

First Financial Northwest, Inc.  
Form 10-Q  
May 07, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q

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

For the quarterly period ended March 31, 2010

or

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

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

Commission File Number: 001-33652

FIRST FINANCIAL NORTHWEST, INC.

(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of incorporation or organization)

26-0610707  
(I.R.S. Employer Identification Number)

201 Wells Avenue South, Renton, Washington  
(Address of principal executive offices)

98057  
(Zip Code)

Registrant's telephone number, including area code: (425) 255-4400

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.

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Large accelerated filer  Accelerated filer  Non-accelerated filer  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

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 3, 2010, 18,805,168 shares of the issuer's common stock, \$0.01 par value per share, were outstanding.

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## Item 1. Financial Statements

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
Consolidated Balance Sheets  
(Dollars in thousands, except share data)  
(Unaudited)

| Assets  | March 31,<br>2010 | December 31,<br>2009 |
|---|-------------------|----------------------|
| Cash on hand and in banks   | \$ 8,373          | \$ 8,937             |
| Interest-bearing deposits   | 107,326           | 96,033               |
| Investments available for sale  | 109,593           | 97,383               |
| Loans receivable, net of allowance of \$36,479 and \$33,039   | 1,016,896         | 1,039,300            |
| Premises and equipment, net   | 20,453            | 19,585               |
| Federal Home Loan Bank stock, at cost   | 7,413             | 7,413                |
| Accrued interest receivable   | 4,716             | 4,880                |
| Federal income tax receivable   | 12,160            | 9,499                |
| Deferred tax assets, net  | 5,415             | 12,139               |
| Other real estate owned (OREO)  | 20,500            | 11,835               |
| Prepaid expenses and other assets   | 8,384             | 8,330                |
| Total assets  | \$ 1,321,229      | \$ 1,315,334         |
| <b>Liabilities and Stockholders' Equity</b>   |                   |                      |
| Deposits  | \$ 962,590        | \$ 939,423           |
| Advances from the Federal Home Loan Bank  | 139,900           | 139,900              |
| Advance payments from borrowers for taxes and insurance   | 4,509             | 2,377                |
| Accrued interest payable  | 402               | 457                  |
| Other liabilities   | 3,789             | 4,660                |
| Total liabilities   | 1,111,190         | 1,086,817            |
| <b>Commitments and contingencies</b>  |                   |                      |
| <b>Stockholders' Equity</b>   |                   |                      |
| Preferred stock, \$0.01 par value; authorized 10,000,000<br>shares, no shares issued or outstanding   | —                 | —                    |
| Common stock, \$0.01 par value; authorized 90,000,000<br>shares; issued and outstanding 18,805,168 and 18,823,068<br>shares at March 31, 2010 and December 31, 2009 | 188               | 188                  |
| Additional paid-in capital  | 186,415           | 186,120              |
| Retained earnings, substantially restricted   | 36,078            | 55,251               |
| Accumulated other comprehensive income, net of tax  | 1,465             | 1,347                |
| Unearned Employee Stock Ownership Plan (ESOP) shares  | (14,107)          | (14,389)             |
| Total stockholders' equity  | 210,039           | 228,517              |
| Total liabilities and stockholders' equity  | \$ 1,321,229      | \$ 1,315,334         |

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
Consolidated Statements of Operations  
(Dollars in thousands, except share data)  
(Unaudited)

|   | Three Months Ended March 31, |           |
|---|------------------------------|-----------|
|   | 2010                         | 2009      |
| <b>Interest income</b>                                      |                              |           |
| Loans, including fees                                       | \$ 14,594                    | \$ 15,123 |
| Investments available for sale                              | 1,007                        | 1,625     |
| Federal funds sold and interest-bearing deposits with banks | 61                           | 2         |
| Total interest income                                       | \$ 15,662                    | \$ 16,750 |
| <b>Interest expense</b>                                     |                              |           |
| Deposits  | 6,571                        | 7,329     |
| Federal Home Loan Bank advances                             | 1,023                        | 1,246     |
| Total interest expense                                      | \$ 7,594                     | \$ 8,575  |
| Net interest income   | 8,068                        | 8,175     |
| <b>Provision for loan losses</b>                            |                              |           |
| Net interest income (loss) after provision for loan losses  | \$ (4,932)                   | \$ 6,631  |
| <b>Noninterest income</b>                                   |                              |           |
| Net gain on sale of investments                             | —                            | 76        |
| Other   | 46                           | 54        |
| Total noninterest income                                    | \$ 46                        | \$ 130    |
| <b>Noninterest expense</b>                                  |                              |           |
| Salaries and employee benefits                              | 3,189                        | 3,039     |
| Occupancy and equipment                                     | 425                          | 350       |
| Professional fees   | 459                          | 307       |
| Data processing   | 170                          | 144       |
| Loss on sale of OREO property, net                          | 437                          | —         |
| OREO valuation expense                                      | 2,271                        | —         |
| OREO related expenses, net                                  | 702                          | —         |
| FDIC/OTS assessments  | 580                          | 682       |
| Other general and administrative                            | 634                          | 622       |
| Total noninterest expense                                   | \$ 8,867                     | \$ 5,144  |
| Income (loss) before provision for federal income taxes     | (13,753)                     | 1,617     |
| <b>Provision for federal income taxes</b>                   |                              |           |
| Net income (loss)   | \$ (17,752)                  | \$ 1,196  |
| Basic earnings (loss) per share                             | \$ (1.02)                    | \$ 0.06   |
| Diluted earnings (loss) per share                           | \$ (1.02)                    | \$ 0.06   |

See accompanying notes to consolidated financial statements.





FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
 Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)  
 For the Three Months Ended March 31, 2010  
 (Dollars in thousands, except share data)  
 (Unaudited)

|   | Shares     | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income,<br>net of tax | Unearned<br>ESOP<br>Shares | Total<br>Stockholders'<br>Equity |
|---|------------|-----------------|----------------------------------|----------------------|--|----------------------------|----------------------------------|
| Balances at December 31, 2009                                     | 18,823,068 | \$188           | \$186,120                        | \$55,251             | \$1,347  | \$(14,389)                 | \$228,517                        |
| Comprehensive loss:   |            |                 |                                  |                      |  |                            |                                  |
| Net loss  | —          | —               | —                                | (17,752)             | —  | —                          | (17,752)                         |
| Change in fair value of investments                               |            |                 |                                  |                      |  |                            |                                  |
| available for sale, net of tax \$63                               | —          | —               | —                                | —                    | 118  | —                          | 118                              |
| Total comprehensive loss:   |            |                 |                                  |                      |  |                            | (17,634)                         |
| Cash dividend declared and paid (\$0.085 per share)               | —          | —               | —                                | (1,421)              | —  | —                          | (1,421)                          |
| Purchase and retirement of common stock                           | (17,900)   | —               | (106)                            | —                    | —  | —                          | (106)                            |
| Compensation related to stock options and restricted stock awards |            |                 |                                  |                      |  |                            |                                  |
|   | —          | —               | 497                              | —                    | —  | —                          | 497                              |
| Allocation of 28,213 ESOP shares                                  | —          | —               | (96)                             | —                    | —  | 282                        | 186                              |
| Balances at March 31, 2010  | 18,805,168 | \$188           | \$186,415                        | \$36,078             | \$1,465  | \$(14,107)                 | \$210,039                        |

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
(In thousands)  
(Unaudited)

|   | Three months ended March 31, |           |
|---|------------------------------|-----------|
|   | 2010                         | 2009      |
| <b>Cash flows from operating activities:</b>                              |                              |           |
| Net income (loss)   | \$ (17,752)                  | \$ 1,196  |
| Adjustments to reconcile net income to                                    |                              |           |
| net cash provided by operating activities:                                |                              |           |
| Provision for loan losses   | 13,000                       | 1,544     |
| OREO valuation expense  | 2,271                        | —         |
| Loss on sale of OREO property, net  | 437                          | —         |
| Depreciation and amortization of premises and equipment                   | 254                          | 197       |
| Net amortization of premiums and discounts on investments                 | 250                          | 146       |
| ESOP expense  | 186                          | 234       |
| Compensation expense related to stock options and restricted stock awards | 497                          | 515       |
| Net realized gain on investments available for sale                       | —                            | (76)      |
| Deferred federal income taxes   | 6,661                        | 412       |
| Changes in operating assets and liabilities:                              |                              |           |
| Other assets  | (54)                         | 1,370     |
| Accrued interest receivable   | 164                          | (262)     |
| Accrued interest payable  | (55)                         | 16        |
| Other liabilities   | (871)                        | 596       |
| Federal income taxes  | (2,661)                      | (242)     |
| Net cash provided by operating activities                                 | \$ 2,327                     | \$ 5,646  |
| <b>Cash flows from investing activities:</b>                              |                              |           |
| Proceeds from sales of investments  | —                            | 6,853     |
| Proceeds from sales of OREO's   | 3,031                        | —         |
| Principal repayments on investments available for sale                    | 6,657                        | 7,215     |
| Purchases of investments available for sale                               | (18,936)                     | (4,671)   |
| Net increase (decrease) in loans receivable                               | (5,000)                      | 2,451     |
| Purchases of premises and equipment                                       | (1,122)                      | (353)     |
| Net cash provided (used) by investing activities                          | \$ (15,370)                  | \$ 11,495 |
| Balance, carried forward  | \$ (13,043)                  | \$ 17,141 |

Continued



FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
(In thousands)  
(Unaudited)

|   | Three Months Ended March<br>31, |           |
|---|---------------------------------|-----------|
|   | 2010                            | 2009      |
| Balance, brought forward  | \$ (13,043)                     | \$ 17,141 |
| <b>Cash flows from financing activities:</b>  |                                 |           |
| Net increase in deposits  | 23,167                          | 29,703    |
| Advances from the Federal Home Loan Bank  | 50,000                          | 15,000    |
| Repayments of advances from the Federal Home Loan Bank                              | (50,000)                        | (23,000)  |
| Net increase in advance payments from borrowers for taxes and insurance             | 2,132                           | 2,013     |
| Repurchase and retirement of common stock   | (106)                           | (7,533)   |
| Dividends paid  | (1,421)                         | (1,667)   |
| Net cash provided by financing activities   | \$ 23,772                       | \$ 14,516 |
| Net increase in cash  | 10,729                          | 31,657    |
| <b>Cash and cash equivalents:</b>   |                                 |           |
| Beginning of period   | 104,970                         | 5,756     |
| End of period   | \$ 115,699                      | \$ 37,413 |
| <b>Supplemental disclosures of cash flow information:</b>                           |                                 |           |
| Cash paid during the period for:  |                                 |           |
| Interest  | \$ 7,649                        | \$ 8,559  |
| Federal income taxes  | \$ —                            | \$ 450    |
| <b>Noncash transactions:</b>  |                                 |           |
| Loans, net of deferred loan fees and allowance for loan losses, transferred to OREO | \$ 14,404                       | \$ —      |

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1 – Description of Business

First Financial Northwest, Inc. (“First Financial Northwest” or the “Company”), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest (“First Savings Bank” or the “Bank”) in connection with the conversion from a mutual holding company structure to a stock holding company structure. First Financial Northwest’s business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information presented in the consolidated financial statements and related data, relates primarily to First Savings Bank. First Financial Northwest is a savings and loan holding company and is subject to regulation by the Office of Thrift Supervision (“OTS”). First Savings Bank is regulated by the Federal Deposit Insurance Corporation (“FDIC”) and the Washington State Department of Financial Institutions (“DFI”).

First Savings Bank is a community-based savings bank primarily serving King and to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington through our full-service banking office located in Renton, Washington. First Savings Bank’s business consists of attracting deposits from the public and utilizing these deposits to originate one-to-four family, multifamily, commercial real estate, business, consumer and to a lesser extent, construction/land development loans.

Note 2 – Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles (“GAAP”) for complete financial statements. These unaudited consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the three months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the year ended December 31, 2010. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan losses, other real estate owned (“OREO”), deferred tax assets and the fair value of financial instruments.

Certain amounts in the unaudited consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation.

Note 3 – Recent Accounting Pronouncements

Accounting Standards Update (“ASU”) No. 2010-06, “Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures About Fair Value Measurements.” ASU 2010-06 requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (ii) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (iii) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (iv) for recurring fair value measurements of

assets and liabilities in Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-06 further clarifies that (i) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (ii) company's should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy will be required beginning January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective on January 1, 2010 and did not have a significant impact on our consolidated financial statements. See Note 6 – Fair Value.

Note 4 – Investment Securities Available for Sale

Investment securities available for sale are summarized as follows:

|   | Amortized<br>Cost | March 31, 2010               |                               | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
|   |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |            |
| (In thousands)                                  |                   |                              |                               |            |
| <b>Mortgage-backed and related investments:</b> |                   |                              |                               |            |
| Fannie Mae                                      | \$ 58,736         | \$ 1,403                     | \$ (101)                      | \$ 60,038  |
| Freddie Mac                                     | 32,543            | 1,128                        | (54)                          | 33,617     |
| Ginnie Mae                                      | 4,809             | 90                           | —                             | 4,899      |
| Tax-exempt municipal bonds                      | 4,207             | 45                           | (492)                         | 3,760      |
| Taxable municipal bonds                         | 649               | —                            | (11)                          | 638        |
| U.S. Government agencies                        | 1,936             | 87                           | —                             | 2,023      |
| Mutual fund (1)                                 | 4,460             | 158                          | —                             | 4,618      |
|   | \$ 107,340        | \$ 2,911                     | \$ (658)                      | \$ 109,593 |

|   | Amortized<br>Cost | December 31, 2009            |                               | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
|   |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |            |
| (In thousands)                                  |                   |                              |                               |            |
| <b>Mortgage-backed and related investments:</b> |                   |                              |                               |            |
| Fannie Mae                                      | \$ 50,025         | \$ 1,267                     | \$ (21)                       | \$ 51,271  |
| Freddie Mac                                     | 28,924            | 1,020                        | (3)                           | 29,941     |
| Ginnie Mae                                      | 5,099             | 84                           | —                             | 5,183      |
| Tax-exempt municipal bonds                      | 4,207             | 49                           | (484)                         | 3,772      |
| Taxable municipal bonds                         | 650               | —                            | (48)                          | 602        |
| U.S. Government agencies                        | 1,946             | 57                           | —                             | 2,003      |
| Mutual fund (1)                                 | 4,460             | 151                          | —                             | 4,611      |
|   | \$ 95,311         | \$ 2,628                     | \$ (556)                      | \$ 97,383  |

(1) The majority of the fund value is invested in U.S. Government or agency securities with additional holdings of private label mortgage-backed securities.





FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Investments with unrealized losses at March 31, 2010 and December 31, 2009 by length of time that individual investments have been in a continuous loss position, are as follows:

|                            | Less Than 12 Months |                 | March 31, 2010<br>12 Months or Longer |                 | Total      |                 |
|----------------------------|---------------------|-----------------|---------------------------------------|-----------------|------------|-----------------|
|                            | Fair Value          | Unrealized Loss | Fair Value                            | Unrealized Loss | Fair Value | Unrealized Loss |
|                            | (In thousands)      |                 |                                       |                 |            |                 |
| Fannie Mae                 | \$ 12,049           | \$ (101)        | \$ -                                  | \$ -            | \$ 12,049  | \$ (101)        |
| Freddie Mac                | 4,442               | (52)            | 249                                   | (2)             | 4,691      | (54)            |
| Tax-exempt municipal bonds | -                   | -               | 1,617                                 | (492)           | 1,617      | (492)           |
| Taxable municipal bonds    | -                   | -               | 639                                   | (11)            | 639        | (11)            |
|                            | \$ 16,491           | \$ (153)        | \$ 2,505                              | \$ (505)        | \$ 18,996  | \$ (658)        |

|                            | Less Than 12 Months |                 | December 31, 2009<br>12 Months or Longer |                 | Total      |                 |
|----------------------------|---------------------|-----------------|--|-----------------|------------|-----------------|
|                            | Fair Value          | Unrealized Loss | Fair Value                               | Unrealized Loss | Fair Value | Unrealized Loss |
|                            | (In thousands)      |                 |  |                 |            |                 |
| Fannie Mae                 | \$ 3,255            | \$ (21)         | \$ -                                     | \$ -            | \$ 3,255   | \$ (21)         |
| Freddie Mac                | -                   | -               | 255                                      | (3)             | 255        | (3)             |
| Tax-exempt municipal bonds | -                   | -               | 1,625                                    | (484)           | 1,625      | (484)           |
| Taxable municipal bonds    | -                   | -               | 602                                      | (48)            | 602        | (48)            |
|                            | \$ 3,255            | \$ (21)         | \$ 2,482                                 | \$ (535)        | \$ 5,737   | \$ (556)        |

In May 2008, the Board of Trustees of the AMF Ultra Short Mortgage Fund (“Fund”) (a mutual fund) decided to activate the Fund’s redemption-in-kind provision because of the uncertainty in the mortgage-backed securities market. The activation of this provision has limited the options available to the shareholders of the Fund with respect to

liquidating their investments. Only the Fund may repurchase the shares in accordance with the terms of the Fund. The Fund is currently closed to new investors, which means that no new investors may buy shares in the Fund. Existing participants are allowed to redeem and receive up to \$250,000 in cash per quarter or may receive 100% of their investment in “like kind” securities equal to their proportional ownership in the Fund (i.e. ownership percentage in the Fund times the market value of each of the approximately 150 securities). We have elected to maintain our investment in the mutual fund.

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. We consider many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be other-than-temporary (“OTTI”) are written down to fair value. For equity securities, the write-down is recorded as a realized loss in “other-than-temporary impairment loss on investments” on the income statement. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (“OCI”). Impairment losses related to all other factors are presented as separate categories within OCI. For investment securities held to maturity, this amount is accreted over the remaining life of the debt security prospectively based on the amount and timing of future estimated cash flows. The accretion of the OTTI amount recorded in OCI will increase the carrying value of the investment, and would not affect earnings. If there is an indication of additional credit losses the security is re-evaluated in

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
 SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

accordance with the procedures described above. For the quarter ended March 31, 2010, we did not have any OTTI losses on investments.

The amortized cost and estimated fair value of investments, available for sale at March 31, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments and the mutual fund, are shown separately.

|  | March 31, 2010 |            |
|--|----------------|------------|
|  | Amortized Cost | Fair Value |
|  | (In thousands) |            |
| Due within one year                    | \$ -           | \$ -       |
| Due after one year through five years  | 1,292          | 1,367      |
| Due after five years through ten years | 685            | 693        |
| Due after ten years                    | 4,815          | 4,361      |
|  | 6,792          | 6,421      |
| Mortgage-backed investments            | 96,088         | 98,554     |
| Mutual fund                            | 4,460          | 4,618      |
|  | \$ 107,340     | \$ 109,593 |

There were no sales of investments during the three months ended March 31, 2010.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
 SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

## Note 5 - Loans Receivable, Net

Loans receivable consist of the following:

|   | March 31, 2010      |                | December 31, 2009   |                |
|---|---------------------|----------------|---------------------|----------------|
|   | Amount              | Percent        | Amount              | Percent        |
| (Dollars in thousands)                            |                     |                |                     |                |
| <b>One-to-four family residential: (1)</b>        |                     |                |                     |                |
| Permanent   | \$ 474,210          | 43.65%         | \$ 481,046          | 43.13%         |
| Construction                                      | 14,050              | 1.29           | 15,685              | 1.41           |
|   | 488,260             | 44.94          | 496,731             | 44.54          |
| <b>Multifamily residential:</b>                   |                     |                |                     |                |
| Permanent   | 133,989             | 12.34          | 128,943             | 11.56          |
| Construction                                      | 18,190              | 1.67           | 17,565              | 1.58           |
|   | 152,179             | 14.01          | 146,508             | 13.14          |
| <b>Commercial real estate:</b>                    |                     |                |                     |                |
| Permanent   | 250,334             | 23.04          | 251,185             | 22.52          |
| Construction                                      | 31,599              | 2.91           | 31,605              | 2.83           |
| Land  | 5,877               | 0.54           | 6,206               | 0.56           |
|   | 287,810             | 26.49          | 288,996             | 25.91          |
| <b>Speculative construction/land development:</b> |                     |                |                     |                |
| One-to-four family residential                    | 78,043              | 7.18           | 95,699              | 8.58           |
| Multifamily residential                           | 3,624               | 0.33           | 3,624               | 0.33           |
| Commercial  | 1,125               | 0.10           | 1,129               | 0.10           |
| Land development                                  | 56,179              | 5.17           | 63,501              | 5.69           |
|   | 138,971             | 12.78          | 163,953             | 14.70          |
| Business  | 347                 | 0.03           | 353                 | 0.03           |
| Consumer  | 19,006              | 1.75           | 18,678              | 1.68           |
| <b>Total loans</b>                                | <b>\$ 1,086,573</b> | <b>100.00%</b> | <b>\$ 1,115,219</b> | <b>100.00%</b> |
| <b>Less:</b>                                      |                     |                |                     |                |
| Loans in process                                  | 30,252              |                | 39,942              |                |

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|                           |              |              |
|---------------------------|--------------|--------------|
| Deferred loan fees        | 2,946        | 2,938        |
| Allowance for loan losses | 36,479       | 33,039       |
| Loans receivable, net     | \$ 1,016,896 | \$ 1,039,300 |

(1) Includes \$216.5 million and \$230.8 million of non-owner occupied loans at March 31, 2010 and December 31, 2009, respectively.

At March 31, 2010 and December 31, 2009 there were no loans classified as held for sale.

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A summary of changes in the allowance for loan losses for the three months ended March 31, 2010 and 2009 is as follows:

|                                    | Three Months Ended March 31, |           |
|------------------------------------|------------------------------|-----------|
|                                    | 2010                         | 2009      |
|                                    | (In thousands)               |           |
| Beginning balance, January 1, 2010 | \$ 33,039                    | \$ 16,982 |
| Provision for loan losses          | 13,000                       | 1,544     |
| Charge-offs                        | (9,682)                      | (4,232)   |
| Recoveries                         | 122                          | -         |
| Ending balance, March 31, 2010     | \$ 36,479                    | \$ 14,294 |

Nonaccrual, impaired and troubled debt restructured loans are as follows:

|  | March 31,      | December 31, |
|--|----------------|--------------|
|  | 2010           | 2009         |
|  | (In thousands) |              |
| Impaired loans without a valuation allowance                 | \$ 38,216      | \$ 46,282    |
| Impaired loans with a valuation allowance                    | 130,650        | 109,879      |
| Total impaired loans   | \$ 168,866     | \$ 156,161   |
| Valuation allowance related to impaired loans                | \$ 18,356      | \$ 13,432    |
| Average investment of impaired loans                         | \$ 144,696     | \$ 117,644   |
| Interest income recognized on a cash basis on impaired loans | \$ 345         | \$ 2,134     |
| <b>Nonperforming assets</b>                                  |                |              |
| 90 days or more past due and still accruing                  | \$ -           | \$ -         |
| Nonaccrual loans   | 108,135        | 94,682       |
| Nonaccrual troubled debt restructured loans                  | 37,783         | 26,021       |
| Total nonperforming loans                                    | 145,918        | 120,703      |
| Other real estate owned                                      | 20,500         | 11,835       |
| Total nonperforming assets                                   | \$ 166,418     | \$ 132,538   |
| Performing troubled debt restructured loans                  | \$ 22,948      | \$ 35,458    |
| Nonaccrual troubled debt restructured loans                  | 37,783         | 26,021       |
| Total troubled debt restructured loans (1)                   | \$ 60,731      | \$ 61,479    |

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(1) Troubled debt restructured loans are also considered impaired loans and are included in the impaired category at the beginning of the table.

At March 31, 2010, the amounts committed to be advanced in connection with the impaired loans totaled \$12.6 million.

Foregone interest on nonaccrual loans for the three months ended March 31, 2010 and 2009 was \$797,000 and \$1.1 million, respectively.

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A summary of our OREO at March 31, 2010 is as follows:

|                                       | March 31, 2010         |        | December 31, 2009 |        |
|---------------------------------------|------------------------|--------|-------------------|--------|
|                                       | Amount                 | Number | Amount            | Number |
|                                       | (Dollars in thousands) |        |                   |        |
| Beginning balance,<br>January 1, 2010 | \$ 11,835              | 32     | \$ -              | -      |
| Additions                             | 14,404                 | 34     | 11,835            | 32     |
| Market value<br>adjustments           | (2,271)                | N/A    | -                 | N/A    |
| Sales                                 | (3,468)                | (7)    | -                 | -      |
| Ending balance,<br>March 31, 2010     | \$ 20,500              | 59     | \$ 11,835         | 32     |

#### Note 6 – Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 also establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements.

We determined the fair values of our financial instruments based on the fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair values. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our estimates for market assumptions.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from an independent source. Unobservable inputs are assumptions based on our own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable.
- Level 3 – Instruments whose significant value drivers are unobservable.



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The tables below present the balances of assets and liabilities measured at fair value on a recurring basis:

|                                | Fair Value Measurements at March 31, 2010 |   |  |   |
|--------------------------------|---|---|--|---|
|                                | Fair Value<br>Measurements                | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
| (In thousands)                 |   |   |  |   |
| Available for sale investments |   |   |  |   |
| Mortgage-backed investments    |   |   |  |   |
| Fannie Mae                     | \$ 60,038                                 | \$ -  | \$ 60,038  | \$ -  |
| Freddie Mac                    | 33,617                                    | -   | 33,617   | -   |
| Ginnie Mae                     | 4,899                                     | -   | 4,899  | -   |
| Tax-exempt municipal bonds     | 3,760                                     | -   | 3,760  | -   |
| Taxable municipal bonds        | 638                                       | -   | 638  | -   |
| U.S. Government agencies       | 2,023                                     | -   | 2,023  | -   |
| Mutual Fund                    | 4,618                                     | 4,618   | -  | -   |
|                                | \$ 109,593                                | \$ 4,618  | \$ 104,975   | \$ -  |

|                                | Fair Value Measurements at December 31, 2009 |   |  |   |
|--------------------------------|--|---|--|---|
|                                | Fair Value<br>Measurements                   | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
| (In thousands)                 |  |   |  |   |
| Available for sale investments |  |   |  |   |
| Mortgage-backed investments    |  |   |  |   |
| Fannie Mae                     | \$ 51,271                                    | \$ -  | \$ 51,271  | \$ -  |
| Freddie Mac                    | 29,941                                       | -   | 29,941   | -   |
| Ginnie Mae                     | 5,183  | -   | 5,183  | -   |
| Tax-exempt municipal bonds     | 3,772  | -   | 3,772  | -   |
| Taxable municipal bonds        | 602  | -   | 602  | -   |
| U.S. Government agencies       | 2,003  | -   | 2,003  | -   |

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|             |    |        |       |       |    |        |    |   |
|-------------|----|--------|-------|-------|----|--------|----|---|
| Mutual Fund |    |        | 4,611 |       | -  |        | -  |   |
|             |    | 4,611  |       |       |    |        |    |   |
|             | \$ | 97,383 | \$    | 4,611 | \$ | 92,772 | \$ | - |

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The tables below present the balances of assets and liabilities measured at fair value on a nonrecurring basis.

|   | Fair Value Measurements at March 31, 2010 |   |   |  |                     |
|---|---|---|---|--|---------------------|
|   | Fair Value<br>Measurements                | Quoted<br>Prices<br>in Significant<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Losses (1) |
| Impaired loans including undisbursed but committed funds<br>of \$12.6 million (included in loans receivable, net) | \$ 163,077                                | \$-   | \$-   | \$163,077  | \$4,924             |
| Other real estate owned   | 20,500                                    | -   | -   | 20,500   | 2,271               |
|   | \$ 183,577                                | \$-   | \$-   | \$183,577  | \$7,195             |

(1) This represents the loss for the quarter ended March 31, 2010.

|   | Fair Value Measurements at December 31, 2009 |   |   |  |                     |
|---|--|---|---|--|---------------------|
|   | Fair Value<br>Measurements                   | Quoted<br>Prices<br>in Significant<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total<br>Losses (1) |
| Impaired loans including undisbursed but committed funds<br>of \$10.6 million (included in loans receivable, net) | \$ 153,300                                   | \$-   | \$-   | \$153,300  | \$4,895             |
| Goodwill impairment   | -  | -   | -   | -  | 14,206              |
| Other real estate owned   | 11,835                                       | -   | -   | 11,835   | -                   |
|   | \$ 165,135                                   | \$-   | \$-   | \$165,135  | \$19,101            |

(1) This represents the loss for the year ended December 31, 2009.

Investments available for sale consist primarily of mortgage-backed securities, bank qualified tax-exempt bonds, taxable municipal bonds, a mutual fund and agency securities. The estimated fair value of Level 1 investments, which consists of a mutual fund investment, is based on quoted market prices. The estimated fair value of Level 2 investments is based on quoted prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

Loans are considered impaired when, based upon current information and events, it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The fair value of impaired loans is calculated using the collateral value method. Inputs include appraised values, estimates of certain completion costs and closing and selling costs. Some of these inputs may not be observable in the marketplace.

Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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The carrying amounts and estimated fair values of financial instruments were as follows:

|  | March 31, 2010    |                         | December 31, 2009 |                         |
|--|-------------------|-------------------------|-------------------|-------------------------|
|  | Carrying<br>value | Estimated<br>fair value | Carrying<br>value | Estimated<br>fair value |
| (In thousands)                           |                   |                         |                   |                         |
| <b>Assets:</b>                           |                   |                         |                   |                         |
| Cash on hand and in banks                | \$ 8,373          | \$ 8,373                | \$ 8,937          | \$ 8,937                |
| Interest-bearing deposits                | 107,326           | 107,326                 | 96,033            | 96,033                  |
| Investments available for sale           | 109,593           | 109,593                 | 97,383            | 97,383                  |
| Loans receivable, net                    | 1,016,896         | 982,000                 | 1,039,300         | 1,001,562               |
| Federal Home Loan Bank stock             | 7,413             | 7,413                   | 7,413             | 7,413                   |
| Accrued interest receivable              | 4,716             | 4,716                   | 4,880             | 4,880                   |
| OREO                                     | 20,500            | 20,500                  | 11,835            | 11,835                  |
| <b>Liabilities:</b>                      |                   |                         |                   |                         |
| Deposits                                 | 229,524           | 229,524                 | 225,772           | 225,772                 |
| Certificates of deposit                  | 733,066           | 749,288                 | 713,651           | 727,250                 |
| Advances from the Federal Home Loan Bank | 139,900           | 141,685                 | 139,900           | 140,994                 |
| Accrued interest payable                 | 402               | 402                     | 457               | 457                     |

Fair value estimates, methods, and assumptions are set forth below for our financial instruments.

- Financial instruments with book value equal to fair value: The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value.
- Investments: The fair value of all investments excluding Federal Home Loan Bank of Seattle (“FHLB”) stock was based upon quoted market prices. FHLB stock is not publicly-traded, however it may be redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold. The fair value is therefore equal to the book value.
- Loans receivable: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans is estimated using discounted cash flow analysis utilizing current interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of the current market conditions, cash flow estimates have been further discounted to

include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

- **Liabilities:** The fair value of deposits with no stated maturity, such as statement, NOW, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The fair value of FHLB advances is estimated based on discounting the future cash flows using current interest rates for debt with similar remaining maturities.
- **Off-balance sheet commitments:** No fair value adjustment is necessary for commitments made to extend credit, which represents commitments for loan originations or for outstanding commitments to purchase loans. These commitments are at variable rates, are for loans with terms of less than one year and have interest rates which approximate prevailing market rates, or are set at the time of loan closing.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments.

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Note 7 – Federal Home Loan Bank stock

At March 31, 2010, we held \$7.4 million in shares of FHLB stock. FHLB stock is carried at par and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par. As a result of ongoing turmoil in the capital and mortgage markets, the FHLB of Seattle has a risk-based capital deficiency largely as a result of write-downs on its private label mortgage-backed securities portfolios.

Management evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on our assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB and (4) the liquidity position of the FHLB.

Under Federal Housing Finance Agency Regulations, a Federal Home Loan Bank that fails to meet any regulatory capital requirement may not declare a dividend or redeem or repurchase capital stock in excess of what is required for members' current loans. Based upon an analysis by Standard and Poors regarding the Federal Home Loan Banks they stated that the FHLB System has a special public status (organized under the Federal Home Loan Bank Act of 1932) and because of the extraordinary support offered to it by the U.S. Treasury in a crisis, (though not used), it can be considered an extension of the government. The U.S. government would almost certainly support the credit obligations of the FHLB System. We have determined there is not an other-than-temporary impairment on the FHLB stock investment as of March 31, 2010.

Note 8 - Stock-Based Compensation

In June 2008, our shareholders approved the First Financial Northwest, Inc. 2008 Equity Incentive Plan ("Plan"). The Plan provides for the grant of stock options, awards of restricted stock and stock appreciation rights.

Total compensation cost that has been charged against income for the Plan was \$497,000 and \$515,000 for the three months ended March 31, 2010 and 2009, respectively, and the related income tax benefit was \$174,000 and \$180,000 for the three months ended March 31, 2010 and 2009, respectively.

Stock Options

The Plan authorized the grant of stock options amounting to 2,285,280 shares to our directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of our common stock at the date of grant. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date and a contractual life of ten years. Any unexercised stock options will expire ten years after the grant date or 90 days after employment or service ends. We have a policy of issuing new shares upon exercise. At March 31, 2010, remaining options for 861,756 shares of common stock were available for grant under the Plan.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The expected volatility is generally based on the historical volatility of our stock price over a specified period of time. Since becoming a publicly-held company in October 2007, the amount of historical stock price information is limited. As a result, we elected to use a weighted-average of our peers' historical stock prices as well as our own historical stock prices to estimate volatility. We base the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. We elected to use the "Share-Based Payments" method permitted by the Securities and Exchange



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Commission to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at a midpoint in between. There were no options granted during the three months ended March 31, 2010.

A summary of our stock option plan awards for the three months ended March 31, 2010 follows:

|  | Shares    | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual<br>Term in Years | Aggregate<br>Intrinsic<br>Value |
|--|-----------|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2010   | 1,433,524 | \$ 9.73                            | 8.52  |                                 |
| Granted  | -         | -                                  | -   |                                 |
| Exercised  | -         | -                                  | -   |                                 |
| Forfeited or expired   | (10,000)  | 9.78                               | 8.26  |                                 |
| Outstanding at March 31, 2010  | 1,423,524 | \$ 9.73                            | 8.28  | \$ -                            |
| Expected to vest assuming a 3%<br>forfeiture<br>rate over the vesting term | 1,104,643 | \$ 9.73                            | 8.28  | \$ -                            |
| Exercisable at March 31, 2010  | 284,705   | \$ 9.73                            | 8.28  | \$ -                            |

As of March 31, 2010, there was \$1.7 million of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.3 years.

#### Restricted Stock Awards

The Plan authorized the grant of restricted stock awards amounting to 914,112 shares to our directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the date of grant. The restricted stock awards' fair value is equal to the value on the date of grant. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date. At March 31, 2010, remaining restricted awards for 159,478 shares were available to be issued. Shares that have been repurchased totaled 604,987 and are held in trust until they are vested in connection with the agreement.

A summary of changes in nonvested restricted stock awards for the three months ended March 31, 2010 follows:

| Nonvested Shares             | Shares  | Weighted-Average<br>Grant-Date<br>Fair Value |
|------------------------------|---------|--|
| Nonvested at January 1, 2010 | 604,987 | \$ 10.22                                     |
| Granted                      | -       | -  |

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|  |         |    |       |
|--|---------|----|-------|
| Vested   | (6,400) |    | 8.35  |
| Forfeited  | -       |    | -     |
| Nonvested at March 31, 2010  | 598,587 | \$ | 10.24 |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 580,627 |    |       |

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As of March 31, 2010, there was \$5.1 million of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.4 years. The total fair value of shares vested during the quarter ended March 31, 2010 and 2009 was \$53,000 and \$0, respectively.

Note 9 – Federal Taxes on Income

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax liabilities.

Our primary deferred tax assets relate to our allowance for loan losses, our contribution to the First Financial Northwest Foundation and our impairment charge relating to our investment in the AMF Ultra Short Mortgage Fund.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At March 31, 2010, we considered positive evidence, which includes \$5.4 million of carryback potential and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings. We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing these various factors, we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential.

Note 10 – Earnings (Loss) Per Share

The following table presents a reconciliation of the components used to compute basic and diluted earnings (loss) per share.

|  | Three Months Ended March 31, |            |
|--|------------------------------|------------|
|  | 2010                         | 2009       |
| (Dollars in thousands, except share data)  |                              |            |
| Net income (loss)                          | \$ (17,752)                  | \$ 1,196   |
| Weighted-average common shares outstanding | 17,383,841                   | 19,315,048 |
| Basic income (loss) per share              | \$ (1.02)                    | \$ 0.06    |
| Diluted income (loss) per share            | \$ (1.02)                    | \$ 0.06    |

All outstanding stock options were not included in computing dilutive earnings (loss) per share for the three months ended March 31, 2010 and 2009 because they were antidilutive.

Note 11 – Segment Information

Our activities are considered to be a single industry segment for financial reporting purposes. We are engaged in the business of attracting deposits from the general public and originating loans for our portfolio in our

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primary market area. Substantially all income is derived from a diverse base of commercial and residential real estate loans, consumer lending activities and investments.

#### Note 12 – Subsequent Events

Subsequent events are events or transactions that occur after the date of the statement of financial condition but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the statement of financial condition, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the statement of financial condition but arose after that date.

On April 14, 2010, in connection with the most recent examination of the holding company by the OTS, the members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement. Under the terms of the agreement, the Company has agreed, among other things, to provide notice to and obtain written non-objection from the OTS prior to the Company (a) declaring a dividend or redeeming any capital stock; and (b) incurring, issuing, renewing or repurchasing any new debt. Further, as a result of the most recent examination of the Bank by the FDIC and the Washington State DFI, the FDIC notified us that we must obtain written non-objection from the FDIC before engaging in any transaction that would materially change the balance sheet composition (including growth in total assets of five percent or more), significantly change funding sources (including using brokered deposits) or declare or pay cash dividends. In addition, both the Company and the Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer or pay pursuant to or by entering into certain severance and other forms of compensation agreements.

In light of the continuing challenging operating environment, along with our elevated level of nonperforming assets, delinquencies and adversely classified assets, our recent operating results and the regulatory restrictions recently imposed on us, we expect the Bank to be requested to enter into a formal written enforcement order with the FDIC and the Washington State DFI. We expect that, under this order, the Bank will be required, among other things, to develop and implement plans to reduce concentrations in construction/land development loans; to improve asset quality and credit administration; to reduce classified assets and to improve profitability within specified time frames. See Item 1A, Risk Factors—“Certain regulatory restrictions were recently imposed on us and we expect to be subject to future additional regulatory restrictions and enforcement actions; lack of compliance could result in monetary penalties and/or additional regulatory actions.” We are actively engaged in responding to the concerns raised by our banking regulators.

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

Forward-looking statements:

Certain matters discussed in this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements relate to, among other things, expectations of the business environment in which we operate, projections of future performance, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Office of Thrift Supervision and our bank subsidiary by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may initiate a formal enforcement action against the Company and/or the Bank such as an order to take corrective action and refrain from unsafe and unsound practices which also may require us, among other things, to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our ability to control operating costs and expenses; the use of estimates in determining the fair values of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our reports filed with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2009. Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be

considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

## Overview

First Savings Bank is a community-based savings bank primarily serving King and, to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington through our full-service banking office located in Renton, Washington. First Savings Bank's business consists of attracting deposits from the public and utilizing these funds to originate one-to-four family, multifamily, commercial real estate, business, consumer and to a lesser extent construction/land development loans.

Our primary source of revenue is net interest income. Net interest income is the difference between interest income, which is the income that we earn on our loans and investments, and interest expense, which is the interest that we pay on our deposits and borrowings. Changes in levels of interest rates affect our net interest income.

An offset to net interest income is the provision for loan losses which represents the quarterly charge to operations which is required to adequately provide for probable losses inherent in our loan portfolio.

Noninterest expense consists primarily of salaries and employee benefits, occupancy and equipment, data processing, marketing, postage and supplies, professional services, expenses associated with OREO and deposit insurance premiums. Salaries and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement benefits, the equity incentive plan and other employee benefits. Occupancy and equipment expenses consist primarily of real estate taxes, depreciation charges, maintenance and costs of utilities. OREO expenses consist of valuation allowances related to real estate that we own as well as maintenance costs, taxes and insurance and gains/losses resulting from the sale of these properties.

We incurred a net loss for the first quarter ended March 31, 2010 of \$17.8 million, or \$1.02 per diluted share, as compared to net income of \$1.2 million or \$0.06 per diluted share for the quarter ended March 31, 2009. The change in operating results in the first quarter of 2010 as compared to the first quarter of 2009 was primarily the result of an \$11.5 million increase in the provision for loan losses, a \$3.7 million increase in noninterest expense and an increase of \$3.6 million in federal income tax expense.

During the quarter ended March 31, 2010, our total loan portfolio decreased \$28.6 million or 2.6% from December 31, 2009. The major changes in our loan portfolio for the quarter ended March 31, 2010, were our one-to-four family residential loans decreased \$8.5 million or 1.7%, multifamily loans increased \$5.7 million or 3.9% and construction/land development loans decreased \$25.0 million or 15.2%.

Our loan policy limits the maximum amount of loans we can make to one borrower to 20% of First Savings Bank's risk-based capital. As of March 31, 2010, the maximum amount which we could lend to any one borrower was \$32.1 million based on our policy. Exceptions may be made to this policy with the prior approval of the Executive Committee and ratified by the Board of Directors if the borrower exhibits financial strength or compensating factors to sufficiently offset any weaknesses based on the loan-to-value ratio, borrower's financial condition, net worth, credit history, earnings capacity, installment obligations and current payment history.



The five largest borrowing relationships, as of March 31, 2010, in descending order were:

| Borrower (1)         | Aggregate Amount of Loans (2) | Number of Loans |
|----------------------|-------------------------------|-----------------|
| Real estate builder  | \$ 47.0 million<br>(3)        | 143             |
| Real estate builder  | 39.7 million<br>(4)           | 144             |
| Real estate builder  | 28.2 million                  | 119             |
| Real estate builder  | 19.2 million<br>(5)           | 71              |
| Real estate investor | 17.6 million                  | 3               |
| Total                | \$ 151.7 million              | 480             |

(1) The composition of borrowers represented in the table

may change from one period to the next.

(2) Net of undisbursed funds.

(3) Of this amount, \$21.9 million are considered impaired loans.

(4) Of this amount, \$21.9 million are considered impaired loans.

(5) Of this amount, \$14.8 million are considered impaired loans.

The following table details the breakdown of the types of loans to our top five largest borrowing relationships at March 31, 2010:

| Borrower                | Permanent One-to-Four Family Residential Loans (Rental Properties) | Permanent Multifamily Loans (Rental Properties) | Permanent Commercial Loans (Rental Properties) | Construction/ Land Development (1) | Aggregate Amount of Loans (1) |
|-------------------------|--|---|--|------------------------------------|-------------------------------|
| Real estate builder (2) | \$ 18.4 million  | \$ -  | \$ 0.3 million                                 | \$ 28.3 million                    | \$ 47.0 million               |
| Real estate builder (3) | 26.8 million   | -   | 0.8 million                                    | 12.1 million                       | 39.7 million                  |
| Real estate builder     | 18.7 million   | 1.0 million                                     | 0.1 million                                    | 8.4 million                        | 28.2 million                  |
| Real estate builder (4) | 11.0 million   | -   | -  | 8.2 million                        | 19.2 million                  |
| Real estate investor    | -  | -   | 17.6 million                                   | -                                  | 17.6 million                  |
| Total                   | \$ 74.9 million  | \$ 1.0 million                                  | \$ 18.8 million                                | \$ 57.0 million                    | \$ 151.7 million              |

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(1) Net of undisbursed funds.

(2) Of the \$21.9 million loans considered impaired, \$3.2 million are one-to-four family residential loans and \$18.4 million are construction/land development loans and \$0.3 million are commercial loans.

(3) Of the \$21.9 million loans considered impaired, \$10.4 million are one-to-four family residential loans and \$11.5 million are construction/land development loans.

(4) Of the \$14.8 million loans considered impaired, \$6.7 million are one-to-four family residential loans and \$8.1 million are construction/land development loans.

Some of the builders listed in the above tables, as part of their business strategy, retain a certain percentage of their finished homes in their own inventory of permanent investment properties, (i.e. one-to-four family rental properties). These properties are used to enhance the builders' liquidity through rental income and improve their equity position, long-term, through the appreciation in market value of the property. As part of our underwriting process we review the borrowers' business strategy to determine the feasibility of the project. Starting in 2008, these builders have taken more rental properties into their portfolio than originally planned as a result of the depressed housing market. For the four builders included in the table above, the total one-to-four family rental properties decreased \$800,000, or 1.1% to \$74.9 million at March 31, 2010 from \$75.7 million at December 31, 2009.

During the first quarter of 2010, we have classified all of the loans to our two largest merchant builders, excluding nearly all of their rental properties, as nonperforming. Both of these builders are current on all of their loan payments. As a result of the prolonged recession, these builders are beginning to experience cash flow

difficulties. We are currently establishing workout arrangements with these borrowers to reduce the Bank's exposure. These loans are included in the one-to-four family residential, construction/land development and commercial portfolios totaling \$12.9 million, \$29.9 million and \$300,000, respectively, at March 31, 2010.

The following table includes construction/land development loans, net of undisbursed funds, by the five counties that contain our largest loan concentrations at March 31, 2010.

| County                 | Loan Balance (1) | Percent of<br>Loan Balance (1) | Nonperforming<br>Loans | Nonperforming<br>Loans as a<br>Percent of<br>Loan<br>Balance (2) |
|------------------------|------------------|--------------------------------|------------------------|--|
| (Dollars in thousands) |                  |                                |                        |  |
| King                   | \$ 50,433        | 41.8 %                         | \$ 37,137              | 73.6 %   |
| Pierce                 | 20,155           | 16.7                           | 9,451                  | 46.9   |
| Kitsap                 | 15,815           | 13.1                           | 10,366                 | 65.5   |
| Whatcom                | 11,491           | 9.5                            | 11,491                 | 100.0  |
| Snohomish              | 6,767            | 5.6                            | 4,339(3)               | 64.1   |
| All other<br>counties  | 15,974           | 13.3                           | 10,232                 | 64.1   |
| Total                  | \$ 120,635       | 100.0 %                        | \$ 83,016              | 68.8 %   |

(1) Net of undisbursed funds.

(2) Represents the percent of the loan balance by county that is nonperforming.

(3) Represents one loan.

### Critical Accounting Policies

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

**Allowance for Loan Losses.** Management recognizes that loan losses may occur over the life of a loan and that the allowance for loan losses must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio. Our methodology for analyzing the allowance for loan losses consists of two components: formula and specific allowances. The formula allowance is determined by applying factors to our various groups of loans. Management considers factors such as charge-off history, the prevailing economy, borrower's ability to repay, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, management's experience level, our loan review and grading system, the value of underlying collateral, the level of problem loans, business conditions and credit concentrations in assessing the allowance for loan losses. The specific allowance component is created when management believes that the collectability of a specific loan, such as a construction/land development, multifamily, business or commercial real estate loan, has been impaired and a loss is probable. The specific reserves are computed using current appraisals, listed sales prices and other available information less costs to complete (if any) and costs to sell the property. This evaluation is inherently subjective as it requires estimates that are susceptible to significant

revision as more information becomes available or as future events differ from predictions.

Our Board of Directors approves the provision for loan losses on a quarterly basis. The allowance is increased by the provision for loan losses, which is charged against current period earnings and decreased by the amount of actual loan charge-offs, net of recoveries.

We believe that the accounting estimate related to the allowance for loan losses is a critical accounting estimate because it is highly susceptible to change from period-to-period requiring management to make assumptions about probable losses inherent in the loan portfolio; and the impact of a sudden large loss could deplete the allowance and potentially require increased provisions to replenish the allowance, which would

negatively affect earnings. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution's ALLL and carrying amounts of other real estate owned. Such agencies may require the financial institution to recognize additions to the allowance based on their judgment and information available to them at the time of their examination. For additional information see the section titled "Our provision for loan losses has increased substantially and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could adversely affect our results of operations," within the section titled "Item 1A. Risk Factors".

**Valuation of OREO and Foreclosed Assets.** Real estate properties acquired through foreclosure or by deed-in-lieu of foreclosure are recorded at the lower of cost or fair value less estimated costs to sell. Fair value is generally determined by management based on a number of factors, including third-party appraisals of fair value in an orderly sale. Accordingly the valuation of OREO is subject to significant external and internal judgment. Any differences between management's assessment of fair value, less estimated costs to sell, and the carrying value of the loan at the date a particular property is transferred into OREO are charged to the allowance for loan losses. Management periodically reviews OREO values to determine whether the property continues to be carried at the lower of its recorded book value or fair value, net of estimated costs to sell. Any further decreases in the value of OREO are considered valuation adjustments and trigger a corresponding charge to noninterest expense in the Consolidated Statement of Operations. Expenses from the maintenance and operations and any gains or losses from the sale of OREO are included in noninterest expense.

**Deferred Taxes.** Deferred tax assets arise from a variety of sources, the most significant being: a) expenses, such as our charitable contribution to the First Financial Northwest Foundation, that can be carried forward to be utilized against profits in future years; b) expenses recognized in our books but disallowed in our tax return until the associated cash flow occurs; and c) write-downs in the value of assets for book purposes that are not deductible for tax purposes until the asset is sold or deemed worthless.

We record a valuation allowance to reduce our deferred tax assets to the amount which can be recognized in line with the relevant accounting standards. The level of deferred tax asset recognition is influenced by management's assessment of our historic and future profitability profile. At each balance sheet date, existing assessments are reviewed and, if necessary, revised to reflect changed circumstances. In a situation where income is less than projected or recent losses have been incurred, the relevant accounting standards require convincing evidence that there will be sufficient future tax capacity.

**Other-Than-Temporary Impairments In the Market Value of Investments.** Declines in the fair value of any available for sale or held to maturity investment below their cost that is deemed to be other-than-temporary results in a reduction in the carrying amount of the investment to that of fair value. A charge to earnings and an establishment of a new cost basis for the investment is made. Unrealized investment losses are evaluated at least quarterly to determine whether such declines should be considered other-than-temporary and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the investment security is below the carrying value primarily due to changes in interest rates and there has not been significant deterioration in the financial condition of the issuer. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other-than-temporary include ratings by recognized rating agencies; the extent and duration of an unrealized loss position; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.



## Comparison of Financial Condition at March 31, 2010 and December 31, 2009

General. Total assets increased \$5.9 million, or 0.5%, to \$1.3 billion at March 31, 2010 from December 31, 2009. This asset growth was a result of the increases of \$10.7 million in cash and interest-bearing deposits and \$12.2 million in investment securities. These increases were offset by a decrease in net loans receivable of \$22.4 million. Total liabilities were \$1.1 billion at March 31, 2010, an increase of \$24.4 million or 2.2% from December 31, 2009. The increase in total liabilities was the result of a \$23.2 million increase in deposits. Stockholders' equity decreased \$18.5 million, primarily due to the net loss for the quarter ended March 31, 2010 of \$17.8 million.

Assets. Total assets increased \$5.9 million or 0.5% at March 31, 2010, as compared to December 31, 2009. The following table details the changes in the composition of our assets.

|                                       | Balance at<br>March 31, 2010 | Increase/(Decrease)<br>from<br>December 31, 2009<br>(Dollars in thousands) | Percentage<br>Increase/(Decrease) |
|---------------------------------------|------------------------------|--|-----------------------------------|
| Cash on hand and in banks             | \$ 8,373                     | \$ (564)   | (6.31 )%                          |
| Interest-bearing deposits             | 107,326                      | 11,293   | 11.76                             |
| Investments available for sale        | 109,593                      | 12,210   | 12.54                             |
| Loans receivable, net                 | 1,016,896                    | (22,404)   | (2.16 )                           |
| Premises and equipment, net           | 20,453                       | 868  | 4.43                              |
| Federal Home Loan Bank stock, at cost | 7,413                        | -  | -                                 |
| Accrued interest receivable           | 4,716                        | (164)  | (3.36 )                           |
| Federal income tax receivable         | 12,160                       | 2,661  | 28.01                             |
| Deferred tax assets, net              | 5,415                        | (6,724)  | (55.39 )                          |
| OREO                                  | 20,500                       | 8,665  | 73.22                             |
| Prepaid expenses and other assets     | 8,384                        | 54   | 0.65                              |
| <b>Total assets</b>                   | <b>\$ 1,321,229</b>          | <b>\$ 5,895</b>  | <b>0.45 %</b>                     |

Cash and interest-bearing deposits increased \$10.7 million to \$115.7 million at March 31, 2010 from \$105.0 million at December 31, 2009 as a result of a decline in loan demand. Investments available for sale increased \$12.2 million, or 12.5% to \$109.6 million at March 31, 2010 from \$97.4 million at December 31, 2009. During the first quarter of 2010, we purchased \$18.9 million of investments primarily in mortgage-backed securities issued by Freddie Mac and Fannie Mae. Net loans receivable decreased \$22.4 million or 2.2% to \$1.0 billion at March 31, 2010 as compared to December 31, 2009. OREO increased \$8.7 million or 73.2% to \$20.5 million at March 31, 2010 from \$11.8 million at December 31, 2009. The net increase in these asset categories was funded by the increase in deposits of \$23.2 million or 2.5% to \$962.6 million at March 31, 2010 from \$939.4 million at December 31, 2009.

Loan originations for the three months ended March 31, 2010 totaled \$29.2 million and included: \$10.4 million in one-to-four family mortgages; \$6.2 million and \$5.2 million in multifamily and commercial real estate loans, respectively; and \$5.6 million in construction/land development loans. Included in the one-to-four family residential loan originations are \$772,000 of permanent loans where the builders have financed homes that are being rented by third parties. We also originated \$1.8 million in consumer loans. Origination activity for the first quarter of 2010 was offset by repayments during the same period of \$34.3 million, transfers to OREO of \$14.4 million and charge-offs of \$9.7 million. The originations in the construction/land development loan portfolio were primarily to our merchant builders so they could continue to complete their projects and utilize their existing land inventory. We are concentrating on working with our existing builders and have not expanded our customer base for this type of lending.



Deposits. During the first quarter of 2010, deposits increased \$23.2 million to \$962.6 million. The increase in deposits was a result of the strategic pricing of our deposit accounts and our customers' desire to invest in insured deposit products. While most of our deposit categories increased from December 31, 2009, the increases in certificates of deposit of \$19.4 million and money market accounts of \$2.9 million comprised the majority of the increase. In an effort to increase our core deposits, we have both competitively priced our deposit products and continued our marketing campaign to attract new customers to the Bank. We did not have any brokered deposits at March 31, 2010 or December 31, 2009. A breakdown of our deposits by type is as follows:

|                              | March 31,<br>2010 | December 31,<br>2009 |
|------------------------------|-------------------|----------------------|
|                              | (In thousands)    |                      |
| Noninterest-bearing accounts | \$ 5,201          | \$ 3,294             |
| NOW accounts                 | 12,728            | 12,740               |
| Statement savings accounts   | 14,340            | 15,423               |
| Money market accounts        | 197,255           | 194,315              |
| Certificates of deposit      | 733,066           | 713,651              |
|                              | \$ 962,590        | \$ 939,423           |

Advances. Total advances were \$139.9 million at March 31, 2010 and December 31, 2009. We have focused on extending the maturity dates of our advances to reduce our funding costs as a result of the continued low interest rate environment.

Stockholders' Equity. Total stockholders' equity decreased \$18.5 million, or 8.1%, to \$210.0 million at March 31, 2010 from \$228.5 million at December 31, 2009. The decrease was primarily the result of our net loss for the first quarter of 2010 of \$17.8 million.

#### Comparison of Operating Results for the Three Months Ended March 31, 2010 and 2009

General. We incurred a net loss of \$17.8 million for the first quarter of 2010, a decrease of \$18.9 million from the comparable quarter in the prior year. The decrease in earnings in the first quarter of 2010 as compared to the first quarter of 2009 was primarily the result of a \$13.0 million provision for loan losses, \$3.4 million in noninterest expense related to our OREO and an additional \$7.9 million valuation allowance related to our deferred tax asset.

Net Interest Income. Our net interest income for the quarter ended March 31, 2010 decreased to \$8.1 million, as compared to \$8.2 million for the same quarter in the prior year, a decrease of \$107,000. Interest income for the first quarter of 2010 decreased \$1.1 million, or 6.5% to \$15.7 million from \$16.8 million as compared to the first quarter of 2009. The decline in interest income was offset by a \$981,000 decline in interest expense.

The following table sets forth the effects of changes in rates and volumes on our net interest income.

|  | Three Months Ended March 31, 2010 |                   |                 |
|--|-----------------------------------|-------------------|-----------------|
|  | Increase (Decrease) Due to        |                   |                 |
|  | Rate                              | Volume            | Total           |
|  | (Dollars in thousands)            |                   |                 |
| <b>Interest-earning assets:</b>                                    |                                   |                   |                 |
| Loans receivable, \$   | (567)                             | \$ 38             | \$ (529)        |
| <b>net</b>   |                                   |                   |                 |
| Investments available for sale                                     | (142)                             | (476)             | (618)           |
| <b>Federal funds sold and interest-bearing deposits with banks</b> |                                   |                   |                 |
|  | 41                                | 18                | 59              |
| <b>Total net change in income on interest-earning assets</b>       |                                   |                   |                 |
|  | (668)                             | (420)             | (1,088)         |
| <b>Interest-bearing liabilities:</b>                               |                                   |                   |                 |
| NOW accounts   | (7)                               | 5                 | (2)             |
| Statement savings accounts   | (19)                              | 10                | (9)             |
| Money market accounts  | (227)                             | 365               | 138             |
| Certificates of deposit  | (1,574)                           | 689               | (885)           |
| <b>Advances from the Federal Home Loan Bank</b>                    |                                   |                   |                 |
|  | (185)                             | (38)              | (223)           |
| <b>Total net change in expense on interest-bearing liabilities</b> |                                   |                   |                 |
|  | (2,012)                           | 1,031             | (981)           |
| <b>Net change in net interest income</b>                           | <b>\$ 1,344</b>                   | <b>\$ (1,451)</b> | <b>\$ (107)</b> |

Interest Income. Total interest income for the first quarter of 2010 decreased \$1.1 million, or 6.5%, to \$15.7 million from \$16.8 million as compared to the first quarter of 2009. The following table compares detailed average interest-earning asset balances, associated yields and resulting changes in interest income for the three months ended March 31, 2010 and 2009:

|  | Three Months Ended March 31, |       |                    |       | Increase/<br>(Decrease) in<br>Interest and<br>Dividend<br>Income |
|--|------------------------------|-------|--------------------|-------|--|
|  | 2010                         |       | 2009               |       |  |
|  | Average<br>Balance           | Yield | Average<br>Balance | Yield |  |
| (Dollars in thousands)                                 |                              |       |                    |       |  |
| Loans receivable, net                                  | \$ 1,036,148                 | 5.63% | \$ 1,033,521       | 5.85% | \$ (529)   |
| Investments available for<br>sale                      | 101,414                      | 3.97  | 143,539            | 4.53  | (618)  |
| Federal funds sold and<br>interest-bearing<br>deposits | 98,795                       | 0.25  | 9,492              | 0.08  | 59   |
| Federal Home Loan Bank<br>stock                        | 7,413                        | -     | 7,413              | -     | -  |
| Total interest-earning<br>assets                       | \$ 1,243,770                 | 5.04% | \$ 1,193,965       | 5.61% | \$ (1,088)   |

Interest income from loans decreased \$529,000 during the first quarter of 2010 as compared to the same quarter in 2009. The decline in interest income was primarily the result of \$797,000 in foregone interest income (interest that has not been accrued on nonperforming loans) during the first quarter of 2010. Interest income on investments available for sale decreased \$618,000 to \$1.0 million for the quarter ended March 31, 2010 compared to \$1.6 million for the comparable quarter in 2009. The primary reason for the decline in interest income from investments was due to the decline in yield to 3.97% in the first quarter of 2010 from 4.53% for the same quarter in

2009 resulting in a \$142,000 decrease in interest income and the decline in the average balance of investments available for sale of \$42.1 million resulting in a decrease of \$476,000 in interest income. Interest earned on federal funds sold and interest-bearing deposits totaled \$61,000 for the quarter ended March 31, 2010, an increase of \$59,000 from the same quarter in 2009. At the same time, our liquidity in the form of cash, and interest-bearing deposits increased to \$115.7 million at March 31, 2010 from \$105.0 million at December 31, 2009, as a result of a decline in loan demand.

Average interest-earning assets increased \$49.8 million to \$1.2 billion for the three months ended March 31, 2010 compared to the same quarter in 2009. Average interest-bearing liabilities increased \$140.3 million to \$1.1 billion for the first quarter of 2010 compared to \$940.5 million for the same quarter in 2009. During the same period, our yield on interest-earning assets decreased 57 basis points while our cost of funds decreased 84 basis points, increasing our interest rate spread for the quarter ended March 31, 2010 by 27 basis points to 2.23% from 1.96% during the same quarter in 2009. Our net interest margin for the first quarter of 2010 decreased to 2.59% as compared to 2.74% for the same quarter last year.

Interest Expense. Total interest expense for the three months ended March 31, 2010 was \$7.6 million, a decrease of \$981,000 as compared to the first quarter of 2009. The following table details average balances, cost of funds and the resulting decrease in interest expense for the three months ended March 31, 2010 and 2009:

|   | Three Months Ended March 31, |       |  |       | Increase/<br>(Decrease) in<br>Interest<br>Expense |
|---|------------------------------|-------|--|-------|---|
|   | 2010                         |       | 2009   |       |   |
|   | Average<br>Balance           | Cost  | Average<br>Balance<br>(Dollars in thousands) | Cost  |   |
| NOW accounts                                | \$ 12,895                    | 0.47% | \$ 9,981                                     | 0.68% | \$ (2)  |
| Statement savings<br>accounts               | 15,120                       | 1.22  | 12,824                                       | 1.72  | (9)   |
| Money market accounts                       | 193,823                      | 1.52  | 121,445                                      | 1.98  | 138   |
| Certificates of deposit                     | 718,999                      | 3.21  | 651,902                                      | 4.08  | (885)   |
| Advances from the<br>Federal Home Loan Bank | 139,900                      | 2.92  | 144,328                                      | 3.45  | (223)   |
| Total interest-bearing<br>liabilities       | \$ 1,080,737                 | 2.81% | \$ 940,480                                   | 3.65% | \$ (981)  |

The average balance of our money market accounts increased \$72.4 million, which resulted in an additional \$365,000 of interest expense as compared to the first quarter of 2009. This increase in money market balances was a result of our deposit pricing strategy and the desire of our customers to save more in this challenging economic environment. This increase in interest expense was partially offset by a decrease in the average cost of these funds of 46 basis points or \$227,000 less in interest expense for the first quarter of 2010 as compared to the same quarter in 2009. The average cost of our certificates of deposit decreased 87 basis points as compared to the first quarter of 2009 primarily due to maturing certificates repricing to lower rates. This equates to a decline in interest expense of \$1.6 million, which was partially offset by an increase in the average balance of certificates of deposit of \$67.1 million, which resulted in an additional \$689,000 of interest expense. Interest expense related to our average balance of advances from the FHLB decreased \$223,000 primarily as a result of the decrease in the cost of funds as we took advantage of extending our borrowings at lower interest rates.

Provision for Loan Losses. We establish the provision for loan losses at a level we believe is necessary to absorb known and inherent losses that are both probable and reasonably estimable at the date of the financial statements. Our

methodology in assessing the allowance for loan losses places greater emphasis on factors such as charge-off history, the economy, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, management experience levels, our loan review and grading system and the value of underlying collateral. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or as future events differ from predictions.

During the quarter ended March 31, 2010, management continued to evaluate the adequacy of the allowance for loan losses and concluded that a provision of \$13.0 million was required for the quarter. This

provision increased the allowance for loan losses to \$36.5 million at March 31, 2010 from \$33.0 million at December 31, 2009. Charge-offs for the first quarter of 2010 were \$9.7 million as compared to \$21.8 million for the fourth quarter of 2009. We are continuing to see an increase in the level of nonperforming assets and continued decreases in updated appraised values of real estate collateral securing our nonperforming loans. It is our policy to obtain new appraisals on nonperforming loans every six months or sooner if management believes significant changes have affected market values of these properties. Our total nonperforming loans, net of undisbursed funds, increased \$25.2 million at March 31, 2010 to \$145.9 million from \$120.7 million at December 31, 2009. Nonperforming loans include loans to borrowers who are experiencing deteriorating financial positions. These borrowers may be current on their loan payments but there is doubt as to the ultimate recoverability of the full principal and interest due to the Bank in accordance with the terms of the loan agreement.

The following table presents a breakdown of our nonperforming assets:

|                                    | March 31,<br>2010 | December<br>31,<br>2009 | March 31,<br>2009 | One-Year<br>Change \$ | One-Year<br>Change % |
|------------------------------------|-------------------|-------------------------|-------------------|-----------------------|----------------------|
| (In thousands)                     |                   |                         |                   |                       |                      |
| One-to-four family residential (1) | \$48,035          | \$36,874                | \$16,633          | \$31,402              | 188.79 %             |
| Commercial real estate             | 14,108            | 11,535                  | 9,383             | 4,725                 | 50.36                |
| Construction/land development      | 83,016            | 71,780                  | 54,146            | 28,870                | 53.32                |
| Consumer                           | 759               | 514                     | 50                | 709                   | 1,418.00             |
| Total nonperforming loans (2)      | \$145,918         | \$120,703               | \$80,212          | \$65,706              | 81.92 %              |
| Other real estate owned            | 20,500            | 11,835                  | -                 | 20,500                | 100.00               |
| Total nonperforming assets         | \$166,418         | \$132,538               | \$80,212          | \$86,206              | 107.47 %             |

(1) The majority of these loans are related to our merchant builders rental properties.

(2) There were no accruing loans which were contractually past due 90 days or more at March 31, 2010 or

December 31, 2009, these loans totaled \$12.7 million at March 31, 2009.

The largest addition to nonperforming loans during the first quarter of 2010 was \$43.1 million of loans related to our two largest merchant builders who are current on their loan payments. As a result of the prolonged recession, these builders are beginning to experience cash flow difficulties. We are currently establishing workout arrangements with these borrowers to reduce the Bank's exposure. As a result, we classified these loans as nonperforming at March 31, 2010. These loans are included in the one-to-four family residential, construction/land development and commercial loan portfolios totaling \$12.9 million, \$29.9 million and \$300,000, respectively.

The three largest nonperforming loans in the commercial real estate portfolio at March 31, 2010 consist of a \$2.5 million loan secured by an office building in Pierce County, a \$2.0 million loan secured by an office building also located in Pierce County and a \$1.5 million loan secured by land located in Whatcom County.

During the first quarter of 2010, loans transferred from the nonperforming loan category to OREO totaled \$14.4 million. Charge-offs at March 31, 2010 related to the valuation of the OREO inventory to market were \$2.3 million. OREO increased \$8.7 million or 73.2% to \$20.5 million at March 31, 2010 from \$11.8 million at December 31, 2009. The majority of this increase was in the construction/land development category. Our recently organized special assets department sold \$3.5 million of OREO properties during the first quarter of 2010. We evaluate the market value of our

OREO inventory quarterly. This evaluation includes, among other things, obtaining independent appraisals on these properties every six months or sooner if management believes significant changes have affected the market values of these properties. As a result of this evaluation, we expensed \$2.3 million related to the decline in the market value of our OREO, net losses from sales of OREO properties of \$437,000 and maintenance expenses (which is included in other noninterest expense on the Consolidated Statement of Operations) for the three months ended March 31, 2010.

The following table presents a breakdown of our OREO at March 31, 2010:

|                                | King<br>County         | Pierce<br>County | Snohomish<br>County | Kitsap<br>County | All other<br>counties | Total Other<br>Real Estate<br>Owned | Percent of<br>Total<br>Other<br>Real<br>Estate<br>Owned |
|--------------------------------|------------------------|------------------|---------------------|------------------|-----------------------|-------------------------------------|---|
|                                | (Dollars in thousands) |                  |                     |                  |                       |                                     |   |
| One-to four-family residential | \$ 1,994               | \$ 2,061         | \$ 958              | \$ -             | \$ 610                | \$ 5,623                            | 27.43%  |
| Commercial                     | 188                    | 2,817            | -                   | -                | -                     | 3,005                               | 14.66   |
| Construction/land development  | 7,354                  | -                | 2,076               | 970              | 1,472                 | 11,872                              | 57.91   |
| Total other real estate owned  | \$ 9,536               | \$ 4,878         | \$ 3,034            | \$ 970           | \$ 2,082              | \$ 20,500                           | 100.00%   |

The three largest properties included in OREO at March 31, 2010 were a retail commercial building valued at \$2.2 million located in Pierce County, a parcel of land valued at \$1.6 million intended for multifamily residential development located in King County and developed land ready for residential construction valued at \$845,000 located in Snohomish County.

The following table presents a breakdown of our troubled debt restructured loans:

|   | At March 31,<br>2010 | At December 31,<br>2009 |
|---|----------------------|-------------------------|
|   | (In thousands)       |                         |
| Nonaccrual troubled debt restructured loans (1) | \$ 37,783            | \$ 26,021               |
| Performing troubled debt restructured loans     | 22,948               | 35,458                  |
| Troubled debt restructured loans                | \$ 60,731            | \$ 61,479               |

(1) Balances represent loans, net of undisbursed funds.

Our troubled debt restructured loans decreased \$748,000 to \$60.7 million at March 31, 2010 as compared to \$61.5 million at December 31, 2009. As we work with our borrowers to help them through this difficult economic cycle, we explore all options available to us to minimize our risk of loss. At times, the best option for our customers and the Bank is to modify the loan for a period of time, usually one year or less. These modifications have included lowering the interest rate on the loan for a period of time and/or extending the maturity date of the loan. These modifications are granted only when there is a reasonable and attainable workout plan that has been agreed to by the borrower and is in the Bank's best interest. Of the \$60.7 million in troubled debt restructured loans at March 31, 2010, \$22.9 million were classified as performing and \$37.8 million were not performing according to their terms.

We believe that the allowance for loan losses as of March 31, 2010 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. Future additions to the allowance may become necessary based upon



changing economic conditions, increased loan balances, or changes in the underlying collateral of the loan portfolio.

In addition, the determination of the amount of our allowance for loan losses is subject to review by the Bank's regulators as part of the routine examination process, which may result in the establishment of additional reserves or charge-offs, based upon their judgment of information available to them at the time of their examination.

|   | At or For the Three Months Ended March 31, |              |
|---|--|--------------|
|   | 2010                                       | 2009         |
|   | (Dollars in thousands)                     |              |
| Provision for loan losses   | \$ 13,000                                  | \$ 1,544     |
| Charge-offs   | \$ 9,682                                   | \$ 4,232     |
| Recoveries  | \$ 122                                     | \$ -         |
| Allowances for loan losses  | \$ 36,479                                  | \$ 14,294    |
| Allowance for loan losses as a percent of total loans outstanding                                   |  |              |
| at the end of the period, net of undisbursed funds  | 3.45%                                      | 1.36%        |
| Allowance for loan losses as a percent of nonperforming loans                                       |  |              |
| at the end of the period, net of undisbursed funds  | 25.00%                                     | 17.82%       |
| Total nonaccrual and 90 days or more past due loans, net of undisbursed funds                       | \$ 145,918                                 | \$ 80,212    |
| Nonaccrual and 90 days or more past due loans as a percent of total loans, net of undisbursed funds | 13.81%                                     | 7.65%        |
| Total loans receivable  | \$ 1,056,321                               | \$ 1,048,185 |
| Total loans originated, net of undisbursed funds  | \$ 29,159                                  | \$ 22,236    |

Noninterest Income. Noninterest income decreased \$84,000 to \$46,000 for the three months ended March 31, 2010 from the comparable quarter in 2009. The following table provides a detailed analysis of the changes in the components of noninterest income:

|                                  | Three Months Ended March 31, 2010 | Increase/(Decrease) from March 31, 2009 (Dollars in thousands) | Percentage Increase/(Decrease) |
|----------------------------------|-----------------------------------|--|--------------------------------|
| Service fees on deposit accounts | \$ 19                             | \$ 2   | 11.76 %                        |
| Loan service fees                | 47                                | (28 )  | (37.33 )                       |
| Gain on sale of investments      | -                                 | (76 )  | (100.00 )                      |
| Amortization of servicing rights | (36)                              | 18   | (33.33 )                       |
| Other                            | 16                                | -  | -                              |
| Total noninterest income         | \$ 46                             | \$ (84)  | (64.62 )%                      |

Noninterest income was \$46,000 for the quarter ended March 31, 2010, as compared to \$130,000 for the same quarter in 2009. The decrease in noninterest income for the quarter was predominately related to an absence of net gain on the sale of investments in the first quarter of 2010 compared to a \$76,000 net gain for the quarter ended March 31, 2009.

Noninterest Expense. Noninterest expense increased \$3.7 million during the three months ended March 31, 2010 to \$8.9 million as compared to \$5.1 million for the same quarter in 2009. The following table provides the detail of the changes in noninterest expense:

|                                       | Three Months<br>Ended<br>March 31, 2010 | Increase/(Decrease)<br>from<br>March 31, 2009<br>(Dollars in thousands) | Percentage<br>Increase/(Decrease) |
|---------------------------------------|---|---|-----------------------------------|
| Compensation and benefits             | \$ 3,189                                | \$ 150  | 4.94%                             |
| Occupancy and equipment               | 425                                     | 75  | 21.43                             |
| Professional fees                     | 459                                     | 152   | 49.51                             |
| Data processing                       | 170                                     | 26  | 18.06                             |
| Marketing                             | 43                                      | (9)   | (17.31)                           |
| Office supplies and postage           | 57                                      | (14)  | (19.72)                           |
| Loss on sale of OREO<br>property, net | 437                                     | 437   | 100.00                            |
| OREO valuation expense                | 2,271                                   | 2,271   | 100.00                            |
| OREO related expenses, net            | 702                                     | 702   | 100.00                            |
| FDIC/OTS assessments                  | 580                                     | (113)   | (16.31)                           |
| Bank and ATM charges                  | 34                                      | (2)   | (5.56)                            |
| Other                                 | 500                                     | 48  | 10.62                             |
| Total noninterest expense             | \$ 8,867                                | \$ 3,723  | 72.38%                            |

The significant increase in noninterest expense for the first quarter of 2010 as compared to the same period in 2009 was a result of increases in OREO related expenses. OREO related expenses increased \$3.4 million as compared to the first quarter of 2009. OREO is evaluated on a quarterly basis to determine the fair market value of the real estate at the end of the quarter. During the first quarter of 2010, \$2.3 million of noninterest expense was a result of these evaluations. OREO related expenses associated with the sale of the properties was a loss of \$437,000 for the first quarter of 2010 and maintenance related expenses were \$702,000. We did not have any OREO at March 31, 2009.

Federal Income Tax Expense. Federal income tax expense increased \$3.6 million for the three months ended March 31, 2010 to \$4.0 million as compared to \$421,000 for the three months ended December 31, 2009. The increase in the provision for federal income taxes was principally a result of the increase in the valuation allowance of \$7.9 million related to our deferred tax assets at March 31, 2010.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At March 31, 2010, we considered positive evidence, which includes \$5.4 million of carryback potential and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings due to market conditions.

We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing all of the positive and negative evidence, we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential.

#### Liquidity

We are required to have enough cash flow in order to maintain sufficient liquidity to ensure a safe and sound operation. Historically, we have maintained cash balances above the minimum level believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. On a daily basis, we review

and update cash flow projections to ensure that adequate liquidity is maintained. See the “Consolidated Statements of Cash Flows” contained in Item 1 – Financial Statements, included herein.

Our primary sources of funds are from customer deposits, loan repayments, maturing investment securities and advances from the FHLB. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions and competition. At March 31, 2010, certificates of deposit scheduled to mature in one year or less totaled \$484.1 million. Historically, we have been able to retain a significant amount of the deposits as they mature. We believe that our current liquidity position and our forecasted operating results are sufficient to fund all of our existing commitments.

While our primary source of funds is our deposits, when deposits are not available to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB, wholesale funding, federal funds purchased, dealer repurchase agreements and brokered deposits, as well as other short-term alternatives. At March 31, 2010, the Bank maintained credit facilities with the FHLB totaling \$455.8 million with an outstanding balance of \$139.9 million. In addition, we have a line of credit with the Federal Reserve Bank of San Francisco (“FRB”) totaling \$164.2 million which could be used for liquidity purposes. There was no balance outstanding for the FRB line of credit at March 31, 2010.

#### Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. Commitments to extend credit and lines of credit are not recorded as an asset or liability until the instrument is exercised. At March 31, 2010, we had no commitments to originate loans for sale.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. 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. We evaluate each customer’s creditworthiness on a case-by-case basis. The amount of the collateral obtained, if deemed necessary, varies, but may include real estate and income-producing commercial properties.

The following tables summarize our outstanding commitments to originate loans and to advance additional amounts related to lines of credit and construction loans at March 31, 2010.

|                                   | Total<br>Amounts<br>Committed | Through<br>One Year | Amount of Commitment Expiration - Per Period                |  |                        |
|-----------------------------------|-------------------------------|---------------------|---|--|------------------------|
|                                   |                               |                     | After<br>One<br>Through<br>Three<br>Years<br>(In thousands) | After<br>Three<br>Through<br>Five<br>Years | After<br>Five<br>Years |
| Commitments to originate<br>loans | \$ 2,844                      | \$ -                | \$ -  | \$ -                                       | \$ -                   |
|                                   | 9,088                         | 298                 | -   | 2,525                                      | 6,265                  |

Unused portion of lines of credit

|   |    |        |    |        |    |       |    |       |    |       |
|---|----|--------|----|--------|----|-------|----|-------|----|-------|
| Undisbursed portion of construction loans |    | 30,252 |    | 23,102 |    | 6,791 |    | 359   |    | -     |
| Total commitments                         | \$ | 42,184 | \$ | 23,400 | \$ | 6,791 | \$ | 2,884 | \$ | 6,265 |

We are from time to time involved in various claims and legal actions arising in the ordinary course of business. There are currently no matters that in the opinion of management would have a material adverse effect on our financial position, results of operation, or liquidity.

Among our contingent liabilities are exposures to limited recourse arrangements with respect to sales of whole loans and participation interests.

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

### Capital

Consistent with our goal to operate a sound and profitable financial organization, we actively manage our capital levels in order to be considered “well capitalized” in accordance with established regulatory ratios. As of March 31, 2010, we exceeded all regulatory capital ratios. Regulatory capital ratios for the Bank only were as follows as of March 31, 2010: Tier 1 capital 11.33%; Tier 1 (core) risk-based capital 16.43%; and total risk-based capital 17.73%. The regulatory capital ratio requirements to be considered well capitalized are 5%, 6% and 10%, respectively, although the regulators may impose higher capital levels, if warranted. During the quarter ended March 31, 2010, it came to our attention that more current information was required for our multifamily loans to be assigned a risk rating of 50% for capital risk-weighting purposes. As a result, at March 31, 2010, all of our multifamily loans were risk-weighted at 100% for risk-based capital calculations. The effect of this reclassification was a reduction of approximately 130 basis points in our risk-based capital ratios. In addition, the parent company of the Bank had approximately \$49.1 million of capital at March 31, 2010.

At March 31, 2010, stockholders’ equity totaled \$210.0 million, or 15.9% of total assets. Our book value per share of common stock was \$11.17 as of March 31, 2010, as compared to \$12.14 as of December 31, 2009.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is defined as the sensitivity of income and capital to changes in interest rates and other relevant market rates or prices. Our profitability is largely dependent on our net interest income. Consequently, our primary exposure to market risk arises from the interest rate risk inherent in our lending, deposit and borrowing activities. Interest rate risk is the risk to earnings and capital resulting from adverse movements in interest rates. To that end, we actively monitor and manage our exposure to interest rate risk.

A number of measures are utilized to monitor and manage interest rate risk, including net interest income and economic value of equity simulation models. We prepare these models on a quarterly basis for review by our Asset Liability Committee (“ALCO”), senior management and Board of Directors. The use of these models requires us to formulate and apply assumptions to various balance sheet items. Assumptions regarding interest rate risk are inherent in all financial institutions and may include, but are not limited to, prepayment speeds on loans and mortgage-backed securities, cash flows and maturities of financial instruments held for purposes other than trading, changes in market conditions, loan volumes and pricing, deposit sensitivities, consumer preferences and management’s capital plans. We believe that the data and assumptions used for our models are reasonable representations of our portfolio and possible outcomes under the various interest rate scenarios. Nonetheless, these assumptions are inherently uncertain; therefore, the models cannot precisely estimate net interest income or predict the impact of higher or lower interest rates on net interest income. Actual results may differ significantly from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and specific strategies, among other factors.

### Asset/Liability Management

Our primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on our net interest income and capital, while structuring the asset and liability components to maximize net interest margin, utilize capital effectively and provide adequate liquidity. We rely primarily on our



asset/liability structure to control interest rate risk. We assume a high level of interest rate risk as a result of our business model which calls for us to originate and hold fixed-rate single-family loans, which by their nature are longer-term than the short-term liabilities of customer deposits and borrowed funds.

Asset/liability management is the responsibility of the ALCO, which acts within policy directives established by the Board of Directors. This Committee meets monthly to monitor the composition of the balance sheet, to assess projected earnings trends and to formulate strategies consistent with the objectives for liquidity, interest rate risk and capital adequacy. The objectives of asset/liability management are to maximize long-term stockholder returns by optimizing net interest income within the constraints of credit quality, interest rate risk policies, levels of capital, leverage and adequate liquidity. Assets and liabilities are managed by matching maturities and repricing characteristics in a systematic manner.

#### Net Interest Income

Our primary source of income is net interest income, which is the difference between interest earned on loans and investments and the interest paid on deposits and borrowings. Like other financial institutions, we are subject to interest rate risk and expect periodic imbalances in the interest rate sensitivities of our assets and liabilities. Over any defined period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities or vice versa. We principally manage interest rate risk by managing the volume and mix of our interest-earning assets and interest-bearing liabilities.

Our income simulation model, based on information as of March 31, 2010, indicated that our net interest income over the subsequent 12 months was projected to increase in the increasing rate scenarios of 100, 200 and 300 basis points and the decreasing rate scenario of 100 basis points. Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, gradually increase by 100, 200 and 300 basis points over a 12 month period, or decline assuming a gradual 100 basis point reduction in rates. Reductions of rates by 200 and 300 basis points were not reported due to the very low rate environment and the unlikely nature of rates declining that much further. In a rising rate environment we will benefit from higher cost term liabilities repricing to lower rates. This is especially apparent in the second quarter of 2010 when a large quantity of higher cost term liabilities will reprice. Some of our variable rate liabilities are at their floor. Interest expense will not increase until rates rise enough to exceed these floors. Interest income would remain relatively constant due to the fixed-rate nature of our loan portfolio. Although, we will see a slight increase in interest income as our variable rate loans reprice in a rising rate environment. In a declining rate environment, net interest income increases as higher priced term liabilities reprice into lower priced term liabilities while interest income remains flat because of the fixed-rate nature of our loan portfolio.

| March 31, 2010             |          |
|----------------------------|----------|
| Net Interest Income Change |          |
| Basis Point                |          |
| Change in Rates            | % Change |
| +300                       | 9.27 %   |
| +200                       | 9.98     |
| +100                       | 9.21     |
| Base                       | 7.58     |
| (100)                      | 5.18     |
| (1) (200)                  | N/A      |
| (1) (300)                  | N/A      |

(1) The current federal funds rate is 0.25%

making a 200 and 300 basis point drop  
impossible.

The changes indicated by the simulation model represent anticipated changes in net interest income over a 12 month period if rates were to gradually increase or decrease by the specified amount. The simulation assumes

that the size of the balance sheet remains stable over the forecasted timeframe, with no growth or contraction regardless of interest rate movements. Additionally, the tendency for loan and investment prepayments to accelerate in falling interest rate scenarios and slow when interest rates rise are incorporated in the model assumptions. Included in the assumptions are increased investment purchases and loan originations at lower interest rate levels to offset accelerated prepayments and, conversely, reduced investment purchases and loan originations when rates increase and prepayments slow.

The rising and falling interest rate scenarios indicate that, if customer loan and deposit preferences do not change in response to further movements of the yield curve, a parallel 300, 200 or 100 basis point increase or a 100 basis point decrease in rates will result in a positive change in net interest income over the 12 month period.

#### Economic Value of Equity (EVE) Simulation Model Results

The following table illustrates the change in the net portfolio value at March 31, 2010 that would occur in the event of an immediate change in interest rates equally across all maturities. The simulation model results are reported quarterly and are predicated upon a stable balance sheet, with no growth or change in asset or liability mix. Although the net portfolio value measurement provides an indication of our interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide, a precise forecast.

The EVE analysis goes beyond simulating net interest income for a specified period to estimating the present value of all financial instruments in our portfolio and analyzing how the economic value of the portfolio would be affected by various alternative interest rate scenarios. The portfolio's economic value is calculated by generating principal and interest cash flows for the entire life of all assets and liabilities and discounting these cash flows back to their present values. The assumed discount rate used for each projected cash flow is based on a current market rate, such as a FHLB or Treasury curve and from alternative instruments of comparable risk and duration.

| Basis Point<br>Change in<br>Rates | Net Portfolio Value (2) |             | Net Portfolio as % of<br>Portfolio Value of Assets |              | Market Value<br>of Assets (5) |
|-----------------------------------|-------------------------|-------------|--|--------------|-------------------------------|
|                                   | Amount                  | \$ Change   | %<br>Change<br>(3)                                 | % Change (4) |                               |
|                                   |                         |             | (Dollars in thousands)                             |              |                               |
| +300                              | \$ 139,407              | \$ (64,569) | (31.65) %  | 11.31 %      | \$ 1,232,156                  |
| +200                              | 162,147                 | (41,823)    | (20.50)  | 12.80        | 1,267,113                     |
| +100                              | 184,356                 | (19,614)    | (9.62)   | 14.14        | 1,304,178                     |
| Base                              | 203,970                 | -           | -  | 15.20        | 1,341,715                     |
| (100)                             | 212,880                 | 8,910       | 4.37   | 15.56        | 1,367,881                     |
| (200)                             | (1) N/A                 | N/A         | N/A  | N/A          | N/A                           |
| (300)                             | (1) N/A                 | N/A         | N/A  | N/A          | N/A                           |

- (1) The current federal funds rate is 0.25%, making a 200 or 300 basis point decrease in rates impossible.
- (2) The difference between the present value of discounted cash flows for assets and liabilities represents the net portfolio value or the market value of equity.
- (3) Net portfolio value divided by the market value of assets.
- (4) The increase or decrease in the net portfolio value divided by the market value of assets (base case).
- (5) Calculated based on the present value of the discounted cash flows from assets.

In the simulated upward rate shift of the yield curve, the discount rates used to calculate the present value of assets and liabilities will increase, causing the present values of fixed-rate assets to decline and fixed-rate liabilities to increase. Our EVE simulation model results as of March 31, 2010 indicated that if rates increased 100, 200 or 300 basis points the market value of our assets would decrease. This decrease is largely because of the fixed-rate nature of our loan portfolio. The fair value of our equity would also decrease under all three rising rate shift scenarios. The opposite occurs if rates were to decline. The discount rates used to calculate the present value of assets and liabilities will decrease, causing the present value of fixed-rate assets to increase and fixed-rate liabilities to decrease. If rates were to decrease by 100 basis points, the market value of our assets would increase and the fair value of equity would increase.

If interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth previously. Changes in U.S. Treasury rates in the designated amounts accompanied by changes in the shape of the Treasury yield curve could cause changes to the net portfolio value and net interest income other than those indicated previously.

At March 31, 2010, we had no derivative financial instruments, we did not maintain a trading account for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. Interest rate risk continues to be our primary risk as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

#### Item 4. Controls and Procedures

The management of First Financial Northwest, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (Exchange Act). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

- (a) **Evaluation of Disclosure Controls and Procedures:** An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial and Accounting Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2010, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.
- (b) **Changes in Internal Controls:** In the quarter ended March 31, 2010, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II

### Item 1. Legal Proceedings

From time to time, we are engaged in legal proceedings in the ordinary course of business, none of which are currently considered to have a material impact on our financial position or results of operations.

### Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2009, except that the following risk factors are added to those previously contained in the Form 10-K:

Certain regulatory restrictions were recently imposed on us and we expect to be subject to future additional regulatory restrictions and enforcement actions; lack of compliance could result in monetary penalties and/or additional regulatory actions.

On April 14, 2010, in connection with our most recent examination by the OTS, the members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement (a memorandum of understanding (“MOU”)). Under the terms of the MOU, the Company has agreed, among other things, to provide notice to and obtain written non-objection from the OTS prior to the Company (a) declaring a dividend or redeeming any capital stock; and (b) incurring, issuing, renewing or repurchasing any new debt. Further, as a result of the most recent examination of the Bank by the FDIC and the Washington State DFI, the FDIC notified us that we must obtain written non-objection from the FDIC before engaging in any transaction that would materially change the balance sheet composition (including growth in total assets of five percent or more), significantly change funding sources (including using brokered deposits) or declare or pay cash dividends. In addition, both the Company and the Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer or pay pursuant to or by entering into certain severance and other forms of compensation agreements.

In light of the continuing challenging operating environment, along with our elevated level of nonperforming assets, delinquencies, and adversely classified assets, our recent operating results and the regulatory restrictions recently imposed on us, we expect the Bank to be requested to enter into a formal written enforcement order with the FDIC and the Washington State DFI. We expect that, under this order, the Bank will be required, among other things, to develop and implement plans to reduce concentrations in construction/land development loans; to improve asset quality and credit administration, to reduce classified assets and to improve profitability within specified time frames.

This expected enforcement action or any additional enforcement action by any of our regulators could also place additional limitations on our business and adversely affect our ability to implement our business plans. Even though the Bank remains well-capitalized, the regulatory agencies have the authority to restrict our operations to those consistent with adequately capitalized institutions. For example, if the regulatory agencies were to impose such a restriction, we would likely have limitations on our lending activities. The regulatory agencies also have the power to limit the rates paid by the Bank to attract retail deposits in its local markets.

Our provision for loan losses has increased substantially and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could adversely affect our results of operations.

For the three months ended March 31, 2010 we recorded a provision for loan losses of \$13.0 million, compared to \$1.5 million for the three months ended March 31, 2009. We also recorded net loan charge-offs of \$9.7 million for the three months ended March 31, 2010, compared to \$4.2 million for the three months ended March 31, 2009. We are experiencing increasing loan delinquencies and credit losses. Slower sales and excess inventory in the housing market has been the primary cause of the increase in delinquencies and foreclosures for residential construction/land development loans, which represent 49.9% of our nonperforming assets at March 31, 2010. In addition, slowing housing sales have been a contributing factor to the increase in nonperforming loans as well as the increase in delinquencies. At March 31, 2010 our total nonperforming assets had increased to \$166.4 million compared to \$80.2 million at March 31, 2009. Further, construction/land development and commercial real estate loans have a higher risk of loss than residential mortgage loans.

If current trends in the housing and real estate markets continue, we expect that we will continue to experience higher than normal delinquencies and credit losses. Moreover, until general economic conditions improve, we expect that we will continue to experience significantly higher than normal delinquencies and credit losses. As a result, we could be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could have a material adverse effect on our financial condition and results of operations.

We may have continuing losses.

We reported a net loss of \$17.8 million for the three months ended March 31, 2010 as compared to a net income of \$1.2 million for the three months ended March 31, 2009. This loss primarily resulted from our high level of nonperforming assets and the resultant increased provision for loan losses. We may continue to suffer further losses.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business and each loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- the cash flow of the borrower and/or the project being financed;
- changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
  - the duration of the loan;
  - the credit history of a particular borrower and
  - changes in economic and industry conditions.

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through periodic reviews and consideration of several factors, including, but not limited to:

- our general reserve, based on our historical default and loss experience and certain macroeconomic factors based on management's expectations of future events;
- and our specific reserve, based on our evaluation of nonperforming loans and their underlying collateral.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets



servicing as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and the loss and delinquency experience, and evaluate economic conditions and make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for additions to our allowance through an increase in the provision for loan losses. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses.

Our allowance for loan losses was 3.45% of loans, net of undisbursed funds, and 25.00% of nonperforming loans, net of undisbursed funds, at March 31, 2010. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. If charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and our capital.

Our concentration in non-owner occupied real estate loans may expose us to increased credit risk.

At March 31, 2010, \$216.5 million, or 44.3% of our one-to-four family residential mortgage loan portfolio and 19.9% of our total loan portfolio, consisted of loans secured by non-owner occupied residential properties. At March 31, 2010, nonperforming non-owner occupied residential loans amounted to \$37.1 million. Prior to foreclosure, loans that were classified as non-owner occupied residential properties and are now classified as held as other real estate owned, amounted to \$5.5 million at March 31, 2010.

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

The Company's repurchase of equity securities for the first quarter of 2010 were as follows:

| 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 Plans |
|--------------------------------------|----------------------------------|------------------------------|--|--|
| January 1, 2010 - January 31, 2010   | -                                | \$ -                         | -  | 312,300  |
| February 1, 2010 - February 28, 2010 | 17,900                           | 5.92                         | 17,900   | 294,400  |
| March 1, 2010 - March 31, 2010       | -                                | -                            | -  | 294,400  |
| <b>Total</b>                         | <b>17,900</b>                    | <b>\$ 5.92</b>               | <b>17,900</b>  | <b>294,400</b>   |

On February 18, 2009, the Board of Directors approved a second stock repurchase plan for the purchase of up to 2,056,752 shares, or approximately 10% of our outstanding shares of common stock. During the first quarter of 2010, we repurchased 17,900 shares at an average cost per share of \$5.92. There are 294,400 shares remaining to be

repurchased under this plan at March 31, 2010. No repurchases of stock are anticipated at this time.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. [Removed and Reserved]

Item 5. Other Information

Not applicable.

Item 6. Exhibits

- 3.1 Articles of Incorporation of First Financial Northwest (1)
- 3.2 Bylaws of First Financial Northwest (1)
- 4 Form of stock certificate of First Financial Northwest (1)
- 10.1 Form of Employment Agreement for President and Chief Executive Officer (1)
- 10.2 Form of Change in Control Severance Agreement for Executive Officers (1)
- 10.3 Form of First Savings Bank Employee Severance Compensation Plan (1)
- 10.4 Form of Supplemental Executive Retirement Agreement entered into by First Savings Bank with Victor Karpiak, Harry A. Blencoe and Robert H. Gagnier (1)
- 10.5 Form of Financial Institutions Retirement Fund (1)
- 10.6 Form of 401(k) Retirement Plan (2)
- 10.7 2008 Equity Incentive Plan (3)
- 10.8 Forms of incentive and non-qualified stock option award agreements (4)
- 10.9 Form of restricted stock award agreement (4)
- 14 Code of Business Conduct and Ethics (5)
- 21 Subsidiaries of the Registrant
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act

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- (1) Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-1 (333-143549).
  - (2) Filed as an exhibit to First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 and incorporated herein by reference.
  - (3) Filed as Appendix A to First Financial Northwest's definitive proxy statement dated April 15, 2008.
  - (4) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated July 1, 2008.
  - (5) Filed as an exhibit to First Financial Northwest's Annual Report on Form 10-K for the year ended December 31, 2007 and incorporated herein by reference.

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.

First Financial Northwest, Inc.

Date: May 7, 2010

/s/Victor Karpiak  
Victor Karpiak  
Chairman of the Board, President and  
Chief Executive Officer  
(Principal Executive Officer)

Date: May 7, 2010

/s/Kari Stenslie  
Kari Stenslie  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act

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