| Total liabilities | 366,230 | | | 283,258 | | | 231,857 | | |
| Shareholders equity | 28,266 | | | 25,989 | | | 21,776 | | |

| | Years Ended December 31, | | |
|---|---|---|---|
| Total liabilities and shareholders equity | $394,496 | $309,247 | $253,633 |
| Net interest income | $ 12,275 | $ 11,062 | $ 9,417 |
| Net interest spread | 2.72% | 3.12% | 3.18% |
| Net interest margin | 3.44% | 3.93% | 4.07% |

-21-

The following schedule presents the dollar amount of changes in interest income and interest expense for the major components of interest-earning assets and interest-bearing liabilities and distinguishes between the increase related to higher outstanding balances and the volatility of interest rates. For purposes of this table, changes attributable to both rate and volume, which can be segregated, have been allocated.

| | Years Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2000 vs. 1999 | | | 1999 vs. 1998 | | |
| | Increase (Decrease) Due To | | | Increase (Decrease) Due To | | |
| | Volume | Rate | Total | Volume | Rate | Total |
| | (Dollars in thousands) | | | | | |
| **Interest-earnings assets:** | | | | | | |
| Loans | $ 4,438 | $1,299 | $ 5,737 | $ 3,768 | $ (831) | $ 2,937 |
| Securities | 1,656 | 307 | 1,963 | 669 | (147) | 522 |
| Federal funds sold | (214) | 38 | (176) | (275) | (29) | (304) |
| Interest-bearing deposits in other financial institutions | (75) | | (75) | 46 | (1) | 45 |
| Total increase (decrease) in interest income | 5,805 | 1,644 | 7,449 | 4,208 | (1,008) | 3,200 |
| **Interest-bearing liabilities:** | | | | | | |
| NOW, savings and money market accounts | 769 | 701 | 1,470 | 534 | 22 | 556 |
| Time deposits | 2,112 | 1,456 | 3,568 | 1,326 | (516) | 810 |
| Other borrowed funds | 452 | 146 | 598 | 99 | 90 | 189 |
| Long-term debt | 600 | | 600 | | | |
| Total increase (decrease) in interest expense | 3,933 | 2,303 | 6,236 | 1,959 | (404) | 1,555 |
| Increase (decrease) in net interest income | $1,872 | $ (659) | $1,213 | $ 2,249 | $ (604) | $ 1,645 |

*Provision for Loan Losses*

The Company s provision for loan losses is established through charges to operating income in the form of the provision in order to bring the total allowance for loan losses to a level deemed appropriate by management of the Company based on such factors as historical experience, the volume and type of lending conducted by the Company, the amount of nonperforming assets, regulatory policies, generally accepted accounting principles, general economic conditions, and other factors related to

the collectability of loans in the Company s portfolio.

The Company s provision for loan losses during the twelve months ended December 31, 2000 was $595,000 compared with $310,000 during the twelve months ended December 31, 1999, an increase of $285,000. The increase in the provision was due in part to the growth in average loans outstanding from $213.7 million for 1999 to $268.0 million for 2000, an increase of $54.3 million or 25.4%. Good asset quality is still reflected as net charge-offs remain at manageable levels totaling $508,000, or 0.19% of average loans in 2000 compared with $177,000, or 0.08% of average loans in 1999. The Company s provision for loan losses decreased from $540,000 in 1998 to $310,000 in 1999 as a result of strong asset quality and low net charge-offs for the year.

*Noninterest Income*

Noninterest income is an important source of revenue for financial institutions. The Company s primary sources of noninterest income are service charges on deposit accounts and other banking service related fees. Noninterest income for the year ended December 31, 2000 was $3.7 million, an increase of $349,000 from $3.4 million in 1999 and up from $2.8 million in 1998. The year ended December 31, 2000 reflected an increase in service charge income of $495,000 over the same period 1999 and $1.1 million over the same period 1998, representing a 26.0% and a 79.3% increase respectively. This results in annual percentage increases of 10.3% and 31.7% for the years ended December 31, 2000 and 1999, respectively.

-22-

The following table presents for the periods indicated the major categories of noninterest income:

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2000** | **1999** | **1998** |
| | (Dollars in thousands) | | |
| Service charges | $ 2,396 | $1,901 | $ 1,336 |
| Fee income | 663 | 518 | 434 |
| Net realized (loss) gain on securities transactions | (34) | 11 | 81 |
| Fiduciary income | 109 | 63 | 46 |
| Earnings from key-man life insurance | 234 | 192 | 89 |
| Gain on sale of loans | | | 674 |
| Gain (loss) on sale of assets | 38 | 330 | (23) |
| Other noninterest income | 317 | 359 | 189 |
| Total noninterest income | $ 3,723 | $3,374 | $ 2,826 |

The increase in noninterest income from 1999 to 2000 resulted primarily from service charges and fee income due to an increase in the number of deposit accounts. Additionally, the Company s increased emphasis on fee-based services resulted in greater income from check cashing, ATM fees, appraisal fees and wire transfer fees.

*Noninterest Expense*

For the years ended December 31, 2000, 1999 and 1998, noninterest expense totaled $12.1 million, $10.3 million and $8.5 million, respectively. The $1.9 million, or 18.3% increase in 2000 was primarily the result of additional operating expenses incurred in connection with the addition of the Sulphur Springs and Commerce locations acquired from First American in September 1999. These new locations as well as customer growth in various other markets contributed to the increase in employee compensation and benefits as the Company s average full-time equivalent employees grew from 158 at December 31, 1999 to 192 at December 31, 2000. Employee compensation and benefits increased from $5.7 million in 1999 to $6.8 million in 2000, an increase of $1.1 million or 19.9%. In addition, bank premises and fixed asset expense increased from $1.4 million to $1.8 million, an increase of $353,000 or 25.1%. Advertising expense increased from $231,000 in 1999 to $357,000 in 2000, an increase of $126,000 or 54.5% primarily due to the Company retaining an ad agency to enhance advertising campaigns. Legal

and professional fees increased $59,000 or 11.8% due to independent loan review expenses and additional bankruptcy and litigation proceedings relating to loan customers.

The increase in total noninterest expense for 1999 over 1998 of $1.8 million or 20.9% was primarily the result of the additional operating expenses incurred at the new Pittsburg, Texas location, which opened in May 1999 and in connection with the addition of the Sulphur Springs, and Commerce locations acquired from First American in September 1999. The Company s efficiency ratios, calculated by dividing total noninterest expenses (excluding securities losses) by net interest income plus noninterest income, were 75.72% in 2000, 71.12% in 1999 and 69.33% in 1998.

-23-

The following table presents for the periods indicated the major categories of noninterest expense:

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2000** | **1999** | **1998** |
| | (Dollars in thousands) | | |
| Employee compensation and benefits | $ 6,791 | $ 5,666 | $ 4,458 |
| Non-staff expenses: | | | |
| Net bank premises and fixed asset expense | 1,758 | 1,405 | 1,206 |
| Office and computer supplies | 357 | 309 | 280 |
| Legal and professional fees | 558 | 499 | 392 |
| Advertising | 357 | 231 | 254 |
| Postage | 156 | 140 | 132 |
| FDIC insurance | 67 | 33 | 26 |
| Other | 2,096 | 1,976 | 1,740 |
| Total non-staff expenses | 5,349 | 4,593 | 4,030 |
| Total noninterest expense | $12,140 | $10,259 | $ 8,488 |

*Income Taxes*

Federal income tax is reported as income tax expense and is influenced by the amount of taxable income, the amount of tax-exempt income, the amount of non-deductible interest expense and the amount of other non-deductible expense. The Company utilized tax benefits on leveraged lease transactions in the amounts of $650,000, $423,000 and $430,000 for the years ended December 31, 2000, 1999 and 1998, respectively. The effective tax rates for the years ended December 31, 2000, 1999 and 1998 were 23.14%, 19.27% and 16.83%, respectively. Income taxes for financial purposes in the consolidated statements of earnings differ from the amount computed by applying the statutory income tax rate of 34% to earnings before income taxes. The difference in the statutory rate is primarily due to the tax benefits on the leveraged lease transactions and non-taxable income.

Additionally, the State of Texas imposes a Texas franchise tax. Taxable income for the income tax component of the Texas franchise tax is the federal pre-tax income, plus certain officers salaries, less interest income from federal securities. Total franchise tax expense was $56,000 in 2000, $40,000 in 1999 and $52,000 in 1998 for each of the twelve month periods ended December 31. Such expense was included as a part of other noninterest expense.

*Impact of Inflation*

The effects of inflation on the local economy and on the Company s operating results have been relatively modest for the past several years. Since substantially all of the Company s assets and liabilities are monetary in nature, such as cash, securities, loans and deposits, their values are less sensitive to the effects of inflation than to changing interest rates, which do not necessarily change in accordance with inflation rates. The Company tries to control the impact of interest rate fluctuations by managing the relationship between its interest rate sensitive assets and liabilities. See **Quantitative and Qualitative Disclosures About Market Risk** below.

**Financial Condition**

*Loan Portfolio*

The Company provides a broad range of commercial, real estate and consumer loan products to small and medium-sized businesses and individuals. The Company aggressively pursues qualified lending customers in both the commercial and consumer sectors, providing customers with direct access to lending personnel and prompt, professional service. The 80.2% loan to deposit ratio as of December 31, 2000, reflects the Company s commitment as an active lender in the local business communities it serves. Total loans were $287.3 million at December 31, 2000, an increase of $32.1 million or 12.6% compared with $255.2 million at December 31, 1999. In 1999, total loans increased by $69.3 million or 37.3% to $255.2 million from $185.9 million at December 31, 1998. In 1998, total loans increased by $28.5 million or 18.1% from $157.4 million at December 31, 1997. The growth in loans reflects the improving local economy, an aggressive advertising campaign, the Company s pro-lending reputation and the solicitation of new companies and individuals entering the Company s market areas.

The following table summarizes the loan portfolio of the Company by type of loan as of the dates indicated:

| | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | | 1999 | | 1998 | | 1997 | | 1996 | |
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | | | | | | | |
| Commercial and industrial | $ 66,616 | 23.18% | $ 61,153 | 23.96% | $ 51,589 | 27.75% | $ 36,598 | 23.26% | $ 29,412 | 21.11% |
| Agriculture | 8,318 | 2.89 | 9,102 | 3.57 | 7,652 | 4.11 | 8,174 | 5.19 | 7,159 | 5.14 |
| Real estate: | | | | | | | | | | |
| Construction and land development | 7,316 | 2.55 | 7,926 | 3.11 | 3,130 | 1.68 | 3,072 | 1.95 | 2,292 | 1.65 |
| 1-4 family residential | 102,614 | 35.71 | 83,777 | 32.83 | 48,376 | 26.02 | 41,398 | 26.30 | 36,967 | 26.54 |
| Farmland | 7,716 | 2.69 | 7,976 | 3.13 | 7,258 | 3.90 | 6,492 | 4.12 | 6,685 | 4.80 |
| Non-residential and non-farmland | 61,224 | 21.31 | 52,303 | 20.49 | 47,977 | 25.81 | 42,363 | 26.92 | 36,460 | 26.18 |
| Multi-family residential | 4,946 | 1.72 | 6,239 | 2.44 | 844 | 0.45 | 360 | 0.23 | 535 | 0.38 |
| Consumer | 28,585 | 9.95 | 26,733 | 10.47 | 19,060 | 10.28 | 18,938 | 12.03 | 19,779 | 14.20 |
| Total loans | $287,335 | 100.00% | $255,209 | 100.00% | $185,886 | 100.00% | $157,395 | 100.00% | $139,289 | 100.00% |

The primary lending focus of the Company is on loans to small and medium-sized businesses and one to four family residential mortgage loans. The Company s commercial lending products include business loans, commercial real estate loans, equipment loans, working capital loans, term loans, revolving lines of credit and letters of credit. Most commercial loans are collateralized and on payment programs. The purpose of a particular loan generally determines its structure. In almost all cases, the Company requires personal guarantees on commercial loans to help assure repayment.

The Company s commercial mortgage loans are generally secured by first liens on real estate, typically have fixed interest rates and amortize over a 10 to 15 year period with balloon payments due at the end of one to five years. In underwriting commercial mortgage loans, consideration is given to the property s operating history, future operating projections, current and projected occupancy, location and physical condition. The underwriting analysis also includes credit checks, appraisals and a review of the financial condition of the borrower.

The Company makes loans to finance the construction of residential and, to a limited extent, nonresidential properties. Construction loans generally are secured by first liens on real estate. The Company conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described above are also used in the Company s construction lending activities. In keeping with the community-oriented nature of its customer base, the Company provides construction and permanent financing for churches located within its market area.



The Company rarely makes loans at its legal lending limit. Lending officers are assigned various levels of loan approval authority based upon their respective levels of experience and expertise. Loans above $600,000 are evaluated and acted upon by the Executive Committee, which meets weekly and are reported to the Board of Directors. The Company s strategy for approving or disapproving loans is to follow conservative loan policies and underwriting practices which include: (i) granting loans on a sound and collectible basis; (ii) investing funds properly for the benefit of shareholders and the protection of depositors; (iii) serving the legitimate needs of the community and the Company s general market area while obtaining a balance between maximum yield and minimum risk; (iv) ensuring that primary and secondary sources of repayment are adequate in relation to the amount of the loan; (v) developing and maintaining adequate diversification of the loan portfolio as a whole and of the loans within each category; and (vi) ensuring that each loan is properly documented and, if appropriate, insurance coverage is adequate. The Company s loan review and compliance personnel interact daily with commercial and consumer lenders to identify potential underwriting or technical exception variances. In addition, the Company has placed increased emphasis on the early identification of problem loans to aggressively seek resolution of the situations and thereby keep loan losses at a minimum. Management believes that this strict adherence to conservative loan policy guidelines has contributed to the Company s below average level of loan losses compared to its industry peer group over the past few years.

The Company s loans collateralized by one to four family residential real estate generally are originated in amounts of no more than 90% of the lower of cost or appraised value. The Company requires mortgage title insurance and hazard insurance in the amount of the loan. Of the mortgages originated, the Company generally retains mortgage loans with short terms or variable rates and sells longer-term fixed-rate loans that do not meet the Company s credit underwriting standards. Prior to the acquisition of First American, the Company sold such loans to Texas Independent Bank Mortgage Company, however, since the First American acquisition, the Company sells these loans directly into the secondary market.

As of December 31, 2000, the Company s one to four family residential real estate loan portfolio was $102.6 million. Of this amount, $37.9 million is repriceable in one year or less and an additional $46.8 million is repriceable from one year to five years. These high percentages in short-term real estate loans reflect the Company s commitment to reducing interest rate risk.

The Company provides a wide variety of consumer loans including motor vehicle, watercraft, education loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 72 months and vary based upon the nature of collateral and size of loan. As of December 31, 2000, the Company had no indirect consumer loans, indicating a preference to maintain personal banking relationships and strict underwriting standards. During the last two years, management has placed tighter controls on consumer credit due to record high personal bankruptcy filings nationwide.

The contractual maturity ranges of the commercial, industrial and real estate construction loan portfolio and the amount of such loans with predetermined interest rates in each maturity range as of December 31, 2000, are summarized in the following table:

| | December 31, 2000 | | | |
|---|---|---|---|---|
| | **One Year or Less** | **After One Through Five Years** | **After Five Years** | **Total** |
| | (Dollars in thousands) | | | |
| Commercial and industrial | $ 40,201 | $ 27,168 | $ 6,312 | $ 73,681 |
| Real estate construction | 6,681 | 635 | | 7,316 |
| Total | $ 46,882 | $ 27,803 | $ 6,312 | $ 80,997 |

| | December 31, 2000 | | | |
|---|---|---|---|---|
| | | | | |
| Loans with a predetermined interest rate | $ 42,497 | $ 13,995 | $ 462 | $ 56,954 |
| Loans with a floating interest rate | 24,043 | | | 24,043 |
| Total | $ 66,540 | $ 13,995 | $ 462 | $ 80,997 |



*Nonperforming Assets*

The Company has several procedures in place to assist it in maintaining the overall quality of its loan portfolio. The Company has established underwriting guidelines to be followed by its officers and also monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company s loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

Nonperforming assets at December 31, 2000, increased 354.0% to $5.0 million compared with $1.1 million at December 31, 1999. This increase was primarily due to the addition of six credits to nonperforming assets in the fourth quarter of 2000. Minimal losses are anticipated on these credits due to strong collateral values. Nonperforming assets were $1.3 million at December 31, 1998. This resulted in ratios of nonperforming assets to total loans plus other real estate of 1.73%, 0.43% and 0.67% for the years ended December 31, 2000, 1999 and 1998, respectively.

The Company generally places a loan on nonaccrual status and ceases to accrue interest when loan payment performance is deemed unsatisfactory. Loans where the interest payments jeopardize the collection of principal are placed on nonaccrual status, unless the loan is both well secured and in the process of collection. Cash payments received while a loan is classified as nonaccrual is recorded as a reduction of principal as long as doubt exists as to collection. The Company is sometimes required to revise a loan s interest rate or repayment terms in a troubled debt restructuring, however, the Company had no restructured loans at either December 31, 2000, December 31, 1999 or December 31, 1998. In addition to an internal loan review, the Company retains IBS for an annual external review to evaluate the loan portfolio.

The Company maintains current appraisals on loans secured by real estate, particularly those categorized as nonperforming loans and potential problem loans. In instances where updated appraisals reflect reduced collateral values, an evaluation of the borrower s overall financial condition is made to determine the need, if any, for possible write-downs or appropriate additions to the allowance for loan losses. The Company records other real estate at fair value at the time of acquisition, less estimated costs to sell.

The following table presents information regarding nonperforming assets at the dates indicated:

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 2000 | 1999 | 1998 | 1997 | 1996 |
| | (Dollars in thousands) | | | | |
| Nonaccrual loans | $ 1,214 | $ 443 | $ 290 | $ 298 | $ 722 |
| Accruing loans past due 90 days or more | 3,488 | 574 | 866 | 918 | 411 |
| Other real estate | 274 | 79 | 97 | 714 | 953 |
| Total nonperforming assets | $ 4,976 | $ 1,096 | $ 1,253 | $ 1,930 | $ 2,086 |
| Nonperforming assets to total loans and other real estate | 1.73% | 0.43% | 0.67% | 1.22% | 1.49% |

The Company has adopted Statement of Financial Accounting Standards ( SFAS ) No. 114, *Accounting by Creditors for Impairment of a Loan,* as amended by SFAS No. 118, *Accounting for Creditors for Impairment of a Loan- Income Recognition and Disclosures.* Under SFAS No. 114, as amended, a loan is considered impaired based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is based on the present value of expected future cash flows discounted at the loan s effective interest rate or the loan s observable market price or based on the fair value of the collateral if the loan is collateral-dependent. The implementation of SFAS No. 114 did not have a material adverse affect on the Company s financial statements.



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*Allowance for Loan Losses*

The allowance for loan losses is a reserve established through charges to earnings in the form of a provision for loan losses. Management has established an allowance for loan losses, which it believes, is adequate for estimated losses in the Company s loan portfolio. Based on an evaluation of the loan portfolio, management presents a quarterly review of the allowance for loan losses to the Company s Board of Directors, indicating any change in the allowance since the last review and any recommendations as to adjustments in the allowance. In making its evaluation, management considers the diversification by industry of the Company s commercial loan portfolio, the effect of changes in the local real estate market on collateral values, the results of recent regulatory examinations, the effects on the loan portfolio of current economic indicators and their probable impact on borrowers, the amount of charge-offs for the period, the amount of nonperforming loans and related collateral security, the evaluation of its loan portfolio through an annual external loan review conducted by IBS and the annual examination of the Company s financial statements by its independent auditors. Charge-offs occur when loans are deemed to be uncollectible.

The Company follows an internal loan review program to evaluate the credit risk in the loan portfolio. In addition, the Company contracts with IBS to annually perform an external loan review. Through the loan review process, the Company maintains an internally classified loan list, which, along with the delinquency list of loans, helps management assess the overall quality of the loan portfolio and the adequacy of the allowance for loan losses. Loans internally classified as substandard or in the more severe categories of doubtful or loss are those loans that at a minimum have clear and defined weaknesses such as a highly-leveraged position, unfavorable financial ratios, uncertain repayment sources or poor financial condition, which may jeopardize recoverability of the debt. At December 31, 2000, the Company had $9.6 million of such loans compared with $7.5 million at December 31, 1999, a 28.0% increase. This increase is due primarily to the classification of two credits of approximately $1.6 million in loans as substandard during the fourth quarter 2000. These classifications were made due to cash flow deficiencies in these lines of credits and are not expected to remain classified as substandard for an extended period of time.

In addition to the internally classified loan list and delinquency list of loans, the Company maintains a separate watch list which further aids the Company in monitoring loan portfolios. Watch list loans show warning elements where the present status portrays one or more deficiencies that require attention in the short term or where pertinent ratios of the loan account have weakened to a point where more frequent monitoring is warranted. These loans do not have all of the characteristics of a classified loan (substandard or doubtful) but do show weakened elements as compared with those of a satisfactory credit. The Company reviews these loans to assist in assessing the adequacy of the allowance for loan losses. At December 31, 2000, the Company had $2.2 million of such loans compared with $3.0 million at December 31, 1999, a 26.7% decrease.

In order to determine the adequacy of the allowance for loan losses, management considers the risk classification or delinquency status of loans and other factors, such as collateral value, portfolio composition, trends in economic conditions and the financial strength of borrowers. Management establishes specific allowances for loans which management believes require reserves greater than those allocated according to their classification or delinquent status. A general reserve allocation is also established primarily based on the Company s historical charge-off experience. The Company then charges to operations a provision for loan losses to maintain the allowance for loan losses at an adequate level determined by the foregoing methodology.

Management actively monitors the Company s asset quality and provides specific loss allowances when necessary. Loans are charged-off against the allowance for loan losses when appropriate. Although management believes it uses the best information available to make determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the initial determinations.

For the twelve months ended December 31, 2000, net loan charge-offs totaled $508,000 or 0.19% of average loans outstanding for the period, compared with $177,000 in net loan charge-offs or 0.08% of average loans for the year ended December 31, 1999. During 2000, the Company recorded a provision for loan losses of $595,000 compared with $310,000 for 1999. The increase in the provision for 2000 is due primarily to the additional net charge-off loans for the year of $331,000 and the increase in nonperforming loans during the year from $1.1 million at December 31, 1999 to $5.0 million at December 31, 2000. The Company made a provision for loan losses of $540,000 for 1998. At December 31, 2000, the allowance for loan losses totaled $2.6 million, or 0.90% of total loans. At December 31, 1999, the allowance for loan losses totaled $2.5 million or 0.98% of total loans.

-28-

The following table presents, for the periods indicated, an analysis of the allowance for loan losses and other related data:

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2000 | 1999 | 1998 | 1997 | 1996 |
| | (Dollars in thousands) | | | | |
| Average loans outstanding | $ 267,996 | $ 213,737 | $ 169,754 | $ 146,061 | $ 132,400 |
| Gross loans outstanding at end of period | $ 287,335 | $ 255,209 | $ 185,886 | $ 157,395 | $ 139,289 |
| Allowance for loan losses at beginning of period | $ 2,491 | $ 1,512 | $ 1,129 | $ 1,055 | $ 1,005 |
| Provision for loan losses | 595 | 310 | 540 | 355 | 206 |
| Balance acquired with First American acquisition | | 846 | | | |
| Charge-offs: | | | | | |
| Commercial and industrial | (360) | (64) | (113) | (53) | (116) |
| Real estate | (146) | (2) | (14) | (170) | (66) |
| Consumer | (172) | (267) | (149) | (162) | (101) |
| Recoveries: | | | | | |
| Commercial and industrial | 80 | 65 | 33 | 65 | 65 |
| Real estate | 11 | 42 | 26 | 13 | 23 |
| Consumer | 79 | 49 | 60 | 26 | 39 |
| Net loan charge-offs | (508) | (177) | (157) | (281) | (156) |
| Allowance for loan losses at end of period | $ 2,578 | $ 2,491 | $ 1,512 | $ 1,129 | $ 1,055 |
| Ratio of allowance to end of period loans | 0.90% | 0.98% | 0.81% | 0.72% | 0.76% |
| Ratio of net loan charge-offs to average loans | 0.19% | 0.08% | 0.09% | 0.19% | 0.12% |
| Ratio of allowance to end of period nonperforming loans | 54.83% | 244.94% | 130.80% | 92.85% | 93.12% |

The following tables describe the allocation of the allowance for loan losses among various categories of loans and certain other information for the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of loans.

| | December 31, | | | |
|---|---|---|---|---|
| | 2000 | | 1999 | |
| | Amount | Percent of Loans to Total Loans | Amount | Percent of Loans to Total Loans |
| | (Dollars in thousands) | | | |
| Balance of allowance for loan losses applicable to: | | | | |
| Commercial, industrial and agriculture | $ 1,430 | 26.07% | $ 1,543 | 27.53% |
| Real estate: | | | | |
| Construction and land development | | 2.55 | | 3.11 |
| 1-4 family residential | 139 | 35.71 | 110 | 32.83 |
| Commercial mortgage | 193 | 21.31 | 176 | 20.49 |
| Farmland | | 2.69 | | 3.13 |
| Multi-family | | 1.72 | | 2.44 |
| Consumer | 289 | 9.95 | 262 | 10.47 |
| General reserve allocation | 527 | | 400 | |
| Total allowance for loan losses | $ 2,578 | 100.00% | $ 2,491 | 100.00% |

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1998 | | 1997 | | 1996 | |
| | Amount | Percent of Loans to Total Loans | Amount | Percent of Loans to Total Loans | Amount | Percent of Loans to Total Loans |
| | (Dollars in thousands) | | | | | |
| Balance of allowance for loan losses applicable to: | | | | | | |

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| Commercial, industrial and agriculture | $ 932 | 31.86% | $ 554 | 28.45% | $ 501 | 26.25% |
| Real estate: | | | | | | |
| Construction and land development | | 1.68 | | 1.95 | | 1.65 |
| 1-4 family residential | 67 | 26.02 | 58 | 26.30 | 86 | 26.54 |
| Commercial mortgage | 145 | 25.81 | 128 | 26.92 | 91 | 26.18 |
| Farmland | | 3.90 | | 4.12 | | 4.80 |
| Multi-family | | 0.45 | | 0.23 | | 0.38 |
| Consumer | 166 | 10.28 | 171 | 12.03 | 128 | 14.20 |
| General reserve allocation | 202 | | 218 | | 249 | |
| Total allowance for loan | $ 1,512 | 100.00% | $ 1,129 | 100.00% | $ 1,055 | 100.00% |

-30-

*Securities*

The Company uses its securities portfolio to ensure liquidity for cash requirements, to manage interest rate risk, to provide a source of income, to ensure collateral is available for municipal pledging requirements and to manage asset quality. At December 31, 2000, investment securities totaled $81.6 million, an increase of $1.9 million from $79.8 million at December 31, 1999. The increase was primarily attributable to the change in unrealized gain or loss on securities available for sale. The December 31, 1999 unrealized loss was $1.2 million compared to the December 31, 2000 unrealized gain of $700,000. During 1999, securities increased approximately $28.4 million from $51.4 million at December 31, 1998 to $79.8 million at December 31, 1999. The increase was primarily attributable to the investment of additional funds both internally generated and acquired with the First American acquisition. At December 31, 2000, investment securities represented 19.9% of total assets compared to 21.5% of total assets at December 31, 1999. The yield on the investment portfolio for the year ended December 31, 2000, was 6.58% compared to a yield of 6.22% for the year ended December 31, 1999.

During 2000, the securities portfolio mix remained steady with the exception of a decrease in mortgage-backed securities from $31.6 million at December 31, 1999 to $26.5 million at December 31, 2000 and an increase in state and municipal securities of $5.3 million during the same time period. The Company continues to hold collateralized mortgage obligations ( CMOs ) in its securities portfolio. A CMO is collateralized directly by mortgages or by mortgage-backed securities issued by government agencies. These changes in the securities portfolio were made in order to obtain higher yielding securities with more defined cash flows and shorter average lives.

The following table summarizes the amortized cost of investment securities held by the Company as of the dates shown:

| | December 31, | | |
|---|---|---|---|
| | 2000 | 1999 | 1998 |
| | (Dollars in thousands) | | |
| U.S. Treasury securities | $ | $ 993 | $ 3,115 |

| | December 31, | | |
|---|---|---|---|
| U.S. Government securities | 25,900 | 25,859 | 27,114 |
| Mortgage-backed securities | 26,482 | 31,610 | 17,884 |
| CMOs | 17,973 | 17,451 | |
| Equity securities | 1,705 | 1,420 | 1,092 |
| State and municipal securities | 8,860 | 3,602 | 1,825 |
| Total securities | $ 80,920 | $ 80,935 | $ 51,030 |

The following table summarizes the contractual maturity of investment securities on an amortized cost basis and their weighted average yields as of December 31, 2000:

| | December 31, 2000 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Within One Year | | After One Year but Within Five Years | | After Five Years but Within Ten Years | | After Ten Years | | Total | |
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| | (Dollars in thousands) | | | | | | | | | |
| U.S. Treasury securities | $ | % | $ | % | $ | % | $ | % | $ | % |
| U.S. Government securities | | | 22,892 | 6.41 | 3,008 | 6.81 | | | 25,900 | 6.46 |
| Mortgage-backed securities | 10 | 8.27 | 6,393 | 6.23 | 5,833 | 6.67 | 14,246 | 6.97 | 26,482 | 6.72 |
| CMOs | | | | | 4,060 | 6.64 | 13,913 | 6.74 | 17,973 | 6.72 |
| Equity securities | | | | | | | 1,705 | 6.02 | 1,705 | 6.02 |
| State and municipal securities | 40 | 7.72 | 605 | 7.40 | 3,836 | 6.86 | 4,379 | 7.79 | 8,860 | 7.36 |
| Totals | $ 50 | 7.83% | $ 29,890 | 6.39% | $ 16,737 | 6.73% | $ 34,243 | 6.93% | $ 80,920 | 6.70% |



The Company accounts for securities according to SFAS No.115, *Accounting for Certain Investments in Debt and Equity Securities.* At the date of purchase, the Company is required to classify debt and equity securities into one of three categories: held-to-maturity, trading or available-for-sale. At each reporting date, the appropriateness of the classification is reassessed. Investments in debt securities are classified as held-to-maturity and measured at amortized cost in the financial statements only if management has the positive intent and ability to hold those securities to maturity. Securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and measured at fair value in the financial statements with unrealized gains and losses included in earnings. Investments not classified as either held-to-maturity or trading are classified as available-for-sale and measured at fair value in the financial statements with unrealized gains and losses reported, net of tax, in a separate component of shareholders equity until realized.

The following table summarizes the carrying value and classification of securities as of the dates shown:

| | December 31, | | |
|---|---|---|---|
| | 2000 | 1999 | 1998 |
| | (Dollars in thousands) | | |
| Available-for-sale | $ 81,620 | $ 79,761 | $ 44,305 |
| Held-to-maturity | | | 7,062 |

| | December 31, | | |
|---|---|---|---|
| Total securities | $ 81,620 | $ 79,761 | $ 51,367 |

The following tables summarizes the amortized cost of securities classified as available-for-sale and their approximate fair values as of the dates shown:

| | December 31, 2000 | | | | December 31, 1999 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value |
| | (Dollars in thousands) | | | | (Dollars in thousands) | | | |
| U.S. Treasury securities | $ | $ | $ | $ | $ 993 | $ | $ 6 | $ 987 |
| U.S. Government securities | 25,900 | 370 | 86 | 26,184 | 25,859 | 6 | 649 | 25,216 |
| Mortgage-backed securities | 26,482 | 200 | 80 | 26,602 | 31,610 | 35 | 388 | 31,257 |
| CMOs | 17,973 | 83 | 14 | 18,042 | 17,451 | 55 | 141 | 17,365 |
| Equity securities | 1,705 | | | 1,705 | 1,420 | | | 1,420 |
| State and municipal securities | 8,860 | 251 | 24 | 9,087 | 3,602 | 13 | 99 | 3,516 |
| Total | $ 80,920 | $ 904 | $ 204 | $ 81,620 | $ 80,935 | $ 109 | $ 1,283 | $ 79,761 |

| | December 31, 1998 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value |
| | (Dollars in thousands) | | | |
| U.S. Treasury securities | $ 3,015 | $ 29 | $ | $ 3,044 |
| U.S. Government securities | 27,114 | 241 | 5 | 27,350 |
| Mortgage-backed securities | 12,747 | 77 | 5 | 12,819 |
| CMOs | | | | |
| Equity securities | 1,092 | | | 1,092 |
| State and municipal securities | | | | |
| Total | $ 43,968 | $ 347 | $ 10 | $ 44,305 |

The following tables summarizes the amortized cost of securities classified as held-to-maturity and their approximate fair values as of the dates shown:

| | December 31, 2000 | | | | December 31, 1999 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value |
| | (Dollars in thousands) | | | | | | | |
| U.S. Treasury securities | | | | | | | | |
| U.S. Government securities. | | | | | | | | |
| Mortgage-backed securities | | | | | | | | |
| CMOs | | | | | | | | |
| State and municipal securities | | | | | | | | |
| Total | | | | | | | | |

*Note: All securities were available for sale at December 31, 2000 and 1999.*

| | December 31, 1998 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Loss | Fair Value |
| | (Dollars in thousands) | | | |
| U.S. Treasury securities | $ 100 | $ 1 | $ 0 | $ 101 |
| U.S. Government securities | | | | |
| Mortgage-backed securities | 5,137 | 74 | 2 | 5,209 |
| CMOs | | | | |
| State and municipal securities | 1,825 | 65 | 4 | 1,886 |
| Total | $ 7,062 | $ 140 | $ 6 | $ 7,196 |

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 — Basis of Presentation

On June 6, 2013, the Board of Directors of Lamplighter Financial, MHC ("MHC") and the Board of Directors of Waterstone Financial, Inc., a federal corporation, ("Waterstone-Federal") adopted a Plan of Conversion and Reorganization (the "Plan"). Pursuant to the Plan, Waterstone Financial, Inc., a Maryland corporation, ("New Waterstone") was organized and the MHC converted from the mutual holding company form of organization to the fully public form on January 22, 2014. As part of the conversion, the MHC's ownership interest of Waterstone-Federal was offered for sale in a public offering. A total of 25,300,000 shares were sold in the offering at a price $10.00 per share, resulting in gross proceeds of $253.0 million. Expenses related to the offering totaled approximately $4.7

million. The existing publicly held shares of Waterstone-Federal were exchanged for new shares of common stock of New Waterstone at a conversion ratio of 1.0973-to-one. The exchange ratio ensured that immediately after the conversion and public offering, the public shareholders of Waterstone-Federal owned the same aggregate percentage of New Waterstone common stock that they owned immediately prior to that time (excluding shares purchased in the stock offering and cash received in lieu of fractional shares). When the conversion and public offering was completed, New Waterstone became the holding company of WaterStone Bank SSB and succeeded to all of the business and operations of Waterstone-Federal and each of Waterstone-Federal and Lamplighter Financial, MHC ceased to exist. Approximately 34,405,458 shares of New Waterstone common stock were outstanding after the completion of the offering and exchange. The words "Waterstone Financial," "we" and "our" thus are intended to refer to Waterstone-Federal and its subsidiaries with respect to matters and time periods occurring on or before January 22, 2014, and to New Waterstone and its subsidiaries with respect to matters and time periods occurring thereafter.

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

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

The accompanying unaudited consolidated financial statements and related notes should be read in conjunction with the Company's December 31, 2014 Annual Report on Form 10-K. Operating results for the six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or for any other period.

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

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

Note 2— Securities Available for Sale

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

| | June 30, 2015 | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| | (In Thousands) | | | |
| Mortgage-backed securities | $108,563 | 1,296 | (365) | 109,494 |
| Collateralized mortgage obligations: | | | | |
| Government sponsored enterprise issued | 60,689 | 288 | (110) | 60,867 |
| Mortgage-related securities | 169,252 | 1,584 | (475) | 170,361 |
| | | | | |
| Government sponsored enterprise bonds | 4,750 | 6 | (2) | 4,754 |
| Municipal securities | 72,174 | 920 | (558) | 72,536 |
| Other debt securities | 17,402 | 132 | (610) | 16,924 |
| Debt securities | 94,326 | 1,058 | (1,170) | 94,214 |
| Certificates of deposit | 4,900 | 20 | - | 4,920 |
| | $268,478 | 2,662 | (1,645) | 269,495 |

| | December 31, 2014 | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| | (In Thousands) | | | |
| Mortgage-backed securities | $115,670 | 1,582 | (124) | 117,128 |
| Collateralized mortgage obligations: | | | | |
| Government sponsored enterprise issued | 58,821 | 320 | (70) | 59,071 |
| Mortgage-related securities | 174,491 | 1,902 | (194) | 176,199 |
| | | | | |
| Government sponsored enterprise bonds | 6,750 | 2 | (41) | 6,711 |
| Municipal securities | 76,037 | 1,442 | (371) | 77,108 |
| Other debt securities | 7,404 | 159 | (35) | 7,528 |
| Debt securities | 90,191 | 1,603 | (447) | 91,347 |
| Certificates of deposit | 5,880 | 17 | - | 5,897 |
| | $270,562 | 3,522 | (641) | 273,443 |

The Company's mortgage-backed securities and collateralized mortgage obligations issued by government sponsored enterprises are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. At June 30, 2015, $95.8 million of the Company's mortgage related securities were pledged as collateral to secure repurchase agreement obligations of the Company. As of June 30, 2015, $2.8 million of mortgage related securities were pledged as collateral to secure mortgage banking related activities. At December 31, 2014, $98.2 million of the Company's government sponsored enterprise bonds and $1.3 million of the Company's mortgage related securities were pledged as collateral to secure repurchase agreement obligations and mortgage banking related activities, respectively.

The amortized cost and fair values of investment securities by contractual maturity at June 30, 2015 are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Fair Value |
|---|---|---|
| | (In Thousands) | |
| Debt and other securities | | |
| Due within one year | $6,677 | 6,770 |
| Due after one year through five years | 20,292 | 20,444 |
| Due after five years through ten years | 42,267 | 42,021 |
| Due after ten years | 29,990 | 29,899 |
| Mortgage-related securities | 169,252 | 170,361 |
| | $268,478 | 269,495 |

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

| | June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| | (In Thousands) | | | | | |
| Mortgage-backed securities | $19,255 | (235) | 6,251 | (130) | 25,506 | (365) |
| Collateralized mortgage obligations: | | | | | | |
| Government sponsored enterprise issued | 22,199 | (110) | - | - | 22,199 | (110) |
| Government sponsored enterprise bonds | 2,998 | (2) | - | - | 2,998 | (2) |
| Municipal securities | 31,989 | (354) | 5,436 | (204) | 37,425 | (558) |
| Other debt securities | 14,401 | (610) | - | - | 14,401 | (610) |
| | $90,842 | (1,311) | 11,687 | (334) | 102,529 | (1,645) |

| | December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| | (In Thousands) | | | | | |
| Mortgage-backed securities | $10,537 | (13) | 12,489 | (111) | 23,026 | (124) |
| Collateralized mortgage obligations: | | | | | | |
| Government sponsored enterprise issued | 23,131 | (70) | - | - | 23,131 | (70) |
| Government sponsored enterprise bonds | 2,739 | (11) | 2,970 | (30) | 5,709 | (41) |
| Municipal securities | 5,671 | (19) | 21,344 | (352) | 27,015 | (371) |
| Other debt securities | 4,977 | (35) | - | - | 4,977 | (35) |
| Certificates of deposit | 490 | - | - | - | 490 | - |
| | $47,545 | (148) | 36,803 | (493) | 84,348 | (641) |

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

As of June 30, 2015, the Company held two municipal securities that had previously been deemed to be other-than-temporarily impaired. Both securities were issued by a tax incremental district in a municipality located in Wisconsin. During the year ended December 31, 2012, the Company received audited financial statements with respect to the municipal issuer that called into question the ability of the underlying taxing district that issued the securities to operate as a going concern. During the year ended December 31, 2012, the Company's analysis of these securities resulted in $100,000 in credit losses that were charged to earnings with respect to these two municipal securities. An additional $17,000 credit loss that was charged to earnings during the year ended December 31, 2014 for these municipal bonds. During the year ended December 31, 2014, there were sales in the market of municipal issuer bonds at a discounted price that resulted in the Company recording additional credit losses. As of June 30, 2015, these securities had a combined amortized cost of $202,000 and a combined estimated fair value of $264,000.

As of June 30, 2015, the Company had 14 municipal securities and four mortgage-backed securities which had been in an unrealized loss position for twelve months or longer. These securities were determined not to be other-than-temporarily impaired as of June 30, 2015. The Company has determined that the decline in fair value of these securities is primarily attributable to an increase in market interest rates compared to the stated rates on these securities and is not attributable to credit deterioration. As the Company does not intend to sell nor is it more likely than not that it will be required to sell these securities before recovery of the amortized cost basis, these securities are not considered other-than-temporarily impaired.

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

During the six months ended June 30, 2015, proceeds from the sale of securities totaled $1.0 million and resulted in gains totaling $44,000. The $44,000 included in gain on sale of available for sale securities in the consolidated statements of income during the six months ended June 30, 2015 was reclassified from accumulated other comprehensive income. There were no sales of securities during the six months ended June 30, 2014.

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

| | (In Thousands) |
|---|---|
| Credit-related impairments on securities as of December 31, 2013 | $ 100 |
| Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized | - |
| Increase in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized | 17 |
| Reduction for sales of securities for which other-than-temporary was previously recognized | - |
| Credit-related impairments on securities as of December 31, 2014 | 117 |
| Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized | - |
| Increase in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized | - |
| Credit-related impairments on securities as of June 30, 2015 | $ 117 |

Note 3 - Loans Receivable

Loans receivable at June 30, 2015 and December 31, 2014 are summarized as follows:

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| | (In Thousands) | |
| Mortgage loans: | | |
| Residential real estate: | | |
| One- to four-family | $393,724 | 411,979 |
| Multi-family | 531,729 | 522,281 |
| Home equity | 26,404 | 29,207 |
| Construction and land | 14,792 | 17,081 |
| Commercial real estate | 103,334 | 94,771 |
| Consumer | 863 | 200 |
| Commercial loans | 23,743 | 19,471 |
| | $1,094,589 | 1,094,990 |

The Company provides several types of loans to its customers, including residential, construction, commercial and consumer loans. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to one borrower or to multiple borrowers engaged in similar activities that would cause them to be

similarly impacted by economic or other conditions. While credit risks are geographically concentrated in the Company's Milwaukee metropolitan area, there are no concentrations with individual or groups of related borrowers. While the real estate collateralizing these loans is residential in nature, it ranges from owner-occupied single family homes to large apartment complexes.

Qualifying loans receivable totaling $832.2 million and $844.2 million at June 30, 2015 and December 31, 2014, respectively, are pledged as collateral against $360.0 million in outstanding Federal Home Loan Bank of Chicago advances under a blanket security agreement.

As of June 30, 2015 and December 31, 2014, there were no loans 90 or more days past due and still accruing interest.



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An analysis of past due loans receivable as of June 30, 2015 and December 31, 2014 follows:

| | As of June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | 1-59 Days Past Due [1] | 60-89 Days Past Due [2] | 90 Days or Greater | Total Past Due | Current [3] | Total Loans |
| | (In Thousands) | | | | | |
| Mortgage loans: | | | | | | |
| Residential real estate: | | | | | | |
| One- to four-family | $2,266 | 989 | 13,059 | 16,314 | 377,410 | 393,724 |
| Multi-family | 1,490 | - | 4,583 | 6,073 | 525,656 | 531,729 |
| Home equity | 313 | 60 | 78 | 451 | 25,953 | 26,404 |
| Construction and land | 31 | - | 347 | 378 | 14,414 | 14,792 |
| Commercial real estate | 402 | - | 77 | 479 | 102,855 | 103,334 |
| Consumer | - | - | - | - | 863 | 863 |
| Commercial loans | 40 | 5 | - | 45 | 23,698 | 23,743 |
| Total | $4,542 | 1,054 | 18,144 | 23,740 | 1,070,849 | 1,094,589 |

| | As of December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | 1-59 Days Past Due [1] | 60-89 Days Past Due [2] | 90 Days or Greater | Total Past Due | Current [3] | Total Loans |
| | (In Thousands) | | | | | |
| Mortgage loans: | | | | | | |
| Residential real estate: | | | | | | |
| One- to four-family | $3,767 | 3,743 | 12,196 | 19,706 | 392,273 | 411,979 |
| Multi-family | 462 | 280 | 11,092 | 11,834 | 510,447 | 522,281 |
| Home equity | 268 | 153 | 250 | 671 | 28,536 | 29,207 |
| Construction and land | 90 | - | 362 | 452 | 16,629 | 17,081 |
| Commercial real estate | 225 | - | 947 | 1,172 | 93,599 | 94,771 |
| Consumer | - | - | - | - | 200 | 200 |
| Commercial loans | 34 | - | 265 | 299 | 19,172 | 19,471 |
| Total | $4,846 | 4,176 | 25,112 | 34,134 | 1,060,856 | 1,094,990 |

(1) Includes $250,000 and $1.6 million at June 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

(2) Includes $559,000 and $795,000 at June 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

(3) Includes $9.8 million and $10.5 million at June 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

A summary of the activity for the six months ended June 30, 2015 and 2014 in the allowance for loan losses follows:

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

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Six months ended June 30, 2015 | | | | | | | | |
| Balance at beginning of period | $9,877 | 5,358 | 422 | 687 | 1,951 | 8 | 403 | 18,706 |
| Provision (credit) for loan losses | 1,402 | (147) | (54) | 47 | (115) | (2) | 9 | 1,140 |
| Charge-offs | (1,220) | (1,304) | (48) | (47) | (45) | - | - | (2,664) |
| Recoveries | 289 | 753 | 95 | 33 | 5 | 3 | - | 1,178 |
| Balance at end of period | $10,348 | 4,660 | 415 | 720 | 1,796 | 9 | 412 | 18,360 |
| Six months ended June 30, 2014 | | | | | | | | |
| Balance at beginning of period | $11,549 | 7,211 | 1,807 | 1,613 | 1,402 | 34 | 648 | 24,264 |
| Provision (credit) for loan losses | (979) | 1,561 | (767) | 195 | 472 | (25) | 78 | 535 |
| Charge-offs | (1,298) | (2,690) | (39) | (142) | - | (4) | (243) | (4,416) |
| Recoveries | 740 | 23 | 6 | 63 | 6 | 3 | 3 | 844 |
| Balance at end of period | $10,012 | 6,105 | 1,007 | 1,729 | 1,880 | 8 | 486 | 21,227 |

- 12 -

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of June 30, 2015 follows:

| | One- to Four-Family | Multi-Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | (In Thousands) | | | | | | | |
| Allowance related to loans individually evaluated for impairment | $3,327 | 15 | 61 | 46 | 303 | - | 5 | 3,757 |
| Allowance related to loans collectively evaluated for impairment | 7,021 | 4,645 | 354 | 674 | 1,493 | 9 | 407 | 14,603 |
| Balance at end of period | $10,348 | 4,660 | 415 | 720 | 1,796 | 9 | 412 | 18,360 |
| Loans individually evaluated for impairment | $27,127 | 8,000 | 430 | 2,110 | 2,446 | - | 34 | 40,147 |
| Loans collectively evaluated for impairment | 366,597 | 523,729 | 25,974 | 12,682 | 100,888 | 863 | 23,709 | 1,054,442 |
| Total gross loans | $393,724 | 531,729 | 26,404 | 14,792 | 103,334 | 863 | 23,743 | 1,094,589 |

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of December 31, 2014 follows:

| | One- to Four-Family | Multi-Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | (In Thousands) | | | | | | | |
| Allowance related to loans individually evaluated for impairment | $2,386 | 731 | 63 | 13 | 526 | - | 7 | 3,726 |
| Allowance related to loans collectively evaluated for impairment | 7,491 | 4,627 | 359 | 674 | 1,425 | 8 | 396 | 14,980 |
| Balance at end of period | $9,877 | 5,358 | 422 | 687 | 1,951 | 8 | 403 | 18,706 |
| Loans individually evaluated for impairment | $29,509 | 15,562 | 589 | 2,266 | 3,077 | - | 299 | 51,302 |
| Loans collectively evaluated for impairment | 382,470 | 506,719 | 28,618 | 14,815 | 91,694 | 200 | 19,172 | 1,043,688 |
| Total gross loans | $411,979 | 522,281 | 29,207 | 17,081 | 94,771 | 200 | 19,471 | 1,094,990 |

The following table presents information relating to the Company's internal risk ratings of its loans receivable as of June 30, 2015 and December 31, 2014:

| | One- to Four- | Multi-Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|

| | Family<br>(In Thousands) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| At June 30, 2015 | | | | | | | | |
| Substandard | $27,228 | 5,826 | 642 | 2,110 | 2,446 | - | 35 | 38,287 |
| Watch | 8,982 | 5,106 | 315 | 1,405 | 2,334 | - | 446 | 18,588 |
| Pass | 357,514 | 520,797 | 25,447 | 11,277 | 98,554 | 863 | 23,262 | 1,037,714 |
| | $393,724 | 531,729 | 26,404 | 14,792 | 103,334 | 863 | 23,743 | 1,094,589 |
| At December 31, 2014 | | | | | | | | |
| Substandard | $28,945 | 12,638 | 624 | 2,266 | 3,077 | - | 299 | 47,849 |
| Watch | 10,779 | 7,070 | 278 | 1,377 | 2,186 | - | 840 | 22,530 |
| Pass | 372,255 | 502,573 | 28,305 | 13,438 | 89,508 | 200 | 18,332 | 1,024,611 |
| | $411,979 | 522,281 | 29,207 | 17,081 | 94,771 | 200 | 19,471 | 1,094,990 |

- 13 -

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

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

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

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

The following tables present data on impaired loans at June 30, 2015 and December 31, 2014.

| | As of or for the Six Months Ended June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal | Reserve | Cumulative Charge-Offs | Average Recorded Investment | Interest Paid |
| | (In Thousands) | | | | | |
| Total Impaired with Reserve | | | | | | |
| One- to four-family | $12,408 | 12,885 | 3,327 | 477 | 12,550 | 180 |
| Multi-family | 1,102 | 1,102 | 15 | - | 1,081 | 10 |
| Home equity | 176 | 176 | 61 | - | 176 | 5 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Construction and land | 249 | 362 | 46 | 113 | 243 | - |
| Commercial real estate | 1,140 | 1,549 | 303 | 409 | 1,234 | 31 |
| Consumer | - | - | - | - | - | - |
| Commercial | 5 | 5 | 5 | - | 6 | 1 |
| | 15,080 | 16,079 | 3,757 | 999 | 15,290 | 227 |
| Total Impaired with no Reserve | | | | | | |
| One- to four-family | 14,719 | 17,248 | - | 2,529 | 14,903 | 342 |
| Multi-family | 6,898 | 9,010 | - | 2,112 | 7,674 | 141 |
| Home equity | 254 | 254 | - | - | 256 | 6 |
| Construction and land | 1,861 | 1,861 | - | - | 1,972 | 35 |
| Commercial real estate | 1,306 | 1,306 | - | - | 1,306 | 32 |
| Consumer | - | - | - | - | - | - |
| Commercial | 29 | 29 | - | - | 32 | 1 |
| | 25,067 | 29,708 | - | 4,641 | 26,143 | 557 |
| Total Impaired | | | | | | |
| One- to four-family | 27,127 | 30,133 | 3,327 | 3,006 | 27,453 | 522 |
| Multi-family | 8,000 | 10,112 | 15 | 2,112 | 8,755 | 151 |
| Home equity | 430 | 430 | 61 | - | 432 | 11 |
| Construction and land | 2,110 | 2,223 | 46 | 113 | 2,215 | 35 |
| Commercial real estate | 2,446 | 2,855 | 303 | 409 | 2,540 | 63 |
| Consumer | - | - | - | - | - | - |
| Commercial | 34 | 34 | 5 | - | 38 | 2 |
| | $40,147 | 45,787 | 3,757 | 5,640 | 41,433 | 784 |

- 14 -

| | As of or for the Year Ended December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal | Reserve | Cumulative Charge-Offs | Average Recorded Investment | Interest Paid |
| | (In Thousands) | | | | | |
| Total Impaired with Reserve | | | | | | |
| One- to four-family | $11,864 | 13,345 | 2,386 | 1,481 | 15,982 | 515 |
| Multi-family | 7,438 | 10,285 | 731 | 2,847 | 12,720 | 177 |
| Home equity | 144 | 144 | 63 | - | 195 | 7 |
| Construction and land | 47 | 61 | 13 | 14 | 63 | - |
| Commercial real estate | 2,984 | 3,544 | 526 | 560 | 4,211 | 128 |
| Consumer | - | - | - | - | - | - |
| Commercial | 7 | 7 | 7 | - | 12 | 1 |
| | 22,484 | 27,386 | 3,726 | 4,902 | 33,183 | 828 |
| Total Impaired with no Reserve | | | | | | |
| One- to four-family | 17,645 | 19,795 | - | 2,150 | 23,215 | 860 |
| Multi-family | 8,124 | 9,364 | - | 1,240 | 12,693 | 439 |
| Home equity | 445 | 445 | - | - | 554 | 15 |
| Construction and land | 2,219 | 2,332 | - | 113 | 3,379 | 97 |
| Commercial real estate | 93 | 93 | - | - | 126 | 4 |
| Consumer | - | - | - | - | - | - |
| Commercial | 292 | 535 | - | 243 | 470 | 2 |
| | 28,818 | 32,564 | - | 3,746 | 40,437 | 1,417 |
| Total Impaired | | | | | | |
| One- to four-family | 29,509 | 33,140 | 2,386 | 3,631 | 39,197 | 1,375 |
| Multi-family | 15,562 | 19,649 | 731 | 4,087 | 25,413 | 616 |
| Home equity | 589 | 589 | 63 | - | 749 | 22 |
| Construction and land | 2,266 | 2,393 | 13 | 127 | 3,442 | 97 |
| Commercial real estate | 3,077 | 3,637 | 526 | 560 | 4,337 | 132 |
| Consumer | - | - | - | - | - | - |
| Commercial | 299 | 542 | 7 | 243 | 482 | 3 |
| | $51,302 | 59,950 | 3,726 | 8,648 | 73,620 | 2,245 |

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

When a loan is considered impaired, interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

The determination as to whether an allowance is required with respect to impaired loans is based upon an analysis of the value of the underlying collateral and/or the borrower's intent and ability to make all principal and interest payments in accordance with contractual terms. The evaluation process is subject to the use of significant estimates and actual results could differ from estimates. This analysis is primarily based upon third party appraisals and/or a discounted cash flow analysis. In those cases in which no allowance has been provided for an impaired loan, the Company has determined that the estimated value of the underlying collateral exceeds the remaining outstanding balance of the loan. Of the total $25.1 million of impaired loans as of June 30, 2015 for which no allowance has been

provided, $4.6 million in charge-offs have been recorded to reduce the unpaid principal balance to an amount that is commensurate with the loans' net realizable value, using the estimated fair value of the underlying collateral. To the extent that further deterioration in property values continues, the Company may have to reevaluate the sufficiency of the collateral servicing these impaired loans resulting in additional provisions to the allowance for loans losses or charge-offs.

At June 30, 2015, total impaired loans includes $18.8 million of troubled debt restructurings. Troubled debt restructurings involve granting concessions to a borrower experiencing financial difficulty by modifying the terms of the loan in an effort to avoid foreclosure. The vast majority of debt restructurings include a modification of terms to allow for an interest only payment and/or reduction in interest rate. The restructured terms are typically in place for six to twelve months. At December 31, 2014, total impaired loans included $26.1 million of troubled debt restructurings.

The following presents data on troubled debt restructurings:

| | As of June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing | | Non-accruing | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| One- to four-family | $3,902 | 4 | $7,426 | 49 | $11,328 | 53 |
| Multi-family | 2,804 | 2 | 1,499 | 5 | 4,303 | 7 |
| Home equity | - | - | 98 | 1 | 98 | 1 |
| Construction and land | 1,716 | 2 | - | - | 1,716 | 2 |
| Commercial real estate | 1,306 | 1 | 77 | 1 | 1,383 | 2 |
| | $9,728 | 9 | $9,100 | 56 | $18,828 | 65 |

| | As of December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing | | Non-accruing | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| One- to four-family | $4,724 | 8 | $10,233 | 55 | $14,957 | 63 |
| Multi-family | 2,923 | 2 | 4,797 | 7 | 7,720 | 9 |
| Home equity | - | - | 98 | 1 | 98 | 1 |
| Construction and land | 1,866 | 2 | - | - | 1,866 | 2 |
| Commercial real estate | 1,306 | 1 | 170 | 1 | 1,476 | 2 |
| | $10,819 | 13 | $15,298 | 64 | $26,117 | 77 |

At June 30, 2015, $18.8 million in loans had been modified in troubled debt restructurings and $9.1 million of these loans were included in the non-accrual loan total. The remaining $9.7 million, while meeting the internal requirements for modification in a troubled debt restructuring, were current with respect to payments under their original loan terms at the time of the restructuring and thus, continued to be included with accruing loans. Provided these loans perform in accordance with the modified terms, they will continue to be accounted for on an accrual basis.

All loans that have been modified in a troubled debt restructuring are considered to be impaired. As such, an analysis has been performed with respect to all of these loans to determine the need for a valuation reserve. When a loan is expected to perform in accordance with the restructured terms and ultimately return to and perform under contract terms, a valuation allowance is established for an amount equal to the excess of the present value of the expected future cash flows under the original contract terms as compared with the modified terms, including an estimated default rate. When there is doubt as to the borrower's ability to perform under the restructured terms or ultimately return to and perform under market terms, a valuation allowance is established equal to the impairment when the carrying amount exceeds fair value of the underlying collateral. As a result of the impairment analysis, a $941,000 valuation allowance has been established as of June 30, 2015 with respect to the $18.8 million in troubled debt restructurings. As of December 31, 2014, a $1.5 million valuation allowance had been established with respect to the $26.1 million in troubled debt restructurings.

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

The following presents troubled debt restructurings by concession type:

| | As of June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Performing in accordance with modified terms | | In Default | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| Interest reduction and principal forbearance | $14,420 | 30 | $838 | 5 | $15,258 | 35 |
| Principal forbearance | 342 | 2 | - | - | 342 | 2 |
| Interest reduction | 3,228 | 28 | - | - | 3,228 | 28 |
| | $17,990 | 60 | $838 | 5 | $18,828 | 65 |

| | As of December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Performing in accordance with modified terms | | In Default | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| Interest reduction and principal forbearance | $15,306 | 36 | $2,014 | 7 | $17,320 | 43 |
| Principal forbearance | 490 | 3 | 2,632 | 1 | 3,122 | 4 |
| Interest reduction | 4,875 | 11 | 800 | 19 | 5,675 | 30 |
| | $20,671 | 50 | $5,446 | 27 | $26,117 | 77 |

The following presents data on troubled debt restructurings:

| | For the three months ended June 30, 2015 | | For the three months ended June 30, 2014 | |
|---|---|---|---|---|
| | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | |
| Loans modified as a troubled debt restructure | | | | |
| One- to four-family | $73 | 1 | $1,381 | 3 |
| | $73 | 1 | $1,381 | 3 |

There were no troubled debt restructurings within the past twelve months for which there was a default during the three months ended June 30, 2015 or June 30, 2014.

The following presents data on troubled debt restructurings:

| | For the six months ended June 30, 2015 | | For the six months ended June 30, 2014 | |
|---|---|---|---|---|
| | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | |
| Loans modified as a troubled debt restructure | | | | |
| One- to four-family | $73 | 1 | $3,806 | 13 |
| Multi family | - | - | 597 | 2 |
| Home equity | - | - | 98 | 1 |
| | $73 | 1 | $4,501 | 16 |

There were no troubled debt restructurings within the past twelve months for which there was a default during the six months ended June 30, 2015 or June 30, 2014.

- 17 -

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The following table presents data on non-accrual loans as of June 30, 2015 and December 31, 2014:

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| | (Dollars in Thousands) | |
| Non-accrual loans: | | |
| Residential | | |
| One- to four-family | $22,399 | 23,918 |
| Multi-family | 5,196 | 12,001 |
| Home equity | 365 | 445 |
| Construction and land | 394 | 401 |
| Commercial real estate | 327 | 947 |
| Commercial | 34 | 299 |
| Consumer | - | - |
| Total non-accrual loans | $28,715 | 38,011 |
| Total non-accrual loans to total loans receivable | 2.62 % | 3.47 % |
| Total non-accrual loans to total assets | 1.65 % | 2.13 % |

Note 4— Real Estate Owned

Real estate owned is summarized as follows:

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| | (In Thousands) | |
| One- to four-family | $8,145 | 10,896 |
| Multi-family | 1,568 | 2,210 |
| Construction and land | 5,334 | 5,400 |
| Commercial real estate | 300 | 300 |
| Total real estate owned | 15,347 | 18,806 |
| Valuation allowance at end of period | (1,021,000) | (100,000) |
| Total real estate owned, net | $14,326 | 18,706 |

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

| | Six months ended June 30, | |
|---|---|---|
| | 2015 | 2014 |
| | (In Thousands) | |
| Real estate owned at beginning of the period | $18,706 | 22,663 |
| Transferred from loans receivable | 9,066 | 6,930 |
| Sales (net of gains / losses) | (12,484) | (6,783) |
| Write downs | (1,244) | (603) |
| Other | 282 | (90) |
| Real estate owned at the end of the period | $14,326 | 22,117 |

- 18 -

Note 5— Mortgage Servicing Rights

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

| | Six months ended June 30, | |
|---|---|---|
| | 2015 | 2014 |
| | (In Thousands) | |
| Mortgage servicing rights at beginning of the period | $2,521 | 3,377 |
| Additions | 1,999 | 1,869 |
| Amortization | (375 ) | (267 ) |
| Sales | (614 ) | (2,189) |
| Mortgage servicing rights at end of the period | 3,531 | 2,790 |
| Valuation allowance at end of period | (20 ) | (75 ) |
| Mortgage servicing rights at end of the period, net | $3,511 | 2,715 |

During the six months ended June 30, 2015, $995.1 million in residential loans were originated for sale. During the same period, sales of loans held for sale totaled $960.8 million, generating mortgage banking income of $50.6 million. The unpaid principal balance of loans serviced for others was $443.6 million and $308.1 million at June 30, 2015 and December 31, 2014 respectively. These loans are not reflected in the consolidated statements of financial condition.

During the six months ended June 30, 2015, the Company sold mortgage servicing rights related to $87.3 million in loans receivable and with a book value of $614,000 for $876,000 resulting in a gain on sale of $262,000. During the six months ended June 30, 2014, the Company sold mortgage servicing rights related to $392.8 million in loans receivable and with a book value of $2.2 million for $4.0 million resulting in a gain on sale of $1.8 million.

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

| Estimate for the period ended December 31: | (In Thousands) |
|---|---|
| 2015 | $ 289 |
| 2016 | 511 |
| 2017 | 465 |
| 2018 | 419 |
| 2019 | 374 |
| Thereafter | 1,453 |
| Total | $ 3,511 |

Note 6— Deposits

At June 30, 2015 and December 31, 2014, time deposits with balances greater than $250,000 amount to $36.0 million and $34.6 million, respectively.

A summary of the contractual maturities of time deposits at June 30, 2015 is as follows:

| | (In Thousands) |
|---|---|
| Within one year | $ 412,678 |
| More than one to two years | 184,061 |
| More than two to three years | 27,555 |
| More than three to four years | 3,722 |
| More than four through five years | 3,780 |
| | $ 631,796 |

Note 7— Borrowings

Borrowings consist of the following:

| | | June 30, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|---|
| | | Balance | Weighted Average Rate | | Balance | Weighted Average Rate | |
| | | (Dollars in Thousands) | | | | | |
| Short term: | | | | | | | |
| Federal Home Loan Bank, Chicago advances | | $10,000 | 0.13 | % | - | 0.00 | % |
| Long term: | | | | | | | |
| Federal Home Loan Bank, Chicago advances maturing: | | | | | | | |
| 2016 | | 220,000 | 4.34 | % | 220,000 | 4.34 | % |
| 2017 | | 65,000 | 3.19 | % | 65,000 | 3.19 | % |
| 2018 | | 65,000 | 2.97 | % | 65,000 | 2.97 | % |
| Repurchase agreements maturing | 2017 | 84,000 | 3.96 | % | 84,000 | 3.96 | % |
| | | $444,000 | 3.81 | % | 434,000 | 3.89 | % |

The $10.0 million short-term advance has a maturity date of November 30, 2015. The rate on the short-term advance is variable and was 0.13% at June 30, 2014. There is no prepayment penalty if voluntarily repaid by the Company prior to stated maturity.

The $220.0 million in advances due in 2016 consist of eight advances with fixed rates ranging from 4.01% to 4.82% callable quarterly until maturity.

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

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

The $84.0 million in repurchase agreements have fixed rates ranging from 2.89% to 4.31% callable quarterly until their maturity in 2017. The repurchase agreements are collateralized by securities available for sale with an estimated

fair value of $95.8 million at June 30, 2015 and $98.2 million at December 31, 2014.

The Company selects loans that meet underwriting criteria established by the Federal Home Loan Bank of Chicago ("FHLBC") as collateral for outstanding advances. The Company's borrowings at the FHLBC are limited to 80% of the carrying value of unencumbered one- to four-family mortgage loans, 51% of the carrying value of home equity loans and 75% of the carrying value of multi-family loans. In addition, these advances are collateralized by FHLBC stock of $19.5 million at June 30, 2015 and $17.5 million at December 31, 2014. In the event of prepayment, the Company is obligated to pay all remaining contractual interest on the advance.

Note 8 – Regulatory Capital

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

As disclosed in the Company's Form 10-K filed with the Securities and Exchange Commission, in July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier I capital ratio, increase the minimum Tier 1 capital ratio requirements and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The Company and the Bank have made the election to retain the existing treatment for accumulated other comprehensive income. The final rules took effect for the Company and the Bank on January 1, 2015, subject to a transition period for certain parts of the rules.

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

The actual and required capital amounts and ratios for the Bank as of June 30, 2015 and December 31, 2014 are presented in the table below:

| | June 30, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Capital Adequacy Purposes | | To Be Well-Capitalized Under Prompt Corrective Action Provisions | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (Dollars In Thousands) | | | | | |
| Total capital (to risk-weighted assets) | | | | | | |
| Consolidated Waterstone Financial , Inc. | $415,509 | 35.43% | $93,830 | 8.00% | N/A | N/A |
| WaterStone Bank | 366,571 | 31.36% | 93,523 | 8.00% | 116,904 | 10.00% |
| Tier I capital (to risk-weighted assets) | | | | | | |
| Consolidated Waterstone Financial , Inc. | 400,803 | 34.17% | 70,373 | 6.00% | N/A | N/A |
| WaterStone Bank | 351,912 | 30.10% | 70,142 | 6.00% | 93,523 | 8.00% |
| Common Equity Tier 1 Capital (to risk-weighted assets) | | | | | | |
| Consolidated Waterstone Financial , Inc. | 400,803 | 34.17% | 52,779 | 4.50% | N/A | N/A |

| | | | | | | |
|---|---|---|---|---|---|---|
| WaterStone Bank | 351,912 | 30.10 % | 52,607 | 4.50 % | 75,988 | 6.50 % |
| Tier I capital (to average assets) | | | | | | |
| Consolidated Waterstone Financial , Inc. | 400,803 | 22.86 % | 70,141 | 4.00 % | N/A | N/A |
| WaterStone Bank | 351,912 | 20.11 % | 69,991 | 4.00 % | 87,489 | 5.00 % |
| State of Wisconsin (to total assets) | | | | | | |
| WaterStone Bank | 351,912 | 20.30 % | 104,001 | 6.00 % | N/A | N/A |

| | December 31, 2014 (Dollars In Thousands) | | | | | |
|---|---|---|---|---|---|---|
| Total capital (to risk-weighted assets) | $357,514 | 31.98 % | 89,428 | 8.00 % | 111,785 | 10.00 % |
| Tier I capital (to risk-weighted assets) | 343,483 | 30.73 % | 44,714 | 4.00 % | 67,071 | 6.00 % |
| Tier I capital (to average assets) | 343,483 | 19.04 % | 72,175 | 4.00 % | 90,219 | 5.00 % |
| State of Wisconsin (to total assets) | 343,483 | 19.33 % | 106,643 | 6.00 % | N/A | N/A |

- 21 -

Note 9 - Stock Based Compensation

Stock-Based Compensation Plan

In 2015, the Company's shareholders approved the 2015 Equity Incentive Plan. A total of 2,530,000 stock options and 1,012,000 restricted shares were approved for award.

Accounting for Stock-Based Compensation Plan

The fair value of stock options granted is estimated on the grant date using a Black-Scholes pricing model. The fair value of restricted shares is equal to the quoted NASDAQ market close price on the date of grant. The fair value of stock grants is recognized as compensation expense on a straight-line basis over the vesting period of the grants. Compensation expense is included in compensation, payroll taxes and other employee benefits in the consolidated statements of income.

Assumptions are used in estimating the fair value of stock options granted. The weighted average expected life of the stock options represent the period of time that the options are expected to be outstanding and is based on the historical results from the previous awards. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility is based on the actual volatility of a peer group including Waterstone Financial, Inc. stock from approximately five years prior to issuance date. The following assumptions were used in estimating the fair value of options granted in the year ended 2015.

| | 2015 | |
|---|---|---|
| | Minimum | Maximum |
| Dividend yield | 1.51 % | 1.57 % |
| Risk-free interest rate | 1.60 % | 1.72 % |
| Expected volatility | 29.23 % | 31.88 % |
| Weighted average expected life (in years) | 4.6 | 5.0 |
| Weighted average per share value of options | $3.08 | 3.24 |

The Company estimates potential forfeitures of stock grants and adjusts compensation expense recorded accordingly. The forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

The 590,000 stock options granted to employees under this plan vest over a period of five years. The 600,000 stock option awards granted to directors under this plan vest over a period of eight years. The exercise price for all stock options granted is equal to the quoted NASDAQ market close price on the date that the awards were granted and expire ten years after the grant date, if not exercised. The unrecognized expense related to these awards is $3.7 million over the next eight years.

The 355,500 restricted stock awards granted to employees under this plan vest in five periods over four years with one period vesting immediately. The 184,000 stock awards granted to directors under this plan vest in eight periods over seven years with one period vesting immediately. The fair value of the award was $12.75. The value of restricted stock awards is equal to the quoted NASDAQ market close price on the vest date. The unrecognized expense related

to this award is $5.2 million over the next seven years.

- 22 -

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Note 10 – Income Taxes

Income tax expense increased from $3.1 million during the six months ended June 30, 2014 to $4.8 million for the six months ended June 30, 2015. This increase was due to the increase in our income before income taxes, which increased from $8.8 million during the six months ended June 30, 2014 to $13.1 million during the six months ended June 30, 2015. Income tax expense is recognized on the statement of income during the six months ended June 30, 2015 at an effective rate of 36.4% of pretax income compared to 35.7% during the six months ended June 30, 2014.

Note 11 – Offsetting of Assets and Liabilities

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

The following table presents the liabilities subject to an enforceable master netting agreement as of June 30, 2015 and December 31, 2014.

| | Gross Recognized Liabilities | Gross Amounts Offset | Net Amounts Presented | Gross Amounts Not Offset | Net Amount |
|---|---|---|---|---|---|
| | (In Thousands) | | | | |
| June 30, 2015 | | | | | |
| Repurchase Agreements | | | | | |
| Short-term | $ - | - | - | - | - |
| Long-term | 84,000 | - | 84,000 | 84,000 | - |
| | $ 84,000 | - | 84,000 | 84,000 | - |
| December 31, 2014 | | | | | |
| Repurchase Agreements | | | | | |
| Short-term | $ - | - | - | - | - |
| Long-term | 84,000 | - | 84,000 | 84,000 | - |
| | $ 84,000 | - | 84,000 | 84,000 | - |

- 23 -

Note 12– Financial Instruments with Off-Balance Sheet Risk

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

| | June 30, 2015 | December 31, 2014 |
|---|---|---|
| | (In Thousands) | |
| Financial instruments whose contract amounts represent potential credit risk: | | |
| Commitments to extend credit under amortizing loans (1) | $22,836 | 18,889 |
| Commitments to extend credit under home equity lines of credit | 14,481 | 14,775 |
| Unused portion of construction loans | 9,295 | 12,333 |
| Unused portion of business lines of credit | 12,487 | 11,599 |
| Standby letters of credit | 574 | 766 |

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(1) Excludes commitments to originate loans held for sale, which are discussed in the following footnote.

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

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

The Company has determined that there are no probable losses related to commitments to extend credit or the standby letters of credit as of June 30, 2015 and December 31, 2014.

Note 13 – Derivative Financial Instruments

In connection with its mortgage banking activities, the Company enters into derivative financial instruments as part of its strategy to manage its exposure to changes in interest rates. Mortgage banking derivatives include interest rate lock commitments provided to customers to fund mortgage loans to be sold in the secondary market and forward commitments for the future delivery of such loans to third party investors. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of future changes in interest rates on its commitments to fund the loans as well as on its portfolio of mortgage loans held for sale. The Company's mortgage banking derivatives have not been designated as being in hedge relationships. These instruments are used to manage the Company's

exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements of ASC 815. Changes in the fair value of derivatives not designated in hedging relationships are recorded as a component of mortgage banking income in the Company's consolidated statements of operations. The Company does not use derivatives for speculative purposes.

Forward commitments to sell mortgage loans represent commitments obtained by the Company from a secondary market agency to purchase mortgages from the Company at specified interest rates and within specified periods of time. Commitments to sell loans are made to mitigate interest rate risk on interest rate lock commitments to originate loans and loans held for sale. At June 30, 2015, the Company had forward commitments to sell mortgage loans with an aggregate notional amount of approximately $272.3 million and interest rate lock commitments with an aggregate notional amount of approximately $230.6 million. The fair value of the forward commitments to sell mortgage loans at June 30, 2015 included a gain of $964,000 that is reported as a component of other assets on the Company's consolidated statement of financial condition. The fair value of the interest rate locks at June 30, 2015 included a gain of $2.7 million that is reported as a component of other assets on the Company's consolidated statements of financial condition.

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

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

Note 14 – Earnings Per Share

Earnings per share are computed using the two-class method. Basic earnings per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted stock awards. Unvested restricted stock awards are considered participating securities because holders of these securities have the right to receive dividends at the same rate as holders of the Company's common stock. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares.

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| | (In Thousands, except per share amounts) | | | |
| Net income | $5,284 | 3,770 | 8,300 | 5,654 |
| Net income available to unvested restricted shares | 83 | 5 | 126 | 8 |
| Net income available to common stockholders | $5,201 | 3,765 | 8,174 | 5,646 |

| | | | | |
|---|---|---|---|---|
| Weighted average shares outstanding | 29,841 | 34,021 | 31,098 | 34,143 |
| Effect of dilutive potential common shares | 350 | 231 | 315 | 242 |
| Diluted weighted average shares outstanding | 30,191 | 34,252 | 31,413 | 34,385 |
| | | | | |
| Basic earnings per share | $0.17 | 0.11 | 0.26 | 0.17 |
| Diluted earnings per share | $0.17 | 0.11 | 0.26 | 0.16 |

Note 15 – Fair Value Measurements

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

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

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

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

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

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

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a recurring basis as of June 30, 2015 and December 31, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | June 30, 2015 | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | |
| Available for sale securities | | | | |
| Mortgage-backed securities | $ 109,494 | - | 109,494 | - |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 60,867 | - | 60,867 | - |
| Government sponsored enterprise bonds | 4,754 | - | 4,754 | - |
| Municipal securities | 72,536 | - | 72,536 | - |

| | | | | |
|---|---|---|---|---|
| Other debt securities | 16,924 | 2,523 | 14,401 | - |
| Certificates of deposit | 4,920 | - | 4,920 | - |
| Loans held for sale | 207,920 | - | 207,920 | - |
| Mortgage banking derivative assets | 3,704 | - | - | 3,704 |

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | December 31, 2014 | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | |
| Available for sale securities | | | | |
| Mortgage-backed securities | $117,128 | - | 117,128 | - |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 59,071 | - | 59,071 | - |
| Government sponsored enterprise bonds | 6,711 | - | 6,711 | - |
| Municipal securities | 77,108 | - | 77,108 | - |
| Other debt securities | 7,528 | 2,550 | 4,978 | - |
| Certificates of deposit | 5,897 | - | 5,897 | - |
| Loans held for sale | 125,073 | - | 125,073 | - |
| Mortgage banking derivative assets | 1,644 | - | - | 1,644 |
| Mortgage banking derivative liabilities | 645 | - | - | 645 |

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

Available for sale securities – The Company's investment securities classified as available for sale include: mortgage-backed securities, collateralized mortgage obligations, government sponsored enterprise bonds, municipal securities and other debt securities. The fair value of mortgage-backed securities, collateralized mortgage obligations and government sponsored enterprise bonds are determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities, prepayment models and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. The fair value of municipal securities is determined by a third party valuation source using observable market data utilizing a multi-dimensional relational pricing model. Standard inputs to this model include observable market data such as benchmark yields, reported trades, broker quotes, rating updates and issuer spreads. These model measurements are classified as Level 2 in the fair value hierarchy. The fair value of other debt securities, which includes a trust preferred security issued by a financial institution, is determined through quoted prices in active markets and is classified as Level 1 in the fair value hierarchy.

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

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

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2015 and 2014.

| | Mortgage banking derivatives, net (In Thousands) | |
|---|---|---|
| Balance at December 31, 2013 | $ 1,189 | |
| Mortgage derivative loss, net | (190 | ) |
| Balance at December 31, 2014 | $ 999 | |
| Mortgage derivative gain, net | 2,705 | |
| Balance at June 30, 2015 | $ 3,704 | |

There were no transfers in or out of Level 1, 2 or 3 measurements during the periods.
Assets Recorded at Fair Value on a Non-recurring Basis

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a non-recurring basis as of June 30, 2015 and December 31, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | June 30, 2015 | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | |
| Impaired loans, net (1) | $11,323 | - | - | 11,323 |
| Real estate owned | 14,326 | - | - | 14,326 |
| Impaired mortgage servicing rights | 1,049 | - | - | 1,049 |

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| | December 31, 2014 | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | |
| Impaired loans, net (1) | $18,758 | - | - | 18,758 |
| Real estate owned | 18,706 | - | - | 18,706 |
| Impaired mortgage servicing rights | 9 | - | - | 9 |

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

- 27 -

Loans – We do not record loans at fair value on a recurring basis. On a non-recurring basis, loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at net realizable value of the underlying collateral. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of impaired loans, loans that have been deemed to be impaired are considered to be Level 3 in the fair value hierarchy of valuation techniques. At June 30, 2015, loans determined to be impaired with an outstanding balance of $15.1 million were carried net of specific reserves of $3.8 million for a fair value of $11.3 million. At December 31, 2014, loans determined to be impaired with an outstanding balance of $22.5 million were carried net of specific reserves of $3.7 million for a fair value of $18.8 million. Impaired loans collateralized by assets which are valued in excess of the net investment in the loan do not require any specific reserves.

Real estate owned – On a non-recurring basis, real estate owned, is recorded in our consolidated statements of financial condition at the lower of cost or fair value. Fair value is determined based on third party appraisals and, if less than the carrying value of the foreclosed loan, the carrying value of the real estate owned is adjusted to the fair value. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of the properties, real estate owned is considered to be Level 3 in the fair value hierarchy of valuation techniques. Changes in the value of real estate owned totaled $1.2 million and $603,000 during the six months ended June 30, 2015 and 2014, respectively and are recorded in real estate owned expense. At June 30, 2015 and December 31, 2014, real estate owned totaled $14.3 million and $18.7 million, respectively.

Mortgage servicing rights - The Company utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of mortgage servicing rights. The model utilizes prepayment assumptions to project cash flows related to the mortgage servicing rights based upon the current interest rate environment, which is then discounted to estimate an expected fair value of the mortgage servicing rights. The model considers characteristics specific to the underlying mortgage portfolio, such as: contractually specified servicing fees, prepayment assumptions, delinquency rates, late charges and costs to service. Given the significance of the unobservable inputs utilized in the estimation process, mortgage servicing rights are classified as Level 3 within the fair value hierarchy. The Company records the mortgage servicing rights at the lower of amortized cost or fair value. At June 30, 2015 and December 31, 2014, the company determined that $1.0 million and $9,000, respectively of mortgage servicing rights were partially impaired, and as a result, recorded an impairment valuation allowance of $20,000 and $10,000, respectively.

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of June 30, 2015, the significant unobservable inputs used in the fair value measurements were as follows:

| | | | | Significant Unobservable Input Value | |
|---|---|---|---|---|---|
| | Fair Value at June 30, 2015 | Valuation Technique | Significant Unobservable Inputs | Minimum Value | Maximum Value |
| Mortgage banking derivatives | $3,704 | Pricing models | Pull through rate | 59.9 % | 100.0 % |
| Impaired loans | 11,323 | Market approach | Discount rates applied to appraisals | 15.0 % | 30.0 % |
| Real estate owned | 14,326 | Market approach | Discount rates applied to appraisals | 5.0 % | 89.4 % |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Impaired mortgage servicing rights | 1,049 | Pricing models | Prepayment rate | 6.1 | % | 36.0 | % |
| | | | Discount rate | 10.0 | % | 12.0 | % |
| | | | Cost to service | $76.00 | | $ 222.00 | |

___________

One of the significant unobservable inputs used in the fair value measurement of the Company's mortgage banking derivatives, including interest rate lock commitments is the loan pull through rate. This represents the percentage of loans currently in a lock position which the Company estimates will ultimately close. Generally, the fair value of an interest rate lock commitment will be positively impacted when the prevailing interest rate is lower than the interest rate lock commitment and negatively impacted when the prevailing interest rate is higher, without respect to the pull through rate. Generally, an increase in the pull through rate will result in the fair value of the interest rate lock increasing when in a gain position, or decreasing when in a loss position. The pull through rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. The pull through rate is computed using historical data and the ratio is periodically reviewed by the Company.

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

The significant unobservable inputs used in the fair value measurement of mortgage servicing rights include the prepayment rate, note rate, and cost to service. The prepayment rate represents the assumed rate of prepayment of the outstanding principal balance of the underlying mortgage notes. Generally, the fair value of mortgage servicing rights will be positively impacted as prepayment rate decreases and negatively impacted when the prepayment rate increases. The note rate represents the contractual rate on the underlying mortgages.

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

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

| | June 30, 2015 | | | | | December 31, 2014 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Carrying amount | Fair Value Total | Level 1 | Level 2 | Level 3 | Carrying amount | Fair Value Total | Level 1 | Level 2 | Level 3 |
| | (In Thousands) | | | | | | | | | |
| nancial Assets | | | | | | | | | | |
| ash and cash quivalents | $48,111 | 48,111 | 40,254 | 7,857 | - | 172,820 | 172,820 | 167,370 | 5,450 | - |
| ecurities vailable-for-sale | 269,495 | 269,495 | 2,523 | 266,972 | - | 273,443 | 273,443 | 2,550 | 270,893 | - |
| oans held for le | 207,920 | 207,920 | - | 207,920 | - | 125,073 | 125,073 | - | 125,073 | - |
| oans receivable | 1,094,589 | 1,152,915 | - | - | 1,152,915 | 1,094,990 | 1,184,398 | - | - | 1,184,398 |
| HLB stock | 19,500 | 19,500 | - | 19,500 | - | 17,500 | 17,500 | - | 17,500 | - |
| ccrued interest ceivable | 3,990 | 3,990 | 3,990 | - | - | 4,029 | 4,029 | 4,029 | - | - |
| ortgage rvicing rights | 3,511 | 4,165 | - | - | 4,165 | 2,511 | 2,808 | - | - | 2,808 |
| ortgage nking erivative assets | 3,704 | 3,704 | - | - | 3,704 | 1,644 | 1,644 | - | - | 1,644 |
| nancial abilities | | | | | | | | | | |
| eposits | 850,314 | 853,284 | 218,518 | 634,766 | - | 863,960 | 866,173 | 211,325 | 654,848 | - |
| dvance yments by rrowers for xes | 16,634 | 16,634 | 16,634 | - | - | 4,991 | 4,991 | 4,991 | - | - |
| orrowings | 444,000 | 463,200 | - | 463,200 | - | 434,000 | 459,484 | - | 459,484 | - |
| ccrued interest yable | 1,559 | 1,559 | 1,559 | - | - | 1,600 | 1,600 | 1,600 | - | - |
| ortgage nking erivative | - | - | - | - | - | 645 | 645 | - | - | 645 |

abilities

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

Cash and Cash Equivalents

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

Securities

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

Loans Held for Sale

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

- 29 -

Loans Receivable

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

FHLB Stock

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

Deposits and Advance Payments by Borrowers for Taxes

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

Borrowings

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

Accrued Interest Payable and Accrued Interest Receivable

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

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would be generally established at market rates at the time of the draw. Fair values for the Company's commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the counterparty's credit standing, and discounted cash flow analyses. The fair value of the Company's commitments to extend credit is not material at June 30, 2015 and December 31, 2014.

Mortgage Banking Derivative Assets and Liabilities

Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company relies on a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment, and then multiplying by quoted investor prices. The Company also relies on a

valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. On the Company's Consolidated Statements of Condition, instruments that have a positive fair value are included in prepaid expenses and other assets, and those instruments that have a negative fair value are included in other liabilities.

Note 16 – Segment Reporting

Selected financial and descriptive information is required to be provided about reportable operating segments, considering a "management approach" concept as the basis for identifying reportable segments. The management approach is based on the way that management organizes the segments within the enterprise for making operating decisions, allocating resources, and assessing performance. Consequently, the segments are evident from the structure of the enterprise's internal organization, focusing on financial information that an enterprise's chief operating decision-makers use to make decisions about the enterprise's operating matters. The Company has determined that it has two reportable segments: community banking and mortgage banking. The Company's operating segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Company and therefore, the financial results of the Company's business segments are not necessarily comparable with similar information for other financial institutions.

Community Banking

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

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

Mortgage Banking

The Mortgage Banking segment provides residential mortgage loans for the purpose of sale on the secondary market. Mortgage banking products and services are provided by offices in 16 states.

| | As of or for the three months ended June 30, 2015 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (In Thousands) | | | |
| Net interest income | $9,742 | 230 | 88 | 10,060 |
| Provision for loan losses | 650 | 155 | - | 805 |
| Net interest income after provision for loan losses | 9,092 | 75 | 88 | 9,255 |
| Noninterest income | 920 | 30,231 | (111) | 31,040 |
| Noninterest expenses: | | | | |

| | | | | |
|---|---|---|---|---|
| Compensation, payroll taxes, and other employee benefits | 3,807 | 19,572 | (107 ) | 23,272 |
| Occupancy, office furniture and equipment | 801 | 1,468 | - | 2,269 |
| FDIC insurance premiums | 271 | - | - | 271 |
| Real estate owned | 687 | (1 ) | - | 686 |
| Other | 1,135 | 4,220 | 94 | 5,449 |
| Total noninterest expenses | 6,701 | 25,259 | (13 ) | 31,947 |
| Income before income taxes | 3,311 | 5,047 | (10 ) | 8,348 |
| Income tax expense | 917 | 2,112 | 35 | 3,064 |
| Net income | $2,394 | 2,935 | (45 ) | 5,284 |
| | | | | |
| Total assets | $1,706,005 | 231,948 | (200,730 ) | 1,737,223 |

- 31 -

| | As of or for the three months ended June 30, 2014 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (In Thousands) | | | |
| Net interest income | $10,085 | 360 | 165 | 10,610 |
| Provision for loan losses | 250 | 35 | - | 285 |
| Net interest income after provision for loan losses | 9,835 | 325 | 165 | 10,325 |
| Noninterest income | 794 | 22,477 | (75) | 23,196 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 3,416 | 14,784 | (10) | 18,190 |
| Occupancy, office furniture and equipment | 784 | 1,837 | - | 2,621 |
| FDIC insurance premiums | 304 | - | - | 304 |
| Real estate owned | 705 | - | - | 705 |
| Other | 1,225 | 4,514 | 44 | 5,783 |
| Total noninterest expenses | 6,434 | 21,135 | 34 | 27,603 |
| Income before income taxes | 4,195 | 1,667 | 56 | 5,918 |
| Income tax expense | 1,436 | 671 | 41 | 2,148 |
| Net income | $2,759 | 996 | 15 | 3,770 |
| Total assets | $1,745,567 | 189,442 | (132,617) | 1,802,392 |

| | As of or for the six months ended June 30, 2015 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (In Thousands) | | | |
| Net interest income | $18,975 | 350 | 171 | 19,496 |
| Provision for loan losses | 950 | 190 | - | 1,140 |
| Net interest income after provision for loan losses | 18,025 | 160 | 171 | 18,356 |
| Noninterest income | 1,678 | 51,557 | (162) | 53,073 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 8,535 | 33,027 | (212) | 41,350 |
| Occupancy, office furniture and equipment | 1,647 | 3,065 | - | 4,712 |
| FDIC insurance premiums | 607 | - | - | 607 |
| Real estate owned | 1,214 | 15.00 | - | 1,229 |
| Other | 2,104 | 8,199 | 174 | 10,477 |
| Total noninterest expenses | 14,107 | 44,306 | (38) | 58,375 |
| Income before income taxes | 5,596 | 7,411 | 47 | 13,054 |
| Income tax expense | 1,582 | 3,101 | 71 | 4,754 |
| Net income | $4,014 | 4,310 | (24) | 8,300 |

- 32 -

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| | As of or for the six months ended June 30, 2014 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (In Thousands) | | | |
| Net interest income | $19,446 | 524 | 340 | 20,310 |
| Provision for loan losses | 500 | 35 | - | 535 |
| Net interest income after provision for loan losses | 18,946 | 489 | 340 | 19,775 |
| Noninterest income | 1,277 | 39,135 | (157) | 40,255 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 7,135 | 26,125 | (11) | 33,249 |
| Occupancy, office furniture and equipment | 1,707 | 3,600 | (1) | 5,306 |
| FDIC insurance premiums | 710 | - | - | 710 |
| Real estate owned | 1,253 | - | - | 1,253 |
| Other | 2,473 | 8,181 | 62 | 10,716 |
| Total noninterest expenses | 13,278 | 37,906 | 50 | 51,234 |
| Income before income taxes | 6,945 | 1,718 | 133 | 8,796 |
| Income tax expense | 2,367 | 692 | 83 | 3,142 |
| Net income | $4,578 | 1,026 | 50 | 5,654 |

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

Forward-Looking Information

This Form 10-Q contains or incorporates by reference various forward-looking statements, which can be identified by the use of words such as "estimate," "project," "believe," "intend," "anticipate," "plan," "seek," "expect" and similar expressions and verbs in the future tense, are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to:

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

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

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

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

See also the factors referred to in reports filed by the Company with the Securities and Exchange Commission (particularly those under the caption "Risk Factors" in Item 1A of the Company's 2014 Annual Report on Form 10-K).

Overview

The following discussion and analysis is presented to assist the reader in the understanding and evaluation of the Company's financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion in the sections below focuses on the results of operations for the three and six months ended June 30, 2015 and 2014 and the financial condition as of June 30, 2015 compared to the financial condition as of December 31, 2014.
As described in the notes to consolidated financial statements, we have two reportable segments: community banking and mortgage banking. The community banking segment provides consumer and business banking products and services to customers. Consumer products include loan products, deposit products, and personal investment services. Business banking products include loans for working capital, inventory and general corporate use, commercial real estate construction loans, and deposit accounts. The mortgage banking segment, which is conducted through Waterstone Mortgage Corporation, consists of originating residential mortgage loans for sale in the secondary market.

Our community banking segment generates the significant majority of our consolidated net interest income and requires the significant majority of our provision for loan losses. Our mortgage banking segment generates the significant majority of our non-interest income and a majority of our non-interest expense. We have provided below a discussion of the material results of operations for each segment on a separate basis for the three and six months ended June 30, 2015 and 2014, which focuses on non-interest income and non-interest expense. We have also provided a discussion of the consolidated operations of Waterstone Financial, which includes the consolidated operations of WaterStone Bank and Waterstone Mortgage Corporation, for the same periods.

Comparison of Community Banking Segment for the Three Months Ended June 30, 2015 and 2014

Net income for the three months ended June 30, 2015 totaled $2.4 million compared to net income of $2.8 million for the three months ended June 30, 2014. Net interest income decreased $343,000 to $9.7 million for the three months ended June 30, 2015 compared to $10.1 million the three months ended June 30, 2014. Provision for loan loss increased $400,000 compared to the prior year. Compensation, payroll taxes, and other employee benefits expense increased along with a slight increase in occupancy, office furniture, and equipment expense offset by a reduction in the other expenses for the three months ended June 30, 2015 compared to the three months ended June 30, 2014.

Comparison of Mortgage Banking Segment Operations for the Three Months Ended June 30, 2015 and 2014

Net income totaled $2.9 million for the three months ended June 30, 2015, compared to $996,000 during the three months ended June 30, 2014. Mortgage banking segment revenues increased $7.8 million, or 34.5%, to $30.2 million for the three months ended June 30, 2015 compared to $22.5 million for the three months ended June 30, 2014. The increase in revenue was attributable to an increase in volume. While revenue increased 34.5%, noninterest expense increased $4.1 million, or 19.5%, to $25.3 million for the three months ended June 30, 2015 compared to $21.1 million for the three months ended June 30, 2014. The improvement is due to ongoing expense control efforts.

Consolidated Waterstone Financial, Inc. Results of Operations

| | Three months ended June 30, | |
|---|---|---|
| | 2015 | 2014 |

| | (Dollars in Thousands, except per share amounts) | |
|---|---|---|
| Net income | $5,284 | 3,770 |
| Earnings per share - basic | 0.17 | 0.11 |
| Earnings per share - diluted | 0.17 | 0.11 |
| Return on assets | 1.21 % | 0.85 % |
| Return on equity | 5.04 % | 3.27 % |

- 34 -

Net Interest Income

Average Balance Sheets, Interest and Yields/Costs

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

| | Three months ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2015 | | | 2014 | | |
| | Average Balance | Interest | Yield/Cost | Average Balance | Interest | Yield/Cost |
| | (Dollars in Thousands) | | | | | |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans receivable and held for sale (1) | $1,240,703 | 14,065 | 4.55 % | $1,229,046 | 14,568 | 4.75 % |
| Mortgage related securities (2) | 175,498 | 820 | 1.87 % | 166,748 | 748 | 1.80 % |
| Debt securities, federal funds sold and short-term investments (2)(3) | 225,319 | 1,090 | 1.94 % | 284,431 | 1,033 | 1.46 % |
| Total interest-earning assets | 1,641,520 | 15,975 | 3.90 % | 1,680,225 | 16,349 | 3.90 % |
| Noninterest-earning assets | 112,600 | | | 108,179 | | |
| Total assets | $1,754,120 | | | $1,788,404 | | |
| Liabilities and equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Demand accounts | $31,335 | 5 | 0.06 % | $47,194 | 4 | 0.03 % |
| Money market and savings accounts | 131,716 | 30 | 0.09 % | 132,789 | 26 | 0.08 % |
| Time deposits | 630,230 | 1,323 | 0.84 % | 627,848 | 1,095 | 0.70 % |
| Total interest-bearing deposits | 793,281 | 1,358 | 0.69 % | 807,831 | 1,125 | 0.56 % |
| Borrowings | 446,983 | 4,324 | 3.88 % | 453,211 | 4,406 | 3.90 % |
| Total interest-bearing liabilities | 1,240,264 | 5,682 | 1.84 % | 1,261,042 | 5,531 | 1.76 % |
| Noninterest-bearing liabilities | | | | | | |
| Noninterest-bearing deposits | 66,399 | | | 42,691 | | |
| Other noninterest-bearing liabilities | 26,992 | | | 22,706 | | |
| Total noninterest-bearing liabilities | 93,391 | | | 65,397 | | |
| Total liabilities | 1,333,655 | | | 1,326,439 | | |
| Equity | 420,465 | | | 461,965 | | |
| Total liabilities and equity | $1,754,120 | | | $1,788,404 | | |
| Net interest income | | 10,293 | | | 10,818 | |
| Net interest rate spread (4) | | | 2.07 % | | | 2.14 % |
| Less: taxable equivalent adjustment | | 233 | | | 208 | |
| Net interest income, as reported | | 10,060 | | | 10,610 | |
| Net interest-earning assets (5) | $401,256 | | | $419,183 | | |
| Net interest margin (6) | | | 2.46 % | | | 2.53 % |
| Tax equivalent effect | | | 0.06 % | | | 0.05 % |
| Net interest margin on a fully tax equivalent basis (6) | | | 2.52 % | | | 2.58 % |

| | | |
|---|---|---|
| Average interest-earning assets to average interest-bearing liabilities | 132.35 % | 133.24 % |

(1) Interest income includes net deferred loan fee amortization income of $163,000 and $165,000 for the three months ended June 30, 2015 and 2014, respectively.
(2) Average balance of mortgage related and debt securities are based on amortized historical cost.
(3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 1.53% and 1.16% for the three months ended June 30, 2015 and 2014, respectively.
(4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.
(5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
(6) Net interest margin represents net interest income divided by average total interest-earning assets.

Rate/Volume Analysis

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

| | Three months ended June 30, 2015 versus 2014 Increase (Decrease) due to | | |
|---|---|---|---|
| | Volume | Rate | Net |
| | (In Thousands) | | |
| Interest income: | | | |
| Loans receivable and held for sale (1)(2) | $ 140 | (643 ) | (503 ) |
| Mortgage related securities (3) | 40 | 32 | 72 |
| Other earning assets (3) (4) | (243 ) | 300 | 57 |
| Total interest-earning assets | (63 ) | (311 ) | (374 ) |
| | | | |
| Interest expense: | | | |
| Demand accounts | (1 ) | 2 | 1 |
| Money market and savings accounts | - | 4 | 4 |
| Time deposits | 4 | 224 | 228 |
| Total interest-earning deposits | 3 | 230 | 233 |
| Borrowings | (59 ) | (23 ) | (82 ) |
| Total interest-bearing liabilities | (56 ) | 207 | 151 |
| Net change in net interest income | $ (7 ) | (518 ) | (525 ) |

---

(1) Interest income includes net deferred loan fee amortization income of $163,000 and $165,000 for the three months ended June 30, 2015 and 2014, respectively.
(2) Non-accrual loans have been included in average loans receivable balance.
(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.
(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income decreased $550,000, or 5.2%, to $10.1 million during the three months ended June 30, 2015 compared to $10.6 million during the three months ended June 30, 2014.

- Interest income on loans decreased due to a 20 basis point decrease in average yield on loans.
- Interest income from mortgage-related securities increased due to an increase in the average balance of mortgage-related securities. Funds received from the second step offering completed in January 2014 were used to purchase additional securities throughout 2014.
- Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased slightly due to an increase in higher yielding municipal securities balance in 2015 compared to cash being held in 2014. The decrease in the average balance of other interest-earning assets reflects utilization of the $248.3 million in net proceeds that were received from our stock offering during January 2014 to purchase

securities and fund loans held for sale.

- Interest expense on deposits increased primarily due to an increase in the average cost of time deposits of 14 basis points along with a slightly higher average balance.
- Interest expense on borrowings decreased slightly due to the decreased use of short-term repurchase agreements within our mortgage banking segment to fund loan originations to be sold in the secondary market during the three months ended June 30, 2015.

- 36 -

Provision for Loan Losses

Our provision for loan losses increased $520,000, or 182.5%, to $805,000 during the three months ended June 30, 2015, from $285,000 during the three months ended June 30, 2014. The increase is largely related to two loans collateralized by out-of-state single-family properties.

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

Noninterest Income

| | Three months ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2015 | 2014 | $ Change | % Change | |
| | (Dollars in Thousands) | | | | |
| Service charges on loans and deposits | $443 | 333 | 110 | 33.0 | % |
| Increase in cash surrender value of life insurance | 352 | 305 | 47 | 15.4 | % |
| Mortgage banking income | 29,577 | 22,188 | 7,389 | 33.3 | % |
| Gain on sale of available for sale securities | - | - | - | N/ | M |
| Other | 668 | 370 | 298 | 80.5 | % |
| Total noninterest income | $31,040 | 23,196 | 7,844 | 33.8 | % |

N/M - Not meaningful

Total noninterest income increased $7.8 million, or 33.8%, to $31.0 million during the three months ended June 30, 2015 compared to $23.2 million during the three months ended June 30, 2014. The increase resulted primarily from an increase in mortgage banking income along with slight increases in other noninterest income.

- The increase in mortgage banking income was the result of an increase in origination volumes. The volume increased $124.3 million, or 26.3%, to $596.1 million during the three months ended June 30, 2015 compared to $471.8 million during the three months ended June 30, 2014.
- The increase in service charges on loans and deposits is related to an increase in loan prepayment penalties.
- The increase in other noninterest income is primarily due to an increase in the sale of mortgage servicing rights which resulted in a $256,000 gain during the three months ended June 30, 2015. There were no sales of mortgage servicing rights during the three months ended June 30, 2014.

Noninterest Expense

| | Three months ended June 30, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2015 | 2014 | $ Change | | % Change | | |
| | (Dollars in Thousands) | | | | | | |
| Compensation, payroll taxes, and other employee benefits | $23,272 | 18,190 | 5,082 | | 27.9 | | % |
| Occupancy, office furniture and equipment | 2,269 | 2,621 | (352 | ) | (13.4 | ) | % |
| Advertising | 712 | 838 | (126 | ) | (15.0 | ) | % |
| Data processing | 630 | 559 | 71 | | 12.7 | | % |
| Communications | 351 | 398 | (47 | ) | (11.8 | ) | % |

| | | | | |
|---|---|---|---|---|
| Professional fees | 632 | 522 | 110 | 21.1 % |
| Real estate owned | 686 | 705 | (19 ) | (2.7 )% |
| FDIC insurance premiums | 271 | 304 | (33 ) | (10.9 )% |
| Other | 3,124 | 3,466 | (342 ) | (9.9 )% |
| Total noninterest expense | $31,947 | 27,603 | 4,344 | 15.7 % |

Total noninterest expense increased $4.3 million, or 15.7%, to $31.9 million during the three months ended June 30, 2015 compared to $27.6 million during the three months ended June 30, 2014.

- Compensation, payroll taxes and other employee benefit expense increased $5.1 million primarily due to a $4.8 million increase in compensation, payroll taxes and other benefits within our mortgage banking segment. The increase in compensation within our mortgage banking segment correlates to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers.
- Compensation, payroll taxes and other employee benefit expense increased $391,000 within the community banking segment primarily due to stock awards granted in 2015.
- Occupancy, office furniture and equipment expense decreased resulting from less rent expense in the three months ended June 30, 2015 compared to the same period during the prior year due to the closing of a number of mortgage branches during the three months ended June 30, 2014.
- Real estate owned expense decreased $19,000. Net real estate owned expenses decreased $70,000 due to a decrease in the number of properties. Offsetting the decrease in operating expenses, net loss on sales and write-downs increased $51,000.
- Other noninterest expense decreased primarily due to a reduced provision for mortgage banking segment branch losses due to increased profitability with high mortgage volumes and continued focus on controlling expenses.

Income Taxes

Driven by an increase in pre-tax income, income tax expense increased $916,000, or 42.6%, to $3.1 million during the three months ended June 30, 2015, compared to $2.1 million during the three months ended June 30, 2014. Income tax expense was recognized during the three months ended June 30, 2015 at an effective rate of 36.7% compared to an effective rate of 36.3% during the three months ended June 30, 2014.

Comparison of Community Banking Segment for the Six Months Ended June 30, 2015 and 2014

Net income for the six months ended June 30, 2015 totaled $4.0 million compared to net income of $4.6 million for the six months ended June 30, 2014. Net interest income decreased $471,000 to $19.0 million for the six months ended June 30, 2015 compared to $19.4 million for the six months ended June 30, 2014. Provision for loan loss increased $450,000. Compensation, payroll taxes, and other employee benefits expense increased $1.4 million due to the grant of stock awards during 2015. The increase in compensation was offset by a reduction in all other expense categories for the six months ended June 30, 2015 compared to the six months ended June 30, 2014.

Comparison of Mortgage Banking Segment Operations for the Six Months Ended June 30, 2015 and 2014

Net income totaled $4.3 million for the six months ended June 30, 2015, compared to $1.0 million during the six months ended June 30, 2014. Mortgage banking segment revenues increased $12.4 million, or 31.7%, to $51.6 million for the six months ended June 30, 2015 compared to $39.1 million for the six months ended June 30, 2014. The increase in revenue was attributable to a 29.7% increase in volume origination to $995.1 million during the six months ended June 30, 2015 compared to $767.0 million during the six months ended June 30, 2014. While revenue increased 31.7%, noninterest expense increased $6.4 million, or 16.9%, to $44.3 million for the six months ended June 30, 2015 compared to $37.9 million for the six months ended June 30, 2014. The improvement is due to ongoing expense control efforts.

Consolidated Waterstone Financial, Inc. Results of Operations

| | Six months ended June 30, | |
|---|---|---|
| | 2015 | 2014 |

| | (Dollars in Thousands, except per share amounts) | |
|---|---|---|
| Net income YTD | $ 8,300 | 5,654 |
| Earnings per share - basic YTD | 0.26 | 0.17 |
| Earnings per share - diluted YTD | 0.26 | 0.16 |
| Return on assets - YTD | 0.95 % | 0.63 % |
| Return on equity - YTD | 3.83 % | 2.62 % |

- 38 -

Average Balance Sheets, Interest and Yields/Costs

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

| | Six months ended June 30, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2015 | | | | 2014 | | | |
| | Average Balance | Interest | Yield/Cost | | Average Balance | Interest | Yield/Cost | |
| | (Dollars in Thousands) | | | | | | | |
| Assets | | | | | | | | |
| Interest-earning assets: | | | | | | | | |
| Loans receivable and held for sale (1) | $1,207,251 | 27,378 | 4.57 | % | $1,195,810 | 28,236 | 4.76 | % |
| Mortgage related securities (2) | 175,957 | 1,659 | 1.90 | % | 146,423 | 1,307 | 1.80 | % |
| Debt securities, federal funds sold and short-term investments (2)(3) | 266,301 | 2,190 | 1.66 | % | 350,510 | 2,041 | 1.17 | % |
| Total interest-earning assets | 1,649,509 | 31,227 | 3.82 | % | 1,692,743 | 31,584 | 3.76 | % |
| Noninterest-earning assets | 112,021 | | | | 103,124 | | | |
| Total assets | $1,761,530 | | | | $1,795,867 | | | |
| Liabilities and equity | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | |
| Demand accounts | $30,206 | 10 | 0.07 | % | $46,884 | 7 | 0.03 | % |
| Money market and savings accounts | 129,224 | 58 | 0.09 | % | 178,845 | 51 | 0.06 | % |
| Time deposits | 638,025 | 2,643 | 0.84 | % | 625,679 | 2,127 | 0.69 | % |
| Total interest-bearing deposits | 797,455 | 2,711 | 0.69 | % | 851,408 | 2,185 | 0.52 | % |
| Borrowings | 440,711 | 8,553 | 3.91 | % | 449,040 | 8,699 | 3.91 | % |
| Total interest-bearing liabilities | 1,238,166 | 11,264 | 1.83 | % | 1,300,448 | 10,884 | 1.69 | % |
| Noninterest-bearing liabilities | | | | | | | | |
| Noninterest-bearing deposits | 64,909 | | | | 42,054 | | | |
| Other noninterest-bearing liabilities | 21,655 | | | | 18,672 | | | |
| Total noninterest-bearing liabilities | 86,564 | | | | 60,726 | | | |
| Total liabilities | 1,324,730 | | | | 1,361,174 | | | |
| Equity | 436,800 | | | | 434,693 | | | |
| Total liabilities and equity | $1,761,530 | | | | $1,795,867 | | | |
| Net interest income | | 19,963 | | | | 20,700 | | |
| Net interest rate spread (4) | | | 1.98 | % | | | 2.07 | % |
| Less: taxable equivalent adjustment | | 467 | | | | 390 | | |
| Net interest income, as reported | | 19,496 | | | | 20,310 | | |
| Net interest-earning assets (5) | $411,343 | | | | $392,295 | | | |
| Net interest margin (6) | | | 2.38 | % | | | 2.42 | % |
| Tax equivalent effect | | | 0.06 | % | | | 0.05 | % |
| Net interest margin on a fully tax equivalent basis (6) | | | 2.44 | % | | | 2.47 | % |
| Average interest-earning assets to average interest-bearing liabilities | | | 133.22 | % | | | 130.17 | % |

(1) Interest income includes net deferred loan fee amortization income of $281,000 and $303,000 for the six months ended June 30, 2015 and 2014, respectively.
(2) Average balance of mortgage related and debt securities are based on amortized historical cost.
(3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 1.30% and 0.95% for the six months ended June 30, 2015 and 2014, respectively.
(4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.
(5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
(6) Net interest margin represents net interest income divided by average total interest-earning assets.

Rate/Volume Analysis

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

| | Six months ended June 30, 2015 versus 2014 Increase (Decrease) due to | | |
|---|---|---|---|
| | Volume | Rate | Net |
| | (In Thousands) | | |
| Interest income: | | | |
| Loans receivable and held for sale (1)(2) | $271 | (1,129) | (858) |
| Mortgage related securities (3) | 283 | 69 | 352 |
| Other earning assets (3) (4) | (569) | 718 | 149 |
| Total interest-earning assets | (15) | (342) | (357) |
| Interest expense: | | | |
| Demand accounts | (4) | 7 | 3 |
| Money market and savings accounts | (17) | 24 | 7 |
| Time deposits | 42 | 474 | 516 |
| Total interest-earning deposits | 21 | 505 | 526 |
| Borrowings | (162) | 16 | (146) |
| Total interest-bearing liabilities | (141) | 521 | 380 |
| Net change in net interest income | $126 | (863) | (737) |

(1) Interest income includes net deferred loan fee amortization income of $281,000 and $303,000 for the six months ended June 30, 2015 and 2014, respectively.
(2) Non-accrual loans have been included in average loans receivable balance.
(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.
(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income decreased $814,000, or 4.0%, to $19.5 million during the six months ended June 30, 2015 compared to $20.3 million during the six months ended June 30, 2014.

- Interest income on loans decreased due to a 19 basis point decrease in average yield on loans.
- Interest income from mortgage related securities increased due to an increase in the average balance of mortgage related securities. Funds received from the second step offering completed in January 2014 were used to purchase additional securities throughout 2014.
- Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased slightly due to an increase in higher yielding municipal securities balance in 2015 compared to cash being held in 2014. The decrease in average balance reflects utilization of the $248.3 million in net proceeds

that were received from our stock offering during January 2014 to purchase securities and fund loans held for sale.

- Interest expense on deposits increased primarily due to an increase in the average cost of time deposits of 15 basis points along with a slightly higher average balance of time deposits.
- Interest expense on borrowings decreased slightly due to the decreased use of short-term repurchase agreements within our mortgage banking segment to fund loan originations to be sold in the secondary market during the six months ended June 30, 2015.

- 40 -

Provision for Loan Losses

Our provision for loan losses increased $605,000, or 113.1%, to $1.1 million during the six months ended June 30, 2015, from $535,000 during the six months ended June 30, 2014. The increase is largely related to two loans collateralized by out-of-state single-family properties.

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

Noninterest Income

| | Six months ended June 30, | | | |
|---|---|---|---|---|
| | 2015 | 2014 | $ Change | % Change |
| | (Dollars in Thousands) | | | |
| Service charges on loans and deposits | $849 | 587 | 262 | 44.6 % |
| Increase in cash surrender value of life insurance | 559 | 452 | 107 | 23.7 % |
| Mortgage banking income | 50,616 | 36,690 | 13,926 | 38.0 % |
| Gain on sale of available for sale securities | 44 | - | 44 | N/M |
| Other | 1,005 | 2,526 | (1,521 ) | (60.2 )% |
| Total noninterest income | $53,073 | 40,255 | 12,818 | 31.8 % |

N/M - Not meaningful

Total noninterest income increased $12.8 million, or 31.8%, to $53.1 million during the six months ended June 30, 2015 compared to $40.3 million during the six months ended June 30, 2014. The increase resulted primarily from an increase in mortgage banking income offset by a decrease in other noninterest income.

- The increase in mortgage banking income was the result of an increase in origination volumes. The volume increased $228.1 million, or 29.7%, to $995.1 million during the six months ended June 30, 2015 compared to a $767.0 million during the six months ended June 30, 2014.
- The increase in service charges on loans and deposits is related to an increase in loan prepayment penalties.
- The increase in cash surrender value of life insurance is related to the additional earnings on the $10 million policy purchased in May 2014.
- The Company sold one municipal security at a gain in the current period compared to none in the prior year period.
- The decrease in other noninterest income is primarily due to a decrease on the sale of mortgage servicing rights which resulted in a $262,000 gain during the six months ended June 30, 2015 compared to a $1.8 million gain on sales of mortgage servicing rights during the six months ended June 30, 2014.

Noninterest Expense

| | Six months ended June 30, | | | |
|---|---|---|---|---|
| | 2015 | 2014 | $ Change | % Change |
| | (Dollars in Thousands) | | | |
| Compensation, payroll taxes, and other employee benefits | $41,350 | 33,249 | 8,101 | 24.4 % |

| | | | | |
|---|---|---|---|---|
| Occupancy, office furniture and equipment | 4,712 | 5,306 | (594 ) | (11.2 )% |
| Advertising | 1,365 | 1,574 | (209 ) | (13.3 )% |
| Data processing | 1,205 | 1,118 | 87 | 7.8 % |
| Communications | 721 | 820 | (99 ) | (12.1 )% |
| Professional fees | 1,129 | 1,030 | 99 | 9.6 % |
| Real estate owned | 1,229 | 1,253 | (24 ) | (1.9 )% |
| FDIC insurance premiums | 607 | 710 | (103 ) | (14.5 )% |
| Other | 6,057 | 6,174 | (117 ) | (1.9 )% |
| Total noninterest expense | $58,375 | 51,234 | 7,141 | 13.9 % |

Total noninterest expense increased $7.1 million, or 13.9%, to $58.4 million during the six months ended June 30, 2015 compared to $51.2 million during the six months ended June 30, 2014.

- Compensation, payroll taxes and other employee benefit expense increased $8.1 million primarily due to a $6.9 million increase in compensation, payroll taxes and other benefits within our mortgage banking segment. The increase in compensation within our mortgage banking segment correlates to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers.
- Compensation, payroll taxes and other employee benefit expense increased $1.4 million within the community banking segment primarily due to stock awards granted in 2015.
- Occupancy, office furniture and equipment expense decreased resulting from less rent expense in the current compared to prior year due to closing a number of mortgage banking segment branches during the first half of 2014. Additionally, there was less snow removal expense in the six months ended June 30, 2015 compared to the same period during the prior year.
- Advertising expense decreased as a result of mortgage banking segment branches closing in 2014 and improved expense management at our mortgage banking segment.
- Real estate owned expense decreased $24,000. Net real estate owned expenses decreased $126,000 due to a decrease in the number of properties. Offsetting the decrease in operating expenses, net loss on sales and write-downs increased $102,000.
- FDIC insurance premiums decreased due to a decrease in our assessment rate in 2015 compared to 2014 as capital increased.
- Other noninterest expense decreased primarily due to a reduced provision for mortgage banking segment branch losses due to increased profitability with high mortgage volumes and continued focus on controlling expenses.

Income Taxes

Driven by an increase in pre-tax income, income tax expense increased $1.6 million, or 51.3%, to $4.8 million during the six months ended June 30, 2015, compared to $3.1 million during the six months ended June 30, 2014. Income tax expense was recognized during the six months ended June 30, 2015 at an effective rate of 36.4% compared to an effective rate of 35.7% during the six months ended June 30, 2014.

Comparison of Financial Condition at June 30, 2015 and December 31, 2014

Total Assets - Total assets decreased by $46.2 million, or 2.6%, to $1.74 billion at June 30, 2015 from $1.78 billion at December 31, 2014. The decrease in total assets is primarily due to the stock buyback program.

Cash and Cash Equivalents – Cash and cash equivalents decreased $124.7 million, or 72.2%, to $48.1 million at June 30, 2015, compared to $172.8 million at December 31, 2014. The decrease in cash and cash equivalents primarily reflects the increase in loans held for sale, repurchase of shares, and slight decrease in deposits. Offsetting these reductions to cash and cash equivalents, borrowings and advanced payments by borrowers for taxes increased from December 31, 2014.

Securities Available for Sale – Securities available for sale decreased slightly at June 30, 2015 compared to December 31, 2014. This decrease reflects a $1.8 million decrease in net unrealized gains as interest rates increased from year end. The remaining decrease is due to paydowns in mortgage related securities and maturities of municipal bonds offset by the purchase of a corporate bond security.

Loans Held for Sale - Loans held for sale increased at June 30, 2015 due to increased volumes at our mortgage subsidiary compared to the fourth quarter of 2014.

Loans Receivable - Loans receivable held for investment decreased $401,000 to $1.09 billion at June 30, 2015 consistent with the balance at December 31, 2014. The decrease in total loans receivable was primarily attributable to decreases in one- to four-family, home equity, and construction and land loans, driven by prepayments and as loans were transferred to real estate owned. The multi-family and commercial real estate loan portfolio categories increased as the bank continues to focus on those areas for growth.

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

| | As of or for the Six months ended June 30, | | As of or for the Year Ended December 31, 2014 |
|---|---|---|---|
| | 2015 | 2014 | |
| | (In Thousands) | | |
| Total gross loans receivable and held for sale at beginning of period | $1,220,063 | 1,189,697 | 1,189,697 |
| Real estate loans originated for investment: | | | |
| Residential | | | |
| One- to four-family | 17,253 | 18,542 | 48,325 |
| Multi-family | 57,540 | 51,357 | 88,958 |
| Home equity | 2,837 | 459 | 4,177 |
| Construction and land | 1,985 | 1,449 | 8,806 |
| Commercial real estate | 15,019 | 18,545 | 29,294 |
| Total real estate loans originated for investment | 94,634 | 90,352 | 179,560 |
| Consumer loans originated for investment | 673 | 4 | 10 |
| Commercial business loans originated for investment | 13,121 | 5,495 | 7,863 |
| Total loans originated for investment | 108,428 | 95,851 | 187,433 |
| Principal repayments | (97,099) | (56,524) | (159,619) |
| Transfers to real estate owned | (9,066) | (6,930) | (16,645) |
| Loan principal charged-off | (2,664) | (4,416) | (8,855) |
| Net activity in loans held for investment | (401) | 27,981 | 2,314 |
| Loans originated for sale | 995,131 | 767,020 | 1,661,376 |
| Loans sold | (912,284) | (695,571) | (1,633,324) |
| Net activity in loans held for sale | 82,847 | 71,449 | 28,052 |
| Total gross loans receivable and held for sale at end of period | $1,302,509 | 1,289,127 | 1,220,063 |

Allowance for Loan Losses - The allowance for loan losses decreased at June 30, 2015 from December 31, 2014. The decrease resulted from the charge-off of specific reserves and improvement of key loan quality metrics decreasing the allowance related to the loans collectively reviewed. The reserve related to the individually reviewed loans stayed consistent with the amount at December 31, 2014. The overall decrease was primarily in the allowance for the multi-family and commercial real estate categories, offset by an increase in the allowance for the one- to four-family category. The remaining categories were consistent with the amounts at December 31, 2014.

Real Estate Owned – Total real estate owned decreased $4.4 million from December 31, 2014. During the six months ended June 30, 2015, $9.1 million was transferred from loans receivable to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled $12.5 million. Declines in real estate owned property values evidenced by updated appraisals and responses to list prices on properties held for sale resulted in $1.2 million in write downs during the six months ended June 30, 2015.

Deposits – Total deposits decreased $13.6 million to $850.3 million at June 30, 2015 from December 31, 2014. The decrease was driven by a decrease in time deposits partially offset by an increase in more cost effective transaction accounts.

Borrowings – Total borrowings increased $10.0 million to $444.0 million at June 30, 2015 compared to December 31, 2014.  The  bank borrowed additional FHLB advances of $10.0 million to fund the increased mortgage banking loan origination volumes.

- 43 -

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

Other Liabilities - Other liabilities decreased $5.4 million at June 30, 2015 compared to December 31, 2014. Of the total decrease, $9.7 million related to a seasonal decrease in outstanding checks related to advance payments by borrowers for taxes. The Company receives payments from borrowers for their real estate taxes during the course of the calendar year until real estate tax obligations are paid out in the fourth quarter. At the time at which the disbursements are made, the outstanding checks are classified as other liabilities. These amounts remain classified as other liabilities until settled. The accrued compensation for the mortgage banking segment increased $2.6 million from December 31, 2014, driven by increased loan origination volumes.

Shareholders' Equity – Shareholders' equity decreased by $48.8 million, or 10.8%, to $401.4 million at June 30, 2015 from December 31, 2014. The decrease in shareholders' equity was due to the stock repurchase programs initiated during the six months ended June 30, 2015, dividends declared, and the decrease in accumulated other comprehensive income. These decreases were offset by net income and the stock compensation awards.

ASSET QUALITY

NONPERFORMING ASSETS

| | At June 30, 2015 | At December 31, 2014 |
|---|---|---|
| | (Dollars in Thousands) | |
| Non-accrual loans: | | |
| Residential | | |
| One- to four-family | $22,399 | 23,918 |
| Multi-family | 5,196 | 12,001 |
| Home equity | 365 | 445 |
| Construction and land | 394 | 401 |
| Commercial real estate | 327 | 947 |
| Commercial | 34 | 299 |
| Consumer | - | - |
| Total non-accrual loans | 28,715 | 38,011 |
| | | |
| Real estate owned | | |
| One- to four-family | 8,145 | 10,896 |
| Multi-family | 1,568 | 2,210 |
| Construction and land | 5,334 | 5,400 |
| Commercial real estate | 300 | 300 |
| Total real estate owned | 15,347 | 18,806 |
| Valuation allowance at end of period | (1,021 ) | (100 ) |
| Total real estate owned, net | 14,326 | 18,706 |
| Total nonperforming assets | $43,041 | 56,717 |
| | | |
| Total non-accrual loans to total loans, net | 2.62 % | 3.47 % |

| | | | | |
|---|---|---|---|---|
| Total non-accrual loans to total assets | 1.65 | % | 2.13 | % |
| Total nonperforming assets to total assets | 2.48 | % | 3.18 | % |

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

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

| | At or for the Six Months Ended June 30, | |
|---|---|---|
| | 2015 | 2014 |
| | (In Thousands) | |
| Balance at beginning of period | $38,011 | 50,961 |
| Additions | 7,176 | 11,430 |
| Transfers to real estate owned | (9,066 ) | (6,930 ) |
| Charge-offs | (1,003 ) | (3,702 ) |
| Returned to accrual status | (3,188 ) | (1,769 ) |
| Principal paydowns and other | (3,215 ) | (3,969 ) |
| Balance at end of period | $28,715 | 46,021 |

Total non-accrual loans decreased by $9.3 million, or 24.5%, to $28.7 million as of June 30, 2015 compared to $38.0 million as of December 31, 2014. The ratio of non-accrual loans to total loans receivable was 2.62% at June 30, 2015 compared to 3.47% at December 31, 2014. During the six months ended June 30, 2015, $9.1 million were transferred to real estate owned, $1.0 million in loan principal was charged off, $3.2 million in loans were returned to accrual status and approximately $3.2 million in principal payments were received. Offsetting this activity, $7.2 million in loans were placed on non-accrual status during the six months ended June 30, 2015.

Of the $28.7 million in total non-accrual loans as of June 30, 2015, $27.3 million in loans have been specifically reviewed to assess whether a specific valuation allowance is necessary. A specific valuation allowance is established for an amount equal to the impairment when the carrying value of the loan exceeds the present value of expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral with an adjustment made for costs to dispose of the asset. Based upon these specific reviews, a total of $5.0 million in cumulative partial charge-offs have been recorded with respect to these loans as of June 30, 2015. Partially charged-off loans measured for impairment based upon net realizable collateral value are maintained in a "non-performing" status and are disclosed as impaired loans. In addition, specific reserves totaling $3.3 million have been recorded as of June 30, 2015. The remaining $1.5 million of non-accrual loans were reviewed on an aggregate basis and $364,000 in valuation allowance was deemed necessary related to those loans as of June 30, 2015. The $364,000 in general valuation allowance is based upon a migration analysis performed with respect to similar non-accrual loans in prior periods.

Our largest non-accrual loan was collateralized by single-family residential real estate. This loan had a principal balance of $2.3 million at June 30, 2015, as well as a specific reserve of $732,000. Our second largest non-accrual loan was collateralized by single-family residential real estate. This loan had a principal balance of $1.9 million at June 30, 2015, as well as a specific reserve of $833,000. Our third largest non-accrual loan as of June 30, 2015 was collateralized by single-family residential real estate. This loan had a principal balance of $1.3 million, which is net of life-to-date charge-offs of $865,000 at June 30, 2015. Our fourth largest non-accrual loan as of June 30, 2015 was collateralized by multi-family residential real estate. This loan had a principal balance of $1.3 million, which is net of life-to-date charge-offs of $102,000, at June 30, 2015. Our fifth largest non-accrual loan as of June 30, 2015 was collateralized by multi-family residential real estate. This loan had a principal balance of $1.2 million, which is net of life-to-date charge-offs of $948,000, at June 30, 2015. Together, these five largest non-accrual loans comprised 28.1% of total non-accrual loans at June 30, 2015.

For the six months ended June 30, 2015, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was $910,000. We recognized $544,000 of interest income

on such loans during the six months ended June 30, 2015.

There were no accruing loans past due 90 days or more during the six months ended June 30, 2015 or 2014.

TROUBLED DEBT RESTRUCTURINGS

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

| | As of June 30, 2015 | | |
|---|---|---|---|
| | Accruing | Non-accruing | Total |
| | (In Thousands) | | |
| One- to four-family | $3,902 | 7,426 | 11,328 |
| Multi-family | 2,804 | 1,499 | 4,303 |
| Home equity | - | 98 | 98 |
| Construction and land | 1,716 | - | 1,716 |
| Commercial real estate | 1,306 | 77 | 1,383 |
| | $9,728 | 9,100 | 18,828 |

| | As of December 31, 2014 | | |
|---|---|---|---|
| | Accruing | Non-accruing | Total |
| One- to four-family | $4,724 | 10,233 | 14,957 |
| Multi-family | 2,923 | 4,797 | 7,720 |
| Home equity | - | 98 | 98 |
| Construction and land | 1,866 | - | 1,866 |
| Commercial real estate | 1,306 | 170 | 1,476 |
| | $10,819 | 15,298 | 26,117 |

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

We do not participate in government-sponsored troubled debt restructuring programs.  Our troubled debt restructurings are short-term modifications.  Typical initial restructured terms include six to twelve months of principal forbearance, a reduction in interest rate or both.  Restructured terms do not include a reduction of the outstanding principal balance unless mandated by a bankruptcy court. Troubled debt restructuring terms may be renewed or further modified at the end of the initial term for an additional period if performance has been acceptable and the short-term borrower difficulty persists.
If a restructured loan is current in all respects and a minimum of six consecutive restructured payments have been received, it can be considered for return to accrual status.  After a restructured loan that is current in all respects reverts to contractual/market terms, if a credit department review indicates no evidence of elevated market risk, the loan is removed from the troubled debt restructuring classification.

LOAN DELINQUENCY

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

| | At June 30, 2015 | At December 31, 2014 |
|---|---|---|
| | (Dollars in Thousands) | |
| Loans past due less than 90 days | $5,596 | 9,022 |
| Loans past due 90 days or more | 18,144 | 25,112 |
| Total loans past due | $23,740 | 34,134 |
| Total loans past due to total loans receivable | 2.17 % | 3.12 % |

Past due loans decreased by $10.4 million, or 30.5%, to $23.7 million at June 30, 2015 from $34.1 million at December 31, 2014. Loans past due 90 days or more decreased by $7.0 million, or 27.7%, during the six months ended June 30, 2015 and loans past due less than 90 days decreased by $3.4 million, or 38.0%. The $7.0 million decrease in loans past due 90 days or more was primarily due to $9.1 million in loans transferred to real estate owned during the six months ended June 30, 2015 offset by additional loans which were included in the less than 90 day group in the previous period. The $3.4 million decrease in loans past due less than 90 days or more was primarily attributable to a decrease in delinquent loans collateralized by one- to four-family loans as one significant relationship entered the past 90 days due category, in addition to fewer loans entering past due status.

REAL ESTATE OWNED

Total real estate owned decreased by $4.4 million, or 23.4%, to $14.3 million at June 30, 2015, compared to $18.7 million at December 31, 2014. During the six months ended June 30, 2015, $9.1 million was transferred from loans to real estate owned upon completion of foreclosure including a $1.5 million relationship and a $1.2 million relationship. Declines in property values evidenced by updated appraisals and responses to list prices on properties held for sale resulted in write-downs totaling $1.2 million during the six months ended June 30, 2015. During the same period, sales of real estate owned totaled $12.5 million. New appraisals received on real estate owned and collateral dependent impaired loans are based upon an "as is value" assumption. During the period of time in which we are awaiting receipt of an updated appraisal, loans evaluated for impairment based upon collateral value are measured by the following:

- Applying an updated adjustment factor (as described previously) to an existing appraisal;
- Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;
- Comparing the estimated current value of the collateral to that of updated sales values experienced on similar collateral;
- Comparing the estimated current value of the collateral to that of updated values seen on current appraisals of similar collateral; and
- Comparing the estimated current value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

Virtually all habitable real estate owned is managed with the intent of attracting a lessee to generate revenue. Foreclosed properties are recorded at the lower of carrying value or fair value, less costs to sell, with charge-offs, if any, charged to the allowance for loan losses upon transfer to real estate owned. The fair value is primarily based upon updated appraisals in addition to an analysis of current real estate market conditions.

ALLOWANCE FOR LOAN LOSSES

| | At or for the Six Months Ended June 30, | |
|---|---|---|
| | 2015 | 2014 |
| | (Dollars in Thousands) | |
| Balance at beginning of period | $18,706 | 24,264 |
| Provision for loan losses | 1,140 | 535 |
| Charge-offs: | | |
| Mortgage | | |
| One- to four-family | 1,220 | 1,298 |
| Multi-family | 1,304 | 2,690 |
| Home equity | 48 | 39 |
| Commercial real estate | 45 | - |
| Construction and land | 47 | 142 |
| Consumer | - | 4 |
| Commercial | - | 243 |
| Total charge-offs | 2,664 | 4,416 |
| Recoveries: | | |
| Mortgage | | |
| One- to four-family | 289 | 740 |
| Multi-family | 753 | 23 |
| Home equity | 95 | 6 |
| Commercial real estate | 5 | 6 |
| Construction and land | 33 | 63 |
| Consumer | 3 | 3 |
| Commercial | - | 3 |
| Total recoveries | 1,178 | 844 |
| Net charge-offs | 1,486 | 3,572 |
| Allowance at end of period | $18,360 | 21,227 |
| | | |
| Ratios: | | |
| Allowance for loan losses to non-accrual loans at end of period | 63.94 % | 46.12 % |
| Allowance for loan losses to loans receivable at end of period | 1.68 % | 1.89 % |
| Net charge-offs to average loans outstanding (annualized) | 0.28 % | 0.60 % |
| Current period provision for loan losses to net charge-offs | 76.72 % | 14.98 % |
| Net charge-offs (annualized) to beginning of the period allowance | 16.02 % | 29.69 % |

At June 30, 2015, the allowance for loan losses was $18.4 million, compared to $18.7 million at December 31, 2014. The decrease in the allowance for loan losses during the six months ended June 30, 2015 reflects improvement in both the quality of the loan portfolio as well as stabilization the overall local real estate market. The Company has experienced improvement in a number of key loan-related loan quality metrics compared to December 31, 2014, including impaired loans, substandard loans, loans contractually past due and non-accrual loans.

Net charge-offs totaled $1.5 million, or an annualized 0.28% of average loans for the six months ended June 30, 2015, compared to $3.6 million, or an annualized 0.60% of average loans for the six months ended June 30, 2014. Of the $1.5 million in net charge-offs during the six months ended June 30, 2015, approximately 99.7% of the activity related to loans secured by multi-family and single-family residential loans.

Our underwriting policies and procedures emphasize the fact that credit decisions must rely on both the credit quality of the borrower and the estimated value of the underlying collateral. Credit quality is assured only when the estimated value of the collateral is objectively determined and is not subject to significant fluctuation. The quantified deterioration of the credit quality of our loan portfolio as described above is the direct result of borrowers who were not financially strong enough to make regular interest and principal payments or maintain their properties when the economic environment no longer allowed them the option of converting estimated real estate value increases into short-term cash flow.

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

The establishment of the amount of the loan loss allowance inherently involves judgments by management as to the appropriateness of the allowance, which ultimately may or may not be correct. Higher than anticipated rates of loan default would likely result in a need to increase provisions in future years. See "Critical Accounting Policies" above for a discussion on the use of judgment in determining the amount of the allowance for loan losses.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet our liquidity needs. We adjust our liquidity levels to fund loan commitments, repay our borrowings, fund deposit outflows and pay real estate taxes on mortgage loans. We also adjust liquidity as appropriate to meet asset and liability management objectives. The operational adequacy of our liquidity position at any point in time is dependent upon the judgment of the senior management as supported by the Asset/Liability Committee. Liquidity is monitored on a daily, weekly and monthly basis using a variety of measurement tools and indicators.
Our primary sources of liquidity are deposits, amortization and repayment of loans, sales of loans held for sale, maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan repayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competitors. We set the interest rates on our deposits to maintain a desired level of total deposits. In addition, we invest excess funds in short-term, interest-earning assets, which provide liquidity to meet lending requirements. Additional sources of liquidity used for the purpose of managing long- and short-term cash flows include advances from the FHLB.
During the six months ended June 30, 2015 primary uses of cash and cash equivalents included: $995.1 million funding loans held for sale, $55.6 million for the purchase of common stock, $15.9 million in purchases of mortgage related securities, $10.2 million increase in net fundings of loans receivable (irrespective of loans transferred to real estate owned), $10.0 million in purchases of debt securities, and $13.6 million related to a decrease in deposits.
During the six months ended June 30, 2015, primary sources of cash and cash equivalents included: $960.8 million in proceeds from the sale of loans held for sale, $20.7 million in principal repayments on mortgage related securities, $5.7 million from maturities and calls of debt securities, $10.0 million increase in borrowings, and $13.5 million from real estate owned sales.
During the six months ended June 30, 2014 primary uses of cash and cash equivalents included: $767.0 million in originations of loans held for sale, $141.9 million in funds returned to stock subscribers, $70.1 million in purchases of mortgage related securities, $38.5 million in loan originations, net of principal payments, $16.0 million in purchases of debt securities, $10.2 million in purchase of bank owned life insurance, and $10.0 million in funding ESOP.
During the six months ended June 30, 2014, primary sources of cash and cash equivalents included: $732.8 million in proceeds from the sale of loans held for sale and $14.6 million from principal repayments on mortgage related securities.

A portion of our liquidity consists of cash and cash equivalents, which are a product of our operating, investing and financing activities. At June 30, 2015 and 2014, respectively, $48.1 million and $112.6 million of our assets were invested in cash and cash equivalents. At June 30, 2015 cash and cash equivalents are comprised of the following: $28.6 million in cash held at the Federal Reserve Bank and other depository institutions and $19.5 million in federal funds sold and short-term investments. Our primary sources of cash are principal repayments on loans, proceeds from the calls and maturities of debt and mortgage-related securities, increases in deposit accounts and advances from the FHLBC.

Liquidity management is both a daily and longer-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLBC which provide an additional source of funds. At June 30, 2015, we had $10.0 million in short-term advances from the FHLBC with contractual maturity date of November 30, 2015. There is no prepayment penalty on the short-term advance if voluntarily repaid by the Company prior to stated maturity. At June 30, 2015, we had $350.0 million in advances from the FHLBC with contractual maturity dates in 2016, 2017 or 2018. All advances are callable quarterly until maturity. As an additional source of funds, we also enter into repurchase agreements. At June 30, 2015, we had $84.0 million in repurchase agreements. The repurchase agreements mature at various times in 2017, however, all are callable quarterly until maturity.

At June 30, 2015, we had outstanding commitments to originate loans receivable of $22.8 million. In addition, at June 30, 2015 we had unfunded commitments under construction loans of $9.3 million, unfunded commitments under business lines of credit of $12.5 million and unfunded commitments under home equity lines of credit and standby letters of credit of $15.1 million. At June 30, 2015 certificates of deposit scheduled to mature in one year or less totaled $412.7 million. Based on prior experience, management believes that, subject to the Bank's funding needs, a significant portion of such deposits will remain with us, although there can be no assurance that this will be the case. In the event a significant portion of our deposits is not retained by us, we will have to utilize other funding sources, such as FHLBC advances, in order to maintain our level of assets. However, we cannot assure that such borrowings would be available on attractive terms, or at all, if and when needed. Alternatively, we could reduce our level of liquid assets, such as our cash and cash equivalents and securities available-for-sale in order to meet funding needs. In addition, the cost of such deposits may be significantly higher if market interest rates are higher or there is an increased amount of competition for deposits in our market area at the time of renewal.

Capital

Shareholders' equity decreased by $48.8 million to $401.4 million at June 30, 2015 from $450.2 million December 31, 2014. The decrease in shareholders' equity was due to the $55.5 million in stock repurchased during the first six months, $3.0 million for cash dividends, and $1.1 million decrease in accumulated other comprehensive income. This decrease was offset by $8.3 million in net income, $2.0 million in stock compensation, and an increase due to ESOP shares committed to be released.

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

The Company repurchased a total of 4,276,815 shares at an average price of $12.90 under previously approved stock repurchase plans. The Company is authorized to purchase up to 1,131,698 additional shares under the current approved stock repurchase program as of June 30, 2015.

WaterStone Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories. At June 30, 2015, WaterStone Bank exceeded all regulatory capital requirements and is considered "well capitalized" under regulatory guidelines. See "Notes to Consolidated Financial Statements - Regulatory Capital."

The net proceeds from the stock offering significantly increased our liquidity and capital resources. Over time, the initial level of liquidity will be reduced as net proceeds from the stock offering are used for general corporate purposes, including the funding of loans. Our financial condition and results of operations will be enhanced by the net proceeds from the stock offering, resulting in increased net interest-earning assets and net interest income. However, due to the increase in equity resulting from the net proceeds from the stock offering, our return on assets and return on equity will continue to be adversely affected following the stock offering.

Contractual Obligations, Commitments and Contingent Liabilities

The following tables present information indicating various contractual obligations and commitments of the Company as of June 30, 2015 and the respective maturity dates.

| | Total | One Year or Less | More than One Year Through Three Years | More than Three Years Through Five Years | Over Five Years |
|---|---|---|---|---|---|
| | (In Thousands) | | | | |
| Demand deposits (4) | $96,969 | 96,969 | - | - | - |
| Money market and savings deposits (4) | 121,549 | 121,549 | - | - | - |
| Time deposit (4) | 631,796 | 412,678 | 211,616 | 7,502 | - |
| Federal Home Loan Bank advances (1) | 360,000 | 80,000 | 280,000 | - | - |
| Repurchase agreements (2)(4) | 84,000 | - | 84,000 | - | - |
| Operating leases (3) | 10,861 | 2,545 | 3,772 | 2,418 | 2,126 |
| Salary continuation agreements | 340 | 170 | 170 | - | - |
| | $1,305,515 | 713,911 | 579,558 | 9,920 | 2,126 |

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(1) Secured under a blanket security agreement on qualifying assets, principally, mortgage loans. Excludes interest which will accrue on the advances.
All Federal Home Loan Bank advances with maturities exceeding one year are callable on a quarterly basis.
(2) The repurchase agreements are callable on a quarterly basis until maturity.
(3) Represents non-cancelable operating leases for offices and equipment.
(4) Excludes interest.

- 50 -

Off-Balance Sheet Commitments

The following table details the amounts and expected maturities of significant off-balance sheet commitments as of June 30, 2015.

| | Total | One Year or Less | More than One Year Through Three Years | More than Three Years Through Five Years | Over Five Years |
|---|---|---|---|---|---|
| | (In Thousands) | | | | |
| Real estate loan commitments (1) | $22,836 | 22,836 | - | - | - |
| Unused portion of home equity lines of credit (2) | 14,481 | 14,481 | - | - | - |
| Unused portion of construction loans (3) | 9,295 | 9,295 | - | - | - |
| Unused portion of business lines of credit | 12,487 | 12,487 | - | - | - |
| Standby letters of credit | 574 | 574 | - | - | - |
| Total Other Commitments | $59,673 | 59,673 | - | - | - |

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

(1) Commitments for loans are extended to customers for up to 90 days after which they expire.

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

(3) Unused portions of construction loans are available to the borrower for up to 1 year.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Management of Market Risk

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

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

- 51 -

Income Simulation. Simulation analysis is an estimate of our interest rate risk exposure at a particular point in time. At least quarterly we review the potential effect changes in interest rates may have on the repayment or repricing of rate sensitive assets and funding requirements of rate sensitive liabilities. Our most recent simulation uses projected repricing of assets and liabilities at June 30, 2015 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rate assumptions may have a significant impact on interest income simulation results. Because of the large percentage of loans and mortgage-backed securities we hold, rising or falling interest rates may have a significant impact on the actual prepayment speeds of our fixed-rate mortgage related assets that may in turn affect our interest rate sensitivity position.

| | Percentage Increase (Decrease) in Estimated Annual Net Interest Income Over 12 Months | |
|---|---|---|
| 400 basis point gradual rise in rates | 8.52 | % |
| 300 basis point gradual rise in rates | 6.59 | % |
| 200 basis point gradual rise in rates | 4.58 | % |
| 100 basis point gradual rise in rates | 2.35 | % |
| Unchanged rate scenario | 0.00 | % |
| 100 basis point gradual decline in rates (1) | (2.06 | %) |

(1) Given the current low point in the interest rate cycle, rate decline scenarios in excess of 100 basis points are not meaningful.

WaterStone Bank's Asset/Liability policy limits projected changes in net average annual interest income to a maximum decline of 25% for various levels of interest rate changes measured over a 12-month period when compared to the flat rate scenario. In addition, projected changes in the economic value of equity are limited to a maximum decline of 30% for interest rate movements of up to 400 basis points when compared to the flat rate scenario. These limits are re-evaluated on a periodic basis and may be modified, as appropriate. At June 30, 2015, a 100 basis point gradual increase in interest rates had the effect of increasing forecast net interest income by 2.35% while a 100 basis point decrease in rates had the effect of decreasing net interest income by 2.06%. At June 30, 2015, a 100 basis point gradual increase in interest rates had the effect of decreasing the economic value of equity by 1.54% while a 100 basis point decrease in rates had the effect of increasing the economic value of equity by 1.39%. While we believe the assumptions used are reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

Item 4. Controls and Procedures

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

Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is not involved in any pending legal proceedings as a defendant other than routine legal proceedings occurring in the ordinary course of business. At June 30, 2015, the Company believes that any liability arising from the resolution of any pending legal proceedings will not be material to its financial condition or results of operations.

Item 1A. Risk Factors

There have been no changes in risk factors applicable to the Company from those disclosed in "Risk Factors" in Item 1A of the Company's annual report on Form 10-K for the year ended December 31, 2014.

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

Following are the Company's monthly common stock purchases during the second quarter of 2015:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans | Maximum Number of Shares that May Yet Be Purchased Under the Plan[(a)] |
|---|---|---|---|---|
| April 1, 2015 - April 30, 2015 | 1,004,313 | $ 12.90 | 1,385,313 | 335,857 |
| May 1, 2015 - May 31, 2015 | 2,592,300 | 12.86 | 3,977,613 | 1,430,900 |
| June 1, 2015 - June 30, 2015 | 298,402 | 13.12 | 4,276,815 | 1,131,698 |
| Total | 3,895,015 | $ 12.89 | 4,276,815 | 1,131,698 |

(a) On March 6, 2015, the Board of Directors authorized the repurchase of up to 1,721,170 shares of common stock (Plan 1), of which 1,408,513 shares were purchased. On May 1, 2015, the Board of Directors terminated the existing plan and authorized the repurchase of 2,000,000 shares of common stock (Plan 2), of which, 2,000,000 shares were purchased. On May 12, 2015, the Board of Directors authorized the repurchase of 2,000,000 shares of common stock (Plan 3).

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

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

Signatures

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

WATERSTONE FINANCIAL, INC.
(Registrant)

Date: July 31, 2015

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

Date: July 31, 2015

/s/ Allan R. Hosack
Allan R. Hosack
Chief Financial Officer
Principal Financial Officer

EXHIBIT INDEX

WATERSTONE FINANCIAL, INC.

Form 10-Q for Quarter Ended June 30, 2015

| Exhibit No. | Description | Filed Herewith |
|---|---|---|
| 31.1 | Sarbanes-Oxley Act Section 302 Certification signed by the Chief Executive Officer of Waterstone Financial, Inc. | X |
| 31.2 | Sarbanes-Oxley Act Section 302 Certification signed by the Chief Financial Officer of Waterstone Financial, Inc. | X |
| 32.1 | Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer of Waterstone Financial, Inc. | X |
| 32.2 | Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer of Waterstone Financial, Inc. | X |
| 101 | The following financial statements from Waterstone Financial, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, formatted in Extensive Business Reporting Language (XBRL): (i) consolidated balance sheets, (ii) consolidated statements of operations, (iii) consolidated statements of comprehensive income, (iv) consolidated statements of changes in shareholders' equity, (v) consolidated statements of cash flows and (vi) the notes to consolidated financial statements. | X |