

FS Bancorp, Inc.  
Form 10-K  
March 15, 2019  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 K

(Mark one)

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

For the fiscal year ended December 31, 2018 OR

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

Commission File Number: 001 35589

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington 45 4585178  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

6920 220th Street SW, Mountlake Terrace, Washington 98043  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (425) 771 5299

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

Securities registered pursuant to Section 12(g) of the Act: Common Stock, par value \$0.01 per share  
(Title of Each Class)

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

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

Edgar Filing: FS Bancorp, Inc. - Form 10-K

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, every Interactive Data File required to be submitted 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 such files). YES  NO

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
Emerging growth company

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

Indicate by check mark whether the Registrant is a shell company (as defined in Exchange Act Rule 12b 2). YES  NO

As of March 8, 2019, there were 4,495,078 shares of the Registrant's common stock outstanding. The Registrant's common stock is listed on the NASDAQ Capital Market under the symbol "FSBW." The aggregate market value of the common stock held by non-affiliates of the Registrant was \$217,380,383, based on the closing sales price of \$63.25 per share of the Registrant's common stock as quoted on the NASDAQ Capital Market on June 30, 2018. For purposes of this calculation, common stock held by executive officers and directors of the Registrant is considered to be held by affiliates.

#### DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the definitive Proxy Statement for the 2019 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

Table of Contents

FS Bancorp, Inc.

Table of Contents

	Page
<b><u>PART I</u></b>	
<b><u>Item 1 Business</u></b>	5
<u>General</u>	5
<u>Market Area</u>	6
<u>Lending Activities</u>	7
<u>Loan Originations, Servicing, Purchases and Sales</u>	17
<u>Asset Quality</u>	20
<u>Allowance for Loan Losses</u>	23
<u>Investment Activities</u>	27
<u>Deposit Activities and Other Sources of Funds</u>	29
<u>Subsidiary and Other Activities</u>	32
<u>Competition</u>	32
<u>Employees</u>	33
<u>How We Are Regulated</u>	35
<u>Taxation</u>	44
<b><u>Item 2 Risk Factors</u></b>	45
<b><u>Item 3 Unresolved Staff Comments</u></b>	64
<b><u>Item 4 Properties</u></b>	64
<b><u>Item 5 Legal Proceedings</u></b>	66
<b><u>Item 6 Mine Safety Disclosures</u></b>	66
<b><u>PART II</u></b>	
<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity</u>	
<b><u>Item 5 Securities</u></b>	66
<b><u>Item 6 Selected Financial Data</u></b>	68
<b><u>Item 7 Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b>	70
<u>Overview</u>	70
<u>Critical Accounting Policies and Estimates</u>	71
<u>Our Business and Operating Strategy and Goals</u>	73
<u>Comparison of Financial Condition at December 31, 2018 and December 31, 2017</u>	74
<u>Average Balances, Interest and Average Yields/Costs</u>	77
<u>Rate/Volume Analysis</u>	78
<u>Comparison of Results of Operations for the Years Ended December 31, 2018 and December 31, 2017</u>	78
<u>Asset and Liability Management and Market Risk</u>	82
<u>Liquidity</u>	84
<u>Off-Balance Sheet Activities</u>	84
<u>Capital Resources</u>	85
<u>Recent Accounting Pronouncements</u>	85
<b><u>Item 8 Quantitative and Qualitative Disclosures about Market Risk</u></b>	86
<b><u>Item 9 Financial Statements and Supplementary Data</u></b>	86
<b><u>Item 10 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u></b>	137
<b><u>Item 11 Controls and Procedures</u></b>	137
<b><u>Item 12 Other Information</u></b>	138



Table of Contents

	Page
<u>PART III</u>	
<u>Directors,</u>	139
<u>Executive</u>	
<u>Officers and</u>	
<u>Corporate</u>	
<u>Item 10. Governance</u>	
<u>Executive</u>	139
<u>Item 11. Compensation</u>	
<u>Security</u>	
<u>Ownership of</u>	
<u>Certain</u>	
<u>Beneficial</u>	
<u>Owners and</u>	
<u>Management</u>	
<u>and Related</u>	
<u>Stockholder</u>	
<u>Item 12. Matters</u>	139
<u>Certain</u>	140
<u>Relationships</u>	
<u>and Related</u>	
<u>Transactions,</u>	
<u>and Director</u>	
<u>Item 13. Independence</u>	
<u>Principal</u>	140
<u>Accounting</u>	
<u>Fees and</u>	
<u>Item 14. Services</u>	
<u>PART IV</u>	
<u>Exhibits and</u>	141
<u>Financial</u>	
<u>Statement</u>	
<u>Item 15. Schedules</u>	
<u>Form 10_K</u>	142
<u>Item 16. Summary</u>	
<u>EXHIBIT</u>	
<u>INDEX</u>	142
<u>SIGNATURES</u>	143

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



Table of Contents

Forward-Looking Statements

This Form 10 K contains forward-looking statements, which can be identified by the use of words such as “believes,” “expects,” “anticipates,” “estimates” or similar expressions. Forward-looking statements include, but are not limited to:

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

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- the expected cost savings, synergies and other financial benefits from our recent merger with Anchor Bancorp (“Anchor”) might not be realized within the expected time frames or at all and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, might be greater than expected;
- the combined company might not perform as well as expected;
- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies, write offs, changes in our allowance for loan losses, and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to originate loans for sale and sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our home lending operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to control operating costs and expenses;
- our ability to retain key members of our senior management team;
- changes in consumer spending, borrowing, and savings habits;

Table of Contents

- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd Frank Act”), changes in regulation policies and principles, an increase in regulatory capital requirements or change in the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board, or the Financial Accounting Standards Board (“FASB”);
- costs and effects of litigation, including settlements and judgments;
- disruptions, security breaches, or other adverse events, failures or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products, and services, and other risks described elsewhere in this Form 10 K and our other reports filed with the U.S. Securities and Exchange Commission (“SEC”).

Any of the forward-looking statements made in this Form 10 K and in other public statements may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Forward-looking statements are based upon management’s beliefs and assumptions at the time they are made. The Company undertakes no obligation to update or revise any forward-looking statement included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward-looking statements.

Available Information

The Company provides a link on its investor information page at [www.fsbwa.com](http://www.fsbwa.com) to filings with the SEC for purposes of providing copies of its annual report on Form 10 K, quarterly reports on Form 10 Q, current reports on Form 8 K and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to the SEC. Other than an investor’s own internet access charges, these filings are free of charge and available through the SEC’s website at [www.sec.gov](http://www.sec.gov). The information contained on the Company’s website is not included as part of, or incorporated by reference into, this Annual Report on Form 10 K.



Table of Contents

PART 1

Item 1. Business

General

FS Bancorp, Inc. (“FS Bancorp” or the “Company”), a Washington corporation, was organized in September 2011 for the purpose of becoming the holding company of 1st Security Bank of Washington (“1st Security Bank of Washington” or the “Bank”) upon the Bank’s conversion from a mutual to a stock savings bank (“Conversion”). The Conversion was completed on July 9, 2012. At December 31, 2018, the Company had consolidated total assets of \$1.62 billion, total deposits of \$1.27 billion, and stockholders’ equity of \$180.0 million. The Company has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10 K (“Form 10 K”), including the consolidated financial statements and related data, relates primarily to the Bank.

1st Security Bank of Washington is a relationship-driven community bank. The Bank delivers banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets. The Bank has been serving the Puget Sound area since 1936. Originally chartered as a credit union, and known as Washington’s Credit Union, the Bank served various select employment groups. On April 1, 2004, the Bank converted from a credit union to a Washington state-chartered mutual savings bank. Upon completion of the Conversion in July 2012, 1st Security Bank of Washington became a Washington state-chartered stock savings bank and the wholly owned subsidiary of the Company.

At December 31, 2018, the Bank maintained its main administrative office that also accepts deposits, 21 full-service bank branches and eight home loan production offices in suburban communities in the greater Puget Sound area. The Bank also has one home loan production office in the Tri-Cities, Washington. On November 15, 2018, the Company completed the acquisition of Anchor Bancorp which was merged with and into the Company, and immediately thereafter Anchor’s bank subsidiary, Anchor Bank was merged with and into 1st Security Bank of Washington (the “Anchor Acquisition”). The Anchor Acquisition added nine full-service bank branches within Grays Harbor, Thurston, Lewis, and Pierce counties, and one loan production office located in King County, Washington. The Anchor Acquisition expanded our Puget Sound-focused retail footprint and provided an opportunity to extend our unique brand of community banking into those communities. For additional information on the Anchor Acquisition, see Note 2 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

The Company is a diversified lender with a focus on the origination of one-to-four-family, commercial real estate, consumer, including indirect home improvement (“fixture secured loans”), solar and marine lending, commercial business and second mortgage or home equity loans. Historically, consumer loans, in particular fixture secured loans had represented the largest portion of the Company’s loan portfolio and had been the mainstay of the Company’s lending strategy. In recent years, the Company has placed more of an emphasis on real estate lending products, such as one-to-four-family, commercial real estate, including speculative residential construction, as well as commercial business loans, while growing the current size of the consumer loan portfolio. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale into the secondary market, through a mortgage banking program. The Company’s lending strategies are intended to take advantage of: (1) the Company’s historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities, and (3) relationship lending. Retail deposits will continue to serve as an important funding source. For more information regarding the business and operations of 1st Security Bank of Washington, see “Item 7. Management’s Discussion and

Analysis of Financial Condition and Results of Operations” of this Form 10 K.

1st Security Bank of Washington is examined and regulated by the Washington State Department of Financial Institutions (“DFI”), its primary regulator, and by the Federal Deposit Insurance Corporation (“FDIC”). 1st Security Bank of Washington is required to have certain reserves set by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and is a member of the Federal Home Loan Bank of Des Moines (“FHLB” or “FHLB of Des Moines”), which is one of the 11 regional banks in the Federal Home Loan Bank System.

Table of Contents

The principal executive offices of the Company are located at 6920 220th Street SW, Mountlake Terrace, Washington 98043 and its telephone number is (425) 771 5299.

Market Area

The Company conducts operations out of its main administrative office, nine home loan production offices (five of which stand alone), and 21 full-service bank branches in the Puget Sound region of Washington, and one of the stand-alone loan production offices in Eastern Washington. The administrative office is located in Mountlake Terrace, in Snohomish County, Washington. The four stand-alone home lending offices in the Puget Sound region are located in Puyallup, in Pierce County, Bellevue, in King County, Port Orchard, in Kitsap County, Everett, in Snohomish County, and in Eastern Washington located in the Tri-Cities (Kennewick), in Benton County, Washington. The 21 full-service bank branches are located in the following counties: three in Snohomish, two in King, two in Clallam, two in Jefferson, two in Pierce, five in Grays Harbor, two in Thurston, one in Lewis, and two in Kitsap County.

The primary market area for business operations is the Seattle-Tacoma-Bellevue, Washington Metropolitan Statistical Area (the "Seattle MSA"). Kitsap, Clallam, Jefferson, Thurston, Lewis, and Grays Harbor counties, though not in the Seattle MSA, are also part of the Company's market area. This overall region is typically known as the Puget Sound region. The population of the Puget Sound region as estimated by Puget Sound Regional Council was 4.1 million in 2018, over half of the state's population, representing a large population base for potential business. The region has a well-developed urban area in the western portion along Puget Sound, with the north, central and eastern portions containing a mixture of developed residential and commercial neighborhoods and undeveloped, rural neighborhoods.

The Puget Sound region is the largest business center in both the State of Washington and the Pacific Northwest. Currently, key elements of the economy are aerospace, military bases, clean technology, biotechnology, education, information technology, logistics, international trade and tourism. The region is well known for the long presence of The Boeing Corporation and Microsoft, two major industry leaders, and for its leadership in technology. Amazon.com has expanded significantly in the Seattle downtown area. The workforce in general is well-educated and strong in technology. Washington State's location with regard to the Pacific Rim, along with a deepwater port has made international trade a significant part of the regional economy. Tourism has also developed into a major industry for the area, due to the scenic beauty, temperate climate and easy accessibility.

King County, the location of the city of Seattle, has the largest employment base and overall level of economic activity. Six of the largest employers in the state are headquartered in King County including Microsoft Corporation, University of Washington, Amazon.com, King County Government, Starbucks, and Swedish Health Services. Pierce County is the second most populous county in the state and its economy is also well diversified with the presence of military related government employment (Joint Base Lewis-McChord), along with health care (the Multicare Health System and the Franciscan Health System). In addition, there is a large employment base in the economic sectors of shipping (the Port of Tacoma) and aerospace employment (Boeing). Snohomish County to the north has an economy based on aerospace employment (Boeing), health care (Providence Regional Medical Center), and military (the Everett Naval Station) along with additional employment concentrations in biotechnology, electronics/computers, and wood products.

The United States Navy is a key element for Kitsap County's economy. The United States Navy is the largest employer in the county, with installations at Puget Sound Naval Shipyard, Naval Undersea Warfare Center Keyport and Naval Base Kitsap (which comprises former Naval Submarine Base Bangor, and Naval Station Bremerton). The largest private employers in the county are the Harrison Medical Center and Port Madison Enterprises. Clallam County depends on agriculture, forestry, fishing, outdoor recreation and tourism. Jefferson County's largest private employer is Port Townsend Paper Mill and the largest employer overall (private and public) is Jefferson Healthcare.

From the Anchor Acquisition, we have entered three new counties, Thurston, Lewis, and Grays Harbor. Thurston County includes Olympia, home of Washington State's capital and its economic base is largely driven by state government related employment. Lewis County is supported by manufacturing, retail trade, local government and industrial services. Grays Harbor County has been historically dependent on the timber and fishing industries, but also relies on tourism, manufacturing, agriculture, shipping, transportation, and technology.

## Table of Contents

In 2016, the median household income for King County was \$86,000, compared to \$67,000 for the State of Washington, and \$58,000 for the United States. Seattle has been listed in the top three most literate cities in the country every year since 2005 by an annual review conducted by Central Connecticut State University.

Unemployment in Washington was an estimated 4.3% at December 31, 2018, closely paralleling national trends as disclosed in the U.S. Bureau of Labor Statistics. King County had the lowest unemployment rate in the state at 3.3%, slightly decreased from 3.6% in the prior year, and much lower than the state average of 4.5% and national average of 4.1%, respectively. The estimated unemployment rate in Snohomish County at year end 2018 was 3.6%, slightly decreased from 4.0% at year end 2017. Kitsap County's unemployment rate improved slightly to 4.9% at December 31, 2018, compared to 5.0% at December 31, 2017. At December 31, 2018, the estimated unemployment rate in Pierce County was 5.3%, down from 5.4% at December 31, 2017. Grays Harbor County's, Thurston County's, and Lewis County's unemployment rate was 7.4%, 5.0%, and 6.9%, respectively at December 31, 2018, compared to 7.2%, 5.0%, and 6.7% at year end 2017, respectively. Outside of the Puget Sound area, the Tri-Cities market includes two counties, Benton and Franklin, and we have two full-service branches in Clallam County and two in Jefferson County. The estimated unemployment rate in Benton County at year end 2018 was 5.8%, down from 6.1% at year end 2017. At December 31, 2018, the estimated unemployment rate in Franklin County was down to 7.7%, from 8.0% at December 31, 2017. For Clallam and Jefferson counties, the estimated unemployment rates at December 31, 2018 decreased to 6.9% and 5.9%, respectively, compared to 7.0% and 6.2%, respectively at December 31, 2017.

According to the Washington Center for Real Estate Research, home values in the State of Washington continued to improve in 2018. For the quarter ended December 31, 2018, the average home value was \$657,000 in King County, \$473,000 in Snohomish County, \$387,000 in Jefferson County, \$345,000 in Kitsap County, \$342,000 in Pierce County, \$318,000 in Thurston County, \$296,000 in Clallam County, \$279,000 in both Benton and Franklin counties, \$227,000 in Lewis County, and \$200,000 in Grays Harbor County. Compared to the statewide average increase in home values of 1.1% in the fourth quarter of 2018, all counties: Benton, Franklin, Thurston, Jefferson, Pierce, Kitsap, Clallam, Snohomish, Grays Harbor, Lewis, and King counties outperformed the state average, with 10.9%, 10.9%, 10.3%, 8.4%, 8.4%, 7.8%, 7.4%, 7.0%, 6.0%, 4.6% and 2.5% increases in average home values, respectively.

For a discussion regarding the competition in the Company's primary market area, see "Competition."

## Lending Activities

General. Historically, the Company's primary emphasis was the origination of consumer loans (primarily indirect home improvement loans), one-to-four-family residential first mortgages, and second mortgage/home equity loan products. As a result of the Company's initial public offering in 2012, while maintaining the active indirect consumer lending program, the Company shifted its lending focus to include non-mortgage commercial business loans, as well as commercial real estate which includes construction and development loans. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale in the secondary market. While maintaining the Company's historical strength in consumer lending, the Company has added management and personnel in the commercial and home lending areas to take advantage of the relatively favorable long-term business and economic environments prevailing in the markets.



Table of Contents

Loan Portfolio Analysis. The following table sets forth the composition of the loan portfolio by type of loan at the dates indicated.

	December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015		December 31, 2014
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount
TE	\$ 204,699	15.43 %	\$ 63,611	8.22 %	\$ 55,871	9.23 %	\$ 50,034	9.78 %	\$ 42,970
and	247,306	18.65	143,068	18.50	94,462	15.60	80,806	15.80	57,813
family	40,258	3.04	25,289	3.27	20,081	3.32	16,540	3.24	15,737
(S)	249,397	18.80	163,655	21.16	124,009	20.48	102,921	20.13	46,801
ate	104,663	7.89	44,451	5.75	37,527	6.20	22,223	4.35	16,201
	846,323	63.81	440,074	56.90	331,950	54.83	272,524	53.30	179,522
	167,793	12.65	130,176	16.83	107,759	17.80	103,064	20.16	99,304
	44,433	3.35	41,049	5.31	36,503	6.03	29,226	5.72	18,162
er	57,822	4.36	35,397	4.58	28,549	4.71	23,851	4.66	16,713
er	5,425	0.41	2,046	0.26	1,915	0.32	2,181	0.43	2,628
	275,473	20.77	208,668	26.98	174,726	28.86	158,322	30.97	136,807
AL									
and	138,686	10.46	83,306	10.77	65,841	10.88	59,619	11.66	55,624
rcial	65,756	4.96	41,397	5.35	32,898	5.43	20,817	4.07	22,257
s	204,442	15.42	124,703	16.12	98,739	16.31	80,436	15.73	77,881
ross	1,326,238	100.00 %	773,445	100.00 %	605,415	100.00 %	511,282	100.00 %	394,210
r loan	(12,349)		(10,756)		(10,211)		(7,785)		(6,090)
s and	(2,907)		(2,708)		(1,887)		(962)		(946)
ns	1,537		1,577		—		—		—

Edgar Filing: FS Bancorp, Inc. - Form 10-K

\$ 1,312,519

\$ 761,558

\$ 593,317

\$ 502,535

\$ 387,174

8

---



Table of Contents

The following table shows the composition of the loan portfolio by fixed- and adjustable-rate loans at the dates indicated.

December 31, 2018		2017		2016		2015		2014	
Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	
\$ 58,037	4.37 %	\$ 32,430	4.19 %	\$ 30,445	5.03 %	\$ 26,189	5.12 %	\$ 23,144	
25,613	1.93	286	0.04	—	—	315	0.06	322	
14,134	1.07	2,649	0.34	1,644	0.27	2,146	0.42	2,677	
45,126	3.40	11,804	1.53	10,267	1.69	9,305	1.82	8,108	
41,832	3.15	14,453	1.87	4,538	0.75	2,659	0.52	3,240	
184,742	13.92	61,622	7.97	46,894	7.74	40,614	7.94	37,491	
272,279	20.53	207,671	26.85	174,041	28.75	157,805	30.87	136,368	
59,195	4.46	32,835	4.24	26,901	4.45	17,440	3.41	16,197	
—	—	673	0.09	—	—	—	—	—	
59,195	4.46	33,508	4.33	26,901	4.45	17,440	3.41	16,197	
516,216	38.91	302,801	39.15	247,836	40.94	215,859	42.22	190,056	
146,662	11.06	31,181	4.03	25,426	4.20	23,845	4.66	19,826	
221,693	16.72	142,782	18.46	94,462	15.60	80,491	15.74	57,491	
26,124	1.97	22,640	2.93	18,437	3.05	14,394	2.82	13,060	
204,271	15.40	151,851	19.63	113,742	18.79	93,616	18.31	38,693	
62,831	4.74	29,998	3.88	32,989	5.45	19,564	3.83	12,961	
661,581	49.89	378,452	48.93	285,056	47.09	231,910	45.36	142,031	
3,194	0.24	997	0.13	685	0.11	517	0.10	439	
79,491	6.00	50,471	6.53	38,940	6.43	42,178	8.25	39,427	

Edgar Filing: FS Bancorp, Inc. - Form 10-K

cial	65,756	4.96	40,724	5.26	32,898	5.43	20,818	4.07	22,257
	145,247	10.96	91,195	11.79	71,838	11.86	62,996	12.32	61,684
e	810,022	61.09	470,644	60.85	357,579	59.06	295,423	57.78	204,154
oss	1,326,238	100.00 %	773,445	100.00 %	605,415	100.00 %	511,282	100.00 %	394,210
loan	(12,349)		(10,756)		(10,211)		(7,785)		(6,090)
and	(2,907)		(2,708)		(1,887)		(962)		(946)
ns	1,537		1,577		—		—		—
c	\$ 1,312,519		\$ 761,558		\$ 593,317		\$ 502,535		\$ 387,174

9

---

Table of Contents

Loan Maturity and Repricing. The following table sets forth certain information at December 31, 2018, regarding the dollar amount and current note rates of interest for the loans maturing or repricing in the portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income, and allowance for loan losses.

	Home Equity		One-to-Four-Family (2)		Multi-family		Consumer		
Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	
6.79	% \$ 26,271	6.47	% \$ 24,311	5.61	% \$ 6,310	4.18	% \$ 91,835	7.32	%
6.52	32	7.04	2,248	5.06	1,078	6.75	650	7.60	
5.09	11	5.00	3,657	5.40	5,819	5.79	1,994	6.69	
6.73	1,008	5.41	4,507	5.59	4,794	4.89	5,225	6.86	
5.18	2,766	6.73	31,987	4.81	60,526	4.73	33,747	7.15	
—	3,085	5.11	7,263	5.31	4,726	6.57	107,565	5.88	
5.68	7,085	5.87	175,424	4.46	21,410	4.64	34,457	6.24	
6.78	% \$ 40,258	6.25	% \$ 249,397	4.68	% \$ 104,663	4.85	% \$ 275,473	6.59	%

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

(2) Excludes loans held for sale.

The total amount of loans due after December 31, 2019, which have predetermined interest rates is \$347.2 million, while the total amount of loans due after this date which have floating or adjustable interest rates is \$400.9 million.

## Table of Contents

Lending Authority. The Chief Credit Officer has the authority to approve multiple loans to one borrower up to \$6.0 million in aggregate. Loans in excess of \$10.0 million require an additional signature from the Chief Executive Officer and/or Chief Financial Officer. All loans that are approved over \$2.5 million are reported to the Asset Quality Committee (“AQC”) at each AQC meeting. The Chief Credit Officer may delegate lending authority to other individuals at levels consistent with their responsibilities.

The Board of Directors has implemented a lending limit policy that it believes matches the Washington State legal lending limit. At December 31, 2018, the Company’s policy limits loans to one borrower and the borrower’s related entities to 20% of the Bank’s unimpaired capital and surplus, or \$39.1 million at December 31, 2018. Management has adopted an internal lending limit of a maximum of 80% of the Bank’s legal lending limit for risk mitigation purposes and all loans over this limit require approval from the AQC. The Bank’s largest lending relationship at December 31, 2018, consisted of a commercial line of credit to one company having a commitment of \$24.0 million. This line of credit is secured by notes to finance residential construction projects located primarily in Seattle, Washington. The outstanding balance of this line of credit at December 31, 2018 was \$24.0 million. The second largest lending relationship consisted of 11 residential construction loans having combined commitments of \$18.2 million to two related limited liability companies. All of these loans are secured by residential construction loan projects located in the Seattle metropolitan area of Washington State. The outstanding balance of these 11 loans at December 31, 2018 was \$16.1 million. The third largest lending relationship consisted of two commercial lines of credit having combined commitments of \$18.0 million, to two related limited liability companies. Both of these loans are secured by notes to finance residential construction projects located primarily in Seattle, Washington. The outstanding balance of these two lines of credit at December 31, 2018 was \$12.0 million. All of the loans listed above were performing in accordance with their repayment terms at December 31, 2018.

At December 31, 2018, the Company had \$87.0 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from \$5.0 million to \$24.0 million. At December 31, 2018, there was \$61.4 million outstanding, compared to \$84.7 million approved in commercial construction warehouse lending lines for nine companies with \$34.0 million outstanding at December 31, 2017. In addition, the Company had \$23.0 million approved in mortgage warehouse lending lines for four companies. The commitments ranged from \$4.0 million to \$8.0 million. At December 31, 2018, there was \$4.4 million in mortgage warehouse lines outstanding, compared to \$35.0 million approved in mortgage warehouse lending lines with \$7.4 million outstanding at December 31, 2017.

Commercial Real Estate Lending. The Company offers a variety of commercial real estate loans. Most of these loans are secured by income producing properties, including multi-family residences, retail centers, warehouses and office buildings located in the market areas. At December 31, 2018, commercial real estate loans (including \$104.7 million of multi-family residential loans) totaled \$309.4 million, or 23.3%, of the gross loan portfolio.

The Company’s loans secured by commercial real estate are originated with a fixed or variable interest rate for up to a 15 year maturity and a 30 year amortization. The variable rate loans are indexed to the prime rate of interest or a short-term LIBOR rate, or five or seven-year FHLB rate, with rates equal to the prevailing index rate to 5.0% above the prevailing rate. Loan-to-value ratios on the Company’s commercial real estate loans typically do not exceed 80% of the appraised value of the property securing the loan. In addition, personal guarantees are obtained from the primary borrowers on substantially all credits.

Loans secured by commercial real estate are generally underwritten based on the net operating income of the property and the financial strength of the borrower. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt plus an additional coverage requirement. The Company generally requires an assignment of rents or leases in order to be assured that the cash flow from the project will be sufficient to repay the debt. Appraisals on properties securing

commercial real estate loans are performed by independent state certified or licensed fee appraisers. The Company does not generally maintain insurance or tax escrows for loans secured by commercial real estate. In order to monitor the adequacy of cash flows on income-producing properties, the borrower is required to provide financial information on at least an annual basis.

Table of Contents

Loans secured by commercial real estate properties generally involve a greater degree of credit risk than one-to-four-family residential mortgage loans. These loans typically involve large balances to single borrowers or groups of related borrowers. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

Commercial and multi-family loans also expose a lender to greater credit risk than loans secured by one-to-four-family because the collateral securing these loans typically cannot be sold as easily as one-to-four-family. In addition, most of our commercial and multi-family loans are not fully amortizing and include balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. The largest single commercial real estate loan at December 31, 2018 was a 15.9% participation loan originated by another bank in the Puget Sound area. The Bank's share of the total outstanding loan at December 31, 2018 was \$8.2 million, and is collateralized by commercial real estate located in Thurston County, Washington. At December 31, 2018 this loan was performing in accordance with its repayment terms.

The Company intends to continue to emphasize commercial real estate lending and, as a result, the Company has assembled a highly experienced team, with an average of over 20 years of experience. The Bank's Chief Credit Officer and Chief Lending Officer are both senior bankers with over 30 years of commercial lending experience in the northwestern U.S. region. Management has also hired experienced commercial loan officers to support the Company's commercial real estate lending objectives. As the commercial loan portfolio expands, the Company intends to bring in additional experienced personnel in the areas of loan analysis and commercial deposit relationship management.

**Construction and Development Lending.** The Company expanded its residential construction lending team in 2011 with a focus on vertical, in-city one-to-four-family development in our market area. This team has over 60 years of combined experience and expertise in acquisition, development and construction ("ADC") lending in the Puget Sound market area. The Company has implemented this strategy to take advantage of what is believed to be a strong demand for construction and ADC loans to experienced, successful and relationship driven builders in our market area after many other banks abandoned this segment because of previous overexposure. At December 31, 2018, outstanding construction and development loans totaled \$247.3 million, or 18.7%, of the gross loan portfolio and consisted of 279 projects, compared to \$143.1 million and 188 projects at December 31, 2017. The construction and development loans at December 31, 2018, consisted of loans for residential and commercial construction projects primarily for vertical construction and \$16.7 million of land acquisition and development loans. Total committed, including unfunded construction and development loans at December 31, 2018, was \$333.2 million. At December 31, 2018, \$142.0 million, or 57.4% of our outstanding construction and development loan portfolio was comprised of speculative one-to-four-family construction loans. Approximately \$9.3 million of our residential construction loans at December 31, 2018 were made to finance the custom construction of owner-occupied homes and are structured to be converted to permanent loans at the end of the construction phase. In addition, the Company had nine commercial secured lines of credit, secured by notes to residential construction borrowers with guarantees from principles with experience in the construction re-lending market. These loans had combined commitments of \$87.0 million, and an outstanding balance of \$61.4 million at December 31, 2018.

The Company's residential construction lending program includes loans for the purpose of constructing both speculative and pre-sold one-to-four-family residences, the acquisition of in-city lots with and without existing improvements for later development of one-to-four-family residences, the acquisition of land to be developed, and loans for the acquisition and development of land for future development of single family residences. The Company generally limits these types of loans to known builders and developers in the market area. Construction loans generally provide for the payment of interest-only during the construction phase, which is typically up to 12 months. At the end of the construction phase, the construction loan is generally paid off through the sale of the newly

constructed home and a permanent loan from another lender, although commitments to convert to a permanent loan may be made by us. Construction loans are generally made with a maximum loan amount of the lower of 95% of cost or 75% of appraised value at completion. During the term of construction, the accumulated interest on the loan is typically added to the principal balance of the loan through an interest reserve of 3% to 5.5% of the loan commitment amount.

## Table of Contents

Commitments to fund construction loans generally are made subject to an appraisal of the property by an independent licensed appraiser. The Company also reviews and has a licensed third-party inspect each property before disbursement of funds during the term of the construction loan. Loan proceeds are disbursed after inspection by a third-party inspector based on the percentage of completion method.

The Company may also make land acquisition and development loans to builders or residential lot developers on a limited basis. These loans involve a higher degree of credit risk, similar to commercial construction loans. At December 31, 2018, included in the \$247.3 million of construction and development loans, were 10 residential land acquisition and development loans for finished lots totaling \$13.7 million, with total commitments of \$17.1 million. These land loans also involve additional risks because the loan amount is based on the projected value of the lots after development. Loans are made for up to 75% of the estimated value with a term of up to two years. These loans are required to be paid on an accelerated basis as the lots are sold, so that the Company is repaid before all the lots are sold. Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate.

Construction and development lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. Changes in the demand, such as for new housing and higher than anticipated building costs may cause actual results to vary significantly from those estimated. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. This type of lending also typically involves higher loan principal amounts and is often concentrated with a small number of builders. In addition, during the term of most of our construction loans, an interest reserve is created at origination and is added to the principal of the loan through the construction phase. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. Because construction loans require active monitoring of the building process, including cost comparisons and on-site inspections, these loans are more difficult and costly to monitor.

Increases in market rates of interest may have a more pronounced effect on construction loans by rapidly increasing the end-purchasers' borrowing costs, thereby reducing the overall demand for the project. Properties under construction are often difficult to sell and typically must be completed in order to be successfully sold which also complicates the process of working out problem construction loans. This may require us to advance additional funds and/or contract with another builder to complete construction. Furthermore, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences as there is the added risk associated with identifying an end-purchaser for the finished project. Loans on land under development or held for future construction pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest.

The Company seeks to address the forgoing risks associated with construction development lending by developing and adhering to underwriting policies, disbursement procedures, and monitoring practices. Specifically, the Company (i) seeks to diversify the number of loans and projects in the market area, (ii) evaluate and document the creditworthiness of the borrower and the viability of the proposed project, (iii) limit loan-to-value ratios to specified levels, (iv) control disbursements on construction loans on the basis of on-site inspections by a licensed third-party, (v) monitor economic conditions and the housing inventory in each market, and (iv) personal guarantees are obtained from the primary borrowers on substantially all credits. No assurances, however, can be given that these practices will be successful in mitigating the risks of construction development lending.



Home Equity Lending. The Company has been active in second mortgage and home equity lending, with the focus of this lending being conducted in the Company's primary market area. The home equity lines of credit generally have adjustable rates tied to the prime rate of interest with a draw term of 10 years plus and a term to maturity of 15 years. Monthly payments are based on 1.0% of the outstanding balance with a maximum combined loan-to-value ratio of up to 90%, including any underlying first mortgage. Fixed second mortgage home equity loans are

Table of Contents

typically amortizing loans with terms of up to 20 years. Total second mortgage/home equity loans totaled \$40.3 million, or 3.0% of the gross loan portfolio, at December 31, 2018, \$26.1 million of which were adjustable rate home equity lines of credit. Unfunded commitments on home equity lines of credit at December 31, 2018, was \$41.2 million.

Residential. The Company originates loans secured by first mortgages on one-to-four-family residences primarily in the market area. The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Retail banking customers are also important referral sources of the Company's loan originations. The Company originated \$711.3 million of one-to-four-family consumer mortgages (including \$7.1 million loans brokered to other institutions) and sold \$637.7 million to investors in 2018. Of the loans sold to investors, \$417.3 million were sold to the Federal National Mortgage Association ("Fannie Mae"), the Government National Mortgage Association ("Ginnie Mae"), the FHLB, and/or the Federal Home Loan Mortgage Corporation ("Freddie Mac") with servicing rights retained in order to further build the relationship with the customer. At December 31, 2018, one-to-four-family residential mortgage loans totaled \$249.4 million, or 18.8%, of the gross loan portfolio, excluding loans held for sale of \$51.2 million. In addition, the Company originated \$11.8 million in residential loans through our commercial lending channel, secured by single family rental homes in Washington, with combined commitments of \$57.2 million, and an outstanding balance of \$57.0 million at December 31, 2018, classified as commercial business loans that are not included in our one-to-four-family residential mortgage loan portfolio. See "Commercial Business Lending."

The Company generally underwrites the one-to-four-family loans based on the applicant's ability to repay. This includes employment and credit history and the appraised value of the subject property. The Company will lend up to 100% of the lesser of the appraised value or purchase price for one-to-four-family first mortgage loans. For first mortgage loans with a loan-to-value ratio in excess of 80%, the Company generally requires either private mortgage insurance or government sponsored insurance in order to mitigate the higher risk level associated with higher loan-to-value loans. Fixed-rate loans secured by one-to-four-family residences have contractual maturities of up to 30 years and are generally fully amortizing, with payments due monthly. Adjustable-rate mortgage loans generally pose different credit risks than fixed-rate loans, primarily because as interest rates rise the borrower's payments rise, increasing the potential for default. Properties securing the one-to-four-family loans are appraised by independent fee appraisers who are selected in accordance with industry and regulatory standards. The Company requires borrowers to obtain title and hazard insurance, and flood insurance, if necessary. Loans are generally underwritten to the secondary market guidelines with overlays as determined by the internal underwriting department.

Consumer Lending. Consumer lending represents a significant and important historical activity for the Company, primarily reflecting the indirect lending through home improvement contractors and dealers. At December 31, 2018, consumer loans totaled \$275.5 million, or 20.8% of the gross loan portfolio.

The Company's indirect home improvement loans, also referred to as fixture secured loans, represent the largest portion of the consumer loan portfolio and have traditionally been the mainstay of the Company's consumer lending strategy. These loans totaled \$167.8 million, or 12.7% of the gross loan portfolio, and 60.9% of total consumer loans, at December 31, 2018. Indirect home improvement loans are originated through a network of 162 home improvement contractors and dealers located in Washington, Oregon, California, Idaho, Colorado, and recently in Arizona. Ten dealers are responsible for a majority, or 54.1% of the loan volume. These fixture secured loans consist of loans for a wide variety of products, such as replacement windows, siding, roofs, HVAC systems, roofing materials, and pools.

In connection with fixture secured and solar loans, the Company receives loan applications from the dealers, and originates the loans based on pre-defined lending criteria. These loans are processed through the loan origination software, with approximately 20% of the loan applications receiving an automated approval based on the information provided, and the remaining loans are processed by the Company's credit analysts. The Company follows the internal

underwriting guidelines in evaluating loans obtained through the indirect dealer program, including using a Fair Isaac and Company, Incorporated (“FICO”), credit score to approve loans. A FICO score is a principal measure of credit quality and is one of the significant criteria we rely upon in our underwriting in addition to the borrower’s debt to income.

## Table of Contents

The Company's fixture secured and solar loans generally range in amounts from \$2,500 to \$50,000, and generally carry terms of 12 to 20 years with fixed rates of interest. In some instances, the participating dealer may pay a fee to buy down the borrower's interest rate to a rate below the Company's published rate. Fixture secured and solar loans are secured by the personal property installed in, on or at the borrower's real property, and may be perfected with a financing statement under the Uniform Commercial Code ("UCC-2") filed in the county of the borrower's residence. The Company generally files a UCC 2 financing statement to perfect the security interest in the personal property in situations where the borrower's credit score is below 720 or the home improvement loan is for an amount in excess of \$5,000. Perfection gives the Company a claim to the collateral that is superior to someone that obtains a lien through the judicial process subsequent to the perfection of a security interest. The failure to perfect a security interest does not render the security interest unenforceable against the borrower. However, failure to perfect a security interest risks avoidance of the security interest in bankruptcy or subordination to the claims of third parties.

The Company also offers consumer marine loans secured by boats. At December 31, 2018, the marine loan portfolio totaled \$57.8 million, or 21.0% of total consumer loans. Marine loans are originated with borrowers on both a direct and indirect basis, and generally carry terms of up to 20 years with fixed rates of interest. The Company generally requires a 10% down payment, and the loan amount may be up to the lesser of 120% of factory invoice or 90% of the purchase price.

Solar loans mentioned above with fixture secured loans represent the third largest segment of the consumer loan portfolio following marine loans. At December 31, 2018, the solar loan portfolio totaled \$44.4 million, or 16.1% of total consumer loans.

The Company originates other consumer loans which totaled \$5.4 million at December 31, 2018. These loans primarily include personal lines of credit, credit cards, automobile, direct home improvement, loans on deposit, and recreational loans.

In evaluating any consumer loan application, a borrower's FICO score is utilized as an important indicator of credit risk. The FICO score represents the creditworthiness of a borrower based on the borrower's credit history, as reported by an independent third party. A higher FICO score typically indicates a greater degree of creditworthiness. Over the last several years the Company has emphasized originations of loans to consumers with higher credit scores. This has resulted in a lower level of loan charge-offs in recent periods. At December 31, 2018, 71.3% of the consumer loan portfolio was originated with borrowers having a FICO score over 720 at the time of origination, and 24.5% was originated with borrowers having a FICO score between 660 and 720 at the time of origination. Generally, a FICO score of 660 or higher indicates the borrower has an acceptable credit reputation. A credit score at the time of loan origination of less than 660 is considered "subprime" by federal banking regulators and these loans comprised just 4.2% of our consumer loan portfolio at December 31, 2018. Consideration for loans with FICO scores below 660 require additional management oversight and approval.

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

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

personal property securing these loans as they are typically attached to the borrower's personal residence. Accordingly, if a borrower defaults on a fixture secured or solar loan the only practical recourse is to wait until the borrower wants to sell or refinance the home, at which time if there is a perfected security interest the Company generally will be able to collect a percentage of the loan previously charged off.

Table of Contents

Commercial Business Lending. The Company originates commercial business loans and lines of credit to local small- and mid-sized businesses in the Puget Sound market area that are secured by accounts receivable, inventory, or personal/business property, plant and equipment. Consistent with management's objectives to expand commercial business lending, in 2009, the Company commenced a mortgage warehouse lending program through which the Company funds third-party residential mortgage bankers. Under this program the Company provides short-term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. The Company's warehouse lending lines are secured by the underlying notes associated with one-to-four-family mortgage loans made to borrowers by the mortgage banking company and generally require guarantees from the principal shareholder(s) of the mortgage banking company. These loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down the outstanding loan before being dispersed to the mortgage bank. The Company had \$23.0 million approved in residential mortgage warehouse lending lines for four companies at December 31, 2018. The commitments ranged from \$4.0 million to \$8.0 million. At December 31, 2018, there was \$4.4 million in residential warehouse lines outstanding, compared to \$35.0 million in approved residential warehouse lending lines with \$7.4 million outstanding at December 31, 2017.

The Company also has commercial construction warehouse lines secured by notes on construction loans and typically guaranteed by principles with experience in construction lending. In April 2013, we commenced an expansion of our mortgage warehouse lending program to include construction re-lending warehouse lines. These lines are secured by notes provided to construction lenders and are typically guaranteed by a principle of the borrower. Terms for the underlying notes can be up to 18 months and the Bank will lend a percentage (typically 75%) of the underlying note which may have a loan-to-value ratio up to 75%. Combined, the loan-to-value ratio on the underlying note would be up to 52.5% with additional credit support provided by the guarantor. At December 31, 2018, the Company had \$87.0 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from \$5.0 million to \$24.0 million. At December 31, 2018, there was \$61.4 million outstanding, compared to \$84.7 million approved in commercial warehouse lending lines for eight companies with \$34.0 million outstanding at December 31, 2017.

Commercial business loans may be fixed-rate, but are usually adjustable-rate loans indexed to the prime rate of interest, plus a margin. Some of the commercial business loans, such as those made pursuant to the warehouse lending program, are structured as lines of credit with terms of 12 months and interest-only payments required during the term, while other loans may reprice on an annual basis and amortize over a two to five year period. Due to the current interest rate environment, these loans and lines of credit are generally originated with a floor, which is set between 2.0% and 7.0%. Loan fees are generally charged at origination depending on the credit quality and account relationships of the borrower. Advance rates on these types of lines are generally limited to 80% of accounts receivable and 50% of inventory. The Company also generally requires the borrower to establish a deposit relationship as part of the loan approval process. At December 31, 2018, the commercial business loan portfolio totaled \$204.4 million, or 15.4%, of the gross loan portfolio including warehouse lending loans.

At December 31, 2018, most of the commercial business loans were secured. The Company's commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of credit analysis. The Company generally requires personal guarantees on commercial business loans. Nonetheless, commercial business loans are believed to carry higher credit risk than residential mortgage loans. The two largest commercial business lending relationships consisted of one line of credit to one company, and two lines of credit to two related limited liability companies. The first line of credit loan or lending relationship at December 31, 2018 consisted of a commercial line of credit having a commitment of \$24.0 million. This line of credit is secured by residential construction projects located primarily in Seattle, Washington. The outstanding balance of this line of credit at

December 31, 2018 was \$24.0 million. The second of the two largest commercial business lending relationships consisted of two commercial lines of credit having combined commitments of \$18.0 million. Both of these lines of credit are secured by notes to finance residential construction projects located primarily in Seattle, Washington. The outstanding balance of these two lines of credit at December 31, 2018 was \$12.0 million.

Table of Contents

Unlike residential mortgage loans, commercial business loans, particularly unsecured loans, are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business and, therefore, are of higher risk. The Company makes commercial loans secured by business assets, such as accounts receivable, inventory, equipment, real estate and cash as collateral with loan-to-value ratios in most cases up to 80%, based on the type of collateral. This collateral depreciates over time, may be difficult to appraise and may fluctuate in value based on the specific type of business and equipment used. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself (which, in turn, is often dependent in part upon general economic conditions).

Loan Originations, Servicing, Purchases and Sales

The Company originates both fixed-rate and adjustable-rate loans. The ability to originate loans, however, is dependent upon customer demand for loans in the market areas. From time to time to supplement our loan originations and based on our asset/liability objectives we will also purchase bulk loans or pools of loans from other financial institutions.

Over the past few years, the Company has continued to originate consumer loans, and increased emphasis on commercial real estate loans, including construction and development lending, as well as commercial business loans. Demand is affected by competition and the interest rate environment. In periods of economic uncertainty, the ability of financial institutions, including us, to originate large dollar volumes of commercial business and real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income. In addition to interest earned on loans and loan origination fees, the Company receives fees for loan commitments, late payments and other miscellaneous services. The fees vary from time to time, generally depending on the supply of funds and other competitive conditions in the market.

The Company will sell long-term, fixed-rate residential real estate loans in the secondary market to mitigate interest rate risk. These loans are generally sold for cash in amounts equal to the unpaid principal amount of the loans determined using present value yields to the buyer. Some residential real estate loans originated as Federal Housing Administration or FHA, U.S. Department of Veterans Affairs or VA, or United States Department of Agriculture or USDA Rural Housing loans were sold by the Company as servicing released loans to other companies. A majority of residential real estate loans sold by the Company were sold with servicing retained at a specified servicing fee. The Company earned gross mortgage servicing fees of \$2.4 million for the year ended December 31, 2018. The Company was servicing \$1.19 billion of one-to-four-family loans at December 31, 2018, for Fannie Mae, Freddie Mac, Ginnie Mae, the FHLB, and another financial institution. These mortgage servicing rights ("MSRs") constituted a \$10.4 million asset on our books on that date, which is amortized in proportion to and over the period of the net servicing income. These MSRs are periodically evaluated for impairment based on their fair value, which takes into account the rates and potential prepayments of those sold loans being serviced. The fair value of our MSRs at December 31, 2018 was \$14.6 million. See Notes 5 and 15 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" of this Form 10 K.



Table of Contents

The following table presents the activity during the year ended December 31, 2018, related to loans serviced for others.

	(In thousands)
Beginning balance at January 1, 2018	
One-to-four-family	\$ 775,765
Consumer	1,183
Commercial business	1,914
Subtotal	778,862
Additions	
One-to-four-family	501,888
Repayments	
One-to-four-family	(90,795)
Consumer	(406)
Commercial business	(1,914)
Subtotal	(93,115)
Ending balance at December 31, 2018	
One-to-four-family	1,186,858
Consumer	777
Commercial business	—
Total	\$ 1,187,635

Table of Contents

The following table shows total loans originated, purchased, sold and repaid during the years indicated.

(In thousands)	Year Ended December 31,	
	2018	2017
Originations by type:		
Fixed-rate:		
Commercial	\$ 6,943	\$ 6,909
Home equity	5,895	4,478
One-to-four-family (1)	4,753	4,177
Loans held for sale (one-to-four-family)	608,065	686,887
Multi-family	132	7,991
Consumer	149,726	107,855
Commercial business (2)	16,811	6,177
Total fixed-rate	792,325	824,474
Adjustable- rate:		
Commercial	14,552	7,107
Construction and development	205,649	123,323
Home equity	15,988	13,758
One-to-four-family (1)	81,256	96,925
Loans held for sale (one-to-four-family)	11,567	11,617
Multi-family	10,793	2,686
Consumer	2,489	2,806
Commercial business (2)	282,868	181,168
Warehouse lines, net	(2,988)	(428)
Total adjustable-rate	622,174	438,962
Total loans originated	1,414,499	1,263,436
Purchases by type (4):		
Fixed-rate:		
Commercial	32,567	—
Home equity	8,795	—
One-to-four-family (1)	38,322	—
Multi-family	28,958	—
Consumer	1,332	—
Construction and development	29,064	—
Commercial business (2) (3)	9,267	9,450
Adjustable-rate:		
Commercial	114,700	4,593
Home equity	3,424	—
One-to-four-family (1)	25,261	1,100
Multi-family	31,974	4,250
Consumer	2,180	—
Construction and development	35,750	—
Commercial business (2) (3)	24,029	19,557
Total loans purchased	385,623	38,950
Sales and repayments:		
Construction and development	—	(449)
One-to-four-family (1)	(16,034)	(20,165)
Loans held for sale (one-to-four-family) and commercial business (2)	(621,636)	(700,450)

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Commercial business (2) (3)	(1,918)	(4,008)
Total loans sold	(639,588)	(725,072)
Total principal repayments	(610,009)	(408,374)
Total reductions	(1,249,597)	(1,133,446)
Net increase	\$ 550,525	\$ 168,940

19

---

Table of Contents

---

- (1) One-to-four-family portfolio loans.
- (2) Excludes warehouse lines.
- (3) Includes USDA/U.S. Small Business Administration or SBA guaranteed loans purchased at a premium.
- (4) Includes loans acquired in the Anchor Acquisition.

Sales of whole real estate loans and participations in real estate loans can be beneficial to us since these sales systematically generate income at the time of sale, produce future servicing income on loans where servicing is retained, provide funds for additional lending and other investments, and increase liquidity.

From time to time we also sell whole consumer loans, specifically long term consumer loans, which can be beneficial to us since these sales generate income at the time of sale, can potentially create future servicing income where servicing is retained, and provide a mitigation of interest rate risk associated with holding 15 20 year maturity consumer loans.

#### Asset Quality

When a borrower fails to make a required payment on a residential real estate loan, the Company attempts to cure the delinquency by contacting the borrower. In the case of loans secured by residential real estate, a late notice typically is sent 16 days after the due date, and the borrower is contacted by phone within 16 to 25 days after the due date. When the loan is 30 days past due, an action plan is formulated for the credit under the direction of the Loan Control department manager. Generally, a delinquency letter is mailed to the borrower. All delinquent accounts are reviewed by a loan control representative who attempts to cure the delinquency by contacting the borrower once the loan is 30 days past due. If the account becomes 60 days delinquent and an acceptable repayment plan has not been agreed upon, a Loan Control representative will generally refer the account to legal counsel with instructions to prepare a notice of intent to foreclose. The notice of intent to foreclose allows the borrower up to 30 days to bring the account current. Between 90 - 120 days past due, a value is obtained for the loan collateral. At that time, a mortgage analysis is completed to determine the loan-to-value ratio and any collateral deficiency. If foreclosed, the Company customarily takes title to the property and sells it directly through a real estate broker.

Delinquent consumer loans are handled in a similar manner. Appropriate action is taken in the form of phone calls and notices to collect any loan payment that is delinquent more than 16 days. Once the loan is 90 days past due, it is classified as non-accrual. Generally, credits are charged off if past due 120 days, unless the collections department provides support for a customer repayment plan. Bank procedures for repossession and sale of consumer collateral are subject to various requirements under the applicable consumer protection laws as well as other applicable laws and the determination by us that it would be beneficial from a cost basis.

Delinquent commercial business loans and loans secured by commercial real estate are handled by the loan officer in charge of the loan, who is responsible for contacting the borrower. The loan officer works with outside counsel and, in the case of real estate loans, a third party consultant to resolve problem loans. In addition, management meets as needed and reviews past due and classified loans, as well as other loans that management feels may present possible collection problems, which are reported to the AQC and the board on a monthly basis. If an acceptable workout of a delinquent commercial loan cannot be agreed upon, the Company customarily will initiate foreclosure or repossession proceedings on any collateral securing the loan.



Table of Contents

The following table shows delinquent loans by the type of loan and number of days delinquent at December 31, 2018. Categories not included in the table below did not have any delinquent loans at December 31, 2018.

	Loans Delinquent For:						Total Loans Delinquent		
	60-89 Days			90 Days or More			60 Days or More		
(in thousands)	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category
Real estate loans									
Home equity	1	\$ 40	0.10	4	\$ 229	0.57	5	\$ 269	0.67
Two-to-four-family	2	164	0.07	7	1,358	0.54	9	1,522	0.61
Real estate loans	3	204	0.02	11	1,587	0.19	14	1,791	0.21
Consumer loans									
Direct home improvement	20	196	0.12	14	113	0.07	34	309	0.18
Other consumer	2	43	0.10	3	41	0.09	5	84	0.19
Consumer loans	6	24	0.44	2	11	0.20	8	35	0.65
Commercial business	28	263	0.10	19	165	0.06	47	428	0.16
Commercial and industrial	3	431	0.31	—	—	—	3	431	0.31
Commercial business loans	3	431	0.21	—	—	—	3	431	0.21
	34	\$ 898	0.07	% 30	\$ 1,752	0.13	% 64	\$ 2,650	0.20

Table of Contents

Non-performing Assets. The following table sets forth information with respect to the Company's non-performing assets.

(Dollars in thousands)	December 31,				
	2018	2017	2016	2015	2014
Non-accruing loans:					
Real estate loans					
Home equity	\$ 229	\$ 151	\$ 210	\$ 47	\$ 61
One-to-four-family	1,552	142	—	525	73
Total real estate loans	1,781	293	210	572	134
Consumer loans					
Indirect home improvement	367	195	435	408	250
Solar	41	—	69	37	29
Marine	18	—	—	—	19
Other consumer	2	—	7	—	1
Total consumer loans	428	195	511	445	299
Commercial business loans					
Commercial and industrial	1,685	551	—	—	—
Total commercial business loans	1,685	551	—	—	—
Total non-accruing loans	3,894	1,039	721	1,017	433
Accruing loans contractually past due 90 days or more	11	—	—	—	—
Real estate owned	689	—	—	—	—
Repossessed consumer property	—	—	15	—	—
Total non-performing assets	\$ 4,594	\$ 1,039	\$ 736	\$ 1,017	\$ 433
Restructured loans	\$ —	\$ 55	\$ 57	\$ 734	\$ 783
Total non-performing assets as a percentage of total assets	0.28 %	0.11 %	0.09 %	0.15 %	0.08 %

For the year ended December 31, 2018, gross interest income which would have been recorded had the non-accruing loans been current in accordance with their original terms was \$45,000. Prior to non-accrual status, the amount of interest income included in net income for the year ended December 31, 2018 was \$141,000 for these loans.

**Real Estate Owned.** Real estate acquired by the Company as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate owned until it is sold. When the property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or the fair market value of the property less selling costs. The Company had two real estate owned properties as of December 31, 2018.

**Restructured Loans.** According to generally accepted accounting principles in the United States of America (“U.S. GAAP”), the Company is required to account for certain loan modifications or restructuring as a “troubled debt restructuring” or “TDR”. In general, the modification or restructuring of a debt is considered a TDR if the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrowers that would not otherwise be considered. The Company had no TDRs at December 31, 2018.

**Other Assets Especially Mentioned.** At December 31, 2018, there was \$254,000 of loans with respect to which known information about the possible credit problems of the borrowers caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items

in the non-performing asset categories.

Classified Assets. Federal regulations provide for the classification of lower quality loans and other assets (such as other real estate owned and repossessed property), debt and equity securities, as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and pay capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the



## Table of Contents

weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When the Company classifies problem assets as either substandard or doubtful, a specific allowance may be established in an amount deemed prudent to address specific impairments. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge off those assets in the period in which they are deemed uncollectible. The Company's determination as to the classification of assets and the amount of valuation allowances is subject to review by the FDIC and the DFI, which can order the establishment of additional loss allowances. Assets which do not currently expose the Company to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention.

In connection with the filing of periodic reports with the FDIC and in accordance with the Company's classification of assets policy, the Company regularly reviews the problem assets in the portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of the review of the Company's assets, at December 31, 2018, the Company had classified \$8.0 million of assets as substandard. The \$8.0 million of classified assets represented 4.4% of equity and 0.5% of total assets at December 31, 2018. The Company had \$254,000 of assets classified as special mention at December 31, 2018, not included in classified assets reported above.

### Allowance for Loan Losses

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

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.

The provision for loan losses was \$1.5 million for the year ended December 31, 2018. The allowance for loan losses was \$12.3 million, or 0.9% of gross loans receivable at December 31, 2018, as compared to \$10.8 million, or 1.4% of gross loans receivable outstanding at December 31, 2017. In accordance with acquisition accounting, loans acquired in the Anchor Acquisition were recorded at their estimated fair value, which resulted in a net discount to the contractual amounts of the loans, of which a portion reflects a discount for possible credit losses. Credit discounts are included in the determination of fair value and as a result no allowance for loan losses is recorded for acquired loans at the acquisition date. Although the discount recorded on the acquired loans is not reflected in the allowance for loan losses, or related allowance coverage ratios, we believe it should be considered when comparing the current ratios to similar ratios in periods prior to the acquisition. The recorded value of loans acquired in the Anchor Acquisition as of November 15, 2018 was \$361.6 million, including \$1.3 million of purchased credit impaired loans, and the fair value discount was \$5.3 million, or 1.5% of the loans acquired. Management will continue to review the adequacy of the

allowance for loan losses and make adjustments to the provision for loan losses based on loan growth, economic conditions, charge-offs and portfolio composition.

Table of Contents

Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects probable incurred loan losses in the loan portfolio. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Comparison of Results of Operations for the Years Ended December 31, 2018 and 2017 - Provision for Loan Losses” and Notes 1 and 4 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

Table of Contents

The following table summarizes the distribution of the allowance for loan losses by loan category.

Allowance for loan losses by loan category	2017			2016			2015		
	Loan balance	Percent of loan balance in each category to total loans	Allowance for loan losses by loan category	Loan balance	Percent of loan balance in each category to total loans	Allowance for loan losses by loan category	Loan balance	Percent of loan balance in each category to total loans	
\$ 985	\$ 63,611	8.22	% \$ 868	\$ 55,871	9.23	% \$ 708	\$ 50,034	9.78	%
2,677	143,068	18.50	2,146	94,462	15.60	1,273	80,806	15.80	
320	25,289	3.27	263	20,081	3.32	244	16,540	3.24	
1,288	163,655	21.16	1,004	124,009	20.48	947	102,921	20.13	
491	44,451	5.75	489	37,527	6.20	375	22,223	4.35	
5,761	440,074	56.90	4,770	331,950	54.83	3,547	272,524	53.30	
2,220	130,176	16.83	1,807	107,759	17.80	1,404	103,064	20.16	
511	41,049	5.31	567	36,503	6.03	407	29,226	5.72	
586	35,397	4.58	405	28,549	4.71	229	23,851	4.66	
34	2,046	0.26	35	1,915	0.32	42	2,181	0.43	
3,351	208,668	26.98	2,814	174,726	28.86	2,082	158,322	30.97	
2,435	83,306	10.77	1,531	65,841	10.88	2,297	59,619	11.66	
756	41,397	5.35	483	32,898	5.43	378	20,817	4.07	
3,191	124,703	16.12	2,014	98,739	16.31	2,675	80,436	15.73	
—	—	—	—	—	—	—	—	—	
46	—	—	1,158	—	—	1,907	—	—	
% \$ 12,349	\$ 773,445	100.00	% \$ 10,756	\$ 605,415	100.00	% \$ 10,211	\$ 511,282	100.00	%



Table of Contents

The following table sets forth an analysis of the allowance for loan losses at the dates and or the years indicated.

(Dollars in thousands)	Year Ended December 31,									
	2018		2017		2016		2015		2014	
Balance at beginning of year	\$ 10,756		\$ 10,211		\$ 7,785		\$ 6,090		\$ 5,092	
Charge-offs:										
Real estate loans										
Commercial	—		—		—		191		120	
Home equity	4		65		65		57		94	
Total real estate loans	4		65		65		248		214	
Consumer loans										
Indirect home improvement	701		652		822		1,265		1,341	
Solar	198		129		50		92		—	
Marine	35		23		81		63		15	
Other consumer	2		28		49		46		51	
Total consumer loans	936		832		1,002		1,466		1,407	
Commercial business loans										
Commercial and industrial	—		33		—		40		75	
Total commercial business loans	—		33		—		40		75	
Total charge-offs	940		930		1,067		1,754		1,696	
Recoveries:										
Real estate loans										
Commercial	—		—		—		191		—	
Home equity	20		35		68		33		80	
One-to-four-family	22		—		48		—		104	
Total real estate loans	42		35		116		224		184	
Consumer loans										
Indirect home improvement	804		610		780		870		630	
Solar	104		1		—		—		—	
Marine	17		27		29		33		13	
Other consumer	22		42		81		56		65	
Total consumer loans	947		680		890		959		708	
Commercial business loans										
Commercial and industrial	4		10		87		16		2	
Total commercial business loans	4		10		87		16		2	
Total recoveries	993		725		1,093		1,199		894	
Net (recoveries) charge-offs	(53)		205		(26)		555		802	
Additions charged to operations	1,540		750		2,400		2,250		1,800	
Balance at end of year	\$ 12,349		\$ 10,756		\$ 10,211		\$ 7,785		\$ 6,090	
Net charge-offs to average loans outstanding	— %		0.03 %		— %		0.11 %		0.24 %	
Net (recoveries) charge-offs to average non-performing assets	(1.90) %		23.10 %		(3.00) %		76.55 %		44.04 %	
Allowance as a percentage of non-performing loans	317.13 %		1,035.23 %		1,416.23 %		765.49 %		1,406.47 %	
Allowance as a percentage of gross loans receivable (end of year)	0.93 %		1.39 %		1.69 %		1.52 %		1.54 %	

While management believes that the estimates and assumptions used in its determination of the adequacy of the allowance for loan losses 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

26

---

Table of Contents

any increased provisions that may be required will not adversely impact the Company's financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

## Investment Activities

General. Under Washington law, savings banks are permitted to invest in various types of liquid assets, including U.S. Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks and savings institutions, banker's acceptances, repurchase agreements, federal funds ("Fed Funds"), commercial paper, investment grade corporate debt securities, and obligations of states and their political subdivisions.

The Chief Financial Officer has the responsibility for the management of the Company's investment portfolio, subject to consultation with the Chief Executive Officer, and the direction and guidance of the Board of Directors. Various factors are considered when making investment decisions, including the marketability, maturity and tax consequences of the proposed investment. The maturity structure of investments will be affected by various market conditions, including the current and anticipated slope of the yield curve, the level of interest rates, the trend of new deposit inflows, and the anticipated demand for funds via deposit withdrawals and loan originations and purchases.

The general objectives of the Company's investment portfolio will be to provide liquidity when loan demand is high, to assist in maintaining earnings when loan demand is low and to maximize earnings while satisfactorily managing risk, including credit risk, reinvestment risk, liquidity risk, and interest rate risk. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management and Market Risk" of this Form 10 K.

As a member of the FHLB of Des Moines, the Bank had \$9.9 million in stock at December 31, 2018. For the year ended December 31, 2018, the Bank received \$379,000 in dividends.

The table below sets forth information regarding the composition of the securities portfolio and other investments at the dates indicated. At December 31, 2018, the securities portfolio did not contain securities of any issuer with an aggregate book value in excess of 10% of equity capital, excluding those issued by the United States Government or its agencies.

(In thousands)	December 31, 2018		2017		2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale						
U.S. agency securities	\$ 16,052	\$ 15,887	\$ 9,077	\$ 9,115	\$ 8,150	\$ 8,068
Corporate securities	7,074	6,865	7,113	7,026	7,654	7,500
Municipal bonds	14,446	14,194	12,720	12,786	15,183	15,264
Mortgage-backed securities	45,827	44,836	40,161	39,734	45,856	45,195
U.S. Small Business Administration securities	15,690	15,423	14,014	13,819	5,862	5,848
Total securities available-for-sale	\$ 99,089	\$ 97,205	\$ 83,085	\$ 82,480	\$ 82,705	\$ 81,875





Table of Contents

The composition and contractual maturities of the investment portfolio at December 31 2018, excluding FHLB stock, are indicated in the following table. The yields on municipal bonds have not been computed on a tax equivalent basis.

	Over 1 year to 5 years		Over 5 to 10 years		Over 10 years		Total Securities		Fair Value
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	
Securities in (hands)									
Securities									
Available-for-sale									
Agency	\$ 1,043	2.62 %	\$ 10,011	3.47 %	\$ 4,998	3.39 %	\$ 16,052	3.39 %	\$ 15,000
Corporate	6,077	2.72	997	2.59	—	—	7,074	2.70	6,000
Municipal bonds	2,659	2.64	2,610	2.91	9,177	2.58	14,446	2.65	14,000
Collateralized mortgage-backed	1,238	1.75	17,039	2.89	27,550	2.62	45,827	2.69	44,000
Small business									
Administration									
Securities	—	—	13,828	2.62	1,862	2.76	15,690	2.64	15,000
Available-for-sale	\$ 11,017	2.58 %	\$ 44,485	2.93 %	\$ 43,587	2.70 %	\$ 99,089	2.79 %	\$ 99,000

Table of Contents

## Deposit Activities and Other Sources of Funds

General. Deposits, borrowings, and loan repayments are the major sources of funds for lending and other investment purposes. Scheduled loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and market conditions. Borrowings from the FHLB of Des Moines are used to supplement the availability of funds from other sources and also as a source of term funds to assist in the management of interest rate risk.

The Company's deposit composition reflects a mixture with certificates of deposit accounting for 38.0% of the total deposits at December 31, 2018, and interest and noninterest-bearing checking, savings and 1,000 accounts comprising the balance of total deposits. The Company relies on marketing activities, convenience, customer service and the availability of a broad range of deposit products and services to attract and retain customer deposits. The Company also had \$116.7 million of brokered deposits, or 9.2% of total deposits at December 31, 2018. As a wholesale funding alternative, brokered deposits have competitive rates that are comparable to FHLB borrowings and local certificates of deposit.

Deposits. Deposits are attracted from within the market area through the offering of a broad selection of deposit instruments, including checking accounts, money market deposit accounts, savings accounts, and certificates of deposit with a variety of rates. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit, and the interest rate, among other factors. In determining the terms of the Company's deposit accounts, the Company considers the development of long term profitable customer relationships, current market interest rates, current maturity structure and deposit mix, customer preferences, and the profitability of acquiring customer deposits compared to alternative sources.

The following table sets forth total deposit activities for the years indicated.

(Dollars in thousands)	Year Ended December 31,					
	2018		2017		2016	
Beginning balance	\$	829,842	\$	712,593	\$	485,178
Net deposits before interest credited		437,056	(1)(2)	113,329		224,161 (1)
Interest credited		7,321		3,920		3,254
Ending balance	\$	1,274,219	\$	829,842	\$	712,593
Net increase in deposits	\$	444,377	\$	117,249	\$	227,415
Percent increase		53.55	%	16.45	%	46.87 %

(1) On January 22, 2016, the Company purchased four retail bank branches from Bank of America, N.A (the "Branch Purchase") and acquired approximately \$186.4 million in deposits. At December 31, 2018, approximately \$120.0 million of the acquired deposits remained with the Bank. These branches also attracted new deposits. At December 31, 2018, they had an aggregated total of \$251.4 million in deposits, including public funds.

(2) On November 15, 2018, the Company completed the Anchor Acquisition and acquired approximately \$357.9 million in deposits.

Table of Contents

The following table sets forth the dollar amount of savings deposits in the various types of deposit programs the Company offered at the dates indicated.

(Dollars in thousands)	December 31, 2018		2017		
	Amount	Percent of Total	Amount	Percent of Total	
Transactions and Savings Deposits					
Noninterest-bearing checking	\$ 221,107	17.35	% \$ 177,739	21.42	%
Interest-bearing checking	151,103	11.86	119,872	14.45	
Savings	122,344	9.60	72,082	8.69	
Money market	282,595	22.18	228,742	27.56	
Escrow accounts related to mortgages serviced	13,425	1.05	9,151	1.10	
Total transaction and savings deposits	790,574	62.04	607,586	73.22	
Certificates					
0.00 - 1.99%	188,049	14.76	207,485	25.00	
2.00 - 3.99%	295,596	23.20	14,701	1.77	
4.00% and greater	—	—	70	0.01	
Total certificates	483,645	37.96	222,256	26.78	
Total deposits	\$ 1,274,219	100.00	% \$ 829,842	100.00	%

The following table sets forth the rate and maturity information of time deposit certificates at December 31, 2018.

(Dollars in thousands)	Rate		Total	Percent of Total	
	0.00 - 1.99%	2.00 - 3.99%			
Certificate accounts maturing in quarter ending:					
March 31, 2019	\$ 18,952	\$ 44,175	\$ 63,127	13.05	%
June 30, 2019	24,146	20,039	44,185	9.14	
September 30, 2019	43,307	48,926	92,233	19.07	
December 31, 2019	31,067	60,210	91,277	18.87	
March 31, 2020	18,981	51,189	70,170	14.51	
June 30, 2020	6,408	9,141	15,549	3.22	
September 30, 2020	16,408	10,246	26,654	5.51	
December 31, 2020	3,754	950	4,704	0.97	
March 31, 2021	6,415	55	6,470	1.34	
June 30, 2021	5,350	10,031	15,381	3.18	
September 30, 2021	5,705	265	5,970	1.23	
December 31, 2021	2,807	6,649	9,456	1.96	
Thereafter	4,749	33,720	38,469	7.95	
Total	\$ 188,049	\$ 295,596	\$ 483,645	100.00	%
Percent of total	38.89	% 61.11	% 100.00	%	



Table of Contents

The following table indicates the amount of jumbo certificates of deposit by time remaining until maturity at December 31, 2018. Jumbo certificates of deposit are certificates in amounts of \$100,000 or more.

(In thousands)	Maturity				Total
	3 Months or Less	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	
Certificates of deposit of less than \$100,000(1)	\$ 42,562	\$ 23,080	\$ 103,184	\$ 74,367	\$ 243,193
Certificates of deposit of \$100,000 to less than \$250,000	6,425	13,168	59,381	75,121	154,095
Certificates of deposit of \$250,000 and over	14,140	7,937	20,945	43,335	86,357
Total certificates of deposit	\$ 63,127	\$ 44,185	\$ 183,510	\$ 192,823	\$ 483,645

(1) Includes \$116.7 million of brokered deposits at December 31, 2018.

The Federal Reserve requires the Bank to maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the Federal Reserve Bank of San Francisco (“Federal Reserve Bank”). Negotiable order of withdrawal (“NOW”) accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. At December 31, 2018, the Bank’s deposit with the Federal Reserve Bank and vault cash exceeded the reserve requirements.

Debt. Although customer deposits are the primary source of funds for lending and investment activities, the Company uses various borrowings such as advances and warehouse lines of credit from the FHLB of Des Moines, and to a lesser extent Fed Funds purchased to supplement the supply of lendable funds, to meet short-term deposit withdrawal requirements and also to provide longer term funding to better match the duration of selected loan and investment maturities.

As one of the Company’s capital management strategies, the Company has used advances from the FHLB of Des Moines to fund loan originations in order to increase net interest income. Depending upon the retail banking activity, the Company will consider and may undertake additional leverage strategies within applicable regulatory requirements or restrictions. These borrowings would be expected to primarily consist of FHLB of Des Moines advances.

As a member of the FHLB of Des Moines, the Bank is required to own capital stock in the FHLB of Des Moines and authorized to apply for advances on the security of that stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the U.S. Government) provided certain creditworthiness standards have been met. Advances are individually made under various terms pursuant to several different credit programs, each with its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. The Bank maintains a committed credit facility with the FHLB of Des Moines that provides for immediately available advances up to an aggregate of \$262.9 million at December 31, 2018. Outstanding advances from the FHLB of Des Moines totaled \$137.1 million at December 31, 2018.

At December 31, 2018, the Bank had no outstanding borrowings and \$127.7 million additional short-term borrowing capacity with the Federal Reserve Bank. The Bank also had an aggregate of \$51.0 million in unsecured Fed Funds lines of credit with other financial institutions of which none was outstanding at December 31, 2018.

On October 15, 2015 (the “Closing Date”), FS Bancorp, Inc. closed on a third-party loan commitment by the issuance of an unsecured subordinated term note in the aggregate principal amount of \$10.0 million due October 1, 2025 (the “Subordinated Note”). The Subordinated Note bears interest at an annual interest rate of 6.50%, payable by the Company quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, commencing on the first such date following the Closing Date and on the maturity date. The Subordinated Note will mature on October 1, 2025 but may be prepaid at the Company’s option and with regulatory approval at any time on or after five years after the Closing Date or at any time upon certain events, such as a change in the regulatory capital treatment of the Subordinated Note or the interest on the Subordinated Note no longer being deductible by the Company for United States federal income tax purposes. The Company contributed \$9.0 million of the proceeds from the Subordinated Note as additional capital to the Bank in the

Table of Contents

fourth quarter of 2015. See Note 9 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

The following tables set forth information regarding both long- and short-term borrowings.

(Dollars in thousands)	Year Ended December 31,					
	2018	2017	2016			
Maximum balance:						
Federal Home Loan Bank advances and Fed Funds	\$ 180,025	\$ 70,419	\$ 98,769			
Federal Reserve Bank	\$ —	\$ 1,000	\$ 1,000			
Fed Funds lines of credit	\$ 21,016	\$ 17,501	\$ 6,000			
Subordinated note	\$ 10,000	\$ 10,000	\$ 10,000			
Average balances:						
Federal Home Loan Bank advances and Fed Funds	\$ 96,044	\$ 25,635	\$ 26,259			
Federal Reserve Bank	\$ —	\$ 3	\$ 3			
Fed Funds lines of credit	\$ 5,286	\$ 876	\$ 16			
Subordinated note (excluding unamortized debt issuance cost)	\$ 10,000	\$ 10,000	\$ 10,000			
Weighted average interest rate:						
Federal Home Loan Bank advances and Fed Funds	2.02	%	1.26	%	0.98	%
Federal Reserve Bank	—	%	1.75	%	1.00	%
Fed Funds lines of credit	1.93	%	1.30	%	0.77	%
Subordinated note (excluding unamortized debt issuance cost)	6.50	%	6.50	%	6.50	%

(Dollars in thousands)	At December 31,					
	2018	2017	2016			
Balance outstanding at end of year:						
Federal Home Loan Bank advances	\$ 137,149	\$ 7,529	\$ 12,670			
Weighted average interest rate of:						
Federal Home Loan Bank advances, at end of year	2.38	%	1.34	%	1.24	%

### Subsidiary and Other Activities

The Company has one active subsidiary, the Bank, and the Bank has one inactive subsidiary. The Bank had no capital investment in its inactive subsidiary at December 31, 2018.

### Competition

The Company faces strong competition in attracting deposits. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions, life insurance companies, mortgage bankers, and more recently, financial technology (or “FinTech”) companies. Other savings institutions, commercial banks, credit unions, finance, and FinTech companies provide vigorous competition in consumer lending, including indirect lending. Commercial business competition is primarily from local commercial banks. The Company competes by delivering high-quality, personal service to customers that result in a high level of customer satisfaction.



The Company's market areas have a high concentration of financial institutions, many of which are branches of large money centers and regional banks that have resulted from the consolidation of the banking industry in Washington and other western states. These include such large national lenders as Wells Fargo, Bank of America, Chase, and others in the Company's market area that have greater resources and offer services that the Bank does not provide. For example, the Bank does not offer trust services. Customers who seek "one-stop shopping" may be drawn to institutions that offer services that the Bank does not.

The Company attracts deposits through the branch office system. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds, FinTech companies, and other alternative investments. The Bank competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent branch deposit data provided by

Table of Contents

the FDIC, at June 30, 2018, 1st Security Bank of Washington's share of aggregate deposits in the market area consisting of the seven counties where the Company has branches was less than one percent.

## Employees

At December 31, 2018, the Company had 424 full-time equivalent employees. Company employees are not represented by any collective bargaining group. The Company considers employee relations to be good.

Set forth below is certain information regarding the executive officers of the Company and the Bank. There are no family relationships among or between the executive officers.

Executive Officers. The following table sets forth information with respect to the executive officers of the Company and the Bank.

Name	Age (1)	Position with FS Bancorp, Inc.	Position with 1st Security Bank of Washington
Joseph C. Adams	59	Director and Chief Executive Officer	Director and Chief Executive Officer
Matthew D. Mullet	40	Chief Financial Officer, Treasurer and Secretary	Chief Financial Officer and Chief Operating Officer
Robert B. Fuller	59	Chief Credit Officer	Chief Credit Officer
Dennis V. O'Leary	51		Chief Lending Officer
Erin Burr	41		Executive Vice President, Chief Risk Officer and CRA Officer
Vickie Jarman	41		Executive Vice President, Chief Human Resources Officer/WOW! Officer
Donn C. Costa	57		Executive Vice President, Home Lending Production
Debbie L. Steck	59		Executive Vice President, Home Lending Operations
Kelli B. Nielsen	47		Executive Vice President, Retail Banking and Marketing

---

(1) At December 31, 2018.

Joseph C. Adams, age 59, is a director and has been the Chief Executive Officer of 1st Security Bank of Washington since July 2004. He joined 1st Security Bank of Washington in April 2003 as its Chief Financial Officer, when the Bank was Washington's Credit Union. Mr. Adams also served as Supervisory Committee Chairperson from 1993 to 1999. Mr. Adams is a lawyer having worked for Deloitte as a tax consultant, K&L Gates as a lawyer and then at Univar USA as a lawyer and Director, Regulatory Affairs. Mr. Adams received a Master's Degree equivalent from the Pacific Coast Banking School. Mr. Adams' legal and accounting backgrounds, as well as his duties as Chief Executive Officer of 1st Security Bank of Washington, bring a special knowledge of the financial, economic, and regulatory challenges faced by the Bank which makes him well suited to educate the Board on these matters.

Matthew D. Mullet, age 40, joined 1st Security Bank of Washington in July 2011 and was appointed Chief Financial Officer in September 2011 and Chief Operating Officer in January 2018. Mr. Mullet started his banking career in June 2000 as a financial examiner with the Washington State Department of Financial Institutions, Division of Banks, where he worked until October 2004. From October 2004 until August 2010, Mr. Mullet was employed at Golf Savings Bank, Mountlake Terrace, WA, where he served in several financial capacities, including as Chief Financial Officer from May 2007 until August 2010. In August 2010, Golf Savings Bank was merged with Sterling Savings Bank, where

Table of Contents

Mr. Mullet held the position as Senior Vice President of the Home Loan Division until resigning and commencing work at 1st Security Bank of Washington.

Robert B. Fuller, age 59, joined 1st Security Bank of Washington as Chief Credit Officer in September of 2013. Prior to his employment with the Bank, Mr. Fuller served as Chief Financial Officer/Chief Credit Officer for Blueprint Capital, REIT in 2013, Chief Credit Officer for Core Business Bank during 2012, and Plaza Bank during 2011, and in credit administration at Golf Savings Bank/Sterling Bank during 2009 and 2010. Mr. Fuller also served as Executive Vice President, Chief Operating Officer, and Chief Financial Officer for Golf Savings Bank from March 2001 to September 2006 and was a member of the integration team for the Golf sale to Sterling Savings Bank. Mr. Fuller started his banking career at US Bank of Washington's mid-market production team and has over 30 years of banking experience.

Dennis V. O'Leary, age 51, joined 1st Security Bank of Washington as Senior Vice President - Consumer, Small Business and Construction Lending in August 2011 and currently holds the position of Chief Lending Officer. Prior to his employment with the Bank, Mr. O'Leary previously was employed by Sterling Savings Bank from July 2006 until August 2011 as Senior Vice President and Puget Sound Regional Director of the residential construction lending division. Sterling Savings Bank acquired Golf Savings Bank in 2006 where Mr. O'Leary had served as Executive Vice President, Commercial Real Estate Lending, having previously served in various senior lending positions at Golf Savings Bank since June 1985.

Erin Burr, age 41, joined 1st Security Bank of Washington in January 2009 and became the Enterprise Risk Manager in 2012. She was appointed Chief Risk Officer in April 2018. Ms. Burr started her banking career in July 1999 as a financial examiner with the Washington State Department of Financial Institutions, Division of Banks where she worked until May 2006. From May 2006 until December 2008, Ms. Burr served as senior underwriter for Builders Capital Mortgage. Ms. Burr became the CRA Officer in January 2010. As the Bank's CRA Officer, she enjoys building relationships with non-profit groups that benefit the communities in which we serve. As the Chief Risk Officer, she uses her regulatory background to help promote and build risk awareness culture throughout the Bank.

Vickie Jarman, age 41, has been a 1st Security Bank of Washington teammate since 2002. Prior to becoming the Chief Human Resources Officer/WOW! Officer in April 2018, she worked in our indirect lending department. In 2011, Ms. Jarman became the Director of WOW! and focused on corporate culture. Since 2012, she has overseen Human Resources, Payroll, Benefits, and Recruiting, as well as continuing her work on corporate culture and core values. Ms. Jarman ensures that as the organization evolves, core values continue to reflect the personal principles that all employees stand behind and are held accountable.

Donn C. Costa, age 57, Executive Vice President, Home Lending, joined 1st Security Bank of Washington in October 2011 as Senior Vice President, Home Lending. He previously held the position of Executive Vice President at Sterling Savings Bank, Mountlake Terrace, Washington after the merger with Golf Savings Bank in August 2009, and held the position of Executive Vice President at Golf Savings Bank, Mountlake Terrace, Washington since 2006. With more than 30 years of home lending experience, Mr. Costa began as a loan officer at Lomas and Nettleton Mortgage Company in Mountlake Terrace in 1986.

Debbie L. Steck, age 59, Executive Vice President, Home Lending Operations, joined 1st Security Bank of Washington in September 2011. Prior to her employment at the Bank, she served as Chief Operating Officer and Vice President at Sterling Savings Bank after the merger with Golf Savings Bank in August 2009, and held that position with Golf Savings Bank for several years prior to that. Ms. Steck has over 30 years of experience in the mortgage industry. She currently serves on the Board of Directors for the Everett Gospel Mission.

Kelli B. Nielsen, age 47, Executive Vice President, Retail Banking and Marketing, joined 1st Security Bank of Washington in June 2016. Prior to her employment at the Bank, she served as Senior Vice President of Retail Banking and Marketing at Sound Community Bank and prior to that, Ms. Nielsen was Vice President, Sales and Service Manager of Retail Banking at Cascade Bank and its acquirer Opus Bank. Ms. Nielsen has 27 years of experience in the banking industry and started her banking career at Seafirst Bank and Bank of America.

Table of Contents

HOW WE ARE REGULATED

The following is a brief description of certain laws and regulations applicable to FS Bancorp and 1st Security Bank of Washington. Descriptions of laws and regulations here and elsewhere in this Form 10 K do not purport to be complete and are qualified in their entirety by reference to the actual laws and regulations. Legislation is introduced from time to time in the United States Congress or in the Washington State Legislature that may affect the operations of FS Bancorp and 1st Security Bank of Washington. In addition, the regulations governing the Company and the Bank may be amended from time to time by the FDIC, DFI, Federal Reserve and the Consumer Financial Protection Bureau (“CFPB”). Any such legislation or regulatory changes in the future could adversely affect our operations and financial condition. We cannot predict whether any such changes may occur.

The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Act. Among other changes, the Dodd-Frank Act established the CFPB as an independent bureau of the Federal Reserve. The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. However, as an institution with less than \$10 billion in assets, 1st Security Bank of Washington is subject to consumer protection regulations issued by the CFPB, supervision and enforcement of its compliance with consumer financial protection laws and regulations is conducted by the FDIC and the DFI.

Many aspects of the Dodd-Frank Act are to be implemented under regulations promulgated by the federal banking agencies, some of which have not been completed and which in some instances will not take effect for some time, making it difficult to anticipate the overall financial impact of the Dodd-Frank Act on 1st Security Bank of Washington, FS Bancorp and the financial services industry more generally.

In May 2018 the Economic Growth, Regulatory Relief and Consumer Protection Act (the “Act”), was enacted to modify or remove certain financial reform rules and regulations, including some of those implemented under the Dodd-Frank Act. While the Act maintains most of the regulatory structure established by the Dodd-Frank Act, it amends certain aspects of the regulatory framework for small depository institutions with assets of less than \$10 billion and for large banks with assets of more than \$50 billion. Many of these changes could result in meaningful regulatory changes for community banks such as the Bank, and their holding companies.

The Act, among other matters, expands the definition of qualified mortgages which may be held by a financial institution and simplifies the regulatory capital rules for financial institutions and their holding companies with total consolidated assets of less than \$10 billion by instructing the federal banking regulators to establish a single “Community Bank Leverage Ratio” of between 8 and 10 percent. Any qualifying depository institution or its holding company that exceeds the “community bank leverage ratio” will be considered to have met generally applicable leverage and risk-based regulatory capital requirements and any qualifying depository institution that exceeds the new ratio will be considered to be “well capitalized” under the prompt corrective action rules.

The Act also expands the category of holding companies that may rely on the “Small Bank Holding Company and Savings and Loan Holding Company Policy Statement” by raising the maximum amount of assets a qualifying holding company may have from \$1 billion to \$3 billion. The Federal Reserve made this change which became effective on August 30, 2018. In addition, the Act includes regulatory relief for community banks regarding regulatory examination cycles, call reports, mortgage disclosures and risk weights for certain high-risk commercial real estate loans.

It is difficult at this time to predict when or how any new standards under the Act will ultimately be applied to us or what specific impact the Act and the yet-to-be-written implementing rules and regulations will have on community banks.

Regulation of 1st Security Bank of Washington

General. 1st Security Bank of Washington, as a state-chartered savings bank, is subject to applicable provisions of Washington law and to regulations and examinations of the DFI. As an insured institution, it also is subject to examination and regulation by the FDIC, which insures the deposits of 1st Security Bank of Washington to the maximum permitted by law. During these state or federal regulatory examinations, the examiners may require 1st Security Bank of

Table of Contents

Washington to provide for higher general or specific loan loss reserves, which can impact capital and earnings. This regulation of 1st Security Bank of Washington is intended for the protection of depositors and the Deposit Insurance Fund (“DIF”) of the FDIC and not for the purpose of protecting shareholders of 1st Security Bank of Washington or FS Bancorp. 1st Security Bank of Washington is required to maintain minimum levels of regulatory capital and is subject to some limitations on the payment of dividends to FS Bancorp. See below “Regulatory Capital Requirements” and “Restrictions on Dividends and Stock Repurchases.”

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

Regulation by the Washington State Department of Financial Institutions. State law and regulations govern 1st Security Bank of Washington’s ability to take deposits and pay interest, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers, and to establish branch offices. As a state savings bank, 1st Security Bank of Washington must pay semi-annual assessments, examination costs and certain other charges to the DFI.

Washington law generally provides the same powers for Washington savings banks as federally and other-state chartered savings institutions and banks with branches in Washington, subject to the approval of the DFI. Washington law allows Washington savings banks to charge the maximum interest rates on loans and other extensions of credit to Washington residents which are allowable for a national bank in another state if higher than Washington limits. In addition, the DFI may approve applications by Washington savings banks to engage in an otherwise unauthorized activity, if the DFI determines that the activity is closely related to banking, and 1st Security Bank of Washington is otherwise qualified under the statute. This additional authority, however, is subject to review and approval by the FDIC if the activity is not permissible for national banks.

Insurance of Accounts and Regulation by the FDIC. Through the DIF, the FDIC insures deposit accounts in 1st Security Bank of Washington up to \$250,000 per separately insured per separately insured deposit ownership right or category. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. The Bank’s deposit insurance premiums for the year ended December 31, 2018, were \$517,000. Those premiums have been reduced in recent years due to management’s focus on asset quality, risk management, and growing capital levels.

The FDIC’s deposit insurance assessments are based on the assessment base for a bank, which is equal to its total average consolidated assets less average tangible capital. Based on the current reserve ratio of the DIF, FDIC assessment rates applicable to 1st Security Bank range from three basis points to 30 basis points, subject to certain adjustments where applicable for unsecured debt issued by the institution, brokered deposits, and unsecured debt of other FDIC-insured institutions. Under current regulations, if the reserve ratio becomes equal to, or greater than 2.0% and less than 2.5%, the assessment rates are scheduled to range from two basis points to 28 basis points (subject to adjustments as described above), and further reductions in rates may occur if the reserve ratio increases to 2.5% or more.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as 1st Security Bank of Washington. The FDIC also may prohibit any insured institution from engaging in any activity determined by



regulation or order to pose a serious risk to the DIF. No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation established in 1987 to recapitalize a predecessor deposit insurance fund. These assessments, which may be revised based upon the level of DIF deposits, will continue until the bonds mature in 2019 through 2021. This payment is assessed quarterly at an annualized rate applied to assessable assets. During 2018, the

Table of Contents

rate was 3.85%. The FDIC may terminate the deposit insurance of any insured depository institution, including 1st Security Bank of Washington, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily under certain circumstances. Management is aware of no existing circumstances which would result in termination of 1st Security Bank of Washington's deposit insurance.

A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of 1st Security Bank of Washington. There can be no prediction as to what changes in insurance assessment rates may be made in the future.

**Prompt Corrective Action.** Federal statutes establish a supervisory framework for FDIC-insured institutions based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category generally depends upon where its capital levels are in relation to relevant capital measures, which include risk-based capital measures, a leverage ratio capital measure and certain other factors. The well capitalized category is described below in "Capital Requirements". An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by 1st Security Bank of Washington to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At December 31, 2018, 1st Security Bank of Washington was categorized as well capitalized under the prompt corrective action regulations of the FDIC. For additional information, see "Capital Requirements" below and Note 14 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data," of this Form 10 K.

**Capital Requirements.** Effective January 1, 2015 (with some changes transitioned into full effectiveness over a number of years), 1st Security Bank of Washington became subject to new capital regulations adopted by the Federal Reserve and the FDIC, which created a new required ratio for common equity Tier 1 ("CET1") capital, increased the minimum leverage and Tier 1 capital ratios, changed the risk-weightings of certain assets for purposes of the risk-based capital ratios, required an additional capital conservation buffer over the minimum capital ratios, and changed what qualifies as capital for purposes of meeting the capital requirements. These regulations implement the regulatory capital reforms required by the Dodd Frank Act and the "Basel III" requirements.

Under the capital regulations, the minimum capital ratios are: (1) a CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total risk-based capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio (the ratio of Tier 1 capital to average total adjusted assets) of 4.0%. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income ("AOCI") unless an institution elects to exclude AOCI from regulatory capital; and certain minority interests; all subject to applicable regulatory adjustments and deductions. Tier 1 capital generally consists of CET1 and noncumulative perpetual preferred stock. Tier 2 capital generally consists of other preferred stock and subordinated debt meeting certain conditions plus an

amount of the allowance for loan and lease losses up to 1.25% of assets. Total capital is the sum of Tier 1 and Tier 2 capital.

In addition to the minimum capital requirements, a capital conservation buffer must be maintained by 1st Security Bank of Washington which consists of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, repurchasing shares, and paying discretionary

Table of Contents

bonuses. The new capital conservation buffer requirement was phased in beginning on January 1, 2016 when a buffer greater than 0.625% of risk-weighted assets was required, increasing each year until fully phased in on January 1, 2019.

To be considered well capitalized, a depository institution must have a Tier 1 risk-based capital ratio of at least 8.00%, a total risk-based capital ratio of at least 10%, a CET1 capital ratio of at least 6.50% and a leverage ratio of at least 5.00% and not be subject to an individualized order, directive or agreement under which its primary federal banking regulator requires it to maintain a specific capital level.

At December 31, 2018, 1st Security Bank of Washington met the requirements to be well capitalized and met the fully phased in capital conservation buffer requirement. Management monitors the capital levels of the Bank to provide for current and future business opportunities and to meet regulatory guidelines for well capitalized institutions. The Bank's actual capital ratios at December 31, 2018 and 2017 are presented in the following tables:

	Actual Ratio	For Capital Adequacy Purposes Ratio	For Capital Adequacy with Capital Buffer Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Ratio	
At December 31, 2018					
Total risk-based capital (to risk-weighted assets)	13.52	% 8.00	% 9.88	% 10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	12.62	% 6.00	% 7.88	% 8.00	%
Tier 1 leverage capital (to average assets)	10.67	% 4.00	% N/A	5.00	%
CET1 capital (to risk-weighted assets)	12.62	% 4.50	% 6.38	% 6.50	%

	Actual Ratio	For Capital Adequacy Purposes Ratio	For Capital Adequacy with Capital Buffer Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Ratio	
At December 31, 2017					
Total risk-based capital (to risk-weighted assets)	16.25	% 8.00	% 9.25	% 10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	15.00	% 6.00	% 7.25	% 8.00	%
Tier 1 leverage capital (to average assets)	12.61	% 4.00	% N/A	5.00	%
CET1 capital (to risk-weighted assets)	15.00	% 4.50	% 5.75	% 6.50	%

The FDIC also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution's capital level is or may become inadequate in light of particular risks or circumstances. Management of 1st Security Bank of Washington believes that, under the current regulations, 1st Security Bank of Washington will continue to meet its minimum capital requirements in the foreseeable future.

The FASB has adopted a new accounting standard for U.S. GAAP that will be effective for us for our first fiscal year beginning after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, requires FDIC-insured institutions and their holding companies (banking organizations) to recognize credit losses expected over the life of certain financial assets. CECL covers a broader range of assets than the current method of recognizing credit losses and generally results in earlier recognition of credit losses. Upon adoption of CECL, a banking organization must record a one-time adjustment to its credit loss allowances as of the beginning of the fiscal year of adoption equal to the difference, if any, between the amount of credit loss allowances under the current methodology and the amount required

Table of Contents

under CECL. For a banking organization, implementation of CECL is generally likely to reduce retained earnings, and to affect other items, in a manner that reduces its regulatory capital.

The federal banking regulators (the Federal Reserve, the Office of the Comptroller of the Currency and the FDIC) have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital.

For a complete description of the Bank's required and actual capital levels on December 31, 2018, see Note 14 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data," of this Form 10 K.

Standards for Safety and Soundness. The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to internal controls, information systems and internal audit systems; loan documentation; credit underwriting; interest rate risk exposure; asset growth; asset quality; earnings; and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Federal Home Loan Bank System. The FHLB of Des Moines is one of 11 regional FHLBs that administer the home financing credit function of savings institutions. The FHLBs are subject to the oversight of the Federal Housing Finance Agency and each FHLB serves as a reserve or central bank for its members within its assigned region. The FHLBs are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System and make loans or advances to members in accordance with policies and procedures established by the Board of Directors of the FHLB, which are subject to the oversight of the Federal Housing Finance Agency. All advances from a FHLB are required to be fully secured by sufficient collateral as determined by the FHLB. In addition, members are required to purchase stock equal to 4.0% of advances. That stock may be redeemed if advances are paid down. See "Business - Deposit Activities and Other Sources of Funds - Debt." At December 31, 2018, 1st Security Bank of Washington had \$9.9 million in FHLB of Des Moines stock, which was in compliance with this requirement.

The FHLB pays dividends quarterly, and 1st Security Bank of Washington received \$379,000 in dividends during the year ended December 31, 2018.

The FHLBs continue to contribute to low- and moderately-priced housing programs through direct loans or interest subsidies on advances targeted for community investment and low- and moderate-income housing projects. These contributions have adversely affected the level of FHLB dividends paid and could continue to do so in the future. These contributions could also have an adverse effect on the value of FHLB stock in the future. A reduction in value of 1st Security Bank of Washington's FHLB stock may result in a decrease in net income.

Commercial Real Estate Lending Concentrations. The federal banking agencies have issued guidance on sound risk management practices for concentrations in commercial real estate lending. The particular focus is on exposure to

commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be sensitive to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is not to limit a bank's commercial real estate lending but to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance directs the FDIC and other federal bank regulatory agencies to focus their supervisory resources on institutions that may have significant commercial real estate loan concentration risk. A bank that has experienced rapid growth in commercial real estate lending, has notable exposure to a specific type of commercial

Table of Contents

real estate loan, or is approaching or exceeding the following supervisory criteria may be identified for further supervisory analysis with respect to real estate concentration risk:

Total reported loans for construction, land development and other land represent 100% or more of the Bank's total regulatory capital; or

Total commercial real estate loans (as defined in the guidance) represent 300% or more of the Bank's total regulatory capital and the outstanding balance of the bank's commercial real estate loan portfolio has increased 50% or more during the prior 36 months.

The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory guidance on evaluation of capital adequacy. At December 31, 2018, 1st Security Bank of Washington's aggregate recorded loan balances for construction, land development and land loans were 131.2% of regulatory capital. In addition, at December 31, 2018, 1st Security Bank of Washington's loans on all commercial real estate, including construction, owner and non-owner occupied commercial real estate, and multi-family lending, as defined by the FDIC, were 300.0% of regulatory capital.

Activities and Investments of Insured State-Chartered Financial Institutions. Federal law generally limits the activities and equity investments of FDIC insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (1) acquiring or retaining a majority interest in a subsidiary, (2) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank's total assets, (3) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (4) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

Dividends. Dividends from 1st Security Bank of Washington constitute a major source of funds for dividends in future periods that may be paid by FS Bancorp to shareholders. The amount of dividends payable by 1st Security Bank of Washington to FS Bancorp depends upon the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies. According to Washington law, 1st Security Bank of Washington may not declare or pay a cash dividend on its capital stock if it would cause its net worth to be reduced below (1) the amount required for liquidation accounts or (2) the net worth requirements, if any, imposed by the Director of the DFI. Dividends on 1st Security Bank of Washington's capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of 1st Security Bank of Washington, without the approval of the Director of the DFI. The Bank paid \$1.4 million in dividends to the holding company in 2018.

The amount of dividends actually paid during any one period will be strongly affected by 1st Security Bank of Washington's policy of maintaining a strong capital position. Federal law further limits and can prohibit dividends when an institution does not meet the capital conservation buffer requirement and provides that no insured depository institution may pay a cash dividend if it would cause the institution to be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments are deemed to constitute an unsafe and unsound practice.

Affiliate Transactions. FS Bancorp and 1st Security Bank of Washington are separate and distinct legal entities. FS Bancorp (and any non-bank subsidiary of FS Bancorp) is an affiliate of 1st Security Bank of Washington. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates. Transactions deemed to be "covered transactions" under Section 23A of the Federal Reserve Act and between a bank and an affiliate are limited to 10% of the bank subsidiary's capital and surplus and, with respect to all affiliates, to an aggregate of 20% of the bank's



capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

Table of Contents

Community Reinvestment Act. 1st Security Bank of Washington is also subject to the provisions of the Community Reinvestment Act of 1977 (“CRA”), which requires the appropriate federal bank regulatory agency to assess a bank’s performance under the CRA in meeting the credit needs of the community serviced by the Bank, including low and moderate income neighborhoods. The regulatory agency’s assessment of a bank’s record is made available to the public. Further, a bank’s CRA performance rating must be considered in connection with a bank’s application to, among other things, establish a new branch office that will accept deposits, relocate an existing office or merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution, and in connection with certain applications by a bank holding company, such as bank acquisitions. 1st Security Bank of Washington received a “satisfactory” rating during its most recent CRA examination.

Privacy Standards. 1st Security Bank of Washington is subject to FDIC regulations implementing the privacy protection provisions of the Gramm-Leach-Bliley Act of 1999. These regulations require 1st Security Bank of Washington to disclose its privacy policy, including informing consumers of its information sharing practices and informing consumers of its rights to opt out of certain practices.

Environmental Issues Associated with Real Estate Lending. The Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”) is a federal statute that generally imposes strict liability on, all prior and present “owners and operators” of sites containing hazardous waste. However, Congress asked to protect secured creditors by providing that the term “owner and operator” excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this “secured creditor exemption” has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including 1st Security Bank of Washington, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System. The Federal Reserve requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the regional Federal Reserve Bank. NOW accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. At December 31, 2018, 1st Security Bank of Washington’s deposit with the Federal Reserve Bank and vault cash exceeded its reserve requirements.

Other Consumer Protection Laws and Regulations. The Dodd-Frank Act established the CFPB and empowered it to exercise broad regulatory, supervisory and enforcement authority with respect to both new and existing consumer financial protection laws. 1st Security Bank of Washington is subject to consumer protection regulations issued by the CFPB, but as a financial institution with assets of less than \$10 billion, 1st Security Bank of Washington is generally subject to supervision and enforcement by the FDIC and the DFI with respect to compliance with consumer financial protection laws and CFPB regulations.

1st Security Bank of Washington is subject to a broad array of federal and state consumer protection laws and regulations that govern almost every aspect of its business relationships with consumers. While the list set forth below is not exhaustive, these include the Truth-in-Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Right to Financial Privacy Act, the Home Ownership and Equity Protection Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Homeowners Protection Act, the Check Clearing for the 21st Century Act, laws governing flood insurance, laws governing consumer protections in connection with the sale of insurance, federal and state laws prohibiting unfair and deceptive business practices, and various regulations that

implement the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans, and providing other services. Failure to comply with these laws and regulations can subject 1st Security Bank of Washington to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

Table of Contents

Regulation and Supervision of FS Bancorp

General. FS Bancorp is a bank holding company registered with the Federal Reserve and is the sole shareholder of 1st Security Bank of Washington. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended (“BHCA”), and the regulations promulgated there under. This regulation and oversight is generally intended to ensure that FS Bancorp limits its activities to those allowed by law and that it operates in a safe and sound manner without endangering the financial health of 1st Security Bank of Washington.

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

The Bank Holding Company Act. Under the BHCA, FS Bancorp is supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd-Frank Act provides that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial stress to the bank. A bank holding company’s failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve’s regulations or both. No regulations have yet been proposed by the Federal Reserve to implement the source of strength doctrine required by the Dodd-Frank Act. FS Bancorp and any subsidiaries that it may control are considered “affiliates” of 1st Security Bank of Washington within the meaning of the Federal Reserve Act, and transactions between 1st Security Bank of Washington and its affiliates are subject to numerous restrictions. With some exceptions, FS Bancorp and its subsidiaries are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by FS Bancorp or its subsidiaries.

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

Regulatory Capital Requirements. As discussed above, pursuant to the Act, effective August 30, 2018, bank holding companies with less than \$3 billion in consolidated assets were generally no longer subject to the Federal Reserve’s capital regulations, which are generally the same as the capital regulations applicable to 1st Security Bank of Washington. At the time of this change, FS Bancorp was considered “well capitalized” (as defined for a bank holding company), and was not subject to an individualized order, directive or agreement under which the Federal Reserve requires it to maintain a specific capital level.



Table of Contents

The Company's regulatory capital amounts and ratios at December 31, 2018 are presented in the following table.

	Actual Amount	Ratio	For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2018								
Total risk-based capital (to risk-weighted assets)	\$ 185,636	13.32 %	\$ 111,493	8.00 %	\$ 137,694	9.88 %	\$ 139,366	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 172,988	12.41 %	\$ 83,620	6.00 %	\$ 109,820	7.88 %	\$ 111,493	8.00 %
Tier 1 leverage capital (to average assets)	\$ 172,988	12.07 %	\$ 57,317	4.00 %	\$ —	N/A	\$ 71,647	5.00 %
CET1 capital (to risk-weighted assets)	\$ 172,988	12.41 %	\$ 62,715	4.50 %	\$ 88,846	6.38 %	\$ 90,588	6.50 %

For additional information, see Note 14 to the Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data" of this Form 10 K.

**Interstate Banking.** The Federal Reserve may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the law of the host state. Nor may the Federal Reserve approve an application if the applicant controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

The federal banking agencies are generally authorized to approve interstate merger transactions without regard to whether the transaction is prohibited by the law of any state. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions are also subject to the nationwide and statewide insured deposit concentration amounts described above.

**Restrictions on Dividends and Stock Repurchases.** FS Bancorp's ability to declare and pay dividends is subject to the Federal Reserve limits and Washington law, and it may depend on its ability to receive dividends received from 1st

Security Bank of Washington.

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

Except for a company that meets the applicable standard to be considered a well capitalized and well-managed bank holding company and is not subject to any unresolved supervisory issues, a bank holding company is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation or regulatory order, condition, or written agreement.

## Table of Contents

Under Washington corporate law, FS Bancorp generally may not pay dividends if after that payment it would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than the sum of its total liabilities.

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

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

Sarbanes-Oxley Act of 2002. As a public company that files periodic reports with the SEC, under the Securities Exchange Act of 1934, FS Bancorp is subject to the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”), which addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

The Dodd-Frank Act. The Dodd-Frank Act of 2010 imposed new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions, and implements new capital regulations that FS Bancorp and 1st Security Bank of Washington have and will become subject to and that are discussed above under the section entitled “Regulation of 1st Security Bank of Washington - Capital Requirements.”

In addition, among other changes, the Dodd-Frank Act requires public companies like FS Bancorp, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a “say on pay” vote every one, two, or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions, or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer’s annual total compensation to the median annual total compensation of all other employees. For certain of these changes, the implementing regulations have not been promulgated, so the full impact of the Dodd-Frank Act on public companies cannot be determined at this time.

## TAXATION

### Federal Taxation

General. FS Bancorp and 1st Security Bank of Washington are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to FS Bancorp. 1st Security Bank of Washington is no longer subject to U.S. federal income tax examinations by tax authorities for years ended before 2015, and income tax returns have not been audited for the past seven years, 2012 to 2018. On December 22, 2017, the U.S. Government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act amended the Internal Revenue Code



to reduce tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduced the corporate federal income tax rate from a maximum of 35% to a flat 21% rate. The corporate income tax rate reduction was effective January 1, 2018.

FS Bancorp files a consolidated federal income tax return with 1st Security Bank of Washington. Accordingly, any cash distributions made by FS Bancorp to its shareholders would be considered to be taxable dividends and not as a non-taxable return of capital to shareholders for federal and state tax purposes. For additional information, see Note 11 of

## Table of Contents

the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

**Method of Accounting.** For federal income tax purposes, FS Bancorp currently reports its income and expenses on the accrual method of accounting and uses a fiscal year ending on December 31 for filing its federal income tax return.

**Minimum Tax.** The Internal Revenue Code imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, called alternative minimum taxable income. The alternative minimum tax is payable to the extent such alternative minimum taxable income is in excess of an exemption amount. Net operating losses can offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years.

**Corporate Dividends Received Deduction.** FS Bancorp may eliminate from its income dividends received from 1st Security Bank of Washington as a wholly owned subsidiary of FS Bancorp if it elects to file a consolidated return with 1st Security Bank of Washington. The corporate dividends-received deduction is 100%, or 80%, in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, depending on the level of stock ownership of the payor of the dividend. Corporations which own less than 20% of the stock of a corporation distributing a dividend may deduct 70% of dividends received or accrued on their behalf.

## Washington Taxation

The Company and the Bank are subject to a business and occupation tax which is imposed under Washington law at the rate of 1.50% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities are not subject to this tax.

## Item 1A. Risk Factors

An investment in our common stock is subject to risks inherent in our business. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included in this report and our other filings with the SEC. In addition to the risks and uncertainties described below, other risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition, capital levels, cash flows, liquidity, results of operations, and prospects. The market price of our common stock could decline significantly due to any of these identified or other risks, and you could lose some or all of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements. This report is qualified in its entirety by these risk factors.

### Risks Related to Our Business

Our business may be adversely affected by downturns in the national economy and in the economies in our market areas.

Our primary market areas are in the Puget Sound region of Washington and Kitsap, Clallam, Jefferson, Grays Harbor, Thurston, Lewis, and Benton counties. Our business is directly affected by market conditions, trends in industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies, and inflation, all of which are beyond our control. General economic conditions, including inflation, unemployment and money supply fluctuations, also may affect our profitability adversely. A decline in the economies of the counties in which we operate could have a material adverse effect on our business, financial condition, results of operations, and

prospects. Weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade and it is not known how the recent changes in tariffs being imposed on international trade may also affect these businesses. Changes in agreements or relationships between the United States and other countries may also affect these businesses.

## Table of Contents

While real estate values and unemployment rates have recently improved, a deterioration in economic conditions in the market areas we serve could result in loan losses beyond that which is provided for in our allowance for loan losses and could result in the following consequences, any of which could have a material adverse effect on the business, financial condition, and results of operations:

- demand for our products and services may decline, possibly resulting in a decrease in our total loans or assets;
- loan delinquencies, problem assets and foreclosures may increase;
- we may increase our allowance for loan losses;
- collateral for our loans may further decline in value, in turn reducing customer's borrowing power, reducing the value of assets and collateral associated with existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our low-cost or noninterest-bearing deposits may decrease.

A decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are geographically diverse. Many of the loans in our portfolio are secured by real estate or fixtures attached to real estate. Deterioration in the real estate markets where collateral for a mortgage loan is located could negatively affect the borrower's ability to repay the loan and the value of the collateral securing the loan. Real estate values are affected by various other factors, including changes in general or regional economic conditions, governmental rules or policies, and natural disasters such as earthquakes. If we are required to liquidate a significant amount of collateral during a period of reduced real estate values, our financial condition and profitability could be adversely affected.

Adverse changes in the regional and general economy could reduce our growth rate, impair our ability to collect loans, and generally have a negative effect on our financial condition and results of operations.

Our loan portfolio possesses increased risk due to a large percentage of consumer loans.

Our consumer loans accounted for \$275.5 million, or 20.8% of our total gross loan portfolio as of December 31, 2018, of which \$167.8 million (60.9% of total consumer loans) consisted of indirect home improvement loans (some of which were not secured by a lien on the real property), \$57.8 million (21.0% of total consumer loans) consisted of marine loans secured by boats, \$44.4 million (16.1% of total consumer loans) consisted of solar loans, and \$5.4 million (2.0% of total consumer loans) consisted of other consumer loans, which includes personal lines of credit, credit cards, automobile, direct home improvement, loans on deposit, and recreational loans. Generally, we consider these types of loans to involve a higher degree of risk compared to first mortgage loans on owner-occupied, one-to-four-family residential properties. As a result of our large portfolio of consumer loans, it may become necessary to increase the level of provision for our loan losses, which would reduce profits. Consumer loans generally entail greater risk than do one-to-four-family residential mortgage loans, particularly in the case of loans that are secured by rapidly depreciable assets, such as automobiles and boats. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance.

Most of our consumer loans are originated indirectly by or through third parties, which presents greater risk than our direct lending products which involves direct contact between us and the borrower. Unlike a direct loan where the borrower makes an application directly to us, in these loans the dealer, who has a direct financial interest in the loan transaction, assists the borrower in preparing the loan application. Although we disburse the loan proceeds directly to the dealer upon receipt of a "completion certificate" signed by the borrower, because we do not have direct contact with the borrower, these loans may be more susceptible to a material misstatement on the loan application or having the loan proceeds being misused by the borrower or the dealer. In addition, if the work is not properly performed, the borrower may cease payment on the loan until the problem is rectified. Although we file a UCC-2 financing statement to perfect the security interest in the personal property collateral for most fixture and solar loans, there are no guarantees on our ability



Table of Contents

to collect on that security interest or that the repossessed collateral for a defaulted fixture or solar loan will provide an adequate source of repayment for the outstanding loan given the limited stand-alone value of the collateral.

Indirect home improvement, marine, and solar loans totaled \$270.0 million, or 20.4% of our total gross loan portfolio at December 31, 2018, and are originated through a network of 162 home improvement contractors and dealers located in Washington, Oregon, California, Idaho, Colorado, and Arizona. At December 31, 2018, the Company had \$60.5 million of these types of loans to borrowers residing in California. Adverse economic conditions in California, including an increase in the level of unemployment, or a decline in real estate values could adversely affect the ability of these borrowers to make loan payments to us.

In addition, we rely on 10 dealers for a majority, or 54.1% of our loan volume so the loss of one of these dealers can have a significant effect on our loan origination volume. See “Item 1. Business - Lending Activities - Consumer Lending” and “- Asset Quality.”

Our business could suffer if we are unsuccessful in making, continuing, and growing relationships with home improvement contractors and dealers.

Our indirect home improvement lending, which is the largest component of our consumer loan portfolio, is reliant on our relationships with home improvement contractors and dealers. In particular, our indirect home improvement loan operations depend in large part upon our ability to establish and maintain relationships with reputable contractors and dealers who originate loans at the point of sale. Our indirect home improvement contractor/dealer network is currently comprised of 162 active contractors and dealers with businesses located throughout Washington, Oregon, California, Idaho, Colorado, and Arizona, with approximately 10 contractors/dealers responsible for more than half of this loan volume. Indirect home improvement and solar loans totaled \$212.2 million, or 16.0% of our total gross loan portfolio, at December 31, 2018, reflecting approximately 16,000 loans with an average balance of approximately \$13,000.

We have relationships with home improvement contractors/dealers, however, the relationships generally are not exclusive, some of them are newly established and they may be terminated at any time. If there is another economic downturn and contraction of credit to both contractors/dealers and their customers, there could be an increase in business closures and our existing contractor/dealer base could experience decreased sales and loan volume, which may have an adverse effect on our business, results of operations and financial condition. In addition, if a competitor were to offer better service or more attractive loan products to our contractor/dealer partners, it is possible that our partners would terminate their relationships with us or recommend customers to our competitors. If we are unable to continue to grow our existing relationships and develop new relationships, our results of operations and financial condition could be adversely affected.

A significant portion of our business involves commercial real estate lending which is subject to various risks that could adversely impact our results of operations and financial condition.

At December 31, 2018, our loan portfolio included \$309.4 million of commercial real estate and multi-family real estate loans, or 23.3% of our total gross loan portfolio, compared to \$108.1 million, or 14.0%, at December 31, 2017. We have been increasing and intend to continue to increase, subject to market demand, the origination of commercial and multi-family real estate loans. The credit risk related to these types of loans is considered to be greater than the risk related to one-to-four-family residential loans because the repayment of commercial and multi-family real estate loans typically is dependent on the successful operation and income stream of the property securing the loan and the value of the real estate securing the loan as collateral, which can be significantly affected by economic conditions.

Our focus on these types of loans will increase the risk profile relative to traditional one-to-four-family lenders as we continue to implement our business strategy. Although commercial and multi-family real estate loans are intended to

enhance the average yield of the earning assets, they do involve a different, and possibly higher, level of risk of delinquency or collection than generally associated with one-to-four-family loans for a number of reasons. Among other factors, these loans involve larger balances to a single borrower or groups of related borrowers. Since commercial real estate and multi-family real estate loans generally have large balances, if we make any errors in judgment in the collectability of these loans, we may need to significantly increase the provision for loan losses since any resulting charge offs will be larger on a per loan basis. Consequently, this could materially adversely affect our future earnings.

## Table of Contents

Collateral evaluation for these types of loans also requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. In addition, most of our commercial and multi-family loans are not fully amortizing and include balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. Finally, if foreclosure occurs on a commercial real estate loan, the holding period for the collateral, if any, typically is longer than for a one-to-four-family residence because the secondary market for most types of commercial and multi-family real estate is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these assets. See “Item 1. Business - Lending Activities - Commercial Real Estate Lending” of this Form 10 K.

Repayment of our commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.

At December 31, 2018, our commercial business loan portfolio included commercial and industrial loans of \$138.7 million, or 10.5%, and warehouse lending of \$65.8 million, or 5.0%, of our total gross loan portfolio compared to commercial and industrial loans of \$83.3 million, or 10.8%, and warehouse lending of \$41.4 million, or 5.3% at December 31, 2017. Commercial business lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral-based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial and industrial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers’ cash flow may be unpredictable and collateral securing these loans may fluctuate in value. This collateral may consist of equipment, inventory, accounts receivable, or other business assets. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing these loans may depreciate over time, may be difficult to appraise, may be illiquid, and may fluctuate in value based on the specific type of business and equipment. As a result, the availability of funds for the repayment of commercial and industrial business loans may be substantially dependent on the success of the business itself, which, in turn, is often dependent in part upon general economic conditions and secondarily on the underlying collateral provided by the borrower. For additional information related to the risks of warehouse lending, see “Our residential mortgage warehouse lending and construction warehouse lending programs are subject to various risks that could adversely impact our results of operations and financial condition.”

We continue to expand residential construction lending which is subject to various risks that could adversely impact our results of operations and financial condition.

We make real estate construction loans to individuals and builders, primarily for the construction of residential properties. We originate these loans whether or not the collateral property underlying the loan is under contract for sale. At December 31, 2018, construction and development loans totaled \$247.3 million, or 18.7% of our total gross loan portfolio (excluding \$76.9 million of undisbursed construction loan commitments), of which \$196.5 million were for residential real estate projects. This compares to construction and development loans of \$143.1 million, or 18.5% of our total loan portfolio at December 31, 2017, or an increase of 72.3% during the past year. In addition to these construction and development loans, the Company had nine commercial note-secured lines of credit to residential construction re-lenders with combined commitments of \$87.0 million, and an outstanding balance of \$61.4 million at December 31, 2018. Construction financing is generally considered to involve a higher degree of credit risk than longer term financing on improved, owner-occupied real estate.

In general, construction lending involves additional risks because funds are advanced upon estimates of costs in relation to values associated with the completed project. Construction lending involves additional risks when compared with permanent residential lending because funds are advanced upon the collateral for the project based on



an estimate of costs that will produce a future value at completion. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the complete project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the completed project loan-to-value ratio. Changes in demand for new housing and higher than anticipated building costs may cause actual results to vary significantly from those estimated. For these reasons, this type of lending also typically involves higher loan principal amounts and may be concentrated with a small number of builders. A downturn in housing, or the real estate market, could increase delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell

Table of Contents

the collateral upon foreclosure. Some of the builders we deal with have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss. In addition, during the term of most of our construction loans, no payment from the borrower is required since the accumulated interest is added to the principal of the loan through an interest reserve. As a result, these loans often involve the disbursement of funds with repayment substantially dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property or obtain permanent take-out financing, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of a completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project and may incur a loss. Because construction loans require active monitoring of the building process, including cost comparisons and on-site inspections, these loans are more difficult and costly to monitor.

Increases in market rates of interest may have a more pronounced effect on construction loans by rapidly increasing the end-purchaser's borrowing costs, thereby possibly reducing the homeowner's ability to finance the home upon completion or the overall demand for the project. Properties under construction are often difficult to sell and typically must be completed in order to be successfully sold which also complicates the process of working out problem construction loans. This may require us to advance additional funds and/or contract with another builder to complete construction and assume the market risk of selling the project at a future market price, which may or may not enable us to fully recover unpaid loan funds and associated construction and liquidation costs. Furthermore, in the case of speculative construction loans, there is the added risk associated with identifying an end-purchaser for the finished project. At December 31, 2018, outstanding construction and development loans totaled \$247.3 million of which \$140.6 million was comprised of speculative one-to-four-family construction loans and \$13.7 million of land acquisition and development loans. Approximately \$9.3 million of our residential construction loans at December 31, 2018 were made to finance the custom construction of owner-occupied homes and are structured to be converted to permanent loans at the end of the construction phase. Total committed, including unfunded construction and development loans at December 31, 2018 was \$331.7 million. Loans on land under development or held for future construction pose additional risks because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest. No real estate construction and development loans were non-performing at December 31, 2018. A material increase in our non-performing construction and development loans could have a material adverse effect on our financial condition and results of operation.

Our construction warehouse lending and residential mortgage warehouse lending programs are subject to various risks that could adversely impact our results of operations and financial condition.

Our commercial construction warehouse lending program provides lines secured by notes on residential construction loans and typically guaranteed by principals with experience in construction lending. At December 31, 2018, the Company had \$87.0 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from \$5.0 million to \$24.0 million. At December 31, 2018, there was \$61.4 million outstanding, compared to \$84.7 million approved in commercial warehouse lending lines for nine companies with \$34.0 million outstanding at December 31, 2017. The underlying collateral risks associated with our commercial construction warehouse lines are similar to the risks related to our residential construction and development loans.

The Company also has residential mortgage warehouse lending program that focuses on four Pacific Northwest mortgage banking companies. Short-term funding is provided to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. Our warehouse lending lines are secured by the underlying notes associated with mortgage loans made to borrowers by the mortgage banking company and we

generally require guarantees from the principle shareholder(s) of the mortgage banking company. Because these loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down our outstanding loan before being dispersed to the mortgage bank, interest rate fluctuation is also a key risk factor affecting repayment. At December 31, 2018, we had approved residential warehouse lending lines in varying amounts from \$4.0 million to \$8.0 million with each of the four companies, for an aggregate amount of \$23.0 million. During the year ended December 31, 2018, we processed approximately 740 loans and funded approximately \$275.4 million under this program. Our residential mortgage warehouse related gross revenues totaled \$360.9 million for the year ended December 31, 2018.

Table of Contents

At December 31, 2018, there was \$4.4 million in residential warehouse lines outstanding, compared to \$7.4 million outstanding at December 31, 2017. See “We continue to expand residential construction lending which is subject to various risks that could adversely impact our results of operations and financial condition.”

There are numerous risks associated with residential mortgage warehouse lending, which include, without limitation, (i) credit risks relating to the mortgage bankers that borrow from us, (ii) the risk of intentional misrepresentation or fraud by any of these mortgage bankers, (iii) changes in the market value of mortgage loans originated by the mortgage banker, the sale of which is the expected source of repayment of the borrowings under the warehouse line of credit, due to changes in interest rates during the time in warehouse, (iv) unsalable or impaired mortgage loans originated, which could lead to decreased collateral value and the failure of a purchaser of the mortgage loan to purchase the loan from the mortgage banker, and (v) the volatility of mortgage loan originations.

Additionally, the impact of interest rates on our residential mortgage warehouse lending business can be significant. Changes in interest rates can impact the number of residential mortgages originated and initially funded under our residential mortgage warehouse lines of credit and thus our residential mortgage warehouse related revenues and may also impact repayment of our commercial construction warehouse lines. A decline in mortgage rates generally increases the demand for mortgage loans. Conversely, in a constant or increasing rate environment, we would expect fewer loans to be originated. In addition, because our residential warehouse lending balances are contingent upon residential mortgage lending activity, changes in the residential real estate market nationwide can also lead to wide fluctuations of balances in this lending product, materially impacting both interest and non-interest income. Further, residential warehouse lending period-end balances are generally higher than the average balance during the period due to increased mortgage activity that occurs at the end of a month, which can significantly impact the Company's reported capital ratios.

The level of our commercial real estate loan portfolio may subject us to additional regulatory scrutiny.

The FDIC, the Federal Reserve and the Office of the Comptroller of the Currency have promulgated joint guidance on sound risk management practices for financial institutions with concentrations in commercial real estate lending. Under this guidance, a financial institution that, like us, is actively involved in commercial real estate lending should perform a risk assessment to identify concentrations. A financial institution may have a concentration in commercial real estate lending if, among other factors (i) total reported loans for construction, land development and other land represent 100% or more of total capital, or (ii) total reported loans secured by multi-family and non-farm non-residential properties, loans for construction, land development and other land, and loans otherwise sensitive to the general commercial real estate market, including loans to commercial real estate related entities, represent 300% or more of total capital. The particular focus of the guidance is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be at greater risk to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance states that management should employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing.

Based on factor (i) mentioned above, we have concluded that we have a concentration in commercial real estate lending because our total reported loans for construction, land development, and other land at December 31, 2018 represent 100% or more of total capital. While we believe we have implemented policies and procedures with respect to our commercial real estate loan portfolio consistent with this guidance, bank regulators could require us to implement additional policies and procedures consistent with their interpretation of the guidance that may result in additional costs to us.

Our lending limit may limit growth.

The Board of Directors has implemented a policy lending limit that it believes matches the Washington State legal lending limit. Our policy limits loans to one borrower and the borrower's related entities to 20% of our unimpaired capital and surplus, or \$39.1 million at December 31, 2018. Management has adopted an internal lending limit of a maximum of 80% of the Bank's legal lending limit for risk mitigation purposes and all loans over this limit require approval from the AQC. These amounts are less than that of many of our competitors and may discourage potential commercial

50

---

Table of Contents

borrowers who have credit needs in excess of our lending limit from doing business with us. The lending limit also impacts the efficiency of our commercial lending operation because it tends to lower the average loan size, which means a higher number of transactions have to be generated to achieve the same portfolio volume. We can accommodate larger loans by selling participations in those loans to other financial institutions, but this strategy is not efficient or always available. We may not be able to attract or maintain clients seeking larger loans or may not be able to sell participations in these loans on terms that are considered favorable.

Revenue from mortgage banking operations are sensitive to changes in economic conditions, decreased economic activity, a slowdown in the housing market, higher interest rates or new legislation and may adversely impact our financial condition and results of operations.

Our mortgage banking program, which we restarted in the fourth quarter of 2011 in an effort to diversify our revenue streams and to generate additional income is dependent upon our ability to originate and sell loans to investors. Mortgage revenues are primarily generated from gains on the sale of one-to-four-family residential loans underwritten to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae, FHA, VA, USDA Rural Housing, the FHLB, and other non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. We sell loans on both a servicing retained and servicing released basis utilizing market execution analysis and customer relationships as the criteria. Any future changes in these programs, our eligibility to participate in these programs, the criteria for loans to be accepted, or laws that significantly affect the activity of these entities could, in turn, materially adversely affect the success of our mortgage banking program and, consequently, our results of operations.

Mortgage loan production levels are sensitive to changes in economic conditions and can suffer from decreased economic activity, a slowdown in the housing market or higher interest rates. Generally, any sustained period of decreased economic activity or higher interest rates could adversely affect mortgage originations and, consequently, adversely affect income from mortgage lending activities.

In the past several years, as a result of government actions and other economic factors related to the economic downturn, interest rates have been at historically low levels. In December 2018, the Federal Reserve slightly increased the targeted Fed Funds rate by 25 basis points for the fourth time within a year and indicated further increases may occur during 2019 subject to economic conditions. As the Federal Reserve increases the Fed Funds rate, refinancing activity typically declines and new home purchases may be negatively impacted. To the extent that market interest rates increase in the future, our ability to originate mortgage loans held for sale may decrease, resulting in fewer loans that are available to be sold to investors. This would adversely affect our ability to generate mortgage revenues, and consequently noninterest income. Because interest rates depend on factors outside of our control, we cannot eliminate the interest rate risk associated with our mortgage operations.

Our results of operations will also be affected by the amount of noninterest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense, and other operating costs. If we cannot generate a sufficient volume of loans for sale, our results of operations may be adversely affected. In addition, during periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

When we sell or securitize mortgage loans in the ordinary course of business, we are required to make certain representations and warranties to the purchaser about the mortgage loans and the manner in which they were originated. Under these agreements, we may be required to repurchase mortgage loans if we have breached any of these representations or warranties, in which case we may record a loss. In addition, if repurchase and indemnity demands increase on loans that we sell from our portfolios, our liquidity, results of operations, and financial condition could be adversely affected.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could be reduced.

While conditions in the housing and real estate markets and economic conditions in our market areas have recently improved, if slow economic conditions return or real estate values and sales deteriorate, we may experience higher delinquencies and credit losses. As a result, we could be required to increase our provision for loan losses and to charge-

51

---

Table of Contents

off additional loans in the future. If charge-offs in future periods exceed the allowance for loan losses, we may need additional provisions to replenish the allowance for loan and lease losses.

We maintain our allowance for loan losses at a level that management considers adequate to absorb probable loan losses based on an analysis of our portfolio and market environment. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review loans and our historical loss and delinquency experience and evaluate economic conditions. Management recognizes that significant new growth in loan portfolios, new loan products, and the refinancing of existing loans can result in portfolios comprised of unseasoned loans that may not perform in a historical or projected manner and will increase the risk that our allowance may be insufficient to absorb losses without significant additional provisions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover actual losses, resulting in additional provisions for loan losses to replenish the allowance for loan losses. Deterioration in economic conditions, new information regarding existing loans, identification of additional problem loans or relationships, and other factors, both within and outside of our control, may increase our loan charge-offs and/or may also otherwise also require an increase in our provision for loan losses.

In addition, the FASB has adopted a new accounting standard referred to as Current Expected Credit Loss, or CECL, which will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for credit losses. This will change the current method of providing allowances for credit losses only when they have been incurred and are probable, which may require us to increase our allowance for loan losses, and may greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for credit losses. This accounting pronouncement is expected to be applicable to us for our first fiscal year after December 15, 2019. We are evaluating the impact the CECL accounting model will have on our accounting, but expect to recognize a one-time cumulative-effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. We cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our financial condition or results of operations. The federal banking regulators, including the Federal Reserve and the FDIC, have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital. Any increase in our allowance for loan losses or expenses incurred to determine the appropriate level of the allowance for loan losses may have a material adverse effect on our financial condition and results of operations. For more on this new accounting standard, see Note 1 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10-K.

Our allowance for loan losses was 0.9% of total gross loans, and 317.1% of non-performing loans at December 31, 2018, compared to 1.4% of total gross loans, and 1,035.2% of non-performing loans at December 31, 2017. 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 their judgment about information available to them at the time of their examination. 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 capital.

The unseasoned nature of our commercial business, commercial construction, and commercial real estate portfolios may result in difficulties in judging collectability, which may lead to additional provisions or charge-offs, which would reduce our profits.

As a result of our rapid growth, a significant portion of our loan portfolio at any given time is of relatively recent origin. Typically, loans do not begin to show signs of credit deterioration or default until they have been outstanding



for some period of time (which varies by loan duration and loan type), a process referred to as “seasoning.” During the period from January 1, 2012 through December 31, 2018, we originated \$1.38 billion of commercial loans, including loans in process, with an outstanding balance of \$809.6 million, at December 31, 2018. As a result, a significant portion of the portfolio is relatively unseasoned and some borrowers may not have had sufficient time to perform to properly indicate the magnitude of potential losses. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which could have a material adverse effect on our business, financial condition, results of operations, and growth prospects.

Table of Contents

Our business may be adversely affected by credit risk associated with residential property.

At December 31, 2018, \$249.4 million, or 18.8% of our total loan portfolio was secured by first liens on one-to-four-family residential loans and our home equity lines of credit totaled \$40.3 million, or 3.0% of our total loan portfolio. These types of loans are generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. A decline in residential real estate values resulting from a downturn in the Washington housing markets in which our loans are concentrated may reduce the value of the real estate collateral securing these types of loans and increase our risk of loss if borrowers default on their loans. A decline in economic conditions or in the volume of real estate sales and/or the sales prices coupled with elevated unemployment rates may result in higher than expected loan delinquencies or problem assets, and a decline in demand for our products and services. In addition, residential loans with high combined loan-to-value ratios will be more sensitive to the fluctuation of property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. Further, the majority of our home equity lines of credit consist of second mortgage loans. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. For these reasons, we may experience higher rates of delinquencies, defaults and losses which would adversely affect our net income.

We may be adversely affected by recent changes in U.S. tax laws.

Changes in tax laws contained in the Tax Act, which was enacted in December 2017, include a number of provisions that will have an impact on the banking industry, borrowers and the market for single-family residential real estate. Changes include (i) a lower limit on the deductibility of mortgage interest on single-family residential mortgage loans, (ii) limitations on interest deductions for home equity loans, (iii) a limitation on the deductibility of business interest expense, and (iv) a limitation on the deductibility of property taxes and state and local income taxes. The recent changes in the tax laws may have an adverse effect on the market for, and valuation of, residential properties, and on the demand for such loans in the future and could make it harder for borrowers to make their loan payments. If home ownership becomes less attractive, demand for mortgage loans could decrease which could adversely affect our business and loan growth. The value of the properties securing loans in our loan portfolio may also be adversely impacted as a result of the changing economics of home ownership, which could require an increase in our provision for loan losses, which would reduce our profitability and could materially adversely affect our business, financial condition and results of operations.

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

At December 31, 2018, \$126.1 million, or 9.5% of our total loan portfolio, consisted of loans secured by non-owner occupied commercial real estate properties. Loans secured by non-owner occupied properties generally expose a lender to greater risk of non-payment and loss than loans secured by owner occupied properties because repayment of such loans depend primarily on the tenant's continuing ability to pay rent to the property owner, who is our borrower, or, if the property owner is unable to find a tenant, the property owner's ability to repay the loan without the benefit of a rental income stream. Furthermore, some of our non-owner occupied commercial loan borrowers have more than one loan outstanding with us. At December 31, 2018, we had 17 non-owner occupied commercial multi-loan relationships, the largest of which had a combined outstanding balance of \$10.7 million, with an aggregate outstanding balance of \$54.0 million. Consequently, an adverse development with respect to one credit relationship may expose us to a greater risk of loss compared to an adverse development with respect to an owner occupied commercial real estate loan.

We occasionally purchase loans in bulk or “pools.” We may experience lower yields or losses on loan pools because the assumptions we use when purchasing loans in bulk may not prove correct.

From time to time, we purchase real estate loans in bulk or “pools.” When we determine the purchase price we are willing to pay to purchase loans in bulk, management makes certain assumptions about, among other things, how fast borrowers will prepay their loans, the real estate market and our ability to collect loans successfully and, if necessary, to dispose of any real estate that may be acquired through foreclosure. When we purchase loans in bulk, we perform certain due diligence procedures and we purchase the loans subject to customary limited indemnities. To the extent that our underlying assumptions prove to be inaccurate or the basis for those assumptions change (such as an unanticipated decline

## Table of Contents

in the real estate market), the purchase price paid for pools of loans may prove to have been excessive, resulting in a lower yield or a loss of some or all of the loan principal. For example, if we purchase pools of loans at a premium and some of the loans are prepaid before we expected we will earn less interest income on the purchase than expected. Our success in growing through purchases of loan pools depends on our ability to price loan pools properly and on general economic conditions in the geographic areas where the underlying properties of our loans are located.

Acquiring loans through bulk purchases may involve acquiring loans of a type or in geographic areas where management may not have substantial prior experience. We may be exposed to a greater risk of loss to the extent that bulk purchases contain such loans.

Uncertainty relating to the London Interbank Offered Rate ("LIBOR") calculation process and potential phasing out of LIBOR may adversely affect our results of operations.

On July 27, 2017, the Chief Executive of the United Kingdom Financial Conduct Authority, which regulates LIBOR, announced that it intends to stop persuading or compelling banks to submit rates for the calibration of LIBOR to the administrator of LIBOR after 2021. The announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. It is impossible to predict whether and to what extent banks will continue to provide LIBOR submissions to the administrator of LIBOR or whether any additional reforms to LIBOR may be enacted in the United Kingdom or elsewhere. At this time, no consensus exists as to what rate or rates may become acceptable alternatives to LIBOR and it is impossible to predict the effect of any such alternatives on the value of LIBOR-based securities and variable rate loans, subordinated debentures, or other securities or financial arrangements, given LIBOR's role in determining market interest rates globally. Uncertainty as to the nature of alternative reference rates and as to potential changes or other reforms to LIBOR may adversely affect LIBOR rates and the value of LIBOR-based loans, and to a lesser extent, securities in our portfolio, and may impact the availability and cost of hedging instruments and borrowings. If LIBOR rates are no longer available, and we are required to implement substitute indices for the calculation of interest rates under our loan agreements with our borrowers or our existing borrowings, we may incur significant expenses in effecting the transition, and may be subject to disputes or litigation with customers and creditors over the appropriateness or comparability to LIBOR of the substitute indices, which could have an adverse effect on our results of operations.

Our securities portfolio may be negatively impacted by fluctuations in market value, changes in the tax code, and interest rates.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. At December 31, 2018, the fair value of our securities portfolio was approximately \$97.2 million. Factors beyond our control can significantly influence the fair value of securities in our portfolio and can cause potential adverse changes to the fair value of these securities. Changes in interest rates can have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. For example, fixed-rate securities acquired by us are generally subject to decreases in market value when interest rates rise. Additional factors include, but are not limited to, rating agency downgrades of the securities or our own analysis of the value of the security, defaults by the issuer or individual mortgagors with respect to the underlying securities, and limited investor demand. Our securities portfolio is evaluated quarterly for other-than-temporary impairment ("OTTI"). The process for determining whether impairment is other-than-temporary usually requires difficult, subjective judgments about the future financial performance of the issuer and any collateral underlying the security in order to assess the probability of receiving all contractual principal and interest payments on the security. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in OTTI of these

assets, which would lead to accounting charges that could have a material adverse effect on our financial condition and results of operations.

The valuation of our investment securities also is influenced by additional external market and other factors, including implementation of SEC and FASB guidance on fair value accounting, default rates on residential mortgage securities, changes in the tax code and rating agency actions. Accordingly, there can be no assurance that future declines

Table of Contents

in the market value of our private label mortgage backed securities or other investment securities will not result in OTTI of these assets and lead to accounting charges that could have an adverse effect on our results of operations.

New lines of business or new products and services may subject us to additional risk.

From time to time, we may implement new lines of business or offer new products and services within existing lines of business. Currently, we are expanding existing commercial real estate, commercial business and residential lending programs such as home improvement loans for consumer solar projects. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also impact the successful implementation of a new line of business and/or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business and/or new products or services could have a material adverse effect on our business, results of operations, and financial condition.

If 1st Security Bank of Washington is unable to integrate the combined operations successfully, its business and earnings may be negatively affected.

The Anchor Acquisition involves the integration of companies that have previously operated independently. Successful integration of Anchor Bank's operations will depend primarily on the Bank's ability to consolidate operations, systems and procedures and to eliminate redundancies and costs. No assurance can be given that the Bank will be able to integrate its post-acquisition operations without encountering difficulties including, without limitation, the loss of key employees and customers, the disruption of the ongoing business of the Bank or Anchor Bank or possible inconsistencies in standards, controls, procedures and policies. Anticipated economic benefits of the acquisition are projected to come from various areas that the Bank's management has identified through the due diligence and integration planning process. The elimination and consolidation of duplicate tasks are projected to result in annual cost savings. If the Bank has difficulties with the integration, it might not fully achieve the economic benefits it expects to result from the acquisition. In addition, the Bank may experience greater than expected costs or difficulties relating to the integration of the business of Anchor Bank, and/or may not realize expected cost savings from the acquisition within the expected time frame. The required accounting treatment of loans we acquire through acquisitions including purchase credit impaired loans could result in higher net interest margins and interest income in current periods and lower net interest margins and interest income in future periods.

Under U.S. GAAP, we are required to record loans acquired through acquisitions, including purchase credit impaired loans, at fair value. Estimating the fair value of such loans requires management to make estimates based on available information and facts and circumstances on the acquisition date. Actual performance could differ from management's initial estimates. If these loans outperform our original fair value estimates, the difference between our original estimate and the actual performance of the loan (the "discount") is accreted into net interest income. Thus, our net interest margins may initially increase due to the discount accretion. We expect the yields on our loans to decline as our acquired loan portfolio pays down or matures and the discount decreases, and we expect downward pressure on our interest income to the extent that the runoff on our acquired loan portfolio is not replaced with comparable high-yielding loans. This could result in higher net interest margins and interest income in current periods and lower net interest rate margins and lower interest income in future periods. The recorded value of loans acquired in the Anchor Acquisition was \$361.6 million, including \$1.3 million of purchased credit impaired loans and the fair value discount was \$5.3 million, or 1.5% of the loans acquired.

Our inability to manage our growth or deploy assets profitably could harm our business and decrease our overall profitability, which may cause our stock price to decline.

Our assets and deposit base have grown substantially in recent years, and we anticipate that we will continue to grow over time, perhaps significantly. To manage the expected growth of our operations and personnel, we will be required to manage multiple aspects of the business simultaneously, including among other things: (i) improve existing and

Table of Contents

implement new transaction processing, operational and financial systems, procedures and controls; (ii) maintain effective credit scoring and underwriting guidelines; (iii) maintain sufficient levels of regulatory capital; and (iv) expand our employee base and train and manage this growing employee base. In addition, to the extent we acquire other banks and or bank branches, asset pools or deposits we may have to manage additional risks such as exposure to potential asset quality issues, disruption to our normal business activities, and diversion of management's time and attention due to integration and conversion efforts. If we are unable to manage growth effectively or execute integration efforts properly, we may not be able to achieve the anticipated benefits of growth, and our business, financial condition, and results of operations could be adversely affected.

We may not be able to sustain past levels of profitability as we grow, and our past levels of profitability should not be considered a guarantee or indicator of future success. If we are not able to maintain our levels of profitability by deploying growth in our deposits in profitable assets or investments, our net interest margin and overall level of profitability will decrease and our stock price may decline.

Hedging against interest rate exposure may adversely affect our earnings.

We employ techniques that limit, or "hedge," the adverse effects of rising interest rates on our loans held for sale, and originated interest rate locks to customers. Our hedging activity varies based on the level and volatility of interest rates and other changing market conditions. These techniques may include purchasing or selling forward contracts, purchasing put and call options on securities or securities underlying futures contracts, or entering into other mortgage-backed derivatives. There are, however, no perfect hedging strategies, and interest rate hedging may fail to protect us from loss. Moreover, hedging activities could result in losses if the event against which we hedge does not materialize. Additionally, interest rate hedging could fail to protect us or adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction;
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value; and
- downward adjustments, or "mark-to-market losses," could reduce our stockholders' equity.

Changes in interest rates may reduce our net interest income, and may result in higher defaults in a rising rate environment.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. The Federal Reserve has steadily increased the targeted federal funds rate over the last three fiscal years to 2.50% at December 31, 2018. The Federal Reserve could make additional increases in interest rates during 2019 subject to economic conditions. If the Federal Reserve increases the targeted federal funds rate, overall interest rates will likely rise, which may negatively impact both the housing markets by reducing refinancing activity and new home purchases and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of collateral securing loans, which could negatively affect our financial performance.





Table of Contents

We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate and/or sell loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, which could negatively impact shareholders' equity, and our ability to realize gains from the sale of such assets, (iii) our ability to obtain and retain deposits in competition with other available investment alternatives, (iv) the ability of our borrowers to repay adjustable or variable rate loans, and (v) the average duration of our investment securities portfolio and other interest-earning assets. If the interest rates paid on deposits and borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. In a changing interest rate environment, we may not be able to manage this risk effectively. If we are unable to manage interest rate risk effectively, our business, financial condition, and results of operations could be materially affected.

Changes in interest rates could also have a negative impact on our results of operations by reducing the ability of borrowers to repay their current loan obligations or by reducing our margins and profitability. Our net interest margin is the difference between the yield we earn on our assets and the interest rate we pay for deposits and our other sources of funding. Changes in interest rates-up or down-could adversely affect our net interest margin and, as a result, our net interest income. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest margin to expand or contract. Our liabilities tend to be shorter in duration than our assets, so they may adjust faster in response to changes in interest rates. As a result, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest margin to contract until the yields on interest-earning assets catch up.

Changes in the slope of the "yield curve", or the spread between short-term and long-term interest rates could also reduce our net interest margin. Normally, the yield curve is upward sloping, meaning short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or even inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets. Also, interest rate decreases can lead to increased prepayments of loans and mortgage-backed securities as borrowers refinance their loans to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk as we may have to redeploy such repayment proceeds into lower yielding investments, which would likely hurt our income.

A sustained increase in market interest rates could adversely affect our earnings. As a result of the exceptionally low interest rate environment, an increasing percentage of our deposits have been comprised of deposits bearing no or a relatively low rate of interest and having a shorter duration than our assets. At December 31, 2018, we had \$290.8 million in certificates of deposit that mature within one year and \$790.6 million in non-interest bearing, NOW checking, savings and money market accounts. We would incur a higher cost of funds to retain these deposits in a rising interest rate environment. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. In addition, a substantial amount of our residential mortgage loans and home equity lines of credit have adjustable interest rates. As a result, these loans may experience a higher rate of default in a rising interest rate environment. Our net income can also be reduced by the impact that changes in interest rates can have on the value of our capitalized servicing rights. At December 31, 2018, we serviced \$1.19 billion of loans sold to third parties, and the servicing rights associated with such loans had an amortized cost of \$10.4 million and an estimated fair value, at that date, of \$14.6 million. Because the estimated life and estimated income to be derived from servicing the underlying loans generally increase with rising interest rates and decrease with falling interest rates, the value of servicing rights generally increases as interest rates rise and decreases as interest rates fall. If interest rates fall and the value of our capitalized servicing rights decrease, we may be required to recognize an additional impairment charge

against income for the amount by which amortized cost exceeds estimated fair market value.

Changes in interest rates also affect the value of our interest-earning assets and in particular our investment securities portfolio. Generally, the fair value of fixed-rate securities fluctuates inversely with changes in interest rates. Unrealized gains and losses on securities available for sale are reported as a separate component of equity, net of tax. Decreases in the fair value of securities available for sale resulting from increases in interest rates could have an adverse effect on stockholders' equity.

## Table of Contents

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management and Market Risk” of this Form 10 K.

We may experience future goodwill impairment, which could reduce our earnings.

We performed our test for goodwill impairment for fiscal year 2018, and the test concluded that recorded goodwill was not impaired. Our test of goodwill for potential impairment is based on a qualitative assessment by management that takes into consideration macroeconomic conditions, industry and market conditions, cost or margin factors, financial performance and share price. Our evaluation of the fair value of goodwill involves a substantial amount of judgment. If our judgment was incorrect, or if events or circumstances change, and an impairment of goodwill was deemed to exist, we would be required to write down our goodwill resulting in a charge against operations, which would adversely affect our results of operations, perhaps materially; however, it would have no impact on our liquidity, operations or regulatory capital.

We may experience decreases in the fair value of our mortgage servicing rights, which could reduce our earnings.

Mortgage servicing rights (“MSRs”) are capitalized at estimated fair value when acquired through the origination of loans that are subsequently sold with servicing rights retained. At December 31, 2018, our MSRs totaled \$10.4 million. MSRs are amortized to servicing income on loans sold over the period of estimated net servicing income. The estimated fair value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The fair market value of the servicing rights’ assets was \$14.6 million at December 31, 2018. On a quarterly basis, we evaluate the fair value of MSRs for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. Our methodology for estimating the fair value of MSRs is highly sensitive to changes in assumptions, such as prepayment speeds. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs portfolio. For example, a decrease in mortgage interest rates typically increases the prepayment speeds of MSRs and therefore decreases the fair value of the MSRs. Future decreases in mortgage interest rates could decrease the fair value of our MSRs below their recorded amount, which would decrease our earnings.

If our non-performing assets increase, our earnings will be adversely affected.

At December 31, 2018, our non-performing assets (which consist of non-accruing loans, accruing loans 90 days or more past due, and other real estate owned (“OREO”)) were \$4.6 million, or 0.28% of total assets. Our non-performing assets adversely affect our net income in various ways:

- We do not record interest income on non-accrual loans, except on a cash basis when the collectability of the principal is not in doubt.
- We must provide for probable loan losses through a current period charge to the provision for loan losses.
- Non-interest expense increases when we must write down the value of properties in our OREO portfolio to reflect changing market values.
  - There are legal fees associated with the resolution of problem assets, as well as carrying costs, such as taxes, insurance, and maintenance costs related to our OREO.

- The resolution of non-performing assets requires the active involvement of management, which can distract them from more profitable activity.

Table of Contents

If additional borrowers become delinquent and do not pay their loans and we are unable to successfully manage our non-performing assets, our losses and troubled assets could increase significantly, which could have a material adverse effect on our financial condition and results of operations.

Ineffective liquidity management could adversely affect our financial results and condition.

Effective liquidity management is essential for the operation of our business. We require sufficient liquidity to meet customer loan requests, customer deposit maturities/withdrawals, payments on our debt obligations as they come due, and other cash commitments under both normal operating conditions and other unpredictable circumstances causing industry or general financial market stress. Our access to funding sources in amounts adequate to finance our activities on terms that are acceptable to us could be impaired by factors that affect us specifically, or the financial services industry or economy generally. Factors that could detrimentally impact our access to liquidity sources include a downturn in the geographic markets in which our loans and operations are concentrated or difficult credit markets. Our access to deposits may also be affected by the liquidity needs of our depositors. In particular, a majority of our liabilities are checking accounts and other liquid deposits, which are payable on demand or upon several days' notice, while by comparison, a substantial majority of our assets are loans, which cannot be called or sold in the same time frame. Although we have historically been able to replace maturing deposits and advances as necessary, we might not be able to replace such funds in the future, especially if a large number of our depositors seek to withdraw their accounts, regardless of the reason. A failure to maintain adequate liquidity could materially and adversely affect our business, results of operations or financial condition. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity" of this Form 10-K.

Our ability to retain bankers and recruit additional successful bankers is critical to the success of our business strategy and any failure to do so could impair our customer relationships and adversely affect our business and results of operations.

Our ability to retain and grow our loans, deposits, and fee income depends upon the business generation capabilities, reputation, and relationship management skills of our lenders. If we were to lose the services of any of our bankers, including successful bankers employed by banks that we may acquire, to a new or existing competitor, or otherwise, we may not be able to retain valuable relationships and some of our customers could choose to use the services of a competitor instead of our services.

Our success and growth strategy also depends on our continued ability to attract and retain experienced loan officers and support staff, as well as other management personnel. We may face difficulties in recruiting and retaining lenders and other personnel of our desired caliber, including as a result of competition from other financial institutions. Competition for loan officers and other personnel is strong and we may not be successful in attracting or retaining the personnel we require. In particular, many of our competitors are significantly larger with greater financial resources, and may be able to offer more attractive compensation packages and broader career opportunities. Additionally, we may incur significant expenses and expend significant time and resources on training, integration and business development before we are able to determine whether a new loan officer will be profitable or effective. If we are unable to attract and retain successful loan officers and other personnel, or if our loan officers and other personnel fail to meet our expectations in terms of customer relationships and profitability, we may be unable to execute our business strategy and our business, financial condition, results of operations, and growth prospects may be negatively affected.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. These competitors primarily include national, regional, and internet

banks within the various markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, mortgage banking finance companies, brokerage firms, insurance companies, and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms, and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. A number of out-of-state financial intermediaries have opened production offices

## Table of Contents

or otherwise solicit deposits in our market areas. Additionally, we face growing competition from so-called “online businesses” with few or no physical locations, including online banks, lenders and consumer and commercial lending platforms from FinTech companies, as well as automated retirement and investment service providers. Technology has also lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints, may have lower cost structures, and due to their size, may be able to achieve economies of scale resulting in their ability to offer a broader range of products and services, as well as better pricing for those products and services than we can. Increased competition in our markets may result in reduced loans, deposits and commissions and brokers’ fees, as well as reduced net interest margin and profitability. Ultimately, we may not be able to compete successfully against current and future competitors. If we are unable to attract and retain banking and mortgage customers, we may be unable to continue to grow our business, and our financial condition and results of operations may be adversely affected.

Our ability to compete successfully depends on a number of factors including the following:

- the ability to develop, maintain, and build upon long-term customer relationships based on top-quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance, and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations. See “Item 1. Business - Competition” of this Form 10 K.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations that are expected to increase our costs of operations.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company’s shareholders. These regulations may sometimes impose significant limitations on operations. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. These bank regulators also have the ability to impose conditions in the approval of merger and acquisition transactions.

The significant federal and state banking regulations that affect us are described under the heading “Item 1. Business - How we are Regulated” of this Form 10-K. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures.

These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time. Any new regulations or legislation, change in existing regulations or oversight, whether a change in regulatory policy or a change in a regulator’s interpretation of a law or regulation, could have a material impact on our operations, increase our costs of regulatory compliance and of doing business and/or otherwise adversely affect us and our profitability. Additionally, actions by regulatory agencies or significant litigation against us and may lead to penalties that materially affect us. Further, changes in accounting standards can be both difficult to



predict and involve judgment and discretion in their interpretation by us and our independent registered public accounting firm. These changes could materially impact, potentially even retroactively, how we report our financial condition and results of our operations as

60

---

Table of Contents

could our interpretation of those changes. We cannot predict what restrictions may be imposed upon us with future legislation.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. At some point, we may need to raise additional capital or issue additional debt to support our growth or replenish future losses. Our ability to raise additional capital or issue additional debt depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities, and on our financial condition and performance. Such borrowings or additional capital, if sought, may not be available to us or, if available, may not be on favorable terms.

Accordingly, we cannot make assurances that we will be able to raise additional capital or issue additional debt if needed on terms that are acceptable to us, or at all. If we cannot raise additional capital or issue additional debt when needed, our ability to further expand our operations could be materially impaired and our financial condition and liquidity could be materially and adversely affected. In addition, any additional capital we obtain may result in the dilution of the interests of existing holders of our common stock. Further, if we are unable to raise additional capital when required by our bank regulators, we may be subject to adverse regulatory action.

The Company's ability to pay dividends and make subordinated debt payments is subject to the ability of the Bank to make capital distributions to the Company.

The Company is a separate legal entity from its subsidiary and does not have significant operations of its own. The long-term ability of the Company to pay dividends to its stockholders and debt payments is based primarily upon the ability of the Bank to make capital distributions to the Company, and also on the availability of cash at the holding company level. The availability of dividends from the Bank is limited by the Bank's earnings and capital, as well as various statutes and regulations. In the event, the Bank is unable to pay dividends to the Company, the Company may not be able to pay dividends on its common stock or make payments on its outstanding debt. Consequently, the inability to receive dividends from the Bank could adversely affect the Company's financial condition, results of operations, and future prospects. At December 31, 2018, FS Bancorp, Inc. had \$7.0 million in unrestricted cash to support dividend and debt payments.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions.

The USA PATRIOT and Bank Secrecy Acts and related regulations require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts and beneficial owners of accounts. Failure to comply with these regulations could result in fines or sanctions. During the last few years, several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, no assurance can be given that these policies and procedures will be effective in preventing violations of these laws and regulations. If our policies and procedures are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the denial of regulatory approvals to proceed with certain aspects of our business plan.

Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition, results of operations, and growth prospects.

Our operations rely on numerous external vendors.

We rely on numerous external vendors to provide us with products and services necessary to maintain our day-to-day operations. Accordingly, our operations are exposed to risk that these vendors will not perform in accordance with the contracted arrangements under service level agreements. The failure of an external vendor to perform in accordance

Table of Contents

with the contracted arrangements under service level agreements because of changes in the vendor's organizational structure, financial condition, support for existing products and services or strategic focus or for any other reason, could be disruptive to our operations, which in turn could have a material negative impact on our financial condition and results of operations. We also could be adversely affected to the extent such an agreement is not renewed by the third-party vendor or is renewed on terms less favorable to us.

We are subject to certain risks in connection with our use of technology.

Our security measures may not be sufficient to mitigate the risk of a cyber attack. Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger, and virtually all other aspects of our business. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, fraudulent or unauthorized access, denial or degradation of service, attacks, misuse, computer viruses, malware, or other malicious code and cyber attacks that could have a security impact. If one or more of these events occur, this could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us. We could also suffer significant reputational damage.

Security breaches in our internet banking activities could further expose us to possible liability and damage our reputation. Increases in criminal activity levels and sophistication, advances in computer capabilities, new discoveries, vulnerabilities in third party technologies (including browsers and operating systems) or other developments could result in a compromise or breach of the technology, processes and controls that we use to prevent fraudulent transactions and to protect data about us, our clients and underlying transactions. Any compromise of our security could deter customers from using our internet banking services that involve the transmission of confidential information. We rely on standard internet security systems to provide the security and authentication necessary to effect secure transmission of data. Although we have developed and continue to invest in systems and processes that are designed to detect and prevent security breaches and cyber-attacks and periodically test our security, these precautions may not protect our systems from compromises or breaches of our security measures, and could result in losses to us or our customers, our loss of business and/or customers, damage to our reputation, the incurrence of additional expenses, disruption to our business, our inability to grow our online services, or other businesses, additional regulatory scrutiny or penalties, or our exposure to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

Our security measures may not protect us from system failures or interruptions. While we have established policies and procedures to prevent or limit the impact of systems failures and interruptions, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, we outsource certain aspects of our data processing and other operational functions to certain third-party providers. While we select third-party vendors carefully, we do not control their actions. If our third-party providers encounter difficulties including those resulting from breakdowns or other disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher transaction volumes, cyber-attacks and security breaches or if we otherwise have difficulty in communicating with them, our ability to adequately process and account for transactions could be affected, and our ability to deliver products and services to our customers and otherwise conduct business operations could be adversely

impacted. Replacing these third-party vendors could also entail significant delay and expense. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

We cannot assure you that such breaches, failures or interruptions will not occur or, if they do occur, that they will be adequately addressed by us or the third parties on which we rely. We may not be insured against all types of losses as a result of third-party failures and insurance coverage may be inadequate to cover all losses resulting from breaches, system failures or other disruptions. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to identify alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us, or

Table of Contents

could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Further, the occurrence of any systems failure or interruption could damage our reputation and result in a loss of customers and business, could subject us to additional regulatory scrutiny, or could expose us to legal liability. Any of these occurrences could have a material adverse effect on our financial condition and results of operations.

The Board of Directors oversees the risk management process, including the risk of cybersecurity, and engages with management on cybersecurity issues.

If our enterprise risk management framework is not effective at mitigating risk and loss to us, we could suffer unexpected losses and our results of operations could be materially adversely affected.

Our enterprise risk management framework seeks to achieve an appropriate balance between risk and return, which is critical to optimizing stockholder value. We have established processes and procedures intended to identify, measure, monitor, report, analyze, and control the types of risk to which we are subject to. These risks include, among others, liquidity, credit, market, interest rate, operational, legal and compliance, and reputational risk. Our framework also includes financial or other modeling methodologies that involve management assumptions and judgment. We also maintain a compliance program to identify measure, assess, and report on our adherence to applicable laws, policies, and procedures. While we assess and improve these programs on an ongoing basis, there can be no assurance that our risk management or compliance programs, along with other related controls, will effectively mitigate risk under all circumstances, or that it will adequately mitigate any risk or loss to us. However, as with any risk management framework, there are inherent limitations to our risk management strategies as they may exist, or develop in the future, including risks that we have not appropriately anticipated or identified. If our risk management framework proves ineffective, we could suffer unexpected losses and our business, financial condition, results of operations or growth prospects could be materially adversely affected. We may also be subject to potentially adverse regulatory consequences.

We are subject to certain risks in connection with our data management or aggregation.

We are reliant on our ability to manage data and our ability to aggregate data in an accurate and timely manner to ensure effective risk reporting and management. Our ability to manage data and aggregate data may be limited by the effectiveness of our policies, programs, processes and practices that govern how data is acquired, validated, stored, protected, and processed. While we continuously update our policies, programs, processes, and practices, many of our data management and aggregation processes are manual and subject to human error or system failure. Failure to manage data effectively and to aggregate data in an accurate and timely manner may limit our ability to manage current and emerging risks, as well as to manage changing business needs.

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.

Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur.

The markets in which the Company operates are subject to the risk of flooding, mudslides, and other natural disasters.

The Company's offices are located in Washington. Also, most of the real and personal properties securing the Company's loans are located in Washington. Washington is prone to flooding, mudslides, brush fires, earthquakes, and other natural disasters. In addition to possibly sustaining damage to its own properties, if there is a major flood, mudslide, brush fire, earthquake or other natural disaster, the Company faces the risk that many of the Company's borrowers may experience uninsured property losses, or sustained job interruption and/or loss which may materially impair their ability to meet the terms of their loan obligations. Therefore, a major flood, mudslide, brush fire, earthquake or other natural disaster in Washington could have a material adverse effect on the Company's business, financial condition, results of operations, and cash flows.

Table of Contents

## Item 1B. Unresolved Staff Comments

None.

## Item 2. Properties

At December 31, 2018, the Company had two main administrative offices, one free-standing ATM, five stand-alone loan production offices, and 21 full-service bank branches with an aggregate net book value of \$29.1 million. The following table sets forth certain information concerning the properties at December 31, 2018. For additional information see Note 6 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K. In the opinion of management, the facilities are adequate and suitable for the Company’s needs.

Location	Square Footage	Owned or Leased	Lease Expiration Date	Net Book Value at December 31, 2018(1) (In thousands)
Aberdeen (Administrative) 100 West First Aberdeen, WA 98520	7,410	Owned		\$ 1,004
Aberdeen 120 N. Broadway Aberdeen, WA 98520	17,550	Owned		\$ 2,555
Capitol Hill (Banking and Home Lending) 614 Broadway East Seattle, WA 98102	5,100	Leased	December 2022 (2)	\$ 350
Centralia 604 S. Tower Centralia, WA 98531	3,000	Owned		\$ 657
Edmonds 620 Edmonds Way Edmonds, WA 98020	2,474	Owned		\$ 1,161
Elma 216 S. Third St Elma, WA 98541	2,252	Owned		\$ 414
Hadlock 10 Old Oak Bay Rd Hadlock, WA 98339	1,755	Owned		\$ 405
Kingston (ATM)	50	Leased	December 2021 (3)	\$ 80



Edgar Filing: FS Bancorp, Inc. - Form 10-K

8215 NE State Hwy 104  
Kingston, WA 98346

Lacey 601 Woodland Square Loop SE Lacey, WA 98503	13,505	Owned		4,450
Lynnwood 19002 33rd Ave W Lynnwood, WA 98036	3,000	Leased	June 2020 (2)	\$ 42
Mill Creek (Banking and Home Lending) 15224 Main St, Suite 105 Mill Creek, WA 98012	2,894	Leased	April 2020 (2)	\$ 147
Montesano 301 Pioneer Ave E Montesano, WA 98563	2,125	Owned		\$ 775
Mountlake Terrace (Administrative)	39,535	Owned		\$ 7,125

64

---

Table of Contents

6920 220th St SW Mountlake Terrace, WA 98043				
Mountlake Terrace (Lending) 6100 219th St SW, Suite 400 Mountlake Terrace, WA 98043	9,980	Leased	July 2027 (2)	\$ 442
Ocean Shores 795 Pt. Brown Ave NW Ocean Shores, WA 98569	2,550	Owned		\$ 488
Olympia 2610 Harrison Ave W Olympia, WA 98502	1,882	Owned		\$ 663
Overlake 14808 NE 24th St, Suite D Redmond, WA 98052	2,331	Leased	May 2021 (5)	\$ 29
Port Angeles 134 W 8th St Port Angeles, WA 98362	2,267	Owned (6)		\$ 1,344
Port Townsend (Banking and Home Lending) 734 Water St Port Townsend, WA 98368	10,157	Leased	September 2019 (4)	\$ 96
Poulsbo (Banking and Home Lending) 21650 Market Place Poulsbo, WA 98370	3,498	Owned		\$ 2,650
Puyallup 307 W Stewart St Puyallup, WA 98371	9,980	Leased	July 2027 (2)	\$ 1,182
Puyallup 10514 156th St E, Bldg B4, Suite 106 Puyallup, WA 98374	3,027	Leased	November 2019	\$ 49
Sequim 114 S Sequim Ave Sequim, WA 98382	8,866	Owned		\$ 1,678
Silverdale 10574 Silverdale Way NW Silverdale, WA 98383	3,340	Leased	March 2023 (3)	\$ 445
Westport	3,850	Owned		\$ 646

915 N. Montesano  
Westport, WA 98595

Bellevue Home Lending 1110 112th Ave NE, Suite 310 Bellevue, WA 98004	4,068	Leased	March 2023 (5)	\$ 2
Everett Home Lending 2825 Colby Ave, Suite 205 Everett, WA 98201	3,020	Leased	December 2021 (5)	\$ 112
Port Orchard Home Lending 450 Port Orchard Blvd, Suite 300 Port Orchard, WA 98366	1,000	Leased		\$ 19
Puyallup Home Lending 2910 S Meridian, Suite 180 Puyallup, WA 98373	3,389	Leased	June 2019 (5)	\$ 17
Tri-Cities Home Lending	5,477	Leased	March 2020 (2)	\$ 83

Table of Contents

8486 West Gage Blvd, Suite A  
Kennewick, WA 99336

---

- (1) Net book value includes investment in premises, equipment and leaseholds.
- (2) Lease provides for two five-year renewal options.
- (3) Lease provides for three five-year renewal options.
- (4) Lease provides for 17 five-year renewal options.
- (5) Lease provides for one five-year renewal option.
- (6) Lease on the parking lot expired February 2018, month-to-month basis thereafter.

The Company maintains depositor and borrower customer files on an on-line basis, utilizing a telecommunications network, portions of which are leased. The book value of all data processing and computer equipment utilized by the Company at December 31, 2018 was \$841,000. Management has a business continuity plan in place with respect to the data processing system, as well as the Company's operations as a whole.

Item 3. Legal Proceedings

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

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

The Company's common stock is traded on The NASDAQ Stock Market LLC's Global Market, under the symbol "FSBW." At December 31, 2018, there were 4,492,478 shares of common stock issued and outstanding and approximately 180 shareholders of record based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or "street name" accounts with brokers.

Common shares outstanding of 4,371,294 were calculated using shares outstanding at December 31, 2018, of 4,492,478, less 43,421 restricted stock shares, and 77,763 unallocated ESOP shares. Common shares of 3,539,626 were calculated using shares outstanding at December 31, 2017, of 3,680,152 less 36,842 restricted stock shares, and 103,684 unallocated ESOP shares.

1st Security Bank of Washington is a wholly-owned subsidiary of FS Bancorp. Under federal regulations, the dollar amount of dividends 1st Security Bank of Washington may pay to FS Bancorp depends upon its capital position and recent net income. Generally, if 1st Security Bank of Washington satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed by state law and FDIC regulations. See "Item 1. Business - How We Are Regulated - Regulation of 1st Security Bank of Washington - Dividends" and "Regulation and Supervision of FS Bancorp - Restrictions on Dividends and Stock Repurchases."

The Cash Dividend Policy is reviewed by management and the Board of Directors. Any dividends declared and paid in the future would depend upon a number of factors including capital requirements, the Company's financial condition and results of operations, tax considerations, statutory and regulatory limitations, and general economic conditions. No assurances can be given that any dividends will be paid or that, if paid, will not be reduced or eliminated in future periods.

Stock Repurchases. There were no stock repurchases by the Company during the quarter ended December 31, 2018.

Table of Contents

Equity Compensation Plan Information. The equity compensation plan information presented under subparagraph (d) in Part III, Item 12 of this report is incorporated herein by reference.

Performance Graph. The following graph compares the cumulative total shareholder return on the Company's common stock with the cumulative total return on the NASDAQ S&P 500 Index (U.S. Stock), SNL U.S. Bank NASDAQ Index, and the SNL Thrift Index. Total return assumes the reinvestment of all dividends and that the value of common stock and bank index was \$100 on December 31, 2013.

Source: SNL Financial LC, Charlottesville, VA

Index	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/2018
FS Bancorp, Inc.	100.00	107.85	155.47	217.99	334.07	265.07
S&P 500 Index	100.00	113.69	115.26	129.05	157.22	150.33
SNL Bank \$1B-\$5B	100.00	104.56	117.04	168.38	179.51	157.27
SNL Thrift \$1B-\$5B	100.00	108.18	126.98	173.07	175.30	121.98

Table of Contents

## Item 6. Selected Financial Data

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

(In thousands)	At December 31,				
	2018	2017	2016	2015	2014
Selected Financial Condition Data:					
Total assets	\$ 1,621,644	\$ 981,783	\$ 827,926	\$ 677,561	\$ 509,754
Loans receivable, net(1)	1,312,519	761,558	593,317	502,535	387,174
Loans held for sale, at fair value	51,195	53,463	52,553	44,925	25,983
Securities available-for-sale, at fair value	97,205	82,480	81,875	55,217	48,744
FHLB stock, at cost	9,887	2,871	2,719	4,551	1,650
Deposits	1,274,219	829,842	712,593	485,178	420,444
Borrowings	137,149	7,529	12,670	98,769	17,034
Subordinated note, net	9,865	9,845	9,825	9,805	—
Total stockholders' equity	180,038	122,002	81,033	75,340	65,836

(In thousands)	Year Ended December 31,				
	2018	2017	2016	2015	2014
Selected Operations Data:					
Total interest and dividend income	\$ 62,326	\$ 46,181	\$ 38,020	\$ 31,707	\$ 24,842
Total interest expense	10,228	4,933	4,163	3,658	2,702
Net interest income	52,098	41,248	33,857	28,049	22,140
Provision for loan losses	1,540	750	2,400	2,250	1,800
Net interest income after provision for loan losses	50,558	40,498	31,457	25,799	20,340
Service charges and fee income	3,233	3,548	3,391	1,977	1,762
Bargain purchase gain	7,414	—	—	—	—
Gain on sale of loans	14,861	17,985	19,058	14,672	7,577
Loss on disposed fixed assets	(71)	—	—	—	(9)
Gain (loss) on sale of investment securities	171	380	146	76	(41)
Gain on sale of mortgage servicing rights	—	1,062	—	—	—
Earnings on cash surrender value of Bank Owned Life Insurance	413	274	282	216	187
Other noninterest income	829	825	692	652	557
Total noninterest income	26,850	24,074	23,569	17,593	10,033
Total noninterest expense	48,838	43,993	38,923	29,643	23,902
Income before provision for income taxes	28,570	20,579	16,103	13,749	6,471
Provision for income taxes	4,223	6,494	5,604	4,873	1,931
Net income	\$ 24,347	\$ 14,085	\$ 10,499	\$ 8,876	\$ 4,540

(1) Net of allowances for loan losses, loans in process and deferred loan costs, fees, premiums, and discounts.

68

---



Table of Contents

Selected Financial Ratios and Other Data	At or For the Year Ended December 31,									
	2018		2017		2016		2015		2014	
Performance ratios:										
Return on assets (ratio of net income to average total assets)	2.07	%	1.53	%	1.31	%	1.52	%	1.00	%
Return on equity (ratio of net income to average equity)	18.15		14.80		13.84		12.73		7.19	
Yield on average interest-earning assets	5.52		5.21		4.97		5.67		5.74	
Rate paid on average interest-bearing liabilities	1.22		0.76		0.74		0.83		0.80	
Net interest rate spread	4.30		4.45		4.23		4.84		4.94	
Net interest margin(1)	4.61		4.65		4.43		5.01		5.12	
Operating expense to average total assets	4.16		4.76		4.87		5.07		5.27	
Average interest-earning assets to average										
interest-bearing liabilities	134.60		136.88		135.96		127.09		128.30	
Efficiency ratio(2)	61.86		67.35		67.78		64.95		74.29	
Margin on loans sold (3)	2.42		2.50		2.64		2.58		2.31	
Asset quality ratios:										
Non-performing assets to total assets at end of period(4)	0.28	%	0.11	%	0.09	%	0.15	%	0.08	%
Non-performing loans to total gross loans(5)	0.29		0.13		0.12		0.20		0.11	
Allowance for loan losses to non-performing loans(5)	317.13		1,035.23		1,416.23		765.49		1,406.47	
Allowance for loan losses to gross loans receivable	0.93		1.39		1.69		1.52		1.54	
Capital ratios:										
Equity to total assets at end of period	11.10	%	12.43	%	9.79	%	11.12	%	12.92	%
Average equity to average assets	11.42		10.30		9.49		11.94		13.92	
Other data:										
Number of full service offices	21		11		11		7		7	
Full-time equivalent employees	424		326		306		239		209	
Net income per common share:										
Basic	\$ 6.58		\$ 4.55		\$ 3.63		\$ 2.98		\$ 1.52	
Diluted	\$ 6.29		\$ 4.28		\$ 3.51		\$ 2.93		\$ 1.52	
Book values:										
Book value per common share	\$ 41.19	(10)	\$ 34.47	(9)	\$ 28.32	(8)	\$ 25.18	(7)	\$ 22.48	(6)

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

(2) Total noninterest expense as a percentage of net interest income and total other noninterest income.

- (3) Cash margins on loans sold net of deferred fees/costs.
- (4) Non-performing assets consists of non-performing loans (which include non-accruing loans and accruing loans more than 90 days past due), foreclosed real estate and other repossessed assets.
- (5) Non-performing loans consists of non-accruing loans and accruing loans more than 90 days past due.
- (6) Book value per common share was calculated using shares outstanding of 3,235,625 at December 31, 2014, less 125,105 shares of restricted stock, and unallocated employee stock ownership plan ("ESOP") shares of 181,447.
- (7) Book value per common share was calculated using shares outstanding of 3,242,120 at December 31, 2015, less 94,684 shares of restricted stock, and unallocated ESOP shares of 155,526.
- (8) Book value per common share was calculated using shares outstanding of 3,059,503 at December 31, 2016, less 68,763 shares of restricted stock, and unallocated ESOP shares of 129,605.
- (9) Book value per common share was calculated using shares outstanding of 3,680,152 at December 31, 2017, less 36,842 shares of restricted stock, and unallocated ESOP shares of 103,684.
- (10) Book value per common share was calculated using shares outstanding of 4,492,478 at December 31, 2018, less 43,421 shares of restricted stock, and unallocated ESOP shares of 77,763.

Table of Contents

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

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

Overview

FS Bancorp, Inc. and its subsidiary bank, 1st Security Bank of Washington have been serving the Puget Sound area since 1936. Originally chartered as a credit union, previously known as Washington’s Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp, Inc.

The Company is relationship-driven delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities, and one loan production office located in the Tri-Cities, Washington. On November 15, 2018, the Company completed the Anchor Acquisition and acquired \$357.9 million in deposits, \$361.6 million in loans, and recorded a bargain purchase gain of \$7.4 million based on financial information at that date. As a result of the Anchor Acquisition, Anchor’s shareholders received 725,518 shares of FS Bancorp common stock and \$30.8 million in cash for total consideration paid of \$64.6 million. The Anchor Acquisition added nine full-service bank branches within the communities of Aberdeen, Centralia, Elma, Lacey, Montesano, Ocean Shores, Olympia, Puyallup, and Westport, Washington. The Anchor Acquisition expanded our Puget Sound-focused retail footprint and provided an opportunity to extend our unique brand of community banking into these communities. For additional details see Note 2 of the Notes to Consolidated Financial Statements contained in “Item 8. Financial Statements and Supplementary Data.”

The Company also maintains its long-standing indirect consumer lending platform which operates throughout the West Coast. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is actively involved in community activities and events within these market areas, which further strengthens our relationships within those markets.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

- Growing and diversifying our loan portfolio;
- Maintaining strong asset quality;
- Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;
- Capturing our customers’ full relationship by offering a wide range of products and services by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers’ banking needs; and
- Expanding the Company’s markets.

The Company is a diversified lender with a focus on the origination of one-to-four-family loans, commercial real estate mortgage loans, second mortgage or home equity loan products, consumer loans including home improvement (“fixture secured”) loans and marine lending, and commercial business loans. As a result of our expanding lending channels, the Company experienced growth in warehouse lending as part of our business plan to diversify revenues. Historically, consumer loans, in particular, fixture secured loans had represented the largest portion of the

Company's loan portfolio and had traditionally been the mainstay of the Company's lending strategy. In recent years, the Company has placed more of an emphasis on real estate lending products, such as one-to-four-family loans, commercial

70

---

## Table of Contents

real estate loans, including speculative residential construction loans, as well as commercial business loans, while growing the current size of the consumer loan portfolio. At December 31, 2018, consumer loans represented 20.8% of the Company's total gross loan portfolio, down from 27.0% at December 31, 2017, as real estate loan originations have increased at a faster pace than consumer loan originations during the year ended December 31, 2018.

Indirect home improvement lending is dependent on the Bank's relationships with home improvement contractors and dealers. The Company funded \$148.3 million, or approximately 7,600 loans during the year ended December 31, 2018, using its indirect home improvement contractor/dealer network located throughout Washington, Oregon, California, Idaho, Colorado, and Arizona with 10 contractor/dealers responsible for 54.1% of the funded loans dollar volume. See "Item 1A. Risk Factors - Our business could suffer if we are unsuccessful in making, continuing and growing relationships with home improvement contractors and dealers" of this Form 10 K.

Since 2012, the Company has had an emphasis on diversifying lending products by expanding commercial real estate, commercial business and residential lending, while maintaining the current size of the consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as an important funding source. See "Item 1. Business: Lending Activities" and "Item 1A. Risk Factors - Risks Related to Our Business" of this Form 10 K.

Recently, improvements in the economy, employment rates, stronger real estate prices, and a general lack of new housing inventory has resulted in our significantly increasing originations of construction loans for properties located in our market areas. We anticipate that construction and development lending will continue to be a strong element of our total loan portfolio in future periods. We will continue to take a disciplined approach in our construction and development lending by concentrating our efforts on loans to builders and developers in our market areas known to us. Originations of construction and development loans increased to \$208.0 million in 2018 from \$123.3 million in 2017. These short-term loans typically mature in six to twelve months. In addition, the commitment is usually not fully disbursed at origination, thereby reducing our net loans receivable in the short term. At December 31, 2018, outstanding construction and development loans totaled \$247.3 million, or 18.7%, of the gross loan portfolio and consisted of loans for residential and commercial construction projects, primarily for vertical construction and \$16.7 million of land acquisition and development loans. Total committed, including unfunded construction and development loans at December 31, 2018, was \$333.2 million as compared to \$222.0 million at December 31, 2017.

The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by a number of factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans and income provided from operations.

The Company's earnings are primarily dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. Another significant influence on the Company's earnings is fee income from mortgage banking activities. The Company's earnings are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

## Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, the fair value

Table of Contents

of servicing rights, derivatives and hedging activity, and the accounting for deferred income taxes. The Company's accounting policies are discussed in detail in Note 1 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" of this Form 10 K.

**Allowance for Loan Loss.** The allowance for loan losses is the amount estimated by management as necessary to cover probable losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. A high degree of judgment is necessary when determining the amount of the allowance for loan losses. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. Although the Company believes that use of the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. As the Company adds new products to the loan portfolio and expands the Company's market area, management intends to enhance and adapt the methodology to keep pace with the increased size and complexity of the loan portfolio. Changes in any of the above factors could have a significant effect on the calculation of the allowance for loan losses in any given period. Management believes that its systematic methodology continues to be appropriate given the Company's increased size and level of complexity.

**Servicing Rights.** Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the consolidated balance sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Derivative and Hedging Activity.** ASC 815, "Derivatives and Hedging," requires that derivatives of the Company be recorded in the consolidated financial statements at fair value. Management considers its accounting policy for derivatives to be a critical accounting policy because these instruments have certain interest rate risk characteristics that change in value based upon changes in the capital markets. The Company's derivatives are primarily the result of its mortgage banking activities in the form of commitments to extend credit, commitments to sell loans, To-Be-Announced ("TBA") mortgage backed securities trades and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded in the Consolidated Statements of Income with offsets to other assets or other liabilities in the Consolidated Balance Sheets.

Fair Value. ASC 820, "Fair Value Measurements and Disclosures," establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market



## Table of Contents

and not yet established and the characteristics specific to the transaction. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). See Note 15 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K for additional information about the level of pricing transparency associated with financial instruments carried at fair value.

**Income Taxes.** Income taxes are reflected in the Company’s consolidated financial statements to show the tax effects of the operations and transactions reported in the consolidated financial statements and consist of taxes currently payable plus deferred taxes. Accounting Standards Codification, ASC 740, “Accounting for Income Taxes,” requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate income and taxes in the jurisdiction in which the Company operates. This process involves estimating the actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes.

Deferred tax assets and liabilities occur when taxable income is larger or smaller than reported income on the income statements due to accounting valuation methods that differ from tax, as well as tax rate estimates and payments made quarterly and adjusted to actual at the end of the year. Deferred tax assets and liabilities are temporary differences deductible or payable in future periods. The Company had a net deferred tax liability of \$361,000 at December 31, 2018, and \$607,000 at December 31, 2017.

### Our Business and Operating Strategy and Goals

The Company’s primary objective is to operate 1st Security Bank of Washington as a well capitalized, profitable, independent, community-oriented financial institution, serving customers in its primary market area defined generally as the greater Puget Sound market area. The Company’s strategy is to provide innovative products and superior customer service to small businesses, industry and geographic niches, and individuals located in its primary market area. Services are currently provided to communities through the main office and 21 full-service bank branches and are supported with 24/7 access to on-line banking and participation in a worldwide ATM network.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. The Board of Directors seeks to accomplish the Company’s objectives through the adoption of a strategy designed to improve profitability and maintain a strong capital position and high asset quality. This strategy primarily involves:

Growing and diversifying the loan portfolio and revenue streams. The Company is transitioning lending activities from a predominantly consumer-driven model to a more diversified consumer and business model by emphasizing three key lending initiatives: expansion of commercial business lending programs, increasing in-house originations of residential mortgage loans primarily for sale into the secondary market through the mortgage banking program; and commercial real estate lending. Additionally, the Company seeks to diversify the loan portfolio by increasing lending to small businesses in the market area, as well as residential construction lending.

Maintaining strong asset quality. The Company believes that strong asset quality is a key to long-term financial success. The percentage of non-performing loans to total gross loans and the percentage of non-performing assets to total assets were 0.3% at December 31, 2018 and 0.1% at December 31, 2017. The Company has actively managed the delinquent loans and non-performing assets by aggressively pursuing the collection of consumer debts and marketing saleable properties upon which were foreclosed or repossessed, work-outs of classified assets and loan charge-offs. In the past several years, the Company also began emphasizing consumer loan originations to borrowers with higher credit scores, generally credit scores over 720 (although the policy allows us to go

Table of Contents

lower), which has led to lower charge-offs in recent periods. Although the Company plans to place more emphasis on certain lending products, such as commercial and multi-family real estate loans, construction and development loans, including speculative residential construction loans, and commercial business loans, while growing the current size of the one-to-four-family residential mortgage loans and the consumer loan portfolios, the Company continues to manage its credit exposures through the use of experienced bankers and an overall conservative approach to lending.

Emphasizing lower cost core deposits to reduce the costs of funding loan growth. The Company offers personal and business checking accounts, NOW accounts and savings and money market accounts, which generally are lower-cost sources of funds than certificates of deposit, and are less sensitive to withdrawal when interest rates fluctuate. In order to build a core deposit base, the Company is pursuing a number of strategies. First, a diligent attempt to recruit all commercial loan customers to maintain a deposit relationship with the Company, generally a business checking account relationship to the extent practicable, for the term of their loan. Second, interest rate promotions are provided on savings and checking accounts from time to time to encourage the growth of these types of deposits. Third, by hiring experienced personnel with relationships in the communities we serve.

Capturing customers' full relationship. The Company offers a wide range of products and services that provide diversification of revenue sources and solidify the relationship with the Bank's customers. The Company focuses on core retail and business deposits, including savings and checking accounts, that lead to long-term customer retention. As part of the commercial lending process cross-selling the entire business banking relationship, including deposit relationships and business banking products, such as online cash management, treasury management, wires, direct deposit, payment processing and remote deposit capture. The Company's mortgage banking program also provides opportunities to cross-sell products to new customers.

Expanding the Company's markets. In addition to deepening relationships with existing customers, the Company intends to expand business to new customers by leveraging the Company's well-established involvement in the community and by selectively emphasizing products and services designed to meet their banking needs. The Company also intends to pursue expansion in other market areas through selective growth of the home lending network. As an example, through the Anchor Acquisition, the Company expanded its retail market area into the communities of Aberdeen, Centralia, Elma, Lacey, Montesano, Ocean Shores, Olympia, Puyallup, and Westport, Washington. See Note 2 of the Notes to the Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" of this Form 10 K.

Comparison of Financial Condition at December 31, 2018 and December 31, 2017

Assets. Total assets increased \$639.9 million, or 65.2%, to \$1.62 billion at December 31, 2018, from \$981.8 million at December 31, 2017, primarily the result of increases in loans receivable, net of \$551.0 million, bank owned life insurance ("BOLI") of \$24.2 million, securities available-for-sale of \$14.7 million, total cash and cash equivalents of \$13.9 million, premises and equipment, net of \$13.7 million, FHLB stock of \$7.0 million, core deposit intangible, net of \$4.9 million, certificates of deposit at other financial institutions of \$4.0 million, servicing rights of \$3.6 million, and accrued interest receivable of \$2.2 million, partially offset by a decrease in loans held for sale of \$2.3 million. These increases in assets were from a combination of organic growth and assets acquired in the Anchor Acquisition and were driven by deposit growth including organic growth, acquired deposits of \$321.1 million, and wholesale funding growth including FHLB borrowings and brokered certificates of deposit.

Loans receivable, net, increased \$551.0 million, or 72.3%, to \$1.31 billion at December 31, 2018, from \$761.6 million at December 31, 2017. The increase in loans receivable, net was primarily a result of a \$406.2 million increase in total real estate loans, including increases in commercial real estate loans of \$141.1 million, construction and development loans of \$104.2 million, one-to-four-family loans of \$85.7 million, multi-family loans of \$60.2 million, and home equity loans of \$15.0 million. Total commercial business loans increased \$79.7 million, mostly due to an increase in

commercial and industrial lending of \$55.4 million, including purchases of \$14.0 million in shared national credits and \$9.7 million in U.S. Department of Agriculture loans. Total consumer loans increased \$66.8 million, reflecting primarily growth of \$37.6 million in indirect home improvement loans and \$22.4 million in marine loans. The undisbursed portion of construction and development loans in process increased by \$3.6 million to \$76.9 million at December 31, 2018, as compared to \$73.3 million at December 31, 2017.

Table of Contents

The increase of \$551.0 million in loans receivable, net mentioned above is attributed primarily to the loans acquired in the Anchor Acquisition of \$328.2 million at December 31, 2018. These loans included commercial real estate of \$131.0 million, one-to-four-family of \$55.9 million, multi-family of \$55.5 million, construction and development of \$50.2 million, commercial business of \$19.0 million, home equity of \$13.1 million, and consumer loans of \$3.4 million. Loans held for sale, consisting of one-to-four-family loans, decreased by \$2.3 million, or 4.2%, to \$51.2 million at December 31, 2018, compared to \$53.5 million for the prior year primarily due to lower loan production. The Company continues to expand its home lending operations by hiring additional lending staff and will continue selling one-to-four-family mortgage loans into the secondary market for asset/liability management purposes.

One-to-four-family originations, including \$619.6 million loans held for sale, \$85.2 million portfolio loans including first and second liens, and \$7.1 million loans brokered to other institutions, decreased 12.3% to \$712.0 million during the year ended December 31, 2018, compared to \$812.1 million for the prior year. Originations of one-to-four-family loans to purchase a home (purchase production) decreased by \$66.3 million, or 10.6% with \$558.0 million in loan purchase production closing during the year ended December 31, 2018, down from \$624.3 million for the year ended December 31, 2017. One-to-four-family loan originations for refinance (refinance production) decreased \$40.1 million, or 21.4% with \$146.8 million in refinance production closing during the year ended December 31, 2018, down from \$186.9 million for the year ended December 31, 2017.

The allowance for loan losses (“ALLL”) at December 31, 2018 was \$12.3 million, or 0.9% of gross loans receivable, excluding loans held for sale, compared to \$10.8 million, or 1.4% of gross loans receivable, excluding loans held for sale, at December 31, 2017. In accordance with acquisition accounting, loans acquired in the Anchor Acquisition were recorded at their estimated fair value, which resulted in a net discount to the contractual amounts of the loans, of which a portion reflects a discount for possible credit losses. Credit discounts are included in the determination of fair value and as a result no allowance for loan losses is recorded for acquired loans at the acquisition date. Although the discount recorded on the acquired loans is not reflected in the ALLL, or related allowance coverage ratios, we believe it should be considered when comparing the current ratios to similar ratios in periods prior to the acquisition. The recorded value of loans acquired in the Anchor Acquisition was \$361.6 million, including \$1.3 million of purchased credit impaired loans, and the fair value discount was \$5.3 million, or 1.5% of the loans acquired. Substandard loans increased \$1.5 million, or 23.4%, to \$8.0 million at December 31, 2018, compared to \$6.5 million at December 31, 2017. The \$1.5 million increase in substandard loans was primarily due to the addition of \$1.3 million of non-performing loans acquired in the Anchor Acquisition. Non-performing loans, substantially all of which are non-accruing loans, increased \$2.9 million, to \$3.9 million at December 31, 2018, from \$1.0 million at December 31, 2017. At December 31, 2018, non-performing loans consisted of \$1.8 million of residential real estate loans, \$1.7 million of commercial business loans, and \$428,000 of consumer loans.

Non-performing loans to total gross loans were 0.3% at December 31, 2018, compared to 0.1% at December 31, 2017. There were two other real estate owned properties totaling \$689,000 at December 31, 2018, which were acquired in the Anchor Acquisition, as compared to none at December 31, 2017. See “Item 1. Business - Lending Activities - Asset Quality” of this Form 10 K for additional information regarding the Company’s non-performing loans.

Liabilities. Total liabilities increased \$581.8 million, or 67.7%, to \$1.44 billion at December 31, 2018, from \$859.8 million at December 31, 2017, primarily due to growth in deposits and borrowings. Deposits increased \$444.4 million, or 53.5% to \$1.27 billion at December 31, 2018, from \$829.8 million at December 31, 2017. The majority of deposit growth occurred due to the deposits acquired from the Anchor Acquisition that resulted in growth in all categories of deposits. Relationship-based transactional accounts (noninterest-bearing checking, interest-bearing checking, and escrow accounts) increased \$78.9 million, or 25.7%, to \$385.6 million at December 31, 2018, from \$306.8 million at December 31, 2017. Money market and savings accounts increased \$104.1 million, or 34.6%, to \$404.9 million at December 31, 2018, from \$300.8 million at December 31, 2017. Time deposits increased \$261.4 million, or 117.6%, to \$483.6 million at December 31, 2018, from \$222.3 million at December 31, 2017. Non-retail certificates of deposit

(“CDs”) which includes brokered CDs, online CDs, and public funds, increased \$82.4 million, or 123.9%, to \$148.9 million, at December 31, 2018, compared to \$66.5 million at December 31, 2017. The \$61.0 million year over year increase in non-retail CDs from \$66.5 million at December 31, 2017, primarily reflects a \$57.4 million increase in brokered CDs. Management remains focused on growth in lower cost relationship-based deposits to fund long-term asset growth.

Table of Contents

At December 31, 2018, borrowings increased \$129.6 million, to \$137.1 million from \$7.5 million at December 31, 2017, primarily as a result of continued growth in real estate loans funded with FHLB borrowings and \$36.7 million of FHLB advances assumed in the Anchor Acquisition.

Stockholders' Equity. Total stockholders' equity increased \$58.0 million, or 47.6%, to \$180.0 million at December 31, 2018, from \$122.0 million at December 31, 2017. The increase in stockholders' equity was primarily due to an increase of \$33.8 million in additional paid-in capital as a result of common stock issued in the Anchor Acquisition, and net income of \$24.3 million. Book value per common share was \$41.19 at December 31, 2018, compared to \$34.47 at December 31, 2017.

Table of Contents

## Average Balances, Interest and Average Yields/Cost

The following table sets forth for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin (otherwise known as net yield on interest-earning assets), and the ratio of average interest-earning assets to average interest-bearing liabilities. Also presented is the weighted average yield on interest-earning assets, rates paid on interest-bearing liabilities and the resultant spread at December 31, 2018. Income and all average balances are monthly average balances. Non-accruing loans have been included in the table as loans carrying a zero yield.

At December 31, 2018	Year Ended December 31, 2018		2017		2016			
Yield/ Rate	Average Balance Outstanding	Interest Earned Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned Paid
6.17	% \$ 979,958	\$ 58,616	5.98	% \$ 749,179	\$ 43,457	5.80	% \$ 618,557	\$ 35,772
2.60	49,065	1,190	2.43	46,178	996	2.16	38,515	793
2.94	49,850	1,391	2.79	41,534	1,000	2.41	41,378	895
5.50	7,143	379	5.31	3,617	112	3.10	2,047	50
1.96	42,923	750	1.75	45,913	616	1.34	64,165	510
5.82	% 1,128,939	62,326	5.52	% 886,421	46,181	5.21	% 764,662	38,020
0.71	% 310,913	2,055	0.66	% 315,635	1,260	0.40	% 280,660	1,019
0.12	124,714	227	0.18	88,060	128	0.15	53,310	27
2.02	295,439	5,039	1.71	207,446	2,532	1.22	192,347	2,208
2.41	97,788	2,228	2.28	26,608	334	1.26	26,278	226
6.79	9,855	679	6.89	9,834	679	6.90	9,814	683
1.42	% 838,709	10,228	1.22	% 647,583	4,933	0.76	% 562,409	4,163



		\$ 52,098		\$ 41,248		\$ 33,857
4.41	%		4.30 %		4.45 %	
		\$ 290,230		\$ 238,838		\$ 202,253
N/A			4.61 %		4.65 %	
		134.60 %		136.88 %		135.96 %

(1) The average loans receivable, net balances include non-accruing loans.

Table of Contents

## Rate/Volume Analysis

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

(In thousands)	Year Ended December 31, 2018 vs. 2017			Year Ended December 31, 2017 vs. 2016		
	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Total Increase (Decrease)	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Total Increase (Decrease)
<b>Interest-earning assets:</b>						
Loans receivable, net and loans held for sale(1)	\$ 13,386	\$ 1,773	\$ 15,159	\$ 7,554	\$ 131	\$ 7,685
Mortgage-backed securities	62	132	194	158	45	203
Investment securities	200	191	391	3	102	105
FHLB stock	109	158	267	38	24	62
Interest-bearing deposits at other financial institutions	(40)	174	134	(145)	251	106
Total interest-earning assets	\$ 13,717	\$ 2,428	\$ 16,145	\$ 7,608	\$ 553	\$ 8,161
<b>Interest-bearing liabilities:</b>						
Savings and money market	\$ (19)	\$ 814	\$ 795	\$ 127	\$ 114	\$ 241
Interest-bearing checking	53	46	99	18	83	101
Certificates of deposit	1,074	1,433	2,507	173	151	324
Borrowings	894	1,000	1,894	3	105	108
Subordinated note	1	(1)	—	1	(5)	(4)
Total interest-bearing liabilities	\$ 2,003	\$ 3,292	\$ 5,295	\$ 322	\$ 448	\$ 770
Net change in interest income			\$ 10,850			\$ 7,391

(1) The average loans receivable, net balances include non-accruing loans.

## Comparison of Results of Operations for the Years Ended December 31, 2018 and 2017

**General.** Net income for the year ended December 31, 2018, increased \$10.3 million, or 72.9%, to \$24.3 million, from \$14.1 million for the year ended December 31, 2017. The increase in net income was primarily a result of a \$16.1 million, or 35.0% increase in interest income, a \$2.8 million increase in noninterest income, and a \$2.3 million reduction in provision for income tax expense, partially offset by a \$5.3 million, or 107.3% increase in interest expense, a \$4.8 million increase in noninterest expense, and a \$790,000 increase in the provision for loan losses.

**Net Interest Income.** Net interest income increased \$10.9 million, or 26.3%, to \$52.1 million for the year ended December 31, 2018, from \$41.2 million for the year ended December 31, 2017. The increase in net interest income was primarily attributable to a \$15.2 million, or 34.9% increase in loan receivable interest income resulting from a \$230.8 million increase in average loans receivable, net and loans held for sale over the last year, and a \$986,000, or

36.2% increase in interest and dividends on investment securities, and cash and cash equivalents, partially offset by a \$5.3 million or 107.3% increase in total interest expense.

The net interest margin (“NIM”) decreased four basis points to 4.61% for the year ended December 31, 2018, from 4.65% for the same period last year. The decrease in NIM was driven primarily by the significant growth in assets from the Anchor Acquisition along with higher cost market rate deposits and increased borrowing costs to fund loan growth. The average cost of funds for total interest-bearing liabilities increased 46 basis points to 1.22% for the year ended December 31, 2018, from 0.76% for the year ended December 31, 2017. This increase was predominantly due to the

Table of Contents

growth in time deposits and an increase in short-term overnight FHLB borrowing rates reflecting increases in the targeted federal funds rate. Management remains focused on matching deposit/liability duration with the duration of loans/assets where appropriate.

**Interest Income.** Interest income for the year ended December 31, 2018, increased \$16.1 million, or 35.0%, to \$62.3 million, from \$46.2 million for the year ended December 31, 2017. The increase during the year was primarily attributable to an increase in the average balance of loans receivable, net and loans held for sale to \$980.0 million for the year ended December 31, 2018, compared to \$749.2 million for the year ended December 31, 2017, and a 31 basis point increase in the average yield on interest-earning assets to 5.52% during the year ended December 31, 2018, from 5.21% for the prior year. The increase in average yield on interest-earning assets compared to the prior year primarily reflects the growth in the loan portfolio and the proportionally larger level of loans in the average interest-earning asset mix. The average yield on loans receivable, net and loans held for sale increased to 5.98% during the year ended December 31, 2018, from 5.80% for the prior year.

The following table compares average earning asset balances, associated yields, and resulting changes in interest income for the years ended December 31, 2018 and 2017:

	Year Ended December 31, 2018		2017		Increase in Interest Income
	Average Balance Outstanding	Yield/ Rate	Average Balance Outstanding	Yield/ Rate	
(Dollars in thousands)					
Loans receivable, net and loans held for sale	\$ 979,958	5.98 %	\$ 749,179	5.80 %	\$ 15,159
Mortgage-backed securities	49,065	2.43	46,178	2.16	194
Investment securities	49,850	2.79	41,534	2.41	391
FHLB stock	7,143	5.31	3,617	3.10	267
Interest-bearing deposits at other financial institutions	42,923	1.75	45,913	1.34	134
Total interest-earning assets	\$ 1,128,939	5.52 %	\$ 886,421	5.21 %	\$ 16,145

(1) The average loans receivable, net balances include non-accruing loans.

**Interest Expense.** Interest expense increased \$5.3 million, or 107.3%, to \$10.2 million for the year ended December 31, 2018, from \$4.9 million for the prior year. The increase was primarily attributable to an increase in interest expense on deposits of \$3.4 million, and an increase in interest on borrowings of \$1.9 million. The average cost of funds for total interest-bearing liabilities increased 46 basis points to 1.22% for the year ended December 31, 2018, compared to 0.76% for the year ended December 31, 2017. The average cost of deposits increased 26 basis points to 0.76% for the year ended December 31, 2018, compared to 0.50% for the year ended December 31, 2017, reflecting primarily the increase of time deposits and rising interest rates over the last year.

The following table details average balances for cost of funds on interest-bearing liabilities and the change in interest expense for the years ended December 31, 2018 and 2017:

	Year Ended December 31, 2018		2017		Increase in Interest
	Average Balance		Average Balance		

Edgar Filing: FS Bancorp, Inc. - Form 10-K

(Dollars in thousands)	Outstanding	Yield		Outstanding	Yield	Expense
Savings and money market	\$ 310,913	0.66	%	\$ 315,635	0.40	\$ 795
Interest-bearing checking	124,714	0.18		88,060	0.15	99
Certificates of deposit	295,439	1.71		207,446	1.22	2,507
Borrowings	97,788	2.28		26,608	1.26	1,894
Subordinated note	9,855	6.89		9,834	6.90	—
Total interest-bearing liabilities	\$ 838,709	1.22	%	\$ 647,583	0.76	\$ 5,295

Table of Contents

Provision for Loan Losses. The provision for loan losses was \$1.5 million for the year ended December 31, 2018, compared to \$750,000 for the year ended December 31, 2017. The increase in the provision was primarily due to organic loan growth. During the year ended December 31, 2018, net recoveries totaled \$53,000 compared to net charge-offs of \$205,000 during the year ended December 31, 2017.

The following table details activity and information related to the allowance for loan losses for the years ended December 31, 2018 and 2017:

(Dollars in thousands)	At or For the Year Ended December 31,			
	2018	2017		
Provision for loan losses	\$ 1,540	\$ 750		
Net (recoveries) charge-offs	\$ (53)	\$ 205		
Allowance for loan losses	\$ 12,349	\$ 10,756		
Allowance for loan losses as a percentage of total gross loans receivable at the end of the year	0.9	%	1.4	%
Non-accrual and 90 days or more past due loans	\$ 3,894	\$ 1,039		
Allowance for loan losses as a percentage of non-performing loans at end of year	317.1	%	1,035.2	%
Non-accrual and 90 days or more past due loans as a percentage of gross loans receivable at the end of the year	0.3	%	0.1	%
Total gross loans	\$ 1,326,238	\$ 773,445		

Management considers the allowance for loan losses at December 31, 2018, to be adequate to cover estimated losses inherent in the loan portfolio based on the assessment of the above-mentioned factors affecting the loan portfolio. While management believes the estimates and assumptions used in its 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 the Company's financial condition and results of operations. In addition, the determination of the amount of allowance for loan losses is subject to review by bank regulators, as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

Noninterest Income. Noninterest income increased \$2.8 million, to \$26.9 million for the year ended December 31, 2018, from \$24.1 million for the year ended December 31, 2017. The following table provides a detailed analysis of the changes in the components of noninterest income:

(Dollars in thousands)	Year Ended December 31,		Increase/(Decrease)	
	2018	2017	Amount	Percent
Service charges and fee income	\$ 3,233	\$ 3,548	\$ (315)	(8.9) %
Bargain purchase gain	7,414	—	7,414	100.0
Gain on sale of loans	14,861	17,985	(3,124)	(17.4)
Loss on disposed fixed assets	(71)	—	(71)	(100.0)
Gain on sale of investment securities	171	380	(209)	(55.0)
Gain on sale of mortgage servicing rights	—	1,062	(1,062)	(100.0)
Earnings on cash surrender value of BOLI	413	274	139	50.7

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Other noninterest income	829	825	4	0.5	
Total noninterest income	\$ 26,850	\$ 24,074	\$ 2,776	11.5	%

The increase during the period was primarily due to the bargain purchase gain of \$7.4 million related to the Anchor Acquisition, partially offset by a decrease in gain on sale of loans of \$3.1 million, no gain on sale of mortgage servicing rights in 2018 compared to \$1.1 million in 2017, a \$315,000 reduction in service charges and fee income, due in part to the sale of mortgage servicing rights in 2017, and a \$209,000 reduction in gain on sale of investment securities. The reduction in the gain on sale of loans included a reduction in the favorable fair-value adjustment on derivative financial instruments (commitments to extend credit, commitments to sell loans, mortgage backed securities trades and option contracts) and reflects a reduction of gain on sale margins associated with the product mix in the Pacific Northwest. The

80

---

Table of Contents

margin on loans sold decreased to 2.42% for the year ended December 31, 2018, from 2.50% a year ago. For the year ended December 31, 2018, we recorded a net loss of \$702,000 for changes in the valuation of derivatives carried at fair value, compared to a net gain of \$2.3 million for the year ended December 31, 2017, which are included in gain on sale of loans. These adjustments in fair value primarily reflect changes in loan volume and interest rate lock commitments issued as a result of subsequent changes in the level of market interest rates. See Note 17 of the Notes to Consolidated Financial Statements included in “Item 8, Financial Statements and Supplementary Data” of this Form 10 K. During the year ended December 31, 2018, the Company originated \$712.0 million of one-to-four-family consumer mortgages during 2018 and sold \$623.6 million to secondary mortgage market investors, and \$14.1 million to another financial institution, compared to sales of \$718.0 million during the year ended December 31, 2017.

Noninterest Expense. Noninterest expense increased \$4.8 million, to \$48.8 million for the year ended December 31, 2018, compared to \$44.0 million for the year ended December 31, 2017. The following table provides an analysis of the changes in the components of noninterest expense:

(Dollars in thousands)	Year Ended		Increase	
	December 31,	December 31,	(Decrease)	
	2018	2017	Amount	Percent
Salaries and benefits	\$ 28,538	\$ 26,595	\$ 1,943	7.3 %
Operations	6,709	6,205	504	8.1
Occupancy	3,042	2,672	370	13.8
Data processing	2,870	2,521	349	13.8
OREO Expense	2	—	2	100.0
Loan costs	2,801	2,652	149	5.6
Professional and board fees	1,872	1,697	175	10.3
FDIC insurance	517	535	(18)	(3.4)
Marketing and advertising	747	716	31	4.3
Acquisition costs	1,389	—	1,389	100.0
Amortization of core deposit intangible	351	400	(49)	(12.3)
Total noninterest expense	\$ 48,838	\$ 43,993	\$ 4,845	11.0 %

At December 31, 2018, the Company employed 424 full-time equivalent employees compared to 326 at December 31, 2017 primarily due to the Anchor Acquisition and growth in our operations which, combined, increased our salaries and benefits expense by \$1.9 million. Other significant increases in noninterest expense were acquisition costs of \$1.4 million related to the Anchor Acquisition as well as \$504,000 in operations, \$370,000 in occupancy expense, and \$349,000 in data processing expense. Included in salaries and benefits expense was a \$1.1 million decrease in commissions and incentives reflecting lower one-to-four-family loan originations as a result of the impact of rising interest rates in 2018 and a reduction of homes available for sale in the Pacific Northwest.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, improved to 61.9% for the year ended December 31, 2018, compared to 67.4% for the year ended December 31, 2017. By definition, a lower efficiency ratio would be an indication that the Company is more efficiently utilizing resources to generate income.

Provision for Income Tax. During the year ended December 31, 2018, the Company recorded a provision for income tax expense of \$4.2 million compared to \$6.5 million for the year ended December 31, 2017 reflecting both higher pre-tax income taxed at the reduced federal corporate income tax rate effective January 1, 2018 from the Tax Act and



no tax benefit recognized in 2018 compared to a tax benefit recognized in 2017 as a result of the Tax Act. The Tax Act required a revaluation the Company's deferred tax assets and liabilities to account for the future impact of lower federal corporate income tax rates and other provisions of the legislation. As a result of the Company's revaluation, the Company recognized \$396,000 in tax benefit for the year ended December 31, 2017 due to a net deferred tax liability position. There was a net deferred tax liability of \$361,000 and \$607,000 at December 31, 2018 and 2017, respectively. The effective tax rate for the year ended December 31, 2018 was 14.8%, compared to 31.6% for the year ended December 31, 2017. The tax benefit recognized in 2018 due to the impact of Accounting Standards Update 2016-09 was \$484,000.

Table of Contents

Asset and Liability Management and Market Risk

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

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

**How The Company Measures Risk of Interest Rate Changes.** As part of an attempt to manage exposure to changes in interest rates and comply with applicable regulations, the Company monitors interest rate risk. In doing so, the Company analyzes and manages assets and liabilities based on their interest rates and payment streams, timing of maturities, repricing opportunities, and sensitivity to actual or potential changes in market interest rates.

The Company is subject to interest rate risk to the extent that its interest-bearing liabilities, primarily deposits and FHLB advances, reprice more rapidly or at different rates than the interest-earning assets. In order to minimize the potential for adverse effects of material prolonged increases or decreases in interest rates on the Company's results of operations, the Company has adopted an Asset and Liability Management Policy. The Board of Directors sets the Asset and Liability Management Policy for the Bank, which is implemented by the asset/liability committee ("ALCO"), an internal management committee. The board level oversight for ALCO is performed by the audit committee of the Board of Directors.

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

The committee generally meets monthly to, among other things, protect capital through earnings stability over the interest rate cycle; maintain the Bank's well capitalized status; and provide a reasonable return on investment. The committee recommends appropriate strategy changes based on this review. The committee is responsible for reviewing and reporting the effects of the policy implementations and strategies to the Board of Directors at least quarterly. The Chief Financial Officer oversees the process on a daily basis.

A key element of the Bank's asset/liability management plan is to protect net earnings by managing the maturity or repricing mismatch between interest-earning assets and rate-sensitive liabilities. The Company seeks to accomplish this by extending funding maturities through wholesale funding sources, including the use of FHLB advances and brokered certificates of deposit, and through asset management, including the use of adjustable-rate loans and selling certain fixed-rate loans in the secondary market. Management is also focused on matching deposit duration with the

duration of earning assets as appropriate.

82

---

Table of Contents

As part of the efforts to monitor and manage interest rate risk, a number of indicators are used to monitor overall risk. Among the measurements are:

**Market Risk.** Market risk is the potential change in the value of investment securities if interest rates change. This change in value impacts the value of the Company and the liquidity of the securities. Market risk is controlled by setting a maximum average maturity/average life of the securities portfolio to 10 years.

**Economic Risk.** Economic risk is the risk that the underlying value of a bank will change when rates change. This can be caused by a change in value of the existing assets and liabilities (this is called Economic Value of Equity or EVE), or a change in the earnings stream (this is caused by interest rate risk). The Company takes economic risk primarily when fixed rate loans are made, or purchase fixed-rate investments, or issue long term certificates of deposit or take fixed-rate FHLB advances. It is the risk that interest rates will change and these fixed-rate assets and liabilities will change in value. This change in value usually is not recognized in the earnings, or equity (other than marking to market securities available-for-sale or fair value adjustments on loans held for sale). The change is recognized only when the assets and liabilities are liquidated. Although the change in market value is usually not recognized in earnings or in capital, the impact is real to the long-term value of 1st Security Bank of Washington. Therefore, the Company will control the level of economic risk by limiting the amount of long-term, fixed-rate assets the Company will have and by setting a limit on concentrations and maturities of securities.

**Interest Rate Risk.** If the Federal Reserve Board changes the Fed Funds rate 100, 200 or 300 basis points, the Bank policy dictates that a change in net interest income should not change more that 7.5%, 15% and 30%, respectively.

The table presented below, as of December 31, 2018, is an analysis prepared for 1st Security Bank of Washington by Olson Research Associates, Inc. utilizing various market and actual experience-based assumptions. The table represents a static shock to the net interest income using instantaneous and sustained shifts in the yield curve, in 100 basis point increments, up and down 100 basis points. No rates in the model are allowed to go below zero. Given that the current targeted Fed Funds rate is a range of 2.25% to 2.50%, a 300 basis point reduction in rates is not reported. The results reflect a projected income statement with minimal exposure to instantaneous changes in interest rates. These results are primarily based upon historical prepayment speeds within the consumer lending portfolio in combination with the above average yields associated with the consumer portfolio if those prepayments do not occur.

Change in Interest Rates in Basis Points	December 31, 2018 Net Interest Income		
	Amount	Change	Change
	(Dollars in thousands)		
300bp	\$ 56,318	\$ (7,748)	(12.09) %
200bp	59,460	(4,606)	(7.19)
100bp	62,137	(1,929)	(3.01)
0bp	64,066	—	—
(100)bp	65,307	1,241	1.94
(200)bp	63,447	(619)	(0.97)

In managing the assets/liability mix the Company typically places an equal emphasis on maximizing net interest margin and matching the interest rate sensitivity of the assets and liabilities. From time to time, however, depending on the relationship between long- and short-term interest rates, market conditions and consumer preference, the Company may place somewhat greater emphasis on maximizing net interest margin than on strict dollar for dollar categories matching the interest rate sensitivity of the assets and liabilities. Management also believes that the

increased net income which may result from a prepayment assumption mismatch in the actual maturity or repricing of the asset and liability portfolios can, during periods of changing interest rates, provide sufficient returns to justify the increased exposure to sudden and unexpected increases in interest rates which may result from such a mismatch. Management believes that 1st Security Bank of Washington's level of interest rate risk is acceptable under this approach.

In evaluating 1st Security Bank of Washington's exposure to interest rate movements, certain shortcomings inherent in the method of analysis presented in the foregoing table must be considered. For example, although certain assets and liabilities may have similar maturities or repricing periods, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest

## Table of Contents

rates, while interest rates on other types may lag behind changes in interest rates. Additionally, certain assets, such as adjustable rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed above. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. 1st Security Bank of Washington considers all of these factors in monitoring its exposure to interest rate risk.

## Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit runoff that may occur in the normal course of business. The Company relies on a number of different sources in order to meet potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, purchases of Fed Funds, sale of securities available-for-sale, cash flows from loan payments, sales of one-to-four-family loans held for sale, and maturing securities.

At December 31, 2018, the Bank's total borrowing capacity was \$262.9 million with the FHLB of Des Moines, with unused borrowing capacity of \$120.0 million at that date. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. At December 31, 2018, the Bank held approximately \$355.5 million in loans that qualify as collateral for FHLB advances.

In addition to the availability of liquidity from the FHLB of Des Moines, the Bank maintained a short-term borrowing line with the Federal Reserve Bank, with a current limit of \$127.7 million, and a combined credit limit of \$51.0 million in written Fed Funds lines of credit through correspondent banking relationships as of December 31, 2018. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. At December 31, 2018, the Bank held approximately \$265.2 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

At December 31, 2018, \$137.1 million in FHLB advances and FHLB Fed Funds were outstanding, and no advances were outstanding against the Federal Reserve Bank line of credit, and Fed Funds lines of credit. The Bank's Asset and Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or \$263.2 million as of December 31, 2018. Total brokered deposits as of December 31, 2018 were \$116.7 million, or 9.2% of total deposits. Management utilizes brokered deposits to mitigate interest rate risk exposure where appropriate.

Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and Fed Funds. On a longer term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and U.S. agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At December 31, 2018, the approved outstanding loan commitments, including unused lines of credit, amounted to \$295.8 million. Certificates of deposit scheduled to mature in one year or less at December 31, 2018, totaled \$290.8 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing deposits will remain with the Bank.

As a separate legal entity from the Bank, FS Bancorp, Inc. must provide for its own liquidity. Sources of capital and liquidity for the FS Bancorp, Inc. include distributions from the Bank and the issuance of debt or equity securities. Dividends and other capital distributions from the Bank are subject to regulatory notice. At December 31, 2018, FS Bancorp, Inc. had \$7.0 million in unrestricted cash to meet liquidity needs.

## Off-Balance Sheet Activities

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. For information regarding our commitments and off-balance sheet arrangements, see Note 12 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

Table of Contents

A summary of off-balance sheet commitments to extend credit at December 31, 2018 was as follows:

	(In thousands)
Off-balance sheet loan commitments:	
Real estate secured (1)	\$ 118,954
Commercial business loans	117,123
Home equity loans and lines of credit	41,204
Consumer loans	18,560
Total commitments to extend credit	\$ 295,841

(1) Includes held for sale interest rate lock commitments.

### Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at December 31, 2018, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a well capitalized status under the capital categories of the FDIC. Based on capital levels at December 31, 2018, the Bank was considered to be well capitalized. At December 31, 2018, the Bank exceeded all regulatory capital requirements with Tier 1 leverage-based capital, Tier 1 risk-based capital, total risk-based capital, and common equity Tier 1 (“CET1”) capital ratios of 10.7%, 12.6%, 13.5%, and 12.6%, respectively. For additional information regarding the Bank’s regulatory capital compliance, see the discussion included in Note 14 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

As a bank holding company registered with the Federal Reserve, the Company is subject to the capital adequacy requirements of the Federal Reserve. For a bank holding company with less than \$3.0 billion in assets, the capital guidelines apply on a bank only basis, and the Federal Reserve expects the holding company’s subsidiary bank to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. were subject to regulatory capital guidelines for bank holding companies with \$3.0 billion or more in assets at December 31, 2018, FS Bancorp would have exceeded all regulatory capital requirements.

The following table compares 1st Security Bank of Washington’s actual capital amounts at December 31, 2018, to its minimum regulatory capital requirements at that date:

(Dollars in thousands) As of December 31, 2018 Total risk-based capital (to risk-weighted assets)	Actual		For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	\$ 188,472	13.52 %	\$ 111,493	8.00 %	\$ 137,694	9.88 %	\$ 139,366	10.00 %



Tier 1 risk-based capital (to risk-weighted assets)	\$ 175,824	12.62 %	\$ 83,620	6.00 %	\$ 109,820	7.88 %	\$ 111,493	8.00 %
Tier 1 leverage capital (to average assets)	\$ 175,824	10.67 %	\$ 65,884	4.00 %	—	N/A	\$ 82,355	5.00 %
CET1 capital (to risk-weighted assets)	\$ 175,824	12.62 %	\$ 62,715	4.50 %	\$ 88,846	6.38 %	\$ 90,588	6.50 %

#### Recent Accounting Pronouncements

For a discussion of recent accounting standards, please see Note 1 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

Table of Contents

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises principally from interest rate risk inherent in lending, investing, deposit and borrowings activities. Management actively monitors and manages its interest rate risk exposure. In addition to other risks that are managed in the normal course of business, such as credit quality and liquidity, management considers interest rate risk to be a significant market risk that could potentially have a material effect on the Company's financial condition and result of operations. The information contained in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management" of this Form 10 K is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data

FS BANCORP, INC. AND SUBSIDIARY

INDEX TO FINANCIAL STATEMENTS

Index to Consolidated Financial Statements

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	87
<u>Consolidated Balance Sheets at December 31, 2018 and 2017</u>	89
<u>Consolidated Statements of Income For the Years Ended December 31, 2018 and 2017</u>	90
<u>Consolidated Statements of Comprehensive Income For the Years Ended December 31, 2018 and 2017</u>	91
<u>Consolidated Statements of Changes in Stockholders' Equity For the Years Ended December 31, 2018 and 2017</u>	92
<u>Consolidated Statements of Cash Flows For the Years Ended December 31, 2018 and 2017</u>	93
<u>Notes to Consolidated Financial Statements</u>	95

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors

FS Bancorp, Inc.

Mountlake Terrace, Washington

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of FS Bancorp, Inc. and subsidiary (“the Company”) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for the years then ended, and the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by COSO.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control over Financial Reporting included in Item 9A. Our responsibility is to express an opinion on the Company’s consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of

material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

#### Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the

Table of Contents

transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Moss Adams LLP

Everett, Washington

March 15, 2019

We have served as the Company's auditor since 2006.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2018 AND 2017

(In thousands, except share data)

	December 31, 2018	December 31, 2017
ASSETS		
Cash and due from banks	\$ 9,408	\$ 3,043
Interest-bearing deposits at other financial institutions	23,371	15,872
Total cash and cash equivalents	32,779	18,915
Certificates of deposit at other financial institutions	22,074	18,108
Securities available-for-sale, at fair value	97,205	82,480
Loans held for sale, at fair value	51,195	53,463
Loans receivable, net	1,312,519	761,558
Accrued interest receivable	5,761	3,566
Premises and equipment, net	29,110	15,458
Federal Home Loan Bank ("FHLB") stock, at cost	9,887	2,871
Other real estate owned ("OREO")	689	—
Bank owned life insurance ("BOLI"), net	34,485	10,328
Servicing rights, held at the lower of cost or fair value	10,429	6,795

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Goodwill	2,312	2,312
Core deposit intangible, net	6,217	1,317
Other assets	6,982	4,612
<b>TOTAL ASSETS</b>	<b>\$ 1,621,644</b>	<b>\$ 981,783</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing accounts	\$ 234,532	\$ 186,890
Interest-bearing accounts	1,039,687	642,952
Total deposits	1,274,219	829,842
Borrowings	137,149	7,529
Subordinated note:		
Principal amount	10,000	10,000
Unamortized debt issuance costs	(135)	(155)
Total subordinated note less unamortized debt issuance costs	9,865	9,845
Deferred tax liability, net	361	607
Other liabilities	20,012	11,958
Total liabilities	1,441,606	859,781
<b>COMMITMENTS AND CONTINGENCIES (NOTE 12)</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.01 par value; 45,000,000 shares authorized; 4,492,478 and 3,680,152 shares issued and outstanding at December 31, 2018 and December 31, 2017, respectively	45	37
Additional paid-in capital	91,466	55,135
Retained earnings	90,854	68,422

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Accumulated other comprehensive loss, net of tax	(1,479)	(475)
Unearned shares – Employee Stock Ownership Plan (“ESOP”)	(848)	(1,117)
Total stockholders’ equity	180,038	122,002
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	\$ 1,621,644	\$ 981,783

See accompanying notes to these consolidated financial statements.



Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017

(In thousands, except earnings per share data)

	2018	2017
INTEREST INCOME		
Loans receivable, including fees	\$ 58,616	\$ 43,457
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	3,710	2,724
Total interest and dividend income	62,326	46,181
INTEREST EXPENSE		
Deposits	7,321	3,920
Borrowings	2,228	334
Subordinated note	679	679
Total interest expense	10,228	4,933
NET INTEREST INCOME	52,098	41,248
PROVISION FOR LOAN LOSSES	1,540	750
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	50,558	40,498
NONINTEREST INCOME		
Service charges and fee income	3,233	3,548
Bargain purchase gain	7,414	—
Gain on sale of loans	14,861	17,985
Loss on disposed fixed assets	(71)	—
Gain on sale of investment securities	171	380
Gain on sale of mortgage servicing rights (“MSR”)	—	1,062
Earnings on cash surrender value of BOLI	413	274
Other noninterest income	829	825
Total noninterest income	26,850	24,074
NONINTEREST EXPENSE		
Salaries and benefits	28,538	26,595
Operations	6,709	6,205
Occupancy	3,042	2,672
Data processing	2,870	2,521
OREO expenses	2	—
Loan costs	2,801	2,652
Professional and board fees	1,872	1,697
Federal Deposit Insurance Corporation (“FDIC”) insurance	517	535
Marketing and advertising	747	716

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Acquisition costs	1,389	—
Amortization of core deposit intangible	351	400
Total noninterest expense	48,838	43,993
INCOME BEFORE PROVISION FOR INCOME TAXES	28,570	20,579
PROVISION FOR INCOME TAXES	4,223	6,494
NET INCOME	\$ 24,347	\$ 14,085
Basic earnings per share	\$ 6.58	\$ 4.55
Diluted earnings per share	\$ 6.29	\$ 4.28

See accompanying notes to these consolidated financial statements.

Table of Contents

FS BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017

(In thousands)

	Year Ended December 31,	
	2018	2017
Net Income	\$ 24,347	\$ 14,085
Other comprehensive (loss) income, before tax:		
Securities available-for-sale:		
Unrealized holding (loss) gain during year	(1,108)	605
Income tax benefit (provision) related to unrealized holding (loss) gain	238	(213)
Reclassification adjustment for realized gain included in net income	(171)	(380)
Income tax provision related to reclassification for realized gain	37	133
Other comprehensive (loss) income, net of tax	(1,004)	145
COMPREHENSIVE INCOME	\$ 23,343	\$ 14,230

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017

(In thousands, except share data)

	Common Stock Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Tax	Unearned ESOP Shares	Total Stockholders' Equity
BALANCE, January 1, 2017	3,059,503	\$ 31	\$ 27,334	\$ 55,584	\$ (536)	\$ (1,380)	\$ 81,033
Net income	—	\$ —	—	14,085	—	—	\$ 14,085
Dividends paid (\$0.43 per share)	—	\$ —	—	(1,331)	—	—	\$ (1,331)
Proceeds from public offering, net of expenses of \$326,000	587,234	\$ 6	25,612	—	—	—	\$ 25,618
Share-based compensation	—	\$ —	634	—	—	—	\$ 634
Common stock repurchased	(6,198)	\$ —	(275)	—	—	—	\$ (275)
Stock options exercised	39,613	\$ —	669	—	—	—	\$ 669
Other comprehensive income, net of tax	—	\$ —	—	—	145	—	\$ 145
ESOP shares allocated	—	\$ —	1,161	—	—	263	\$ 1,424
Income tax rate differential	—	\$ —	—	84	(84)	—	\$ —
BALANCE, December 31, 2017	3,680,152	\$ 37	\$ 55,135	\$ 68,422	\$ (475)	\$ (1,117)	\$ 122,002
BALANCE, January 1, 2018	3,680,152	\$ 37	\$ 55,135	\$ 68,422	\$ (475)	\$ (1,117)	\$ 122,002
Net income	—	\$ —	—	24,347	—	—	\$ 24,347

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Dividends paid (\$0.53 per share)	—	\$ —	—	(1,915)	—	—	\$ (1,915)
Share-based compensation	—	\$ —	767	—	—	—	\$ 767
Restricted stock awards	25,000	\$ —	—	—	—	—	\$ —
Common stock issued	725,518	\$ 7	33,759	—	—	—	\$ 33,766
Common stock repurchased	(4,325)	\$ —	(251)	—	—	—	\$ (251)
Stock options exercised	66,133	\$ 1	1,116	—	—	—	\$ 1,117
Other comprehensive loss, net of tax	—	\$ —	—	—	(1,004)	—	\$ (1,004)
ESOP shares allocated	—	\$ —	940	—	—	269	\$ 1,209
<b>BALANCE, December 31, 2018</b>	<b>4,492,478</b>	<b>\$ 45</b>	<b>\$ 91,466</b>	<b>\$ 90,854</b>	<b>\$ (1,479)</b>	<b>\$ (848)</b>	<b>\$ 180,038</b>

See accompanying notes to these consolidated financial statements.

Table of Contents

## FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017

(In thousands)

	Year Ended December 31,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 24,347	\$ 14,085
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,540	750
Depreciation, amortization and accretion	5,263	3,938
Compensation expense related to stock options and restricted stock awards	767	634
ESOP compensation expense for allocated shares	1,209	1,424
Benefit for deferred income taxes	(768)	(718)
Increase in cash surrender value of BOLI	(413)	(274)
Bargain purchase gain	(7,414)	—
Gain on sale of loans held for sale	(14,654)	(17,487)
Gain on sale of portfolio loans	(207)	(498)
Gain on sale of investment securities	(171)	(380)
Gain on sale of MSR	—	(1,062)
Loss on disposed fixed assets	71	—
Origination of loans held for sale	(619,632)	(698,504)
Proceeds from sale of loans held for sale	631,309	711,766
Changes in operating assets and liabilities		
Accrued interest receivable	(2,156)	(1,042)
Other assets	2,862	1,256
Other liabilities	(516)	1,196
Net cash from operating activities	21,437	15,084
<b>CASH FLOWS USED BY INVESTING ACTIVITIES</b>		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	24,312	39,103
Maturities, prepayments, sales, and calls	10,243	7,580
Purchases	(31,309)	(47,271)
Maturities of certificates of deposit at other financial institutions	992	1,240
Purchase of certificates of deposit at other financial institutions	(4,960)	(4,102)
Loan originations and principal collections, net	(190,125)	(155,793)
Purchase of portfolio loans	(24,007)	(38,950)
Proceeds from sale of portfolio loans	17,952	25,120

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Purchase of premises and equipment, net	(3,796)	(1,016)
Purchase of BOLI	(3,000)	—
Net change in FHLB stock, net	(7,016)	(152)
Net cash acquired from Anchor Acquisition	23,753	—
Proceeds from sale of MSR	—	4,827
Net cash used by investing activities	(186,961)	(169,414)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	87,566	117,249
Proceeds from borrowings	917,239	495,274
Repayments of borrowings	(824,368)	(500,415)
Dividends paid	(1,915)	(1,331)
Proceeds from stock options exercised	1,117	669
Common stock repurchased	(251)	(275)
Proceeds from issuance of common stock	—	25,618
Net cash from financing activities	179,388	136,789

FS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017 (Continued)

Table of Contents

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	13,864	(17,541)
CASH AND CASH EQUIVALENTS, beginning of year	18,915	36,456
CASH AND CASH EQUIVALENTS, end of year	\$ 32,779	\$ 18,915

## SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the period for:

Interest on deposits and borrowings	\$ 10,098	\$ 4,904
Income taxes	2,902	8,100
Anchor acquisition:		
Assets acquired, excluding cash acquired	420,305	—
Liabilities assumed	402,878	—

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

Change in unrealized (loss) gain on investment securities, net	(1,279)	225
Transfer portfolio loans to loans held for sale	—	1,886
Retention of gross mortgage servicing rights from loan sales	5,971	5,075
Additional paid-in-capital from common stock issued	\$ 33,766	\$ —

See accompanying notes to these consolidated financial statements.



Table of Contents

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

Nature of Operations - FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the proposed holding company for 1st Security Bank of Washington (the “Bank” or “1st Security Bank”) in connection with the Bank’s conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based savings bank with 21 full-service bank branches, an administrative office that accepts deposits, and eight home loan production offices in suburban communities in the greater Puget Sound area which includes Snohomish, King, Pierce, Jefferson, Kitsap, Clallam, and the newly added Grays Harbor, Thurston, and Lewis counties, and one home loan production office in the market area of the Tri-Cities, Washington. The Bank provides loan and deposit services to customers who are predominantly small- and middle-market businesses and individuals. The Company and its subsidiary are subject to regulation by certain federal and state agencies and undergo periodic examination by these regulatory agencies.

The Company expanded its footprint in 2018 through the recent merger and acquisition. On November 15, 2018, the Company completed its acquisition of Anchor Bancorp (“Anchor”), pursuant to the Agreement and Plan of Merger dated as of July 17, 2018 (the “Merger Agreement”) by and between FS Bancorp and Anchor. Under the terms of the Merger Agreement, Anchor merged with and into FS Bancorp (“Anchor Acquisition”), with FS Bancorp as the surviving corporation. Immediately after the Anchor Acquisition, FS Bancorp merged Anchor Bank, a wholly-owned subsidiary of Anchor, with and into 1st Security Bank of Washington, a wholly-owned subsidiary of FS Bancorp, with 1st Security Bank of Washington as the surviving bank. For additional information, see “Note 2 - Business Combination.”

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

Financial Statement Presentation - The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) and with prevailing practices within the banking and securities industries. In preparing such financial statements, management is required to make certain estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheet and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan and lease losses, fair value of financial instruments, the valuation of servicing rights, and the deferred income taxes.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented to the nearest thousands of dollars except per share amounts. If the amounts are above \$1.0 million, they are rounded one decimal point, and if they are above \$1.0 billion, they are rounded two decimal points. Certain prior year amounts have been reclassified to conform to the 2018 presentation with no change to consolidated net income or stockholders’ equity previously reported.

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

Segment Reporting - The Company operates in two business segments through the Bank: commercial and consumer banking and home lending. The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is regularly reviewed for the purpose of allocating resources and evaluating performance of the Company's businesses. The results for these business segments are based on management's accounting process, which assigns income statement items and assets to each responsible operating segment. This process is dynamic and is based on management's view of the Company's operations. See "Note 19 - Business Segments."

Table of Contents

Subsequent Events - The Company has evaluated events and transactions subsequent to December 31, 2018 for potential recognition or disclosure.

Cash and Cash Equivalents - Cash and cash equivalents include cash and due from banks, and interest-bearing balances due from other banks and the Federal Reserve Bank of San Francisco (“FRB”) and have an original maturity of 90 days or less at the time of purchase. At times, cash balances may exceed Federal Deposit Insurance Corporation (“FDIC”) insured limits. At December 31, 2018 and 2017, the Company had \$25,000 and \$15,000, respectively, of cash and due from banks and interest-bearing deposits at other financial institutions in excess of FDIC insured limits. Because the Company places these deposits with major financial institutions and monitors the financial condition of these institutions, management believes the risk of loss to any deposits in excess of FDIC limits to be minimal.

Securities Available-for-Sale - Securities available-for-sale consist of debt securities that the Company has the intent and ability to hold for an indefinite period, but not necessarily to maturity. Such securities may be sold to implement the Company’s asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available-for-sale are reported at fair value. Realized gains and losses on securities available-for-sale, determined using the specific identification method, are included in results of operations. Amortization of premium and accretion of discounts are recognized in interest income over the period to maturity.

Unrealized holding gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of equity entitled accumulated other comprehensive income. Unrealized losses that are deemed to be other than temporary are reflected in results of operations. Any declines in the values of these securities that are considered to be other-than-temporary-impairment (“OTTI”) and credit-related are recognized in earnings. Noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income. The review for OTTI is conducted on an ongoing basis and takes into account the severity and duration of the impairment, recent events specific to the issuer or industry, fair value in relationship to cost, extent and nature of change in fair value, creditworthiness of the issuer including external credit ratings and recent downgrades, trends and volatility of earnings, current analysts’ evaluations, and other key measures. In addition, the Company does not intend to sell the securities and it is more likely than not that we will not be required to sell the securities before recovery of their amortized cost basis. In doing this, we take into account our balance sheet management strategy and consideration of current and future market conditions. Dividends and interest income are recognized when earned.

Federal Home Loan Bank Stock - The Bank’s investment in FHLB stock is carried at cost, which approximates fair value. As a member of the FHLB system, the Bank is required to maintain an investment in capital stock of the FHLB in an amount of \$1.7 million and 4.0% of advances from the FHLB. The Bank’s required minimum level of investment in FHLB stock is based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. At December 31, 2018 and 2017, the Bank’s minimum level of investment requirement in FHLB stock was \$9.9 million and \$2.9 million, respectively. The Bank was in compliance with the FHLB minimum investment requirement at December 31, 2018 and 2017.

Management evaluates FHLB stock for impairment as needed. Management’s determination of whether these investments are impaired is based on its 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 with 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. Based on its evaluation, management determined that there was no impairment of FHLB stock at December 31, 2018 and 2017, respectively.

Loans Held for Sale - The Bank records all mortgage loans held-for-sale at fair value. Fair value is determined by outstanding commitments from investors or current investor yield requirements calculated on the aggregate loan basis. Origination fees and costs are recognized in earnings at the time of origination. Mortgage loans held for sale are sold with the mortgage service rights either released or retained by the Bank. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold. All sales are made with limited recourse against the Company.

Table of Contents

Other Real Estate Owned - Other real estate owned (“OREO”) consists of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at fair value less selling costs. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed. Valuations are periodically performed by management, and a charge to earnings is recorded if the recorded value of a property exceeds its estimated net realizable value.

Derivatives - Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free-standing derivatives. The fair value of the interest rate lock is recorded at the time the commitment to fund the mortgage loan is executed and is adjusted for the expected exercise of the commitments to fund the loans, the Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. Changes in the fair values of these derivatives are reported in “Gain on sale of loans” on the Consolidated Statements of Income.

Loans Receivable - Loans receivable, are stated at the amount of unpaid principal reduced by an allowance for loan losses and net deferred fees or costs. Interest on loans is calculated using the simple interest method based on the daily balance of the principal amount outstanding and is credited to income as earned. Loan fees, net of direct origination costs, are deferred and amortized over the life of the loan using the effective yield method.

Interest on loans is accrued daily based on the principal amount outstanding. Generally, the accrual of interest on loans is discontinued when, in management’s opinion, the borrower may be unable to meet payments as they become due or when they are past due 90 days as to either principal or interest (based on contractual terms), unless they are well secured and in the process of collection. All interest accrued but not collected for loans that are placed on non-accrual status or charged off are reversed against interest income. Subsequent collections on a cash basis are applied proportionately to past due principal and interest, unless collectability of principal is in doubt, in which case all payments are applied to principal. Loans are returned to accrual status when the loan is performing according to its contractual terms for at least six months and the collectability of principal and interest is no longer doubtful.

The Company charges fees for originating loans. These fees, net of certain loan origination costs, are deferred and amortized to income, based on the interest method, over the loan term. If the loan is repaid prior to maturity, the remaining unamortized net deferred loan origination fee is recognized in income at the time of repayment.

Impaired Loans - A loan is considered impaired when it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the original or modified terms of the loan agreement. Impaired loans are measured on a loan by loan basis based on the estimated fair value of the collateral less estimated cost to sell if the loan is considered collateral dependent. Impaired loans not considered to be collateral dependent are measured based on the present value of expected future cash flows. Impairment is measured for each loan in the portfolio except for the smaller groups of homogeneous consumer loans.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Company considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the collateral value, reasons for delay, payment record, the amount of past due and the number of days past due. Loans that experience insignificant payment delays and payment shortfalls are generally not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the

reasons for the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed.

Allowance for Loan Losses - The allowance for loan losses is maintained at a level considered adequate to provide for probable losses on existing loans based on evaluating known and inherent risks in the loan portfolio. The allowance is reduced by loans charged off and increased by provisions charged to earnings and recoveries on loans previously charged-off. The allowance is based on management's periodic, systematic evaluation of factors underlying the quality of the loan portfolio including changes in the size and composition of the loan portfolio, the estimated value of any underlying collateral, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectability may not be assured. This evaluation is inherently subjective as it requires estimates that are susceptible

Table of Contents

to significant revision as more information becomes available. While management uses the best information available to make its estimates, future adjustments to the allowance may be necessary if there is a significant change in economic and other conditions. The appropriateness of the allowance for loan losses is estimated based on these factors and trends identified by management at the time the financial statements are prepared.

When available information confirms that specific loans or portions thereof are uncollectible, these amounts are charged-off against the allowance for loan losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not evidenced the ability or intent to bring the loan current; the Company has no recourse to the borrower, or if it does, the borrower has insufficient assets to pay the debt; the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

A provision of loan losses is charged against income and added to the allowance for loan losses based on regular assessment of the loan portfolio. The allowance for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications, and actual loss experience within the loan portfolio. Although management has allocated the allowance for loan losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control. These factors may result in losses or recoveries differing significantly from those provided for in the financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

Reserve for Unfunded Loan Commitments - The reserve for unfunded loan commitments is maintained at a level believed by management to be sufficient to absorb estimated probable losses related to these unfunded credit facilities. The determination of the adequacy of the reserve is based on periodic evaluations of the unfunded credit facilities including an assessment of the probability of commitment usage, credit risk factors for loans outstanding to these same customers, and the terms and expiration dates of the unfunded credit facilities. The reserve for unfunded loan commitments is included in other liabilities on the consolidated balance sheet, with changes to the balance charged against noninterest expense.

Premises and Equipment, Net - Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives used to compute depreciation include building and building improvements from 25 to 40 years and furniture, fixtures, and equipment from 3 to 10 years. Leasehold and tenant improvements are amortized using the straight-line method over the lesser of useful life or the life of the related lease. Gains or losses on dispositions are reflected in results of operations.

Management reviews buildings, improvements and equipment for impairment on an annual basis or whenever events or changes in the circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

Transfers of Financial Assets - Transfers of an entire financial asset, a group of entire financial assets, or participating interest in an entire financial asset are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets

through an agreement to repurchase them before their maturity.

Servicing Rights - Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use



Table of Contents

in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses.

Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income. Capitalized servicing rights are stated separately on the Consolidated Balance Sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Income Taxes - The Company files a consolidated federal income tax return. Deferred federal income taxes result from temporary differences between the tax basis of assets and liabilities, and their reported amounts in the financial statements. These will result in differences between income for tax purposes and income for financial reporting purposes in future years. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established to reduce the net recorded amount of deferred tax assets if it is determined to be more likely than not, that all or some portion of the potential deferred tax asset will not be realized.

The Company follows the authoritative guidance issued related to accounting for uncertainty in income taxes. The guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It is the Company's policy to record any penalties or interest arising from federal or state taxes as a component of income tax expense.

Employee Stock Ownership Plan - Compensation expense recognized for the Company's ESOP equals the fair value of shares that have been allocated or committed to be released for allocation to participants. Any difference between the fair value of the shares at the time and the ESOP's original acquisition cost is charged or credited to stockholders' equity (additional paid-in capital). The cost of ESOP shares that have not yet been allocated or committed to be released is deducted from stockholders' equity.

Earnings Per Share ("EPS") - Basic EPS are computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. For purposes of computing basic and dilutive EPS, ESOP shares that have been committed to be released are outstanding and ESOP shares that have not been committed to be released shall not be considered outstanding.

Comprehensive Income (Loss) - Comprehensive income (loss) is comprised of net income and other comprehensive income (loss). Other comprehensive income (loss) includes items recorded directly to equity, such as unrealized holding gains and losses on securities available-for-sale.

Financial Instruments - In the ordinary course of business, the Company has entered into agreements for off-balance-sheet financial instruments consisting of commitments to extend credit and stand-by letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Restricted Assets – Regulations of the Board of Governors of the Federal Reserve System ("Federal Reserve") require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB, based on a percentage

of deposits. The amounts of such balances for the years ended December 31, 2018 and 2017 were \$17.4 million and \$18.2 million, respectively, included in interest-bearing deposits at other financial institutions on the Consolidated Balance Sheets.

Marketing and Advertising Costs - The Company records marketing and advertising costs as expenses as they are incurred. Total marketing and advertising expense was \$747,000 and \$716,000 for the years ended December 31, 2018 and 2017, respectively.

## Table of Contents

Stock-Based Compensation - Compensation cost is recognized for stock options and restricted stock awards, based on the fair value of these awards at the grant date. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the grant date is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Goodwill - Goodwill is recorded upon completion of a business combination as the difference between the purchase price and the fair value of net identifiable assets acquired. Goodwill was not recorded until the first quarter of 2016 in recognition of the four retail branches purchased from Bank of America on January 22, 2016. Subsequent to initial recognition, the Company tests goodwill for impairment during the fourth quarter of each fiscal year, or more often if events or circumstances, such as adverse changes in the business climate indicate there may be impairment. There was no goodwill impairment at December 31, 2018 or 2017.

### Application of New Accounting Guidance

On January 1, 2018, the Company adopted Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively "ASC 606"), which created Topic 606 and superseded Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of ASU No. 2014-09. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new guidance requires companies to use more judgment and make more estimates than under past guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. For financial reporting purposes, the Company utilized the modified retrospective approach, meaning the ASU is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. As a bank holding company, key revenue sources, such as interest income on loans, investment securities and deposits, as well as other sources of income including loan fees, security sales, and derivatives have been identified as out of the scope of this new guidance. Management conducted an assessment of the revenue streams that were affected by the new guidance and identified those considered material and in scope to ensure compliance with the new guidance concluding those related to credit and debit card fees, and service charges and fees on deposit accounts. No additional changes to processes or procedures were identified for the recognition of revenues in scope. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements. However, additional disclosures required by the ASU have been included in "Note 15 - Revenue from Contracts with Customers" to the Company's consolidated financial statements.

On January 1, 2018, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance improves the recognition and measurement of financial instruments. This ASU requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. Exit price is 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. This ASU also eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The adoption of ASU No. 2016-01 did not have a material impact on the Company's consolidated financial statements. The disclosures to the Company's consolidated financial statements

have been updated appropriately using the exit price notion in “Note 15 - Fair Value of Financial Instruments.”

#### RECENT ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued ASU No. 2016 02, Leases (Topic 842). ASU No. 2016 02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend

100

---

Table of Contents

the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. In July 2018, the FASB issued ASU No. 2018-10, Codification Improvements to Topic 842, Leases and ASU No. 2018-11, Leases (Topic 842): Targeted Improvements. These ASUs contain clarifications to ASU 2016-02, including providing a new transition method in addition to the existing transition method contained in ASU No. 2016-02 to allow entities to initially apply the new standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. These amendments have the same effective date as ASU 2016-02. The effect of the adoption of these ASUs will depend on leases at time of adoption. The Company expects to adopt the new standard on January 1, 2019 and use the adoption date as the date of initial application. Once adopted, the Company expects to report higher assets and liabilities as a result of including right-of-use assets and lease liabilities related to certain banking offices and certain equipment under noncancelable operating lease agreements. While the Company continues to assess all of the effects of adoption, the Company currently believes the most significant effect will relate to the recognition of new right-of-use assets and lease liabilities on the Consolidated Balance Sheets of approximately \$5.0 million at December 31, 2018 based on management's estimate assuming early adoption.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all current expected credit losses ("CECL") for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of CECL. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements. This standard requires FDIC-insured institutions and their holding companies (banking organizations) to recognize credit losses expected over the life of certain financial assets. CECL covers a broader range of assets than the current method of recognizing credit losses and generally results in earlier recognition of credit losses. Upon adoption of CECL, a banking organization must record a one-time adjustment to its credit loss allowances as of the beginning of the fiscal year of adoption equal to the difference, if any, between the amount of credit loss allowances under the current methodology and the amount required under CECL. For a banking organization, implementation of CECL is generally likely to reduce retained earnings, and to affect other items, in a manner that reduces its regulatory capital. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

The federal banking regulators (the Federal Reserve, the OCC and the FDIC) have adopted a rule that gives a banking organization the option to phase in over a three-year period the day-one adverse effects of CECL on its regulatory capital.

In March 2017, the FASB issued ASU No. 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The ASU shortens the amortization period for certain callable debt securities held at a premium. The ASU will take effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This ASU amends the hedge accounting recognition and presentation requirements in ASC 815 to (1) improve the transparency and understandability of information conveyed to financial statement users about

Table of Contents

an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity of and simplify the application of hedge accounting by preparers. The amendments in this ASU permit hedge accounting for hedging relationships involving nonfinancial risk and interest rate risk by removing certain limitations in cash flow and fair value hedging relationships. In addition, the ASU requires an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018 and early adoption is permitted. The adoption of ASU No. 2017-12 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2018, the FASB issued ASU No. 2018-05, Income Taxes (Topic 740). This ASU was issued to provide guidance on the income tax accounting implications of the Tax Cuts and Jobs Act ("Tax Act") and allows for entities to report provisional amounts for specific income tax effects of the Tax Act for which the accounting under Topic 740 was not yet complete but a reasonable estimate could be determined. A measurement period of one year is allowed to complete the accounting effects under Topic 740 and revise any previous estimates reported. Any provisional amounts or subsequent adjustments included in an entity's financial statements during the measurement period should be included in income from continuing operations as an adjustment to tax expense in the reporting period the amounts are determined. The Company adopted this ASU with the provisional adjustments as reported in the Consolidated Financial Statements on Form 10-K as of December 31, 2017. As of December 31, 2018, the Company did not incur any adjustments to the provisional recognition.

In June 2018, the FASB issued ASU No. 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This ASU was issued to expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. Previously, these awards were recorded at the fair value of consideration received or the fair value of the equity instruments issued and was measured as the earlier of the commitment date or date performance was completed. The amendments in this ASU require the awards to be measured at the grant-date fair value of the equity instrument. ASU No. 2018-07 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than an entity's adoption of Topic 606. The adoption of ASU No. 2018-07 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. This ASU contains some technical adjustments related to the fair value disclosure requirements of public companies. Included in this ASU is the additional disclosure requirement of unrealized gains and losses for the period in recurring level 3 fair value disclosures and the range and weighted average of significant unobservable inputs, among other technical changes. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for any removed or modified disclosures. The adoption of ASU 2018-13 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2018, FASB issued ASU No. 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. The amendments in this ASU broaden the scope of ASC Subtopic 350-40 to include costs incurred to implement a hosting arrangement that is a service contract. The amendments align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The costs are capitalized or expensed depending on the nature of the costs and the project stage during which they are incurred, consistent with the accounting for costs for internal-use software. The amendments in this ASU result in consistent capitalization of implementation costs of a hosting arrangement that is a service contract and implementation costs incurred to develop

or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by the amendments in this ASU. This ASU is effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The amendments in this ASU should be applied either retrospectively to all implementation costs incurred after the date of adoption. Adoption of ASU 2018-15 is not expected to have a material impact on the Company's consolidated financial statements.



Table of Contents

In October 2018, FASB issued ASU No. 2018-16, Derivatives and Hedging (Topic 815), Inclusion of the Secured Overnight Financing Rate (“SOFR”) Overnight Index Swap (“OIS”) Rate as a Benchmark Interest Rate for Hedge Accounting. In the United States, eligible benchmark interest rates under Topic 815 are interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (“LIBOR”) swap rate, and the OSI Rate based on the Fed Funds Effective Rate. ASU 2018-16 adds the OIS Rate based on SOFR as a U.S. benchmark interest rate to facilitate the LIBOR to SOFR transition and provide sufficient lead time for entities to prepare for changes to interest rate hedging strategies for both risk management and hedge accounting purposes. The adoption of this ASU is not expected to have a material impact on the Company’s consolidated financial statements.

## NOTE 2 - BUSINESS COMBINATION

On November 15, 2018, the Company completed its acquisition of Anchor Bancorp, pursuant to the Agreement and Plan of Merger dated as of July 17, 2018 by and between FS Bancorp and Anchor. Under the terms of the Merger Agreement, Anchor merged with and into FS Bancorp, with FS Bancorp as the surviving corporation. Immediately after the Anchor Acquisition, FS Bancorp merged Anchor Bank, a wholly-owned subsidiary of Anchor, with and into 1st Security Bank of Washington, a wholly-owned subsidiary of FS Bancorp, with 1st Security Bank of Washington as the surviving bank. Anchor’s principal business activities prior to the acquisition were attracting retail deposits from the general public and utilizing those deposits to originate loans including one-to-four-family residences, commercial real estate, and multi-family residences located in Western Washington. Anchor’s principal lending activity had consisted of the origination of loans secured by first mortgages on owner-occupied, one-to-four-family residences and loans for the construction of one-to-four-family residences, as well as consumer loans, with an emphasis on home equity loans and lines of credit. The primary objective for the acquisition was to significantly expand FS Bancorp’s presence throughout Western Washington, increase nonmaturity deposits, and offer additional banking and lending products to former Anchor customers as well as new customers.

The Anchor Acquisition was accounted for under the acquisition method of accounting and accordingly, the assets and liabilities were recorded at their fair values on November 15, 2018, the date of acquisition. Determining the fair value of assets and liabilities is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values become available.

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

November 15, 2018	Acquired Book Value	Fair Value Adjustments	Amount Recorded
Assets			
Cash and cash equivalents	\$ 54,558	\$ —	\$ 54,558
Securities available-for-sale	19,609	(54)	19,555
Loans receivable, net	361,596	(5,321) (1)	356,275
Premises and equipment, net	8,411	3,354 (2)	11,765
Other real estate owned	689	—	689
Deferred tax asset	4,097	(3,358)	739
Mortgage servicing rights	218	564	782
Core deposit intangible (“CDI”)	—	5,251 (3)	5,251
Other assets	25,231	18	25,249
Total assets acquired	\$ 474,409	\$ 454	\$ 474,863
Liabilities			

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Deposits	\$ 357,863	\$ (1,052)	(4) \$ 356,811
Borrowings	37,000	(282)	36,718
Other liabilities	9,286	63	9,349
Total liabilities assumed	\$ 404,149	\$ (1,271)	\$ 402,878

Table of Contents

## Explanation of Fair Value Adjustments

(1) The fair value discount for acquired loans from Anchor was \$5.3 million and was determined by separate adjustments to reflect a credit risk and marketability component and a yield component reflecting the differential between portfolio and market yields. The discount on acquired loans will be accreted back into interest income over an estimated average life of 60 months.

(2) The fair value adjustment represents the difference between the fair value of the premises and the book value of the those assets acquired. The Company utilized third-party valuations including appraisals, comparative market analysis, and tax-assessed values to assist in the determination of the fair value.

(3) The fair value adjustment of \$5.3 million represents the value of the core deposit base assumed on a study performed by an independent consulting firm. This amount was recorded by the Company as an identifiable intangible asset and will be amortized as an expense on a straight-line basis over an estimated 10 year life of the core deposit base and will be reviewed for impairment annually. See “Note 21- Goodwill and Other Intangible Assets.”

(4) The fair value of transaction and savings accounts was determined to be equal to their carrying values. The fair value of time deposits was calculated using a discounted cash flow analysis that calculated the present value of the projected cash flows from the portfolio versus the present value of a similar portfolio with a similar maturity profile at current market rates. As of the acquisition date, the portfolio of time deposits was valued at a pre-tax discount of \$1.1 million, or 0.65% of core deposits. This adjustment represents a difference in interest rates from the time deposits acquired and the estimated wholesale funding rates used in the application of fair value accounting. The discounted amount will be accreted into expense as an increase in interest expense over the maturity profile of the acquired time deposits.

The following table summarizes the consideration paid, the aggregate amount recognized for each major class of assets acquired and liabilities assumed by 1st Security Bank in the Anchor Acquisition:

	At November 15, 2018
Purchase price of Anchor	
Fair value of FS Bancorp common stock at \$46.54 (1) per share for 725,518 shares	\$ 33,766
Cash paid	30,805
Total purchase price	64,571
Fair value of assets acquired:	
Cash and cash equivalents	\$ 54,558
Securities available-for-sale	19,555
Loans receivable, net	356,275
Premises and equipment	11,765
OREO	689
Deferred tax asset	739
Mortgage servicing rights	782
Intangible assets - CDI	5,251
Other assets	25,249
Total assets and identifiable intangible assets acquired	\$ 474,863
Fair value of liabilities assumed:	
Deposits	\$ 356,811

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Borrowings	36,718
Other liabilities	9,349
Total liabilities assumed	\$ 402,878
Fair value of net assets and identifiable intangible assets acquired	71,985
Bargain purchase gain	\$ (7,414)

---

104

---

Table of Contents

(1) Stock price is as of the closing date.

The application of the acquisition method of accounting resulted in a bargain purchase gain of \$7.4 million which was reported as a component of noninterest income on our Consolidated Statements of Income. The bargain purchase gain was primarily due to the decline in the value of the stock portion of the merger consideration between signing and closing the Anchor Acquisition which resulted in the purchase price for Anchor being less than the fair market value of the net assets acquired. In the merger, each Anchor shareholder received 0.291 of a share of FS Bancorp common stock for each share of Anchor common stock along with \$12.40 in cash.

The Company determined that the disclosure requirements related to the amounts of revenues and earnings of Anchor included in the consolidated statements of operations since the November 15, 2018 acquisition date is impracticable. The financial activity and operating results of Anchor were commingled with the Company's financial activity and operating results as of the acquisition date.

## NOTE 3 - SECURITIES AVAILABLE-FOR-SALE

The following tables present the amortized costs, unrealized gains, unrealized losses, and estimated fair values of securities available-for-sale at December 31, 2018 and 2017:

	December 31, 2018			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 16,052	\$ 32	\$ (197)	\$ 15,887
Corporate securities	7,074	—	(209)	6,865
Municipal bonds	14,446	23	(275)	14,194
Mortgage-backed securities	45,827	83	(1,074)	44,836
U.S. Small Business Administration securities	15,690	—	(267)	15,423
Total securities available-for-sale	\$ 99,089	\$ 138	\$ (2,022)	\$ 97,205

	December 31, 2017			Estimated Fair Values
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
U.S. agency securities	\$ 9,077	\$ 49	\$ (11)	\$ 9,115
Corporate securities	7,113	9	(96)	7,026
Municipal bonds	12,720	148	(82)	12,786
Mortgage-backed securities	40,161	63	(490)	39,734
U.S. Small Business Administration securities	14,014	—	(195)	13,819

Total securities available-for-sale	\$ 83,085	\$ 269	\$ (874)	\$ 82,480
-------------------------------------	-----------	--------	----------	-----------

At December 31, 2018, the Bank pledged 11 securities held at the FHLB with a carrying value of \$13.7 million to secure Washington State public deposits of \$19.9 million with an \$8.4 million collateral requirement by the Washington Public Deposit Protection Commission. At December 31, 2017, the Bank pledged nine securities held at the FHLB of Des Moines with a carrying value of \$10.7 million to secure Washington State public deposits of \$7.6 million with a \$3.2 million minimum collateral requirement by the Washington Public Deposit Protection Commission.

Investment securities that were in an unrealized loss position at December 31, 2018 and 2017 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. Management believes that these securities are only temporarily impaired due to changes in market interest rates or the widening of market spreads

Table of Contents

subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

	December 31, 2018		12 Months or Longer		Total	
	Less than 12 Months		Fair	Unrealized	Fair	Unrealized
	Fair Value	Unrealized Losses	Value	Losses	Value	Losses
<b>SECURITIES</b>						
<b>AVAILABLE-FOR-SALE</b>						
U.S. agency securities	\$ 6,018	\$ (25)	\$ 4,822	\$ (172)	\$ 10,840	\$ (197)
Corporate securities	975	(25)	5,890	(184)	6,865	(209)
Municipal bonds	2,098	(22)	8,787	(253)	10,885	(275)
Mortgage-backed securities	6,266	(40)	32,537	(1,034)	38,803	(1,074)
U.S. Small Business Administration securities	1,958	(11)	13,465	(256)	15,423	(267)
Total	\$ 17,315	\$ (123)	\$ 65,501	\$ (1,899)	\$ 82,816	\$ (2,022)

	December 31, 2017		12 Months or Longer		Total	
	Less than 12 Months		Fair	Unrealized	Fair	Unrealized
	Fair Value	Unrealized Losses	Value	Losses	Value	Losses
<b>SECURITIES</b>						
<b>AVAILABLE-FOR-SALE</b>						
U.S. agency securities	\$ 2,987	\$ (11)	\$ —	\$ —	\$ 2,987	\$ (11)
Corporate securities	4,102	(15)	1,915	(81)	6,017	(96)
Municipal bonds	5,982	(82)	—	—	5,982	(82)
Mortgage-backed securities	7,262	(61)	20,635	(429)	27,897	(490)
U.S. Small Business Administration securities	11,876	(162)	1,943	(33)	13,819	(195)
Total	\$ 32,209	\$ (331)	\$ 24,493	\$ (543)	\$ 56,702	\$ (874)

There were 14 investments with unrealized losses of less than one year and 48 investments with unrealized losses of more than one year at December 31, 2018. There were 21 investments with unrealized losses of less than one year and 17 investments with unrealized losses of more than one year at December 31, 2017. The unrealized losses associated with these investments are believed to be caused by changing market conditions that are considered to be temporary and the Company does not intend to sell these securities, and it is not likely to be required to sell these securities prior to maturity. Based on the Company's evaluation of these securities, no OTTI impairment was recorded for the years ended December 31, 2018 and 2017.

Table of Contents

The contractual maturities of securities available-for-sale at December 31, 2018 and 2017 are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	December 31, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. agency securities				
Due after one year through five years	\$ 1,043	\$ 1,040	\$ —	\$ —
Due after five years through ten years	10,011	9,941	4,079	4,124
Due after ten years	4,998	4,906	4,998	4,991
Subtotal	16,052	15,887	9,077	9,115
Corporate securities				
Due after one year through five years	6,077	5,947	5,117	5,111
Due after five years through ten years	997	918	1,996	1,915
Subtotal	7,074	6,865	7,113	7,026
Municipal bonds				
Due after one year through five years	2,659	2,570	2,001	2,026
Due after five years through ten years	2,610	2,592	4,111	4,206
Due after ten years	9,177	9,032	6,608	6,554
Subtotal	14,446	14,194	12,720	12,786
Mortgage-backed securities				
Federal National Mortgage Association (“FNMA”)	30,554	30,026	23,310	23,091
Federal Home Loan Mortgage Corporation (“FHLMC”)	10,301	9,961	10,818	10,629
Government National Mortgage Association (“GNMA”)	4,972	4,849	6,033	6,014
Subtotal	45,827	44,836	40,161	39,734
U.S. Small Business Administration securities				
Due after five years through ten years	13,828	13,581	12,065	11,896
Due after ten years	1,862	1,842	1,949	1,923
Subtotal	15,690	15,423	14,014	13,819
Total	\$ 99,089	\$ 97,205	\$ 83,085	\$ 82,480

The proceeds and resulting gains and losses, computed using specific identification from sales of securities available-for-sale for the years ended December 31, 2018 and 2017 were as follows:

	December 31, 2018		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	\$ 24,312	\$ 185	\$ (14)

	December 31, 2017		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	\$ 39,103	\$ 413	\$ (33)





Table of Contents

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

The composition of the loan portfolio was as follows at December 31:

	December 31, 2018	December 31, 2017
<b>REAL ESTATE LOANS</b>		
Commercial	\$ 204,699	\$ 63,611
Construction and development	247,306	143,068
Home equity	40,258	25,289
One-to-four-family (excludes loans held for sale)	249,397	163,655
Multi-family	104,663	44,451
Total real estate loans	846,323	440,074
<b>CONSUMER LOANS</b>		
Indirect home improvement	167,793	130,176
Solar	44,433	41,049
Marine	57,822	35,397
Other consumer	5,425	2,046
Total consumer loans	275,473	208,668
<b>COMMERCIAL BUSINESS LOANS</b>		
Commercial and industrial	138,686	83,306
Warehouse lending	65,756	41,397
Total commercial business loans	204,442	124,703
Total loans receivable, gross	1,326,238	773,445
Allowance for loan losses	(12,349)	(10,756)
Deferred costs and fees, net	(2,907)	(2,708)
Premiums on purchased loans	1,537	1,577
Total loans receivable, net	\$ 1,312,519	\$ 761,558

The loans listed above for December 31, 2018 include \$328.2 million of loans acquired at fair value on November 15, 2018 as part of the Anchor Acquisition.

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

**Real Estate Loans**

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

**Construction and Development Lending.** Loans originated by the Company for the construction of, and secured by, commercial real estate, one-to-four-family, and multi-family residences and tracts of land for development that are not pre-sold. A small portion of the one-to-four-family construction portfolio is custom construction loans to the intended occupant of the residence.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences, including home equity lines of credit in our market areas.

One-to-Four-Family Real Estate Lending. One-to-four-family residential loans include owner occupied properties (including second homes), and non-owner occupied properties with four or less units. These loans originated by the Company are secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

108

---

Table of Contents

Multi-family Lending. Apartment term lending (5 or more units) to current banking customers and community reinvestment loans for low to moderate income individuals in the Company's footprint.

Consumer Loans

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

Solar. Fixture secured loans for solar related home improvement projects are originated by the Company through its network of contractors and dealers and are secured by the personal property installed in, on, or at the borrower's real property, and which may be perfected with a UCC 2 financing statement filed in the county of the borrower's residence.

Marine. Loans originated by the Company, secured by boats, to borrowers primarily located in the states the Company originates consumer loans.

Other Consumer. Loans originated by the Company to consumers in our retail branch footprint, including automobiles, recreational vehicles, direct home improvement loans, loans on deposits, and other consumer loans, primarily consisting of personal lines of credit and credit cards.

Commercial Business Loans

Commercial and Industrial Lending ("C&I"). Loans originated by the Company to local small- and mid-sized businesses in our Puget Sound market area are secured primarily by accounts receivable, inventory, or personal property, plant and equipment. Some of the C&I loans purchased by the Company are outside of the Greater Puget Sound market area. C&I loans are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business.

Warehouse Lending. Loans originated to non-depository financial institutions and secured by notes originated by the non-depository financial institution. The Company has two distinct warehouse lending divisions: commercial warehouse re-lending secured by notes on construction loans and mortgage warehouse re-lending secured by notes on one-to-four-family loans. The Company's commercial construction warehouse lines are secured by notes on construction loans and typically guaranteed by principles with experience in construction lending. Mortgage warehouse lending loans are funded through third-party residential mortgage bankers. Under this program, the Company provides short-term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market.

Table of Contents

The following tables detail activities in the allowance for loan losses by loan categories for the years shown:

	At or For the Year Ended December 31, 2018				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 4,770	\$ 2,814	\$ 2,014	\$ 1,158	\$ 10,756
Provision for loan losses	953	526	1,173	(1,112)	1,540
Charge-offs	(4)	(936)	—	—	(940)
Recoveries	42	947	4	—	993
Net recoveries	38	11	4	—	53
Ending balance	\$ 5,761	\$ 3,351	\$ 3,191	\$ 46	\$ 12,349
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ 125	\$ 150	\$ 700	\$ —	\$ 975
Loans collectively evaluated for impairment	5,636	3,201	2,491	46	11,374
Ending balance	\$ 5,761	\$ 3,351	\$ 3,191	\$ 46	\$ 12,349
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 834	\$ 428	\$ 1,685	\$ —	\$ 2,947
Loans collectively evaluated for impairment	845,489	275,045	202,757	—	1,323,291
Ending balance	\$ 846,323	\$ 275,473	\$ 204,442	\$ —	\$ 1,326,238

	At or For the Year Ended December 31, 2017				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
<b>ALLOWANCE FOR LOAN LOSSES</b>					
Beginning balance	\$ 3,547	\$ 2,082	\$ 2,675	\$ 1,907	\$ 10,211
Provision for loan losses	1,253	884	(638)	(749)	750
Charge-offs	(65)	(832)	(33)	—	(930)
Recoveries	35	680	10	—	725
Net charge-offs	(30)	(152)	(23)	—	(205)
Ending balance	\$ 4,770	\$ 2,814	\$ 2,014	\$ 1,158	\$ 10,756
Period end amount allocated to:					
Loans individually evaluated for impairment	\$ 21	\$ 68	\$ —	\$ —	\$ 89
Loans collectively evaluated for impairment	4,749	2,746	2,014	1,158	10,667
Ending balance	\$ 4,770	\$ 2,814	\$ 2,014	\$ 1,158	\$ 10,756
<b>LOANS RECEIVABLE</b>					
Loans individually evaluated for impairment	\$ 348	\$ 195	\$ 551	\$ —	\$ 1,094
	439,726	208,473	124,152	—	772,351

Loans collectively evaluated for  
impairment

Ending balance	\$ 440,074	\$ 208,668	\$ 124,703	\$ —	\$ 773,445
----------------	------------	------------	------------	------	------------

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on non-accrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment obligations as they become due, or as required by regulatory authorities.

110

---

Table of Contents

The following tables provide information pertaining to the aging analysis of contractually past due loans and non-accrual loans for the years ended December 31, 2018 and 2017:

	December 31, 2018		90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due					
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 204,699	\$ 204,699	\$ —
Construction and development	—	—	—	—	247,306	247,306	—
Home equity	158	40	229	427	39,831	40,258	229
One-to-four-family	1,274	164	1,358	2,796	246,601	249,397	1,552
Multi-family	—	—	—	—	104,663	104,663	—
Total real estate loans	1,432	204	1,587	3,223	843,100	846,323	1,781
<b>CONSUMER LOANS</b>							
Indirect home improvement	438	196	113	747	167,046	167,793	367
Solar	62	43	41	146	44,287	44,433	41
Marine	50	—	—	50	57,772	57,822	18
Other consumer	69	24	11	104	5,321	5,425	2
Total consumer loans	619	263	165	1,047	274,426	275,473	428
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	—	431	—	431	138,255	138,686	1,685
Warehouse lending	—	—	—	—	65,756	65,756	—
Total commercial business loans	—	431	—	431	204,011	204,442	1,685
Total loans	\$ 2,051	\$ 898	\$ 1,752	\$ 4,701	\$ 1,321,537	\$ 1,326,238	\$ 3,894

	December 31, 2017		90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non- Accrual
	30-59 Days Past Due	60-89 Days Past Due					
<b>REAL ESTATE LOANS</b>							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 63,611	\$ 63,611	\$ —
Construction and development	—	—	—	—	143,068	143,068	—
Home equity	122	—	136	258	25,031	25,289	151
One-to-four-family	142	—	—	142	163,513	163,655	142
Multi-family	—	—	—	—	44,451	44,451	—
Total real estate loans	264	—	136	400	439,674	440,074	293

## CONSUMER LOANS

Indirect home improvement	255	215	99	569	129,607	130,176	195
Solar	49	19	—	68	40,981	41,049	—
Marine	—	—	—	—	35,397	35,397	—
Other consumer	—	—	—	—	2,046	2,046	—
Total consumer loans	304	234	99	637	208,031	208,668	195

## COMMERCIAL

## BUSINESS LOANS

Commercial and industrial	—	551	—	551	82,755	83,306	551
Warehouse lending	—	—	—	—	41,397	41,397	—
Total commercial business loans	—	551	—	551	124,152	124,703	551
Total loans	\$ 568	\$ 785	\$ 235	\$ 1,588	\$ 771,857	\$ 773,445	\$ 1,039

There were two other consumer loans totaling \$11,000 that were 90 days or more past due and still accruing interest at December 31, 2018 and no loans 90 days or more past due and accruing interest at December 31, 2017.



Table of Contents

The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance was provided for the years ended December 31, 2018 and 2017:

	December 31, 2018			
	Unpaid Principal Balance	Impairment	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 229	\$ —	\$ 229	\$ —
<b>WITH RELATED ALLOWANCE RECORDED</b>				
One-to-four-family	1,552	—	1,552	125
Consumer loans	428	—	428	150
Commercial business loans	1,685	—	1,685	700
	3,665	—	3,665	975
<b>Total</b>	<b>\$ 3,894</b>	<b>\$ —</b>	<b>\$ 3,894</b>	<b>\$ 975</b>

	December 31, 2017			
	Unpaid Principal Balance	Impairment	Recorded Investment	Related Allowance
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 151	\$ —	\$ 151	\$ —
One-to-four-family	67	(12)	55	—
Total real estate loans	218	(12)	206	—
Commercial business loans	551	—	551	—
	769	(12)	757	—
<b>WITH RELATED ALLOWANCE RECORDED</b>				
One-to-four-family	142	—	142	21
Consumer loans	195	—	195	68
	337	—	337	89
<b>Total</b>	<b>\$ 1,106</b>	<b>\$ (12)</b>	<b>\$ 1,094</b>	<b>\$ 89</b>

Table of Contents

The following table presents the average recorded investment in loans individually evaluated for impairment and the interest income recognized and received for the years ended December 31, 2018 and 2017:

	At or For the Year Ended December 31, 2018		December 31, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>WITH NO RELATED ALLOWANCE RECORDED</b>				
Home equity	\$ 404	\$ 8	\$ 219	\$ —
One-to-four-family	719	—	56	3
Total real estate loans	1,123	8	275	3
Commercial business loans	—	—	551	24
	1,123	8	826	27
<b>WITH RELATED ALLOWANCE RECORDED</b>				
One-to-four-family	1,030	28	142 (1)	4
Consumer loans	338	37	281	16
Commercial business loans	1,188	81	—	—
	2,556	146	423	20
Total	\$ 3,679	\$ 154	\$ 1,249	\$ 47

(1) Includes loans supported by Federal Housing Administration (“FHA”) guarantees.

## Credit Quality Indicators

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

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

A description of the 10 risk grades is as follows:

- Grades 1 and 2 - These grades include loans to very high quality borrowers with excellent or desirable business credit.
- Grade 3 - This grade includes loans to borrowers of good business credit with moderate risk.
- Grades 4 and 5 - These grades include “Pass” grade loans to borrowers of average credit quality and risk.
- Grade 6 - This grade includes loans on management’s “Watch” list and is intended to be utilized on a temporary basis for “Pass” grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.
- Grade 7 - This grade is for “Other Assets Especially Mentioned (OAEM)” in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.

- Grade 8 - This grade includes “Substandard” loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.
- Grade 9 - This grade includes “Doubtful” loans in accordance with regulatory guidelines where a loss is highly probable.

Table of Contents

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

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

Homogeneous loans are risk rated based upon the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded "Pass" and risk graded "4" or "5" internally. Loans that are past due more than 90 days are classified "Substandard" risk graded "8" internally until the loan has demonstrated consistent performance, typically six months of contractual payments. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

The following tables summarize risk rated loan balances by category at the dates indicated:

	December 31, 2018						Total
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 203,557	\$ 1,142	\$ —	\$ —	\$ —	\$ —	\$ 204,699
Construction and development	244,577	2,729	—	—	—	—	247,306
Home equity	39,846	—	183	229	—	—	40,258
One-to-four-family	247,575	207	63	1,552	—	—	249,397
Multi-family	103,447	1,216	—	—	—	—	104,663
Total real estate loans	839,002	5,294	246	1,781	—	—	846,323
<b>CONSUMER LOANS</b>							
Indirect home improvement	167,426	—	—	367	—	—	167,793
Solar	44,392	—	—	41	—	—	44,433
Marine	57,804	—	—	18	—	—	57,822
Other consumer	5,415	—	8	2	—	—	5,425
Total consumer loans	275,037	—	8	428	—	—	275,473
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	124,089	8,813	—	5,784	—	—	138,686
Warehouse lending	65,756	—	—	—	—	—	65,756
Total commercial business loans	189,845	8,813	—	5,784	—	—	204,442
Total loans receivable, gross	\$ 1,303,884	\$ 14,107	\$ 254	\$ 7,993	\$ —	\$ —	\$ 1,326,238



Table of Contents

	December 31, 2017						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful (9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$ 62,057	\$ —	\$ 1,554	\$ —	\$ —	\$ —	\$ 63,611
Construction and development	143,068	—	—	—	—	—	143,068
Home equity	25,138	—	—	151	—	—	25,289
One-to-four-family	163,513	—	—	142	—	—	163,655
Multi-family	44,451	—	—	—	—	—	44,451
Total real estate loans	438,227	—	1,554	293	—	—	440,074
<b>CONSUMER LOANS</b>							
Indirect home improvement	129,981	—	—	195	—	—	130,176
Solar	41,049	—	—	—	—	—	41,049
Marine	35,397	—	—	—	—	—	35,397
Other consumer	1,998	—	—	48	—	—	2,046
Total consumer loans	208,425	—	—	243	—	—	208,668
<b>COMMERCIAL BUSINESS LOANS</b>							
Commercial and industrial	76,942	—	425	5,939	—	—	83,306
Warehouse lending	40,724	673	—	—	—	—	41,397
Total commercial business loans	117,666	673	425	5,939	—	—	124,703
Total loans receivable, gross	\$ 764,318	\$ 673	\$ 1,979	\$ 6,475	\$ —	\$ —	\$ 773,445

At December 31, 2018, there were no troubled debt restructured loans (“TDRs”) that were modified in the previous 12 months that subsequently defaulted in the reporting year. The Company had no TDRs at December 31, 2018.

#### Related Party Loans

Certain directors and executive officers or their related affiliates are customers of and have had banking transactions with the Company. Total loans to directors, executive officers, and their affiliates are subject to regulatory limitations.

Outstanding loan balances were as follows and were within regulatory limitations:

	At December 31,	
	2018	2017
Beginning balance	\$ 655	\$ 313
Additions	2,688	351
Repayments	(18)	(9)
Ending balance	\$ 3,325	\$ 655

The aggregate maximum loan balances of extended credit were \$3.6 million and \$819,000 at December 31, 2018 and 2017, respectively, and includes the ending balances from the tables above.

These loans and lines of credit were made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectability.

#### NOTE 5 - SERVICING RIGHTS

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balances of permanent loans serviced for others were \$1.19 billion and \$778.9 million at December 31, 2018 and 2017, respectively and are shown at the lower of cost or market.

Table of Contents

The following table summarizes servicing rights activity for the years ended December 31, 2018 and 2017:

	2018	2017
Beginning balance	\$ 6,795	\$ 8,459
Additions	5,971	5,075
Sales	—	(4,751)
Servicing rights amortized	(2,337)	(1,988)
Ending balance	\$ 10,429	\$ 6,795

The fair market value of the servicing rights' assets was \$14.6 million and \$8.6 million at December 31, 2018 and December 31, 2017, respectively. Fair value adjustments to servicing rights are mainly due to market-based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following provides valuation assumptions used in determining the fair value of MSR at the dates indicated:

	At December 31,			
	2018		2017	
Key assumptions:				
Weighted average discount rate	9.5	%	9.5	%
Conditional prepayment rate ("CPR")	9.4	%	10.9	%
Weighted average life in years	7.7		6.7	

Key economic assumptions and the sensitivity of the current fair value for single family MSR to immediate adverse changes in those assumptions at December 31, 2018 and December 31, 2017 were as follows:

		December 31, 2018		December 31, 2017	
Aggregate portfolio principal balance		\$ 1,186,858		\$ 775,093	
Weighted average rate of note		4.3	%	4.1	%
		0.5% Adverse Rate Change		1.0% Adverse Rate Change	
At December 31, 2018	Base				
Conditional prepayment rate	8.8	%	11.6	%	17.7
Fair value MSR	\$ 14,218		\$ 12,723		\$ 10,358
Percentage of MSR	1.2	%	1.1	%	0.9
Discount rate	9.6	%	10.1	%	10.6
Fair value MSR	\$ 14,218		\$ 13,912		\$ 13,617
Percentage of MSR	1.2	%	1.2	%	1.2
		0.5% Adverse Rate Change		1.0% Adverse Rate Change	
At December 31, 2017	Base				



Edgar Filing: FS Bancorp, Inc. - Form 10-K

Conditional prepayment rate	10.9	%	17.7	%	24.5	%
Fair value MSR	\$ 8,602		\$ 6,811		\$ 5,614	
Percentage of MSR	1.1	%	0.9	%	0.7	%
Discount rate	9.6	%	10.1	%	10.6	%
Fair value MSR	\$ 8,602		\$ 8,433		\$ 8,271	
Percentage of MSR	1.1	%	1.1	%	1.1	%

The above table shows the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four-family FNMA, FHLMC, GNMA, or FHLB serviced home loan. The above table references a 50 basis point and 100 basis point decrease in note rates.

Table of Contents

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR which is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made as a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The Company recorded \$2.4 million and \$2.2 million of gross contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage and commercial loans for the years ended December 31, 2018 and 2017, respectively. The income, net of amortization, is reported in noninterest income on the Consolidated Statements of Income.

## NOTE 6 - PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2018 and 2017 were as follows:

	2018	2017
Land	\$ 5,227	\$ 2,028
Buildings	16,772	8,611
Furniture, fixtures, and equipment	12,039	10,105
Leasehold improvements	2,422	2,108
Building improvements	5,897	4,545
Projects in process	674	189
Subtotal	43,031	27,586
Less accumulated depreciation and amortization	(13,921)	(12,128)
Total	\$ 29,110	\$ 15,458

Depreciation and amortization expense for these assets totaled \$1.8 million and \$1.6 million for the years ended December 31, 2018 and 2017, respectively.

The Company leases premises and equipment under operating leases. Minimum net rental commitments under non-cancelable leases, having an original or remaining term of more than one year for future years, were as follows:

Years Ending December 31,	
2019	\$ 1,312
2020	1,005
2021	855
2022	749
2023	390
Thereafter	1,228

Total \$ 5,539

Certain leases contain renewal options from five to 10 years and escalation clauses based on increases in property taxes and other costs. Rental expense of leased premises and equipment was \$1.2 million and \$1.1 million for the years ended December 31, 2018 and 2017, respectively, which is included in occupancy expense.

117

---

Table of Contents

## NOTE 7 - OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO at and for the years ended December 31:

	At or For the Year Ended December 31,	
	2018	2017
Beginning balance	\$ —	\$ —
Additions	689	—
Ending balance	\$ 689	\$ —

During 2018, there was \$689,000 in OREO properties acquired through the Anchor Acquisition and associated holding costs of \$2,000 for the year ended December 31, 2018.

There were \$261,000 in mortgage loans collateralized by residential real estate property in the process of foreclosure at December 31, 2018, and there were no loans in the process of foreclosure at December 31, 2017.

## NOTE 8 - DEPOSITS

Deposits are summarized as follows at December 31:

	December 31, 2018 (1)(2)	December 31, 2017(1)
Noninterest-bearing checking	\$ 221,107	\$ 177,739
Interest-bearing checking	151,103	119,872
Savings	122,344	72,082
Money market(3)	282,595	228,742
Certificates of deposit less than \$100,000(4)	243,193	111,489
Certificates of deposit of \$100,000 through \$250,000	154,095	77,934
Certificates of deposit of \$250,000 and over(5)	86,357	32,833
Escrow accounts related to mortgages serviced	13,425	9,151
Total	\$ 1,274,219	\$ 829,842

- 
- (1) Includes \$120.0 million and \$134.6 million of deposits at December 31, 2018 and 2017, respectively, remaining from the January 22, 2016 purchase of four retail bank branches from Bank of America, N.A. (the “Branch Purchase”).
- (2) On November 15, 2018, the Company completed the Anchor Acquisition and acquired approximately \$357.9 million in deposits.
- (3) Includes \$1,000 of brokered deposits at December 31, 2018 and \$6.5 million at December 31, 2017.
- (4) Includes \$116.7 million and \$59.3 million of brokered deposits at December 31, 2018 and 2017, respectively.
- (5) Time deposits that meet or exceed the FDIC insurance limit.

Scheduled maturities of time deposits at December 31, 2018 for future years ending are as follows:

	At December 31, 2018
Maturing in 2019	\$ 290,822
Maturing in 2020	117,077
Maturing in 2021	37,277
Maturing in 2022	29,472
Maturing in 2023	8,997
Thereafter	—
Total	\$ 483,645

Table of Contents

Interest expense by deposit category for the years ended December 31, 2018 and 2017 is as follows:

	2018	2017
Interest-bearing checking	\$ 227	\$ 128
Savings and money market	2,054	1,260
Certificates of deposit	5,040	2,532
Total	\$ 7,321	\$ 3,920

The Company had related party deposits of approximately \$6.2 million and \$2.1 million at December 31, 2018 and 2017, respectively, which includes deposits held for directors and executive officers.

## NOTE 9 - DEBT

## Borrowings

The Bank is a member of the FHLB of Des Moines, which entitles it to certain benefits including a variety of borrowing options consisting of a secured credit line that allows both fixed and variable rate advances. The FHLB borrowings at December 31, 2018 and 2017, consisted of a warehouse securities credit line (“securities line”), which allows advances with interest rates fixed at the time of borrowing and a warehouse federal funds (“Fed Funds”) advance, which allows daily advances at variable interest rates. Credit capacity is primarily determined by the value of assets collateralized at the FHLB, funds on deposit at the FHLB, and stock owned by the Bank.

Credit is limited to 45% of the Company’s total assets and available pledged assets. The Bank entered into an Advanced, Pledges and Security Agreement with the FHLB for which specific loans are pledged to secure these credit lines. At December 31, 2018, loans of approximately \$355.5 million were pledged to the FHLB with a borrowing capacity, net of advances of \$120.0 million. In addition, all FHLB stock owned by the Company is collateral for credit lines.

The Bank maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. The Bank can borrow under the Term Auction or Term Facility at rates published by the San Francisco FRB. At December 31, 2018 and 2017, the Bank had approximately \$265.2 million in pledged consumer loans with a Term Auction or Term Facility borrowing capacity of \$127.7 million and \$99.1 million, respectively, of which none was outstanding at either date. The Bank also had \$51.0 million unsecured Fed Funds lines of credit with other financial institutions of which none was outstanding at December 31, 2018.

Advances on these lines at December 31, 2018 and 2017 were as follows:

	2018	2017
Federal Home Loan Bank - (interest rates ranging from 1.15% to 2.87% and 0.96% to 1.73% at December 31, 2018 and 2017, respectively)	\$ 137,149	\$ 7,529
Total	\$ 137,149	\$ 7,529

## Subordinated Note

On October 15, 2015 (the “Closing Date”), FS Bancorp, Inc. issued an unsecured subordinated term note in the aggregate principal amount of \$10.0 million due October 1, 2025 (the “Subordinated Note”) pursuant to a Subordinated Loan Agreement with Community Funding CLO, Ltd. The Subordinated Note bears interest at an annual interest rate of 6.50%, payable by the Company quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, commencing on the first such date following the Closing Date and on the maturity date.

The Subordinated Note will mature on October 1, 2025 but may be prepaid at the Company’s option and with regulatory approval at any time on or after five years after the Closing Date or at any time upon certain events, such as a change in the regulatory capital treatment of the Subordinated Note or the interest on the Subordinated Note no longer being deductible by the Company for United States federal income tax purposes. The Company contributed \$9.0 million of the proceeds from the Subordinated Note as additional capital to the Bank in the fourth quarter of 2015 and used the balance to fund general working capital and operating expenses.

Table of Contents

The maximum and average outstanding and weighted average interest rates on debt during the years ended December 31, 2018 and 2017 were as follows:

	2018	2017		
Maximum balance:				
Federal Home Loan Bank advances and Fed Funds	\$ 180,025	\$ 70,419		
Federal Reserve Bank	\$ —	\$ 1,000		
Fed Funds lines of credit	\$ 21,016	\$ 17,501		
Subordinated note	\$ 10,000	\$ 10,000		
Average balance:				
Federal Home Loan Bank advances and Fed Funds	\$ 96,044	\$ 25,635		
Federal Reserve Bank	\$ 5,286	\$ 3		
Fed Funds lines of credit	\$ —	\$ 876		
Subordinated note	\$ 10,000	\$ 10,000		
Weighted average interest rate:				
Federal Home Loan Bank advances and Fed Funds	2.02	%	1.26	%
Federal Reserve Bank	—	%	1.75	%
Fed Funds lines of credit	1.93	%	1.30	%
Subordinated note	6.50	%	6.50	%

Scheduled maturities of Federal Home Loan Bank advances were as follows:

Year Ending December 31,	Balances	Interest Rates	
2019	\$ 121,233	2.36	%
2020	12,284	2.46	%
2021	—	—	%
2022	—	—	%
2023	3,632	2.87	%
Total	\$ 137,149		

## NOTE 10 - EMPLOYEE BENEFITS

## Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank are eligible to participate in the ESOP if they have been credited with at least 1,000 hours of service during the employees' first 12 month period and based on the employee's anniversary date will be vested in the ESOP. The employee will be 100% vested in the ESOP after two years of working at least 1,000 hours in each of those two years.

The ESOP borrowed \$2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of \$10.17 per share during the second half of



2012. It is anticipated that the Bank will make contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation. Shares purchased by the ESOP with the loan proceeds are held in a suspense account and allocated to ESOP participants on a pro rata basis as principal and interest payments are made by the ESOP to FS Bancorp, Inc. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with funds from the Bank's discretionary contributions to the ESOP and earnings on the ESOP assets. Payments of principal and interest are due annually on December 31, the Company's fiscal year end. On December 31, 2018, the ESOP paid the seventh annual installment of principal in the amount of \$269,000, plus accrued interest of \$26,000 pursuant to the ESOP loan agreement.

Table of Contents

As shares are committed to be released from collateral, the Company reports compensation expense equal to the average daily market prices of the shares at December 31, 2018 for the prior 90 days. These shares become outstanding for earnings per share computations. The compensation expense is accrued monthly throughout the year. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense related to the ESOP for the years ended December 31, 2018 and 2017, was \$1.2 million, and \$1.4 million, respectively.

Shares held by the ESOP at December 31, 2018 and December 31, 2017, were as follows (shown as actual):

	Balances at December 31, 2018	Balances at December 31, 2017
Allocated shares	176,809	153,049
Committed to be released shares	—	—
Unallocated shares	77,763	103,684
Total ESOP shares	254,572	256,733
Fair value of unallocated shares (in thousands)	\$ 3,627	\$ 5,696

## 401(k) Plan

The Company has a salary deferral 401(k) Plan covering substantially all of its employees. Employees are eligible to participate in the 401(k) plan at the date of hire if they are 18 years of age. Eligible employees may contribute through payroll deductions and are 100% vested at all times in their deferral contributions account. The Company matches 100% for contributions of 1% to 3%, and 50% for contributions of 4% to 5%. There was a \$917,000 and \$904,000 matching contribution for the years ended December 31, 2018 and 2017, respectively.

## NOTE 11 - INCOME TAXES

The components of income tax expense for the years ended December 31, 2018 and 2017, were as follows:

	2018	2017
Provision for income taxes		
Current	\$ 3,455	\$ 7,212
Deferred	768	(718)
Total provision for income taxes	\$ 4,223	\$ 6,494

On December 22, 2017, the U.S. Government enacted the Tax Act. The Tax Act amends the Internal Revenue Code to reduce tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduces the corporate federal income tax rate from a maximum of 35% to a flat 21% rate. The corporate income tax rate reduction was effective January 1, 2018. The Tax Act required a revaluation of the Company's deferred tax assets and liabilities to account for the future impact of lower corporate tax rates and other provisions of the legislation. As a result of the Company's revaluation at December 31, 2017, the Company recognized \$396,000 in tax

benefit due to a net deferred tax liability position.

121

---

Table of Contents

A reconciliation of the effective income tax rate with the federal statutory tax rates at December 31, 2018 and 2017 was as follows:

	2018		2017	
	Amount	Rate	Amount	Rate
Income tax provision at statutory rate	\$ 6,000	21.0 %	\$ 7,203	35.0 %
Tax exempt income	(129)	(0.5)	(218)	(1.0)
Nondeductible items resulting in increase in tax	279	1.0	—	—
Decrease in tax resulting from other items	(87)	(0.3)	(487)	(2.4)
Equity compensation	(571)	(2.0)	—	—
Executive compensation	135	0.5	—	—
Bargain purchase gain	(1,594)	(5.6)	—	—
Income tax rate differential	—	—	(396)	(1.9)
ESOP	190	0.7	392	1.9
Total	\$ 4,223	14.8 %	\$ 6,494	31.6 %

Total deferred tax assets and liabilities at December 31, 2018 and 2017 were as follows:

	2018	2017
Deferred Tax Assets		
Net operating loss carryforward	\$ 1,201	\$ —
Allowance for loan losses	3,077	1,912
Other real estate owned	127	—
Non-accrued loan interest	115	9
Restricted stock awards	54	—
Non-qualified stock options	71	—
Securities available-for-sale	405	130
Other	473	210
Total deferred tax assets	5,523	2,261
Deferred Tax Liabilities		
Loan origination costs	(626)	(870)
Servicing rights	(2,241)	(1,461)
Prepays	(166)	(52)
Stock dividend - FHLB stock	(73)	(1)
Property, plant, and equipment	(1,489)	(484)
Acquisition related costs	(1,289)	—
Total deferred tax liabilities	(5,884)	(2,868)
Net deferred tax liabilities	\$ (361)	\$ (607)

At December 31, 2018, the Company had a net operating loss carryforward of approximately \$5.6 million, which begins to expire in 2034. The Company files a U.S. Federal income tax return and Oregon State return, which are subject to examination by tax authorities for years 2015 and later. At December 31, 2018 and 2017, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at December 31, 2018 and 2017, the Company recognized no interest and penalties.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

Commitments - The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets.

122

---

Table of Contents

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

The following table provides a summary of the Company's commitments at December 31, 2018 and 2017:

	2018	2017
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Commercial	\$ 5,836	\$ 107
Construction and development	76,889	73,321
One-to-four-family (includes locks for salable loans)	35,714	37,336
Home equity	41,204	32,889
Multi-family	515	438
Total real estate loans	160,158	144,091
CONSUMER LOANS	18,560	10,041
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	72,880	52,452
Warehouse lending	44,243	78,303
Total commercial business loans	117,123	130,755
Total commitments to extend credit	\$ 295,841	\$ 284,887

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

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of \$299,000 and \$253,000 at December 31, 2018 and 2017, respectively. One-to-four-family commitments included in the table above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company also sells one-to-four-family loans to the FHLB of Des Moines that require a limited level of recourse if the loans default and exceed a certain loss exposure. Specific to that recourse, the FHLB of Des Moines established a first loss account ("FLA") related to the loans and required a credit enhancement ("CE") obligation by the Bank to be utilized after the FLA is used. Based on loans sold through December 31, 2018, the total loans sold to the FHLB were \$66.0 million with the FLA being \$741,000 and the CE obligation at \$472,000 or 0.71% of the loans outstanding. Management has established a holdback of 10% of the outstanding CE, or \$218,000, which is a part of the off-balance sheet holdback for loans sold. There were no outstanding delinquencies on the loans sold to the FHLB of Des Moines at December 31, 2018 and December 31, 2017.

Contingent liabilities for loans held for sale - In the ordinary course of business, loans are sold with limited recourse against the Company and may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payoff, early payment defaults, breach of representation or warranty, servicing errors, and/or fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a holdback reserve of \$1.0 million to cover loss exposure related to these guarantees

Table of Contents

for one-to-four-family loans sold into the secondary market at both December 31, 2018 and 2017, which is included in other liabilities in the Consolidated Balance Sheets.

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

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

The Bank received 7,158 shares of Class B common stock in Visa, Inc. as a result of the Visa initial public offering (“IPO”) in March 2008. These Class B shares of stock held by the Bank could be converted to Class A shares at a conversion rate of 1.6298 when all litigation pending as of the date of the IPO is concluded. The conversion rate was reduced during the year as Visa made an additional deposit to their litigation escrow account thus reducing the number of as-converted Class B shares and corresponding conversion rate. At December 31, 2018, the date that litigation will be concluded cannot be determined. Until such time, the stock cannot be redeemed or sold by the Bank; therefore, it is not readily marketable and has a current carrying value of \$0. Visa, Inc. Class A stock’s market value at December 31, 2018 and December 31, 2017 was \$131.94 per share and \$114.02 per share, respectively.

As a result of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no material pending legal actions at December 31, 2018.

**NOTE 13 - SIGNIFICANT CONCENTRATION OF CREDIT RISK**

Most of the Company’s business and lending activities are primarily with customers located in the greater Puget Sound area and one loan production office located in the Tri-Cities, Washington. The Company originates real estate and consumer loans and has concentrations in these areas, however, indirect home improvement loans are originated through a network of home improvement contractors and dealers located throughout Washington, Oregon, California, Idaho, Arizona, and Colorado. The Company also originates solar loans through contractors and dealers in the state of California. Generally, loans are secured by deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. The concentration on commercial real estate remains below the 300% of Risk Based Capital regulatory threshold and the subset of construction concentration, excluding owner-occupied loans is within Board approved limits. The construction, land development, and other land concentration represents more than 100% of the Bank’s total regulatory capital at 131.2% and is focused on in city, in fill vertical construction financing in King and Snohomish counties. Local economic conditions may affect borrowers’ ability to meet the stated repayment terms.



NOTE 14 - REGULATORY CAPITAL

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

124

---

Table of Contents

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 total capital (as defined) and common equity Tier 1 (“CET 1”) capital to risk-weighted assets (as defined).

The Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage, and CET 1 capital ratios as set forth in the table below to be categorized as well capitalized. At December 31, 2018 and December 31, 2017, the Bank was categorized as well capitalized under applicable regulatory requirements. There are no conditions or events since that notification that management believes have changed the Bank’s category. Management believes, at December 31, 2018, that the Company and the Bank met all capital adequacy requirements.

The following table compares the Bank’s actual capital amounts and ratios at December 31, 2018 and 2017 to their minimum regulatory capital requirements and well capitalized regulatory capital at those dates (dollars in thousands):

Bank Only	Actual Amount	Ratio	For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
			Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2018								
Total risk-based capital (to risk-weighted assets)	\$ 188,472	13.52 %	\$ 111,493	8.00 %	\$ 137,694	9.88 %	\$ 139,366	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 175,824	12.62 %	\$ 83,620	6.00 %	\$ 109,820	7.88 %	\$ 111,493	8.00 %
Tier 1 leverage capital (to average assets)	\$ 175,824	10.67 %	\$ 65,884	4.00 %	\$ —	N/A	\$ 82,355	5.00 %
CET 1 capital (to risk-weighted assets)	\$ 175,824	12.62 %	\$ 62,715	4.50 %	\$ 88,846	6.38 %	\$ 90,588	6.50 %
At December 31, 2017								
Total risk-based capital (to risk-weighted assets)	\$ 133,967	16.25 %	\$ 65,965	8.00 %	\$ 76,272	9.25 %	\$ 82,456	10.00 %
Tier 1 risk-based capital (to risk-weighted assets)	\$ 123,651	15.00 %	\$ 49,474	6.00 %	\$ 59,781	7.25 %	\$ 65,965	8.00 %

Tier 1 leverage capital (to average assets)	\$ 123,651	12.61 %	\$ 39,233	4.00 %	\$ —	N/A	\$ 49,041	5.00 %
CET 1 capital (to risk-weighted assets)	\$ 123,651	15.00 %	\$ 37,105	4.50 %	\$ 47,412	5.75 %	\$ 53,597	6.50 %

In addition to the minimum CET 1, Tier 1, total capital, and leverage ratios, the Bank now has to maintain a capital conservation buffer consisting of additional CET 1 capital above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. The capital conservation buffer requirement was phased-in on January 1, 2016 when more than 0.625% of risk-weighted assets was required and increased by 0.625% on each subsequent January 1, until fully implemented to an amount more than 2.5% of risk-weighted assets on January 1, 2019. At December 31, 2018, the Bank's CET 1 capital exceeded the required capital conservation buffer of 1.875%.

FS Bancorp, Inc. is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and

Table of Contents

the regulations of the Federal Reserve. For a bank holding company with less than \$3.0 billion in assets, the capital guidelines apply on a bank only basis, and the Federal Reserve expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with \$3.0 billion or more in assets at December 31, 2018, FS Bancorp, Inc. would have exceeded all regulatory capital requirements. The regulatory capital ratios calculated for FS Bancorp Inc. at December 31, 2018 were 12.1% for Tier 1 leverage-based capital, 12.4% for Tier 1 risk-based capital, 13.3% for total risk-based capital, and 12.4% for CET 1 capital ratio, and 12.1%, 14.5%, 15.7%, and 14.5% at December 31, 2017, respectively.

NOTE 15 - FAIR VALUE MEASUREMENTS

On January 1, 2018, the Company adopted ASU 2016-01, Financial Instruments - Overall (Subtopic 825 10), Recognition and Measurement of Financial Assets and Financial Liabilities, which requires us to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

The Company determines the fair values of its financial instruments based on the requirements established in Accounting Standards Codification ("ASC") 820, Fair Value Measurements, which provides a framework for measuring fair value in accordance with U.S. GAAP and requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. ASC 820 defines fair values for financial instruments as the exit price, the price that would be received for an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date under current market conditions. The Company's fair values for financial instruments at December 31, 2018 were determined based on these requirements. Fair values for financial instruments at December 31, 2017 were not retroactively adjusted to reflect exit price.

The following definitions describe the levels of inputs that may be used to measure fair value:

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

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

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

The following methods were used to estimate the fair value of financial instrument on a recurring and nonrecurring basis.

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

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

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

Table of Contents

Impaired Loans - Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management's assumptions. Management will utilize discounted cashflow impairment for TDRs when the change in terms result in a discount to the overall cashflows to be received (Level 3).

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

The following tables present securities available-for-sale measured at fair value on a recurring basis at the dates indicated:

	Securities Available-for-Sale			
	Level		Level	Total
	1	Level 2	3	
At December 31, 2018				
U.S. agency securities	\$ —	\$ 15,887	\$ —	\$ 15,887
Corporate securities	—	6,865	—	6,865
Municipal bonds	—	14,194	—	14,194
Mortgage-backed securities	—	44,836	—	44,836
U.S. Small Business Administration securities	—	15,423	—	15,423
Total	\$ —	\$ 97,205	\$ —	\$ 97,205

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
	At December 31, 2017			
U.S. agency securities	\$ —	\$ 9,115	\$ —	\$ 9,115
Corporate securities	—	7,026	—	7,026
Municipal bonds	—	12,786	—	12,786
Mortgage-backed securities	—	39,734	—	39,734
U.S. Small Business Administration securities	—	13,819	—	13,819
Total	\$ —	\$ 82,480	\$ —	\$ 82,480

The following table presents mortgage loans held for sale measured at fair value on a recurring basis at the dates indicated:

	Mortgage Loans Held for Sale			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ 51,195	\$ —	\$ 51,195
December 31, 2017	\$ —	\$ 53,463	\$ —	\$ 53,463

Edgar Filing: FS Bancorp, Inc. - Form 10-K

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

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ —	\$ 503	\$ 503
December 31, 2017	\$ —	\$ —	\$ 726	\$ 726

	Individual Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ (540)	\$ (34)	\$ (574)
December 31, 2017	\$ —	\$ (65)	\$ 51	\$ (14)

Table of Contents

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ (64)	\$ —	\$ (64)
December 31, 2017	\$ —	\$ 53	\$ —	\$ 53

The following tables present impaired loans and OREO measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded during the reporting period. The amounts disclosed below represent the fair values at the time the nonrecurring fair value measurements were evaluated.

	Impaired Loans			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ —	\$ 3,894	\$ 3,894
December 31, 2017	\$ —	\$ —	\$ 1,094	\$ 1,094

	OREO			
	Level 1	Level 2	Level 3	Total
December 31, 2018	\$ —	\$ —	\$ 689	\$ 689
December 31, 2017	\$ —	\$ —	\$ —	\$ —

Quantitative Information about Level 3 Fair Value Measurements - Shown in the table below is the fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at December 31, 2018:

Level 3 Fair Value Instruments	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average	
RECURRING					
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	95.2	%
Individual forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	95.2	%
NONRECURRING					
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 50%	25.0	%
OREO	Fair value of collateral	Discount applied to the obtained appraisal	0% - 75%	71.1	%



An increase in the pull-through rate utilized in the fair value measurement of the interest rate lock commitments with customers and forward sale commitments with investors will result in positive fair value adjustments (and an increase in the fair value measurement). Conversely, a decrease in the pull-through rate will result in a negative fair value adjustment (and a decrease in the fair value measurement).

Table of Contents

The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the years ended December 31, 2018 and 2017.

	Beginning Balance	Purchases and issuances	Sales and settlements	Ending Balance	Net change in fair value for gains/ (losses) relating to items held at end of at end of year
2018					
Interest rate lock commitments with customers	\$ 726	\$ 9,722	\$ (9,945)	\$ 503	\$ (223)
Individual forward sale commitments with investors	51	850	(935)	(34)	(85)
2017					
Interest rate lock commitments with customers	\$ 818	\$ 14,319	\$ (14,411)	\$ 726	\$ (92)
Individual forward sale commitments with investors	177	141	(267)	51	(126)

Gains (losses) on interest rate lock commitments carried at fair value are recorded in other noninterest income. Gains (losses) on forward sale commitments with investors carried at fair value are recorded within other noninterest income.

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.

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. These instruments include cash and cash equivalents and certificates of deposit at other financial institutions, FHLB stock, BOLI, accrued interest, and off balance sheet instruments.

Fair Value Estimates - The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in following financial instrument table:

Loans Receivable, Net - For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using an exit price assumption (Level 3).

Servicing Rights - The fair value of mortgage servicing rights are estimated using net present value of expected cash flows using a third party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information where appropriate (Level 3).

Deposits - The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using an exit price assumption (Level 2).

Borrowings - The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

Subordinated Note - The fair value of the Subordinated Note is based upon the average yield of debt issuances for similarly sized issuances (Level 2).

Table of Contents

The following table provides estimated fair values of the Company's financial instruments at December 31, 2018 and 2017, whether or not recognized at fair value in the Consolidated Balance Sheets:

	2018 Carrying Amount	Fair Value	2017 Carrying Amount	Fair Value
Financial Assets				
Level 1 inputs:				
Cash and cash equivalents	\$ 32,779	\$ 32,779	\$ 18,915	\$ 18,915
Certificates of deposit at other financial institutions	22,074	22,074	18,108	18,108
Level 2 inputs:				
Securities available-for-sale, at fair value	97,205	97,205	82,480	82,480
Loans held for sale, at fair value	51,195	51,195	53,463	53,463
FHLB stock, at cost	9,887	9,887	2,871	2,871
Accrued interest receivable	5,761	5,761	3,566	3,566
Paired off commitments with investors	—	—	53	53
Level 3 inputs:				
Loans receivable, gross	1,326,238	1,320,341	773,445	780,551 (1)
Servicing rights, held at lower of cost or fair value	10,429	14,593	6,795	8,608
Fair value interest rate locks with customers	503	503	726	726
Individual forward sale commitments with investors	—	—	51	51
Financial Liabilities				
Level 2 inputs:				
Deposits	1,274,219	1,261,096	829,842	838,087
Borrowings	137,149	136,873	7,529	7,498
Subordinated note	9,865	10,242	9,845	10,741
Accrued interest payable	344	344	214	214
Paired off commitments with investors	64	64	—	—
Individual forward sale commitments with investors	540	540	65	65
Level 3 inputs:				
Individual forward sale commitments with investors	34	34	—	—

---

(1) Estimated fair values reported at December 31, 2017 were not retroactively valued at exit price.

## NOTE 16 - EARNINGS PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the year. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. For earnings per share calculations, the ESOP shares committed to be released are included as outstanding shares for both basic and diluted earnings per share.

Table of Contents

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the years ended December 31, 2018 and 2017.

	At or For the Year Ended December 31,	
	2018	2017
Numerator:		
Net income (in thousands)	\$ 24,347	\$ 14,085
Denominator:		
Basic weighted average common shares outstanding	3,698,623	3,094,586
Dilutive shares	171,166	197,114
Diluted weighted average common shares outstanding	3,869,789	3,291,700
Basic earnings per share	\$ 6.58	\$ 4.55
Diluted earnings per share	\$ 6.29	\$ 4.28
Potentially dilutive weighted average share options that were not included in the computation of diluted earnings per share because to do so would be anti-dilutive	11,326	—

Potential dilutive shares are excluded from computation of earnings per share if their effect is anti-dilutive. Options to purchase common stock shares were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. At December 31, 2018 and 2017, there were outstanding options to purchase 290,104 shares and 256,237 shares of the Company's common stock, respectively.

## NOTE 17 - DERIVATIVES

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

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

	December 31, 2018		
	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 29,432	\$ 503	\$ —
Mandatory and best effort forward commitments with investors	24,776	—	34
Forward TBA mortgage-backed securities	51,500	—	540
TBA mortgage-backed securities forward sales paired off with investors	6,500	—	64

Edgar Filing: FS Bancorp, Inc. - Form 10-K

December 31, 2017

		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$ 31,951	\$ 726	\$ —
Mandatory and best effort forward commitments with investors	12,505	51	—
Forward TBA mortgage-backed securities	66,500	—	65
TBA mortgage-backed securities forward sales paired off with investors	36,500	53	—

At December 31, 2018 and 2017, the Company had \$51.5 million and \$66.5 million of TBA trades with counterparties that required margin collateral of \$460,000 and \$75,000, respectively. This collateral is included in interest-bearing deposits at other financial institutions on the Consolidated Balance Sheets.

Table of Contents

Changes in the fair value of the derivatives recognized in other noninterest income on the Consolidated Statements of Income and included in gain on sale of loans resulted in a net (loss) gain of \$(702,000) and \$2.3 million for the years ended December 31, 2018 and 2017, respectively.

NOTE 18 - STOCK-BASED COMPENSATION

Stock Options and Restricted Stock

On May 17, 2018, the shareholders of FS Bancorp, Inc. approved the 2018 Equity Incentive Plan (the “2018 Plan”) that authorizes 650,000 shares of the Company’s common stock to be awarded. The 2018 Plan provides for the grant of incentive stock options, non-qualified stock options, and up to 163,000 restricted stock awards (“RSAs”) to directors, emeritus directors, officers, employees or advisory directors of the Company. On August 15, 2018, the Company awarded grants of 25,000 RSAs and 100,000 stock options with an exercise price equal to the market price of FS Bancorp’s common stock at the grant date of \$58.60 per share.

In September 2013, the shareholders of FS Bancorp, Inc. approved the FS Bancorp, Inc. 2013 Equity Incentive Plan (“2013 Plan”). The Plan provides for the grant of stock options and restricted stock awards (“RSAs”). The 2013 Plan authorizes the grant of stock options totaling 324,013 shares of common stock to Company directors and employees of which 322,000 option share awards were granted with an exercise price equal to the market price of FS Bancorp’s common stock at the grant date of May 8, 2014, of \$16.89 per share. The 2013 Plan authorizes the grant of RSAs totaling 129,605 shares to Company directors, advisory directors, emeritus directors, officers, and employees, and 125,105 shares were granted on May 8, 2014 at a grant date fair value of \$16.89 per share. The remaining 4,500 RSAs were granted January 1, 2016 at a grant date fair value of \$26.00 per share.

Total share-based compensation expense for both plans was \$767,000 for the year ended December 31, 2018, and \$634,000 for the year ended December 31, 2017. The related income tax benefit was \$161,000 for the year ended December 31, 2018, and \$222,000 for 2017.

Stock Options

Both plans consist of stock option awards that may be granted as incentive stock options or non-qualified stock options. Options typically vest over a period of five years with 20% vesting on the anniversary date of each grant date as long as the award recipient remains in service to the Company. The options are exercisable after vesting for up to the remaining term of the original grant. The maximum term of the options granted is 10 years. Any unexercised stock options will expire 10 years after the grant date or sooner in the event of the award recipient’s termination of service with the Company or the Bank. At December 31, 2018, there were 387,000 and 6,013 option share awards available to be granted under the 2018 Plan and the 2013 Plan, respectively.

The fair value of each option award is estimated on the grant date using a Black-Scholes Option pricing 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 Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for the “Share-Based Payments” method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at 6.5 years.

The fair value of options granted was determined using the following weighted-average assumptions as of the grant date for the year ended December 31, 2018. There were no options granted in 2017.



Edgar Filing: FS Bancorp, Inc. - Form 10-K

	Year Ended December 31, 2018
Dividend yield	0.95%
Expected volatility	18.80%
Risk-free interest rate	2.77%
Expected term in years	6.5
Weighted-average grant date fair value per option granted	\$ 13.22

132

---

Table of Contents

The following table presents a summary of the Company's stock option plan awards during the year ended December 31, 2018 (shown as actual):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2018	256,237	\$ 16.89	6.36	\$ 9,655,010
Granted	100,000	58.60	—	—
Less exercised	66,133	\$ 16.89	—	\$ 2,453,314
Forfeited or expired	—	—	—	—
Outstanding at December 31, 2018	290,104	\$ 31.27	6.83	\$ 4,940,803
Expected to vest, assuming a 0.31% annual forfeiture rate (1)	289,226	\$ 31.19	6.82	\$ 4,939,069
Exercisable at December 31, 2018	129,304	\$ 16.89	5.36	\$ 3,360,611

(1) Forfeiture rate has been calculated and estimated to assume a forfeiture of 3.1% of the options forfeited over 10 years.

At December 31, 2018, there was \$1.3 million of total unrecognized compensation cost related to nonvested stock options granted under both plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.4 years. The total intrinsic value of options exercised for the years ended December 31, 2018 and 2017 was \$2.5 million and \$1.1 million, respectively.

#### Restricted Stock Awards

The RSAs' fair value is equal to the value on the grant date. Compensation expense is recognized over the vesting period of the awards based on the fair value of the restricted stock. Shares in the 2013 Plan awarded as restricted stock typically vest ratably over a three-year period for directors and a five-year period for employees, beginning at the grant date, and for the 2018 Plan, shares typically vest ratably over a five-year period for both directors and employees beginning at the grant date. Any unvested RSAs will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.

The following table presents a summary of the Company's nonvested awards during the year ended December 31, 2018 (shown as actual):

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share
Nonvested at January 1, 2018	36,842	\$ 17.63
Granted	25,000	58.60
Less vested	18,421	\$ 17.63

Edgar Filing: FS Bancorp, Inc. - Form 10-K

Forfeited or expired	—	—
Nonvested at December 31, 2018	43,421	\$ 41.22

At December 31, 2018, there was \$1.5 million of total unrecognized compensation costs related to nonvested shares granted under both plans as RSAs. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.3 years. The total fair value of shares vested for the years ended December 31, 2018 and 2017 was \$1.1 million and \$1.4 million, respectively.

Table of Contents

NOTE 19 - BUSINESS SEGMENTS

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is currently evaluated by management. This process is dynamic and is based on management's current view of the Company's operations and is not necessarily comparable with similar information for other financial institutions. We define our business segments by product type and customer segment which we have organized into two lines of business: commercial and consumer banking and home lending.

We use various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

- a funds transfer pricing ("FTP") system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets;
- a cost per loan serviced allocation based on the number of loans being serviced on the balance sheet and the number of loans serviced for third parties;
- an allocation based upon the approximate square footage utilized by the home lending segment in Company owned locations;
  - an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on the number of full time employees ("FTEs") in each segment; and
- an allocation of the Company's consolidated income taxes which are based on the effective tax rate applied to the segment's pretax income or loss.

The FTP methodology is based on management's estimated cost of originating funds including the cost of overhead for deposit generation.

A description of the Company's business segments and the products and services that they provide is as follows:

**Commercial and Consumer Banking Segment**

The commercial and consumer banking segment provides diversified financial products and services to our commercial and consumer customers through Bank branches, automated teller machines ("ATM"), online banking platforms, mobile banking apps, and telephone banking. These products and services include deposit products; residential, consumer, business and commercial real estate lending portfolios and cash management services. The Company originates consumer loans, commercial and multi-family real estate loans, construction loans on residential and multi-family construction, and commercial business loans. At December 31, 2018, the Company's retail deposit branch network consisted of 21 branches in the Pacific Northwest. At December 31, 2018 and December 31, 2017, deposits totaled \$1.27 billion and \$829.8 million, respectively. This segment is also responsible for the management of the Company's investment portfolio and other assets of the Bank.

**Home Lending Segment**

The home lending segment originates one-to-four-family residential mortgage loans primarily for sale in the secondary markets as well as originating adjustable rate mortgage ("ARM") loans held for investment. The majority of the Company's mortgage loans are sold to or securitized by FNMA, FHLMC, GNMA or FHLB, while the Company retains the right to service these loans. Loans originated under the guidelines of the Federal Housing Administration or FHA, US Department of Veterans Affairs or VA, and United States Department of Agriculture or USDA are generally sold servicing released to a correspondent bank or mortgage company. The Company has the option to sell loans on a servicing-released or servicing-retained basis to securitizers and correspondent lenders. A small percentage of loans

are brokered to other lenders. On occasion, the Company may sell a portion of its MSR portfolio and may sell small pools of loans initially originated to be held in the loan portfolio. The Company manages the loan funding and the interest rate risk associated with the secondary market loan sales and the retained one-to-four-family mortgage servicing rights within this business

Table of Contents

segment. One-to-four-family loans originated for investment are allocated to the home lending segment with a corresponding provision expense and FTP for cost of funds.

## Segment Financial Results

The tables below summarize the financial results for each segment based primarily on the number of FTEs and assets within each segment for the years ended December 31, 2018 and 2017:

	At or For the Year Ended December 31, 2018		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 3,324	\$ 48,774	\$ 52,098
Provision for loan losses	(224)	(1,316)	(1,540)
Noninterest income (2)	14,025	12,825	26,850
Noninterest expense	(15,894)	(32,944)	(48,838)
Income before provision for income taxes	1,231	27,339	28,570
Provision for income taxes	(182)	(4,041)	(4,223)
Net income	\$ 1,049	\$ 23,298	\$ 24,347
Total assets (3)	\$ 246,280	\$ 1,375,364	\$ 1,621,644
Total average assets at period end	\$ 229,661	\$ 945,052	\$ 1,174,713
FTEs	115	309	424

	At or For the Year Ended December 31, 2017		
	Home Lending	Commercial and Consumer Banking	Total
Condensed income statement:			
Net interest income (1)	\$ 2,587	\$ 38,661	\$ 41,248
Provision for loan losses	(287)	(463)	(750)
Noninterest income	18,973	5,101	24,074
Noninterest expense	(17,052)	(26,941)	(43,993)
Income before provision for income taxes	4,221	16,358	20,579
Provision for income taxes	(1,332)	(5,162)	(6,494)
Net income	\$ 2,889	\$ 11,196	\$ 14,085
Total assets	\$ 220,353	\$ 761,430	\$ 981,783
Total average assets at period end	\$ 203,379	\$ 720,202	\$ 923,581
FTEs	119	207	326

(1) Net interest income is the difference between interest earned on assets and the cost of liabilities to fund those assets. Interest earned includes actual interest earned on segment assets and, if the segment has excess liabilities,

interest credits for providing funding to the other segment. The cost of liabilities includes interest expense on segment liabilities and, if the segment does not have enough liabilities to fund its assets, a funding charge based on the cost of assigned liabilities to fund segment assets.

- (2) Bargain purchase gain of \$7.4 million was included in the commercial and consumer banking segment.
- (3) Increase from prior year relates primarily to the Anchor Acquisition and organic growth.

Table of Contents

NOTE 20 - REVENUE FROM CONTRACTS WITH CUSTOMERS

As noted in Note 1, the Company adopted the provisions of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), on January 1, 2018 and all subsequent ASUs that modified Topic 606. Results for reporting periods beginning after December 31, 2017 are presented under Topic 606, while prior period amounts have not been adjusted and continue to be reported in accordance with Topic 605.

Revenue Recognition

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation. The Company only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Company assesses the goods or services that are promised within each contract and identifies those that contain performance obligations, and assesses whether each promised good or service is distinct. The Company then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied. Based on the adoption of Topic 606, the Company's revenue recognition was unchanged in 2018 compared to 2017.

All of the Company's revenue from contracts with customers in scope of ASC 606 is recognized in noninterest income and included in our commercial and consumer banking segment. For the year ended December 31, 2018, the Company recognized \$2.5 million in total deposit fees, which included \$1.2 million of debit card interchange fees and \$561,000 of fees from non-sufficient funds, both considered within the scope of ASC 606, and \$25.1 million of noninterest income considered not within the scope of ASC 606.

Deposit Fees

The Bank earns fees from its deposit customers for account maintenance, transaction-based and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposits accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

Debit Interchange Income

Debit and ATM interchange income represent fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' debit card. Certain expenses directly associated with the debit card are recorded on a net basis with the interchange income.



NOTE 21 - GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and certain other intangibles generally arise from business combinations accounted for under the purchase method of accounting. Goodwill totaled \$2.3 million at December 30, 2018 and 2017, and represents the excess of the total acquisition price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed as a result of the Branch Purchase in 2016. Goodwill is not amortized but is evaluated for impairment on an annual basis at December 31 of each year or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The

136

---

Table of Contents

Company performed an impairment analysis at December 31, 2018, and 2017 and determined that no impairment of goodwill existed.

The following table summarizes the changes in the Company's other intangible assets and represents the CDI for the years ended December 31, 2018, and December 31, 2017.

	Other Intangible Assets		
	Gross CDI	Accumulated Amortization	Net CDI
Balance, December 31, 2016	\$ 2,239	\$ (522)	\$ 1,717
Amortization	—	(400)	(400)
Balance, December 31, 2017	2,239	(922)	1,317
Amortization	—	(307)	(307)
Additions as a result of the Anchor Acquisition	5,251	(44)	5,207
Balance, December 31, 2018	\$ 7,490	\$ (1,273)	\$ 6,217

The CDI represents the fair value of the core deposit base acquired in business combinations. The CDI will be amortized on a straight-line basis over 10 years for the CDI related to the Anchor Acquisition and on an accelerated basis over approximately nine years for the CDI related to the Branch Purchase. Total amortization expense was \$351,000 for the year ended December 31, 2018, and \$400,000 for the same period in 2017. Amortization expense for the CDI is expected to be as follows at December 31, 2018:

2019	760
2020	706
2021	691
2022	691
2023	691
Thereafter	2,678
Total	\$ 6,217

## Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

## Item 9A. Controls and Procedures

## (i) Disclosure Controls and Procedures.

An evaluation of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") was carried out as of December 31, 2018 under the supervision and with the participation of our Chief Executive Officer ("CEO"), Chief Financial Officer ("CFO"), and several other members of our senior management. The CEO (Principal Executive Officer) and CFO (Principal Financial Officer) concluded that, as of December 31, 2018, FS Bancorp's disclosure controls and procedures were effective in ensuring that information we are required to disclose in the reports we file or submit under the Exchange Act is (1) recorded, processed,

summarized, and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to FS Bancorp management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure, specified in the SEC's rules and forms.

a) Management's Report on internal control over financial reporting.

FS Bancorp's management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) of the Exchange Act. FS Bancorp's internal control system is designed to provide

Table of Contents

reasonable assurance to our management and the Board of Directors regarding the preparation and fair presentation of published financial statements for external purposes in accordance with generally accepted accounting principles.

This process includes policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions of FS Bancorp; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of FS Bancorp are being made only in accordance with authorizations of management and directors of FS Bancorp; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FS Bancorp's assets that could have a material effect on the financial statements. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system 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. Additionally, in designing disclosure controls and procedures, FS Bancorp's management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Furthermore, 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.

FS Bancorp's management assessed the effectiveness of FS Bancorp's internal control over financial reporting as of December 31, 2018. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework (2013 Framework). FS Bancorp is in the process of evaluating the existing controls and procedures of Anchor and integrating Anchor into its internal control over financial reporting. In accordance with SEC Staff guidance permitting a company to exclude an acquired business from management's assessment of the effectiveness of internal control over financial reporting for the year in which the acquisition is completed, FS Bancorp has elected to exclude the non-integrated branches, systems, operations and related loans and deposits of Anchor and Anchor Bank, from management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. The loans and deposits of Anchor and Anchor Bank represented \$328.2 million, or 24.8%, and \$355.7 million, or 27.9%, respectively, of the Company's total loans and deposits as reported in its consolidated financial statements as of December 31, 2018. FS Bancorp's assessment of the internal control over financial reporting of the Company also excluded an evaluation of the internal control over financial reporting of the non-integrated branches, systems, operations and related loans and deposits that were formerly part of Anchor and Anchor Bank. Based on that assessment, FS Bancorp's management believes that, as of December 31, 2018, FS Bancorp's internal control over financial reporting is effective based on those criteria. Moss Adams LLP, an independent registered public accounting firm, has audited the Company's consolidated financial statements and the effectiveness of our internal control over financial reporting as of December 31, 2018, which is included in "Item 8. Financial Statements and Supplementary Data" of this Annual Report on Form 10 K.

b) Attestation report of the registered public accounting firm.

The "Report of Independent Registered Public Accounting Firm" included in "Item 8. Financial Statements and Supplementary Data" of this Annual Report on Form 10 K is incorporated herein by reference.

c) Changes in internal control over financial reporting.

There were no significant changes in FS Bancorp's internal control over financial reporting during FS Bancorp's most recent fiscal quarter that have materially affected or are reasonably likely to materially affect, FS Bancorp's internal control over financial reporting.

Item 9B. Other Information

None.

138

---

Table of Contents

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item regarding the Company's Board of Directors is incorporated herein by reference from the section captioned "Proposal I - Election of Directors" in the Company's Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.

The executive officers of the Company and the Bank are elected annually and hold office until their respective successors have been elected and qualified or until death, resignation or removal by the Board of Directors. For information regarding the Company's executive officers, see "Item 1. Business - Executive Officers" included in this Form 10 K.

Compliance with Section 16(a) of the Exchange Act

The information required by this item is incorporated herein by reference from the section captioned "Compliance with Section 16(a) of the Exchange Act" in the Company's Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.

Code of Ethics for Senior Financial Officers

The Board of Directors has adopted a Code of Ethics for the Company's officers (including its senior financial officers), directors and employees. The Code is applicable to the Company's principal executive officer and senior financial officers. The Company's Code of Ethics is posted on its website at [www.fsbwa.com](http://www.fsbwa.com) under the Investor Relations tab.

Audit Committee Financial Expert

The Audit Committee of the Company is composed of Directors Leech (Chairperson), Mansfield and Cofer-Wildsmith. Each member of the Audit Committee is "independent" as defined in the Nasdaq Stock Market listing standards. The Board of Directors has determined that Mr. Leech and Mr. Mansfield meet the definition of "audit committee financial expert," as defined by the SEC.

Item 11. Executive Compensation

The information required by this item is incorporated herein by reference from the sections captioned "Executive Compensation" and "Directors' Compensation" in the Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

(a) Security Ownership of Certain Beneficial Owners.

The information required by this item is incorporated herein by reference from the section captioned "Security Ownership of Certain Beneficial Owners and Management" in the Company's Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.

(b) Security Ownership of Management.

The information required by this item is incorporated herein by reference from the sections captioned “Security Ownership of Certain Beneficial Owners and Management” and “Proposal I - Election of Directors” in the Company’s Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company’s fiscal year end.

(c) Changes in Control.

The Company is not aware of any arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change in control of the Company.

Table of Contents

d) Equity Compensation Plan Information. The following table summarizes share and exercise price information about FS Bancorp's equity compensation plans as of December 31, 2018:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans (stock options) approved by security holders:			
2013 Equity Incentive Plan(1)	190,104	\$ 16.89	6,013
2018 Equity Incentive Plan(2)	100,000	58.60	525,000
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	290,104	\$ 75.49	531,013

(1) The restricted shares granted under the 2013 Equity Incentive Plan were purchased by FS Bancorp in open market transactions and subsequently issued to the Company's directors and certain employees. At December 31, 2018, there were 129,605 restricted shares granted pursuant to the 2013 Equity Incentive Plan and no shares were available for future grants of restricted stock.

(2) The restricted shares granted under the 2018 Equity Incentive Plan were purchased by FS Bancorp in open market transactions and subsequently issued to the Company's directors and certain employees. At December 31, 2018, there were 25,000 restricted shares granted pursuant to the 2018 Equity Incentive Plan and 138,000 shares were available for future grants of restricted stock.

#### Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is incorporated herein by reference from the section captioned "Transactions with Management" in the Company's Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.

#### Item 14. Principal Accounting Fees and Services

The information required by this item is incorporated herein by reference from the section captioned "Proposal 3 - Ratification of Appointment of Independent Auditor" in the Company's Proxy Statement, a copy of which will be filed with the SEC no later than 120 days after the Company's fiscal year end.



Table of Contents

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) 1. Financial Statements

For a list of the financial statements filed as part of this report see “Part II - Item 8. Financial Statements and Supplementary Data.”

2. Financial Statement Schedules

Schedules to the Consolidated Financial Statements have been omitted as the required information is inapplicable.

(b) Exhibits

Exhibits are available from the Company by written request

2.1 Agreement and Plan of Merger, dated as of July 17, 2018, by and between FS Bancorp, Inc. and Anchor Bancorp (1)

3.1 Articles of Incorporation for FS Bancorp, Inc. (2)

3.2 Bylaws for FS Bancorp, Inc. (3)

4.1 Form of Common Stock Certificate of FS Bancorp, Inc. (2)

10.1 Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams

- (2)
- 10.2 Form of Change of Control Agreement between 1st Security Bank of Washington and Matthew D. Mullet (2)
- 10.3 FS Bancorp, Inc. 2013 Equity Incentive Plan (the “2013 Plan”)
- (4)
- 10.4 Form of Incentive Stock Option Agreement under the 2013 Plan (4)
- 10.5 Form of Non-Qualified Stock Option Agreement under the 2013 Plan (4)
- 10.6 Form of Restricted Stock Agreement under the 2013 Plan (4)
- 10.7 Purchase and Assumption Agreement between Bank of America, National Association and 1st Security Bank dated September 1, 2015 (6)
- 10.8 Subordinated Loan Agreement dated September 30, 2015 by and among Community Funding CLO, Ltd. and the Company. (7)
- 10.9 Form of Change of Control

- Agreement with  
Donn C. Costa,  
Debbie L. Steck,  
Dennis O’Leary,  
Rob Fuller, Erin  
Burr, Victoria  
Jarman, Kelli  
Nielsen, and  
May-Ling  
Sowell (8)
- 10.10 FS Bancorp, Inc.  
2018 Equity  
Incentive Plan  
(9)
- 10.11 Form of  
Incentive Stock  
Option Award  
Agreement under  
the 2018 Equity  
Incentive Plan  
(9)
- 10.12 Form of  
Non-Qualified  
Stock Option  
Award  
Agreement under  
the 2018 Equity  
Incentive Plan  
(9)
- 10.13 Form of  
Restricted Stock  
Award  
Agreement under  
the 2018 Equity  
Incentive Plan  
(9)
- 14 Code of Ethics  
and Conduct  
Policy (5)
- 21 Subsidiaries of  
Registrant
- 23 Consent of  
Independent  
Registered  
Public  
Accounting Firm
- 31.1 Certification of  
Chief Executive  
Officer Pursuant  
to Section 302 of  
the

- 31.2 Sarbanes-Oxley Act of 2002  
Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from the Company's Annual Report on Form 10 K for the fiscal year ended December 31, 2018, formatted in Extensible Business Reporting Language (XBRL):  
(1) Consolidated Balance Sheets;  
(2) Consolidated Statements of Income;  
(3) Consolidated Statements of Comprehensive Income;  
(4) Consolidated Statements of Stockholders' Equity;  
(5) Consolidated

Statements of  
Cash Flows; and  
(6) Notes to  
Consolidated  
Financial  
Statements.

(1) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on July 18, 2018 (File No. 001-35589) and incorporated by reference.

(2) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-177125) filed on October 3, 2011, and incorporated by reference.

(3) Filed as an exhibit to the Registrant's Current Report on Form 8 K filed on July 10, 2013 (File No. 001 355589).

(4) Filed as an exhibit to the Registrant's Registration Statement on Form S 8 (333 192990) filed on December 20, 2013 and incorporated by reference.

Table of Contents

- (5) Registrant elects to satisfy Regulation S-K §229.406(c) by posting its Code of Ethics on its website at www.fsbwa.com in the section titled Investor Relations: Corporate Governance.
- (6) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on September 2, 2015 (File No. 001-35589).
- (7) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on October 19, 2015 (File No. 001-35589).
- (8) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on February 1, 2016 (File No. 001-35589).
- (9) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-22513) filed on May 23, 2018.

Item 16. Form 10-K Summary

None.

EXHIBIT INDEX

- 21 Subsidiaries of Registrant
- 23 Consent of Independent Registered Public Accounting Firm
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 15, 2019 FS Bancorp, Inc.

/s/Joseph C. Adams  
Joseph C. Adams  
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURES	TITLE	DATE
/s/Joseph C. Adams Joseph C. Adams	Director and Chief Executive Officer (Principal Executive Officer)	March 15, 2019
/s/Matthew D. Mullet Matthew D. Mullet	Chief Financial Officer, Treasurer and Secretary (Principal Financial and Accounting Officer)	March 15, 2019
/s/Ted A. Leech Ted A. Leech	Chairman of the Board	March 15, 2019
/s/Margaret R. Piesik Margaret R. Piesik	Director	March 15, 2019
/s/Joseph P. Zavaglia Joseph P. Zavaglia	Director	March 15, 2019
/s/Michael J. Mansfield Michael J. Mansfield	Director	March 15, 2019
/s/Marina Cofer-Wildsmith Marina Cofer-Wildsmith, MA	Director	March 15, 2019
/s/Mark H. Tueffers Mark H. Tueffers	Director	March 15, 2019