

FS Bancorp, Inc.  
Form 10-Q  
May 12, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended March 31, 2016 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: 333-177125

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of incorporation or organization)

45-4585178

(IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043

(Address of principal executive offices; Zip Code)

(425) 771-5299

(Registrant's telephone number, including area code)

None

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

Large accelerated filer

Accelerated filer

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Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting  
company

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of May 6, 2016, there were 3,140,599 outstanding shares of the registrant's common stock.

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

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## Item 1. Financial Statements

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

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

	March 31,	December
	2016	31, 2015
<b>ASSETS</b>		
Cash and due from banks	\$5,491	\$1,708
Interest-bearing deposits at other financial institutions	80,355	22,747
Total cash and cash equivalents	85,846	24,455
Certificates of deposit at other financial institutions	12,420	12,421
Securities available-for-sale, at fair value	80,458	55,217
Loans held for sale, at fair value	64,784	44,925
Loans receivable, net	520,165	502,535
Accrued interest receivable	2,354	2,107
Premises and equipment, net	14,703	13,856
Federal Home Loan Bank (“FHLB”) stock, at cost	1,320	4,551
Other real estate owned (“OREO”)	320	—
Bank owned life insurance (“BOLI”)	9,841	9,772
Servicing rights, held at the lower of cost or fair value	6,104	5,811
Goodwill	2,412	—
Core deposit intangible, net	2,037	—
Other assets	2,619	1,911
<b>TOTAL ASSETS</b>	<b>\$805,383</b>	<b>\$677,561</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing accounts	\$158,443	\$72,247
Interest-bearing accounts	538,236	412,931
Total deposits	696,679	485,178
FHLB advances	12,669	98,769
Subordinated note:		
Principal amount	10,000	10,000
Unamortized debt issuance costs	(190)	(195)
Total subordinated note less unamortized debt issuance costs	9,810	9,805
Other liabilities	11,101	8,469
Total liabilities	730,259	602,221
<b>COMMITMENTS AND CONTINGENCIES (NOTE 9)</b>		
<b>STOCKHOLDERS’ EQUITY</b>		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.01 par value; 45,000,000 shares authorized; 3,149,296 and 3,242,120 shares issued and outstanding at March 31, 2016, and December 31, 2015, respectively	32	32
Additional paid-in capital	28,591	30,692
Retained earnings	47,622	46,175
Accumulated other comprehensive income, net of tax	450	78
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(1,571)	(1,637)
Total stockholders’ equity	75,124	75,340
<b>TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY</b>	<b>\$805,383</b>	<b>\$677,561</b>

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
(Dollars in thousands, except share amounts) (Unaudited)

	Three Months Ended March 31,	
	2016	2015
INTEREST INCOME		
Loans receivable including fees	\$8,320	\$6,819
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	578	264
Total interest and dividend income	8,898	7,083
INTEREST EXPENSE		
Deposits	819	748
FHLB advances	85	67
Subordinated note	171	—
Total interest expense	1,075	815
NET INTEREST INCOME	7,823	6,268
PROVISION FOR LOAN LOSSES	600	600
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	7,223	5,668
NONINTEREST INCOME		
Service charges and fee income	697	425
Gain on sale of loans	3,364	3,326
Gain on sale of investment securities	—	76
Earnings on cash surrender value of BOLI	69	47
Other noninterest income	191	197
Total noninterest income	4,321	4,071
NONINTEREST EXPENSE		
Salaries and benefits	4,866	3,949
Operations	1,374	963
Occupancy	567	434
Data processing	481	359
Loan costs	437	333
Professional and board fees	465	367
Federal Deposit Insurance Corporation (“FDIC”) insurance	102	79
Marketing and advertising	144	130
Acquisition costs	385	—
Amortization of core deposit intangible	102	—
Recovery on servicing rights	(1	) (1
Total noninterest expense	8,922	6,613
INCOME BEFORE PROVISION FOR INCOME TAXES	2,622	3,126
PROVISION FOR INCOME TAXES	961	1,056
NET INCOME	\$1,661	\$2,070
Basic earnings per share	\$0.56	\$0.71

Diluted earnings per share

\$0.55 \$0.70

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (In thousands) (Unaudited)

	Three Months Ended March 31,	
	2016	2015
Net Income	\$1,661	\$2,070
Other comprehensive income, net of tax:		
Unrealized gain on securities available-for-sale:		
Unrealized holding gain arising during period	577	336
Income tax provision related to unrealized holding gain	(205 )	(114 )
Reclassification adjustment for realized gain included in net income	—	(76 )
Income tax provision related to reclassification for realized gain	—	26
Other comprehensive income, net of tax	372	172
COMPREHENSIVE INCOME	\$2,033	\$2,242

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Dollars in thousands, except share amounts) (Unaudited)

	Common Stock			Retained Earnings	Accumulated		Total Stockholders' Equity
	Shares	Amount	Additional Paid-in Capital		Other Comprehensive Income	Unearned ESOP Shares	
BALANCE, January 1, 2015	3,235,625	\$ 32	\$ 29,450	\$ 38,125	\$ 117	\$(1,888)	\$ 65,836
Net income	—	—	—	2,070	—	—	2,070
Dividends paid (\$0.06 per share)	—	—	—	(184)	—	—	(184)
Share-based compensation	—	—	182	—	—	—	182
Restricted stock awards	—	—	—	—	—	—	—
Common stock repurchased	—	—	—	—	—	—	—
Unrealized holding gains, net of tax	—	—	—	—	172	—	172
ESOP cash distribution	—	—	—	—	—	—	—
ESOP shares allocated	—	—	57	—	—	66	123
BALANCE, March 31, 2015	3,235,625	\$ 32	\$ 29,689	\$ 40,011	\$ 289	\$(1,822)	\$ 68,199
BALANCE, January 1, 2016	3,242,120	\$ 32	\$ 30,692	\$ 46,175	\$ 78	\$(1,637)	\$ 75,340
Net income	—	—	—	1,661	—	—	1,661
Dividends paid (\$0.07 per share)	—	—	—	(214)	—	—	(214)
Share-based compensation	—	—	193	—	—	—	193
Restricted stock awards	4,500	—	—	—	—	—	—
Common stock repurchased	(97,524)	—	(2,391)	—	—	—	(2,391)
Stock options exercised	200	—	3	—	—	—	3
Unrealized holding gains, net of tax	—	—	—	—	372	—	372
ESOP shares allocated	—	—	94	—	—	66	160
BALANCE, March 31, 2016	3,149,296	\$ 32	\$ 28,591	\$ 47,622	\$ 450	\$(1,571)	\$ 75,124

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

	Three Months Ended March 31,	
	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$1,661	\$2,070
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	600	600
Depreciation, amortization and accretion	734	468
Compensation expense related to stock options and restricted stock awards	193	182
ESOP compensation expense for allocated shares	160	123
Increase in cash surrender value of BOLI	(69	) (47
Gain on sale of loans held for sale	(3,364	) (3,326
Origination of loans held for sale	(136,330	) (121,943
Proceeds from sale of loans held for sale	119,476	114,268
Gain on sale of investment securities	—	(76
Recovery on servicing rights	(1	) (1
Changes in operating assets and liabilities		
Accrued interest receivable	(247	) (255
Other assets	(5,259	) (920
Other liabilities	2,428	1,591
Net cash used by operating activities	(20,018	) (7,266
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	—	4,178
Maturities, prepayments, sales, and calls	1,654	1,389
Purchases	(26,462	) (4,348
Maturities of interest-bearing time deposits	—	248
Loan originations and principal collections, net	(18,820	) (29,519)
Proceeds from sale of OREO, net	205	—
Purchase of premises and equipment, net	(1,198	) (152
FHLB stock purchased	(2,213	) (292
FHLB stock redeemed	5,444	—
Net cash received from acquisition of branches	180,356	—
Net cash from (used by) investing activities	138,966	(28,496)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	31,145	15,876
Proceeds from borrowings	130,000	75,852
Repayments of borrowings	(216,100	) (62,453)
Dividends paid	(214	) (184
Proceeds from stock options exercised	3	—
Common stock repurchased	(2,391	) —
Net cash (used by) from financing activities	(57,557	) 29,091
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>61,391</b>	<b>(6,671)</b>
<b>CASH AND CASH EQUIVALENTS, beginning of period</b>	<b>24,455</b>	<b>15,555</b>
<b>CASH AND CASH EQUIVALENTS, end of period</b>	<b>\$85,846</b>	<b>\$8,884</b>
<b>SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION</b>		

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Cash paid during the period for:

Interest	\$1,078	\$ 815
Income taxes	\$700	\$ 275
Assets acquired in acquisition of branches	\$181,575	\$—
Liabilities assumed in acquisition of branches	\$186,393	\$—

**SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES**

Change in unrealized gain on investment securities	\$577	\$ 261
Property received in settlement of loans	\$525	\$ 13
Retention of mortgage servicing rights from loan sales	\$613	\$ 785

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

Financial Statement Presentation – The accompanying unaudited consolidated interim financial statements do not contain all necessary disclosures required by generally accepted accounting principles in the United States of America (“U.S. GAAP”) for complete financial statements and, therefore, should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 filed with the U.S. Securities and Exchange Commission (“SEC”) on March 25, 2016. These unaudited consolidated financial statements include all normal and recurring adjustments that management believes are necessary in order to conform to U.S. GAAP and have been reflected as required by Article 10 of Regulation S-X as promulgated by the SEC.

The results for the three months ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016, or any other future period. The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for loan losses, fair value of measurements, servicing assets, and deferred income taxes.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented in thousands of dollars except per share amounts. In the narrative footnote discussion, amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above \$1.0 million. Amounts below \$1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been

reclassified to conform to the 2016 presentation with no change to net income or stockholders' equity previously reported.

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

**Segment Reporting** – The Company's major line of business is community banking. Management has determined that the Company operates as a single operating segment based on U. S. GAAP.

**Subsequent Events** - The Company has evaluated events and transactions subsequent to March 31, 2016, for potential recognition or disclosure.

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RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which creates Topic 606 and supersedes Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of 2014-09. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net, which amended the principal versus agent implementation guidance set for in ASU 2014-09. Among other things, ASU 2016-08 clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The ASU amends certain aspects of the guidance set forth in the FASB's new revenue standard related to identifying performance obligations and licensing implementation. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new ASU requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The standard is effective for public entities for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company is currently evaluating the provisions to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805). This ASU simplifies the accounting for adjustments made to provisional amounts recognized in a business combination during the measurement period. The amendments in this ASU require that the acquirer recognize the adjustments to provisional amounts in the reporting period in which the adjustment amount is determined. The acquirer must also record in the same period's financial statements, the effect on earnings of changes in depreciation, amortization or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

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

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

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should



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include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments. The ASU simplifies the embedded derivative analysis for debt instruments containing contingent call or put options by removing the requirement to assess whether a contingent event is related to interest rates or credit risks. The ASU is effective for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption of the update is permitted. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. The ASU eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an adjustment must be made to the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The ASU is effective for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption of the update is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The amendments in this update seek to simplify several aspects of the accounting for employee share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 will be effective for the Company for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption of the update is permitted. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

NOTE 2 - BUSINESS COMBINATION

On January 22, 2016, the Company's wholly-owned subsidiary, 1st Security Bank, completed the purchase of four branches ("Branch Purchase") from Bank of America, National Association ("Bank of America"). The Branch Purchase included four retail bank branches located in the communities of Port Angeles, Sequim, Port Townsend, and Hadlock, Washington. In accordance with the Purchase and Assumption Agreement, dated as of September 1, 2015, between

Bank of America and 1st Security Bank, 1st Security Bank acquired \$186.4 million of deposits, a small portfolio of performing loans, two owned bank branches, three leases for the bank branches and parking facilities and certain other assets of the branches.

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

The Branch Purchase was accounted for under the acquisition method of accounting and accordingly, the assets and liabilities were recorded at their fair values on January 22, 2016, the date of acquisition. Determining the fair value of assets and liabilities, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing

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date of the acquisition as information relative to closing date fair values become available.

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

January 22, 2016	Acquired Book Value	Fair Value Adjustments	Amount Recorded
<b>Assets</b>			
Cash and cash equivalents	\$ 180,356	\$ —	\$ 180,356
Loans receivable	417	—	417
Premises and equipment, net	697	267	(1) 964
Accrued interest receivable	2	—	2
Core deposit intangible	—	2,139	(2) 2,139
Goodwill	—	2,412	(3) 2,412
Other assets	103	—	103
Total assets acquired	\$ 181,575	\$ 4,818	\$ 186,393
<b>Liabilities</b>			
<b>Deposits:</b>			
Noninterest-bearing accounts	\$ 79,966	\$ —	\$ 79,966
Interest-bearing accounts	106,398	—	106,398
Total deposits	186,364	—	186,364
Accrued interest payable	7	—	7
Other liabilities	22	—	22
Total liabilities assumed	\$ 186,393	\$ —	\$ 186,393

#### Explanation of Fair Value Adjustments

(1) The fair value adjustment represents the difference between the fair value of the acquired branches and the book value of the assets acquired. The Company utilized third-party valuations but did not receive appraisals to assist in the determination of fair value

(2) The fair value adjustment represents the value of the core deposit base assumed in the Branch Purchase based on a study performed by an independent consulting firm. This amount was recorded by the Company as an identifiable intangible asset and will be amortized as an expense on an accelerated basis over the average life of the core deposit base, which is estimated to be nine years.

(3) The fair value adjustment represents the value of the goodwill calculated from the purchase based on the purchase price, less the fair value of assets acquired net of liabilities assumed.

In connection with the business combination, the Company recorded goodwill and core deposit intangible assessed at the date of the Branch Purchase.

Goodwill - The acquired goodwill represents the excess purchase price over the estimated fair value of the net assets acquired and was recorded at \$2.4 million.

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The table below summarizes the aggregate amount recognized for each major class of assets acquired and liabilities assumed by 1st Security Bank in the Branch Purchase on January 22, 2016:

	At January 22, 2016
Purchase price <sup>(1)</sup>	\$ 6,015
Recognized amounts of identifiable assets acquired and (liabilities assumed), at fair value:	
Cash and cash equivalents	186,371
Acquired loans	417
Premises and equipment, net	964
Accrued interest receivable	2
Core deposit intangible	2,139
Other assets	103
Deposits	(186,364)
Accrued interest payable	(7 )
Other liabilities	(22 )
Total fair value of identifiable net assets	3,603
Goodwill	\$ 2,412

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

#### Core deposit intangible

The acquired core deposit intangible represents the fair value of the acquired core deposit base. The core deposit intangible will be amortized on an accelerated basis over approximately nine years. Total amortization expense was \$102,000 and none for the three months ended March 31, 2016 and 2015, respectively. Amortization expense for core deposit intangible is expected to be as follows:

	At January 22, 2016
Year 1	\$ 503
Year 2	385
Year 3	294
Year 4	225
Year 5	172
Thereafter	560
Total	\$ 2,139



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## NOTE 3 - SECURITIES AVAILABLE-FOR-SALE

The following tables present the amortized costs, unrealized gains, unrealized losses, and estimated fair values of securities available-for-sale at March 31, 2016 and December 31, 2015:

SECURITIES AVAILABLE-FOR-SALE	March 31, 2016			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. agency securities	\$8,172	\$ 41	\$ (9)	) \$ 8,204
Municipal bonds	25,597	433	(62)	) 25,968
Corporate securities	5,508	31	(77)	) 5,462
U.S. Small Business Administration securities	5,968	124	—	) 6,092
Mortgage-backed securities	34,516	243	(27)	) 34,732
Total securities available-for-sale	\$79,761	\$ 872	\$ (175)	) \$ 80,458

SECURITIES AVAILABLE-FOR-SALE	December 31, 2015			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
U.S. agency securities	\$6,134	\$ —	\$ (99)	) \$ 6,035
Municipal bonds	18,531	373	(13)	) 18,891
Corporate securities	3,495	5	(67)	) 3,433
U.S. Small Business Administration securities	4,011	23	(11)	) 4,023
Mortgage-backed securities	22,926	72	(163)	) 22,835
Total securities available-for-sale	\$55,097	\$ 473	\$ (353)	) \$ 55,217

Investment securities that were in an unrealized loss position at March 31, 2016 and December 31, 2015 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. In the opinion of management, these securities are considered only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

SECURITIES AVAILABLE-FOR-SALE	March 31, 2016				Fair Value	Unrealized Losses
	Less than 12 Months	Unrealized Losses	12 Months or Longer	Unrealized Losses		
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses

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U.S. agency securities	\$2,044	\$ (1 )	\$2,990	\$ (8 )	\$5,034	\$ (9 )
Municipal bonds	4,637	(55 )	298	(7 )	4,935	(62 )
Corporate securities	—	—	1,423	(77 )	1,423	(77 )
U.S. Small Business Administration securities	—	—	—	—	—	—
Mortgage-backed securities	5,277	(12 )	2,078	(15 )	7,355	(27 )
Total	\$11,958	\$ (68 )	\$6,789	\$ (107 )	\$18,747	\$ (175 )

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	December 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
U.S. agency securities	\$2,107	\$ (31 )	\$3,928	\$ (68 )	\$6,035	\$ (99 )
Municipal bonds	956	(1 )	293	(12 )	1,249	(13 )
Corporate securities	994	(6 )	1,439	(61 )	2,433	(67 )
U.S. Small Business Administration securities	990	(11 )	—	—	990	(11 )
Mortgage-backed securities	15,642	(112 )	2,119	(51 )	17,761	(163 )
Total	\$20,689	\$ (161 )	\$7,779	\$ (192 )	\$28,468	\$ (353 )

There were ten investments with unrealized losses of less than one year, and seven investments with unrealized losses of more than one year at March 31, 2016. There were 17 investments with unrealized losses of less than one year, and eight investments with unrealized losses of more than one year at December 31, 2015. The unrealized losses associated with these investments are believed to be caused by changes in market interest rates that are considered to be temporary and the Company does not intend to sell the securities, and it is not likely to be required to sell these securities. No other-than-temporary impairment was recorded for the three months ended March 31, 2016 and 2015.

The contractual maturities of securities available-for-sale at March 31, 2016 and December 31, 2015 are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	March 31, 2016		December 31, 2015	
	Amortize Cost	Fair Value	Amortize Cost	Fair Value
U.S. agency securities				
Due after five years through ten years	8,172	8,204	6,134	6,035
Municipal bonds				
Due in one year or less	986	990	991	997
Due after one year through five years	7,036	7,139	3,904	3,954
Due after five years through ten years	11,341	11,528	7,807	7,981
Due after ten years	6,234	6,311	5,829	5,959
Subtotal	25,597	25,968	18,531	18,891
Corporate securities				
Due after one year through five years	3,513	3,526	1,500	1,490
Due after five years through ten years	1,995	1,936	1,995	1,943

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Subtotal	5,508	5,462	3,495	3,433
U.S. Small Business Administration securities				
Due after five years through ten years	5,968	6,092	4,011	4,023
Mortgage-backed securities				
Federal National Mortgage Association (“FNMA”)	17,949	18,051	12,515	12,466
Federal Home Loan Mortgage Corporation (“FHLMC”)	8,489	8,553	4,524	4,501
Government National Mortgage Association (“GNMA”)	8,078	8,128	5,887	5,868
Subtotal	34,516	34,732	22,926	22,835
Total	\$79,761	\$80,458	\$55,097	\$55,217

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The proceeds and resulting gains, computed using specific identification, from sales of securities available-for-sale for the three months ended March 31, 2016 and 2015 were as follows:

	Three Months Ended March 31, 2016		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	\$ —	\$ —	\$ —

	Three Months Ended March 31, 2015		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	\$4,178	\$ 76	\$ —

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

The composition of the loan portfolio at March 31, 2016 and December 31, 2015 was as follows:

	March 31, 2016	December 31, 2015
<b>REAL ESTATE LOANS</b>		
Commercial	\$55,505	\$50,034
Construction and development	76,381	80,806
Home equity	15,663	16,540
One-to-four-family (excludes loans held for sale)	106,141	102,921
Multi-family	30,718	22,223
Total real estate loans	284,408	272,524
<b>CONSUMER LOANS</b>		
Indirect home improvement	101,895	103,064
Solar	31,585	29,226
Marine	26,254	23,851
Other consumer	2,105	2,181
Total consumer loans	161,839	158,322
<b>COMMERCIAL BUSINESS LOANS</b>		
Total loans receivable, gross	529,519	511,282
Allowance for loan losses	(8,327 )	(7,785 )
Deferred costs, fees, and discounts, net	(1,027 )	(962 )
Total loans receivable, net	\$520,165	\$502,535

The Company's business activity is with customers located in the greater Puget Sound area which includes Snohomish, King, Pierce, Jefferson, Kitsap, and Clallam Counties, and one loan production office located in the Tri-Cities, Washington. The Company originates real estate and consumer loans and has concentrations in these areas. Generally, loans are secured by deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

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

Real Estate Loans

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

Construction and Development Lending. Loans originated by the Company for the construction of, and secured by, commercial real estate, one-to-four-family, and multi-family residences and tracts of land for development that are not pre-sold.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences in our market areas.

One-to-Four-Family Real Estate Lending. Loans originated by the Company secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

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

Consumer Loans

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

Solar. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on, or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence.

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

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

Commercial Business Loans

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

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The following tables detail activity in the allowance for loan losses by loan categories at or for the three months ended March 31, 2016 and 2015:

ALLOWANCE FOR LOAN LOSSES	At or For the Three Months Ended March 31, 2016				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	\$2,874	\$1,681	\$ 1,396	\$ 1,834	\$7,785
Provision for loan losses	580	468	142	(590)	600
Charge-offs	—	(278)	—	—	(278)
Recoveries	2	213	5	—	220
Net recoveries (charge-offs)	2	(65)	5	—	(58)
Ending balance	\$3,456	\$2,084	\$ 1,543	\$ 1,244	\$8,327
Period end amount allocated to:					
Loans individually evaluated for impairment	\$—	\$—	\$ —	\$ —	\$—
Loans collectively evaluated for impairment	3,456	2,084	1,543	1,244	8,327
Ending balance	\$3,456	\$2,084	\$ 1,543	\$ 1,244	\$8,327
LOANS RECEIVABLE					
Loans individually evaluated for impairment	\$340	\$—	\$ —	\$ —	\$340
Loans collectively evaluated for impairment	284,068	161,839	83,272	—	529,179
Ending balance	\$284,408	\$161,839	\$ 83,272	\$ —	\$529,519
ALLOWANCE FOR LOAN LOSSES	At or For the Three Months Ended March 31, 2015				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	\$1,872	\$1,431	\$ 1,184	\$ 1,603	\$6,090
Provision for loan losses	444	103	948	(895)	600
Charge-offs	(191)	(417)	—	—	(608)
Recoveries	—	321	2	—	323
Net (charge-offs) recoveries	(191)	(96)	2	—	(285)
Ending balance	\$2,125	\$1,438	\$ 2,134	\$ 708	\$6,405
Period end amount allocated to:					
Loans individually evaluated for impairment	\$—	\$—	\$ 6	\$ —	\$6
Loans collectively evaluated for impairment	2,125	1,438	2,128	708	6,399
Ending balance	\$2,125	\$1,438	\$ 2,134	\$ 708	\$6,405
LOANS RECEIVABLE					
Loans individually evaluated for impairment	\$1,554	\$—	\$ 36	\$ —	\$1,590
Loans collectively evaluated for impairment	201,810	141,449	78,596	—	421,855
Ending balance	\$203,364	\$141,449	\$ 78,632	\$ —	\$423,445





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The following tables provide information pertaining to the aging analysis of past due loans at March 31, 2016 and December 31, 2015:

REAL ESTATE LOANS	March 31, 2016				Total Past Due	Current	Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Non-Accrual			
Commercial	\$—	\$—	\$—	—\$ —	\$—	\$55,505	\$ 55,505
Construction and development	—	—	—	—	—	76,381	76,381
Home equity	83	—	—	184	267	15,396	15,663
One-to-four-family	—	—	—	43	43	106,098	106,141
Multi-family	—	—	—	—	—	30,718	30,718
Total real estate loans	83	—	—	227	310	284,098	284,408
CONSUMER LOANS							
Indirect home improvement	292	203	—	343	838	101,057	101,895
Solar	—	33	—	—	33	31,552	31,585
Marine	113	—	—	—	113	26,141	26,254
Other consumer	12	—	—	—	12	2,093	2,105
Total consumer loans	417	236	—	343	996	160,843	161,839
COMMERCIAL BUSINESS LOANS	75	—	—	—	75	83,197	83,272
Total loans	\$575	\$236	\$—	—\$ 570	\$1,381	\$528,138	\$ 529,519

REAL ESTATE LOANS	December 31, 2015				Total Past Due	Current	Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Non-Accrual			
Commercial	\$—	\$—	\$—	—\$ —	\$—	\$50,034	\$ 50,034
Construction and development	—	—	—	—	—	80,806	80,806
Home equity	157	20	—	47	224	16,316	16,540
One-to-four-family	48	—	—	525	573	102,348	102,921
Multi-family	—	—	—	—	—	22,223	22,223
Total real estate loans	205	20	—	572	797	271,727	272,524
CONSUMER LOANS							
Indirect home improvement	266	154	—	408	828	102,236	103,064
Solar	69	—	—	37	106	29,120	29,226
Marine	28	—	—	—	28	23,823	23,851
Other consumer	—	—	—	—	—	2,181	2,181

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Total consumer loans	363	154	—	445	962	157,360	158,322
COMMERCIAL BUSINESS LOANS	—	—	—	—	—	80,436	80,436
Total loans	\$568	\$174	\$	—\$ 1,017	\$1,759	\$509,523	\$ 511,282

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The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided at March 31, 2016 and December 31, 2015:

	March 31, 2016				
WITH NO RELATED ALLOWANCE RECORDED	Unpaid Principal Balance	Write- downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment
Home equity	\$90	\$—	\$ 90	\$	—\$ 90
One-to-four-family	310	(60 )	250	—	250
Total	\$400	\$(60 )	\$ 340	\$	—\$ 340

	December 31, 2015				
WITH NO RELATED ALLOWANCE RECORDED	Unpaid Principal Balance	Write- downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment
One-to-four-family	\$801	\$(67 )	\$ 734	\$	—\$ 734

The following table presents the average recorded investment in loans individually evaluated for impairment and the interest income recognized and received for the three months ended March 31, 2016 and 2015:

	Three Months Ended			
WITH NO RELATED ALLOWANCE RECORDED	March 31, 2016		March 31, 2015	
	Average Recorded Investment	Average Interest Recognized	Average Recorded Investment	Average Interest Recognized
Commercial	\$—	\$ —	\$671	\$ 4
Home equity	90	1	28	—
One-to-four-family	252	4	802	15
Subtotal real estate loans	342	5	1,501	19
WITH AN ALLOWANCE RECORDED				
Commercial business loans	—	—	37	1
Total	\$342	\$ 5	\$1,538	\$ 20

### Credit Quality Indicators

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

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

A description of the 10 risk grades is as follows:

- Grades 1 and 2 - These grades include loans to very high quality borrowers with excellent or desirable business credit.
- Grade 3 - This grade includes loans to borrowers of good business credit with moderate risk.

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

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

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

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

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

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

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

Homogeneous loans are risk rated based upon the FDIC’s Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded “Pass” and risk rated “4” internally. Loans that are past due more than 90 days are classified “Substandard” and risk rated “8” internally. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

The following tables summarize risk rated loan balances by category at March 31, 2016 and December 31, 2015:

	March 31, 2016						
REAL ESTATE LOANS	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
Commercial	\$53,811	\$1,694	\$ —	\$ —	\$ —	—\$	—\$55,505
Construction and development	76,381	—	—	—	—	—	76,381
Home equity	15,479	—	—	184	—	—	15,663
One-to-four-family	106,098	—	—	43	—	—	106,141
Multi-family	30,718	—	—	—	—	—	30,718
Total real estate loans	282,487	1,694	—	227	—	—	284,408
CONSUMER LOANS							
Indirect home improvement	101,552	—	—	343	—	—	101,895
Solar	31,585	—	—	—	—	—	31,585
Marine	26,254	—	—	—	—	—	26,254
Other consumer	2,105	—	—	—	—	—	2,105
Total consumer loans	161,496	—	—	343	—	—	161,839

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COMMERCIAL BUSINESS LOANS	79,588	649	401	2,634	—	—	83,272
Total loans	\$523,571	\$2,343	\$ 401	\$ 3,204	\$	—\$	—\$529,519

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	December 31, 2015						
REAL ESTATE LOANS	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
Commercial	\$50,034	\$—	\$ —	\$ —	\$	—\$	—\$50,034
Construction and development	79,100	1,706	—	—	—	—	80,806
Home equity	16,493	—	—	47	—	—	16,540
One-to-four-family	102,396	—	—	525	—	—	102,921
Multi-family	22,223	—	—	—	—	—	22,223
Total real estate loans	270,246	1,706	—	572	—	—	272,524
CONSUMER LOANS							
Indirect home improvement	102,656	—	—	408	—	—	103,064
Solar	29,189	—	—	37	—	—	29,226
Marine	23,851	—	—	—	—	—	23,851
Other consumer	2,181	—	—	—	—	—	2,181
Total consumer loans	157,877	—	—	445	—	—	158,322
COMMERCIAL BUSINESS LOANS	75,794	2,352	335	1,955	—	—	80,436
Total loans	\$503,917	\$4,058	\$ 335	\$ 2,972	\$	—\$	—\$511,282

#### Troubled Debt Restructured Loans

Troubled debt restructured (“TDR”) loans are loans for which the Company, for economic or legal reasons related to the borrower’s financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The loan terms which have been modified or restructured due to a borrower’s financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status. The Company had two TDR loans still on accrual and included in impaired loans at both March 31, 2016, and December 31, 2015. In addition, the Company had no TDR loans on non-accrual, and had no commitments to lend additional funds on these restructured loans at March 31, 2016 and had one TDR loan on non-accrual at December 31, 2015.

The following table summarizes TDR loan balances at the dates indicated:

	March 31, 2016	December 31, 2015
TDR loans still on accrual	\$ 206	\$ 209
TDR loans on non-accrual	—	525

Total TDR loan balances \$ 206 \$ 734

For the three months ended March 31, 2016 and 2015 there were no reported TDR loans that were modified in the previous 12 months that subsequently defaulted in the reporting period.



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## NOTE 5 - SERVICING RIGHTS

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balances of mortgage, commercial, and consumer loans serviced for others were \$675.2 million and \$636.1 million at March 31, 2016 and December 31, 2015, respectively and are carried at the lower of cost or market. At March 31, 2016 and December 31, 2015, mortgage, commercial, and consumer servicing rights' ("servicing rights") assets are recorded on the Consolidated Balance Sheets at a book value of \$6.1 million and \$5.8 million, respectively. The fair market value of the servicing rights' assets was \$6.2 million and \$6.8 million at March 31, 2016 and December 31, 2015, respectively.

The following table summarizes servicing rights activity for the three months ended March 31, 2016 and 2015:

	At or For the Three Months Ended March 31,	
	2016	2015
Beginning balance	\$5,811	\$3,061
Additions	613	785
Servicing rights amortized	(321 )	(177 )
Recovery on servicing rights	1	1
Ending balance	\$6,104	\$3,670

Fair value adjustments to mortgage, commercial, and consumer servicing rights were mainly due to market based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights. The following provides valuation assumptions used in determining the fair value of servicing rights at the dates indicated:

	At March 31,	
Key assumptions:	2016	2015
Weighted average discount rate	9.5 %	8.5 %
Conditional prepayment rate ("CPR")	15.4%	14.5%
Weighted average life in years	5.4	5.8



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Key economic assumptions and the sensitivity of the current fair value for single family mortgage servicing rights (“MSR”) to immediate adverse changes in those assumptions at March 31, 2016 and December 31, 2015 were as follows:

			March 31, 2016		December 31, 2015	
Aggregate portfolio principal balance			\$670,994		\$631,812	
Weighted average rate of note			4.0	%	4.0	%
			0.5%		1.0%	
At March 31, 2016	Base		Adverse Change		Adverse Change	
Conditional prepayment rate	15.4	%	23.8	%	34.6	%
Fair value MSR	\$6,131		\$4,752		\$3,680	
Percentage of MSR	0.9	%	0.7	%	0.5	%
Discount rate	9.5	%	10.0	%	10.5	%
Fair value MSR	\$6,131		\$6,027		\$5,926	
Percentage of MSR	0.9	%	0.9	%	0.9	%
			0.5%		1.0%	
At December 31, 2015	Base		Adverse Change		Adverse Change	
Conditional prepayment rate	12.2	%	17.8	%	25.3	%
Fair value MSR	\$6,813		\$5,660		\$4,557	
Percentage of MSR	1.1	%	0.9	%	0.7	%
Discount rate	8.5	%	9.0	%	9.5	%
Fair value MSR	\$6,813		\$6,678		\$6,548	
Percentage of MSR	1.1	%	1.1	%	1.0	%

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

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company’s methodology for estimating the fair value of MSR is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the

change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made as a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The Company recorded \$419,000 and \$233,000 of contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage, commercial and consumer loans for the three months ended March 31, 2016 and 2015, respectively. The income, net of amortization, is reported in noninterest income.

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## NOTE 6 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced (“TBA”) mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the Consolidated Balance Sheets and measures those instruments at fair value.

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

	March 31, 2016		
	Fair Value		
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$57,572	\$1,429	\$ —
Mandatory and best effort forward commitments with investors	12,960	—	28
Forward TBA mortgage-backed securities	100,000	—	479
TBA mortgage-backed securities forward sales paired off with investors	38,500	—	127
	December 31, 2015		
	Fair Value		
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$34,154	\$698	\$ —
Mandatory and best effort forward commitments with investors	24,135	74	—
Forward TBA mortgage-backed securities	49,000	3	—
TBA mortgage-backed securities forward sales paired off with investors	28,500	30	—

Changes in the fair value of the derivatives recognized in other noninterest income on the Consolidated Statements of Income and included in gain on sale of loans was \$2.3 million and \$1.8 million for the three months ended March 31, 2016 and 2015, respectively.

## NOTE 7 - OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the three months ended March 31, 2016 and 2015:

At or For  
the Three  
Months  
Ended

	March 31,	
	2016	2015
Beginning balance	\$—	\$ —
Additions	525	—
Capitalized costs	6	—
Disposition of assets (211 )	—	—
Ending balance	\$320	\$ —

There were three properties used as collateral for one loan that went into OREO for the three months ended March 31, 2016, and no OREO properties at March 31, 2015. For the three months ended March 31, 2016 and 2015, the Company recorded no net gain or (loss) on disposal of OREO. There were no holding costs associated with OREO for the three months ended March 31, 2016 and 2015.

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## NOTE 8 - DEPOSITS

Deposits are summarized as follows at March 31, 2016 and December 31, 2015:

	March 31, 2016	December 31, 2015
Noninterest-bearing checking	\$ 150,314	\$ 66,676
Interest-bearing checking	48,022	34,098
Savings	48,556	30,126
Money market	242,516	159,605
Certificates of deposit less than \$100,000 <sup>(1)</sup>	77,557	65,175
Certificates of deposit of \$100,000 through \$250,000	90,164	91,317
Certificates of deposit of \$250,000 and over <sup>(2)</sup>	31,421	32,610
Escrow accounts related to mortgages serviced	8,129	5,571
Total	\$ 696,679	\$ 485,178

(1) Includes \$27.9 million of brokered deposits at March 31, 2016 and December 31, 2015.

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

Scheduled maturities of time deposits at March 31, 2016 for future periods ending is as follows:

	At March 31, 2016
2016	\$ 75,439
2017	72,513
2018	37,497
2019	5,306
2020	6,553
Thereafter	1,834
Total	\$ 199,142

The Bank pledged 12 securities held at the FHLB of Des Moines with a fair value of \$13.3 million to secure Washington State public deposits of \$7.4 million with a \$117,000 collateral requirement by the Washington Public Deposit Protection Commission at March 31, 2016.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances at March 31, 2016 and December 31, 2015 were \$4.0 million and \$3.0 million, respectively, and were in compliance with Federal Reserve regulations.

Interest expense by deposit category for the three months ended March 31, 2016 and 2015 is as follows:

	Three Months Ended March 31, 2016 2015	
Interest-bearing checking	\$6	\$7
Savings and money market	246	239
Certificates of deposit	567	502
Total	\$819	\$748

NOTE 9 - COMMITMENTS AND CONTINGENCIES

Commitments – The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These



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instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the balance sheet.

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

The following table provides a summary of the Company's commitments at March 31, 2016 and December 31, 2015:

COMMITMENTS TO EXTEND CREDIT	March 31, 2016	December 31, 2015
REAL ESTATE LOANS		
Commercial	\$—	\$ 1,988
Construction and development	41,192	44,109
One-to-four-family (includes held for sale)	120,368	76,013
Home equity	20,994	18,089
Multi-family	430	429
Total real estate loans	182,984	140,628
CONSUMER LOANS	8,349	5,754
COMMERCIAL BUSINESS LOANS	67,818	67,138
Total commitments to extend credit	\$259,151	\$213,520

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

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of \$147,000 at both March 31, 2016 and December 31, 2015. One-to-four-family commitments included in the table above are accounted for as fair value derivatives and do not carry an associated loss reserve.

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

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

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us

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to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no pending material legal actions at March 31, 2016.

Contingent liabilities for loans held for sale - In the ordinary course of business, the Company sells loans without recourse that may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payment defaults, breach of representation or warranty, servicing errors, and fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded reserves of \$607,000 and \$561,000 to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at March 31, 2016 and December 31, 2015, respectively, which is included in other liabilities in the Consolidated Balance Sheets.

NOTE 10 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. Consequently, the fair value of the Company's consolidated financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits, and by investing in securities with terms that mitigate the Company's overall interest rate risk.

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

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

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

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

Determination of Fair Market Values:

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

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

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

Impaired Loans - Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management's assumptions (Level 3).

Other Real Estate Owned - Fair value adjustments to OREO are recorded at the lower of carrying amount of the loan or fair value less selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell (Level 3).

The following tables present securities available-for-sale measured at fair value on a recurring basis at March 31, 2016 and December 31, 2015:

	Securities			Total
	Available-for-Sale			
	Level 1	Level 2	Level 3	
At March 31, 2016				
U.S. agency securities	\$—	\$8,204	\$—	\$—
Municipal bonds	—	25,968	—	25,968
Corporate securities	—	5,462	—	5,462
U.S. Small Business Administration securities	—	6,092	—	6,092
Mortgage-backed securities	—	34,732	—	34,732
Total	\$—	\$80,458	\$—	\$—

	Securities			Total
	Available-for-Sale			
	Level 1	Level 2	Level 3	
At December 31, 2015				
U.S. agency securities	\$—	\$6,035	\$—	\$—
Municipal bonds	—	18,891	—	18,891
Corporate securities	—	3,433	—	3,433
U.S. Small Business Administration securities	—	4,023	—	4,023

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Mortgage-backed securities	—22,835	—	22,835
Total	\$—55,217	\$	—\$55,217

The following table presents mortgage loans held for sale measured at fair value on a recurring basis at March 31, 2016 and December 31, 2015:

	Mortgage Loans Held for Sale			Total
	Level 1	Level 2	Level 3	
March 31, 2016	\$—64,784	\$	—\$64,784	
December 31, 2015	\$—44,925	\$	—\$44,925	

The following tables present the fair value of interest rate lock commitments with customers, individual forward sale commitments with investors, and paired off commitments with investors measured at their fair value on a recurring basis at March 31, 2016 and December 31, 2015:

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	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
March 31, 2016	\$-	\$-	-\$1,429	\$1,429
December 31, 2015	\$-	\$-	-\$698	\$698

	Individual Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
March 31, 2016	\$-	\$(479)	\$(28)	\$(507)
December 31, 2015	\$-	\$3	\$74	\$77

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
March 31, 2016	\$-	\$(127)	\$-	\$(127)
December 31, 2015	\$-	\$30	\$-	-\$30

The following tables present impaired loans and OREO measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded during the reporting period. The amounts disclosed below represent the fair values at the time the nonrecurring fair value measurements were made, and not necessarily the fair value as of the dates reported upon.