

First Financial Northwest, Inc.  
Form 10-Q  
November 05, 2010

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

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

For the quarterly period ended September 30, 2010

or

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

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

Commission File Number: 001-33652

FIRST FINANCIAL NORTHWEST, INC.  
(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of  
incorporation or organization)

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

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

98057  
(Zip Code)

Registrant's telephone number,  
including area code:

(425) 255-4400

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

Yes  No

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

Yes  No

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 5, 2010, 18,805,168 shares of the issuer's common stock, \$0.01 par value per share, were outstanding.

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## Item 1. Financial Statements

## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

(Unaudited)

Assets	September 30, 2010	December 31, 2009
Cash on hand and in banks	\$ 7,809	\$ 8,937
Interest-bearing deposits	132,058	96,033
Investments available for sale	157,563	97,383
Loans receivable, net of allowance of \$28,400 and \$33,039	915,562	1,039,300
Premises and equipment, net	20,077	19,585
Federal Home Loan Bank stock, at cost	7,413	7,413
Accrued interest receivable	4,711	4,880
Federal income tax receivable	5,720	9,499
Deferred tax assets, net	—	12,139
Other real estate owned, net	22,927	11,835
Prepaid expenses and other assets	6,617	8,330
Total assets	\$ 1,280,457	\$ 1,315,334
<b>Liabilities and Stockholders' Equity</b>		
Deposits	\$ 952,748	\$ 939,423
Advances from the Federal Home Loan Bank	143,066	139,900
Advance payments from borrowers for taxes and insurance	4,506	2,377
Accrued interest payable	395	457
Other liabilities	5,073	4,660
Total liabilities	1,105,788	1,086,817
<b>Commitments and contingencies</b>		
<b>Stockholders' Equity</b>		
Preferred stock, \$0.01 par value; authorized 10,000,000 shares, no shares issued or outstanding	—	—
Common stock, \$0.01 par value; authorized 90,000,000 shares; issued and outstanding 18,805,168 and 18,823,068 shares at September 30, 2010 and December 31, 2009	188	188
Additional paid-in capital	187,069	186,120

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Retained earnings (deficit), substantially restricted	(874)	55,251
Accumulated other comprehensive income, net of tax	1,828	1,347
Unearned Employee Stock Ownership Plan shares	(13,542)	(14,389)
Total stockholders' equity	174,669	228,517
Total liabilities and stockholders' equity	\$ 1,280,457	\$ 1,315,334

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Interest income</b>				
Loans, including fees	\$ 13,677	14,376	\$ 42,516	43,515
Investments available for sale	1,254	1,813	3,367	5,129
Federal funds sold and interest-bearing deposits with banks	80	32	214	54
<b>Total interest income</b>	<b>\$ 15,011</b>	<b>\$ 16,221</b>	<b>\$ 46,097</b>	<b>\$ 48,698</b>
<b>Interest expense</b>				
Deposits	5,563	7,262	18,456	22,019
Federal Home Loan Bank advances	1,057	1,310	3,115	3,868
<b>Total interest expense</b>	<b>\$ 6,620</b>	<b>\$ 8,572</b>	<b>\$ 21,571</b>	<b>\$ 25,887</b>
<b>Net interest income</b>	<b>8,391</b>	<b>7,649</b>	<b>24,526</b>	<b>22,811</b>
<b>Provision for loan losses</b>	<b>12,000</b>	<b>7,795</b>	<b>51,000</b>	<b>27,595</b>
<b>Net interest loss after provision for loan losses</b>	<b>\$ (3,609)</b>	<b>\$ (146)</b>	<b>\$ (26,474)</b>	<b>\$ (4,784)</b>
<b>Noninterest income</b>				
Net gain (loss) on sale of investments	—	(2)	—	74
Other-than-temporary impairment loss on investments	—	—	—	(152)
Other	38	74	146	183
<b>Total noninterest income</b>	<b>\$ 38</b>	<b>\$ 72</b>	<b>\$ 146</b>	<b>\$ 105</b>
<b>Noninterest expense</b>				
Salaries and employee benefits	3,258	3,077	9,339	9,153
Occupancy and equipment	411	343	1,260	1,986
Professional fees	664	332	1,610	1,028

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Data processing	191	178	533	472
Loss (gain) on sale of OREO property, net	(205)	—	218	—
OREO market value adjustments	2,016	—	5,184	—
OREO related expenses, net	962	37	2,372	152
FDIC/OTS assessments	910	352	2,005	1,930
Insurance and bond premiums	150	17	449	54
Goodwill impairment	—	—	—	14,206
Other general and administrative	143	553	1,407	1,759
<b>Total noninterest expense</b>	<b>\$ 8,500</b>	<b>\$ 4,889</b>	<b>\$ 24,377</b>	<b>\$ 30,740</b>
<b>Loss before provision (benefit) for federal income taxes</b>	<b>(12,071)</b>	<b>(4,963)</b>	<b>(50,705)</b>	<b>(35,419)</b>
<b>Provision (benefit) for federal income taxes</b>	<b>—</b>	<b>(3,304)</b>	<b>3,999</b>	<b>(6,959)</b>
<b>Net loss</b>	<b>\$ (12,071)</b>	<b>\$ (1,659)</b>	<b>\$ (54,704)</b>	<b>\$ (28,460)</b>
<b>Basic loss per share</b>	<b>\$ (0.69)</b>	<b>(0.09)</b>	<b>(3.14)</b>	<b>(1.50)</b>
<b>Diluted loss per share</b>	<b>\$ (0.69)</b>	<b>(0.09)</b>	<b>(3.14)</b>	<b>(1.50)</b>

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)  
For the Nine Months Ended September 30, 2010  
(Dollars in thousands, except share data)  
(Unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income, net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2009	18,823,068	\$ 188	\$ 186,120	\$ 55,251	\$ 1,347	\$ (14,389)	\$ 228,517
Comprehensive loss:							
Net loss	--	--	--	(54,704)	--	--	(54,704)
Change in fair value of investments available for sale	--	--	--	--	481	--	481
Total comprehensive loss:							(54,223)
Cash dividend declared and paid (\$0.085 per share)	--	--	--	(1,421)	--	--	(1,421)
Purchase and retirement of common stock	(17,900)	--	(106)	--	--	--	(106)
Compensation related to stock options and restricted stock awards	--	--	1,441	--	--	--	1,441
Allocation of 84,640 ESOP shares	--	--	(386)	--	--	847	461
Balances at September 30, 2010	18,805,168	\$ 188	\$ 187,069	\$ (874)	\$ 1,828	\$ (13,542)	\$ 174,669

See accompanying notes to consolidated financial statements.



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

	Nine Months Ended September 30,	
	2010	2009
<b>Cash flows from operating activities:</b>		
Net loss	\$ (54,704)	(28,460)
Adjustments to reconcile net loss to		
net cash provided by operating activities:		
Provision for loan losses	51,000	27,595
Goodwill impairment	—	14,206
OREO market value adjustments	5,184	—
Loss on sale of OREO property, net	218	—
Depreciation and amortization of premises and equipment	829	596
Net amortization of premiums and discounts on investments	1,119	785
ESOP expense	461	676
Compensation expense related to stock options and restricted stock awards	1,441	1,569
Net realized gain on investments available for sale	—	(74)
Other-than-temporary impairment loss on investments	—	152
Loss on disposal of equipment	—	983
Deferred federal income taxes	11,878	(5,806)
Changes in operating assets and liabilities:		
Other assets	1,713	1,321
Accrued interest receivable	169	267
Accrued interest payable	(62)	44
Other liabilities	413	2,410
Federal income taxes	3,779	(1,602)
Net cash provided by operating activities	\$ 23,438	\$ 14,662
<b>Cash flows from investing activities:</b>		
Proceeds from sales of investments	—	6,853
Capitalized improvements in OREO	(488)	—
Proceeds from sales of OREO properties	18,837	—
Principal repayments on investments available for sale	23,851	32,180
Purchases of investments available for sale	(84,408)	(60,081)
Net (increase) decrease in loans receivable, net	37,895	(48,320)
Purchases of premises and equipment	(1,321)	(5,162)
Net cash used by investing activities	\$ (5,634)	\$ (74,530)
Balance, carried forward	\$ 17,804	\$ (59,868)



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

	Nine Months Ended September 30,	
	2010	2009
Balance, brought forward	\$ 17,804	(59,868)
Cash flows from financing activities:		
Net increase in deposits	13,325	116,730
Advances from the Federal Home Loan Bank	53,173	16,750
Repayments of advances from the Federal Home Loan Bank	(50,007)	(23,000)
Net increase (decrease) in advance payments from borrowers for taxes and insurance	2,129	1,630
Repurchase and retirement of common stock	(106)	(9,945)
Dividends paid	(1,421)	(4,839)
Net cash provided by financing activities	\$ 17,093	\$ 97,326
Net increase in cash	34,897	37,458
Cash and cash equivalents:		
Beginning of period	104,970	5,756
End of period	\$ 139,867	\$ 43,214
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 21,633	25,843
Federal income taxes	\$ —	450
Noncash transactions:		
Loans, net of deferred loan fees and allowance for loan losses, transferred to OREO	\$ 34,843	—

See accompanying notes to consolidated financial statements.

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

Note 1 – Description of Business

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

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

Note 2 – Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles (“GAAP”) for complete financial statements. These unaudited consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ended December 31, 2010. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan losses, other real estate owned (“OREO”), deferred tax assets and the fair value of financial instruments.

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

Note 3 – Recent Accounting Pronouncements

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

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

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

In February 2010, FASB issued ASU No. 2010-09, Subsequent Events (Topic 855)—Amendments to Certain Recognition and Disclosure Requirements. ASU No. 2010-09 establishes separate subsequent event recognition criteria and disclosure requirements for SEC filers. SEC filers are defined in this update as entities that are required to file or to furnish their financial statements with either the SEC or another appropriate agency, (such as the FDIC or Office of Thrift Supervision) under Section 12(i) of the Securities and Exchange Act of 1934, as amended. Beginning in February 2010, the financial statements of SEC filers will no longer disclose either the date through which subsequent events were reviewed or that subsequent events were evaluated through the date the financial statements were issued. The requirement to evaluate subsequent events through the date of issuance is still in place; only the disclosure is affected. This ASU also removes the requirement to make those disclosures in financial statements revised for either a correction of an error or a retrospective application of an accounting change. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2010, FASB issued ASU No. 2010-18, Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That is Accounted for as a Single Asset, which clarifies the accounting for acquired loans that have evidence of a deterioration in credit quality since origination (referred to as “Subtopic 310-30 Loans”). Under this ASU, an entity may not apply troubled debt restructuring (“TDR”) accounting guidance to individual Subtopic 310-30 Loans that are part of a pool, even if the modification of those loans would otherwise be considered a troubled debt restructuring. Once a pool is established, individual loans should not be removed from the pool unless the entity sells, forecloses, or writes off the loan. Entities would continue to consider whether the pool of loans is impaired if expected cash flows for the pool change. Subtopic 310-30 Loans that are accounted for individually would continue to be subject to TDR accounting guidance. A one-time election to terminate accounting for loans as a pool, which may be made on a pool-by-pool basis, is provided upon adoption of the ASU. This ASU is effective for the quarter ended September 30, 2010. Adoption of this ASU did not significantly impact our consolidated financial statements.

On July 21, 2010, the FASB issued ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010. Adoption of this ASU is not expected to significantly impact our consolidated financial statements.



FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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## Note 4 – Investment Securities Available for Sale

Investment securities available for sale are summarized as follows:

	September 30, 2010			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
<b>Mortgage-backed and related investments:</b>				
Fannie Mae	\$ 99,211	\$ 1,762	\$ (342)	\$ 100,631
Freddie Mac	40,067	1,091	(105)	41,053
Ginnie Mae	4,351	109	0	4,460
Tax-exempt municipal bonds	4,207	81	(298)	3,990
Taxable municipal bonds	648	12	0	660
U.S. Government agencies	1,805	232	0	2,037
Mutual fund (1)	4,460	272	0	4,732
	<b>\$ 154,749</b>	<b>\$ 3,559</b>	<b>\$ (745)</b>	<b>\$ 157,563</b>

	December 31, 2009			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
<b>Mortgage-backed and related investments:</b>				
Fannie Mae	\$ 50,025	\$ 1,267	\$ (\$21)	\$ 51,271
Freddie Mac	28,924	1,020	(\$3)	29,941
Ginnie Mae	5,099	84	\$0	5,183
Tax-exempt municipal bonds	4,207	49	(\$484)	3,772
Taxable municipal bonds	650	—	(\$48)	602
U.S. Government agencies	1,946	57	\$0	2,003
Mutual fund (1)	4,460	151	\$0	4,611
	<b>\$ 95,311</b>	<b>\$ 2,628</b>	<b>\$ (\$556)</b>	<b>\$ 97,383</b>

(1) Represents an investment in the AMF Ultra Short Mortgage Fund. The majority of the fund value is invested in U.S. Government or agency securities.





FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
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Investments with unrealized losses at September 30, 2010 and December 31, 2009 by length of time that individual investments have been in a continuous loss position, are as follows:

	Less Than 12 Months		September 30, 2010 12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
Fannie Mae	\$ 45,381	\$ (342)	\$ -	\$ -	\$ 45,381	\$ (342)
Freddie Mac	15,824	(105)	154	-	15,978	(105)
Tax-exempt municipal bonds	-	-	1,810	(298)	1,810	(298)
Taxable municipal bonds	-	-	-	-	-	-
	\$ 61,205	\$ (447)	\$ 1,964	\$ (298)	\$ 63,169	\$ (745)

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

On September 30, 2010, the Board of Trustees of the AMF Ultra Short Mortgage Fund (“Fund”) (a mutual fund) decided to remove the Fund’s redemption-in-kind provision. Originally this provision was invoked because of the uncertainty in the mortgage-backed securities market. The activation of this provision limited the options available to the shareholders of the Fund with respect to liquidating their investments. Only the Fund may repurchase the shares in accordance with the terms of the Fund. The Fund was closed to new investors. Existing participants, at that time, were

allowed to redeem and receive up to \$250,000 in cash per quarter or could receive 100% of their investment in “like kind” securities equal to their proportional ownership in the Fund (i.e. ownership percentage in the Fund times the market value of each of the approximately 150 securities). Now that the provision has been lifted, we are able to sell any portion of our ownership in the Fund.

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

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
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 (Unaudited)

estimated cash flows. The accretion of the OTTI amount recorded in OCI will increase the carrying value of the investment, and would not affect earnings. If there is an indication of additional credit losses the security is re-evaluated in accordance with the procedures described above. For the quarter and nine months ended September 30, 2010, we did not have any OTTI losses on investments.

The amortized cost and estimated fair value of investments, available for sale at September 30, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments and the mutual fund, are shown separately.

	September 30, 2010	
	Amortized Cost	Fair Value
	(In thousands)	
Due within one year	\$ -	\$ -
Due after one year through five years	1,173	1,269
Due after five years through ten years	1,179	1,213
Due after ten years	4,308	4,205
	6,660	6,687
 Mortgage-backed investments	 143,629	 146,144
Mutual fund	4,460	4,732
	\$ 154,749	\$ 157,563

There were no sales of investments during the three and nine months ended September 30, 2010.

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

## Note 5 - Loans Receivable, Net

Loans receivable consist of the following:

	September 30, 2010		December 31, 2009	
	Amount	Percent	Amount	Percent
(Dollars in thousands)				
<b>One-to-four family residential (1):</b>				
	424,959			
Permanent	\$ 424,959	44.18 %	\$ 481,046	43.13 %
Construction	6,648	0.69	15,685	1.41
	431,607		496,731	44.54
		44.87		
<b>Multifamily residential:</b>				
	137,842			
Permanent	137,842	14.34	128,943	11.56
Construction	19,364	2.01	17,565	1.58
	157,206		146,508	13.14
		16.35		
<b>Commercial real estate:</b>				
	241,996			
Permanent	241,996	25.16	251,185	22.52
Construction	31,112	3.24	31,605	2.83
Land	6,474	0.67	6,206	0.56
	279,582		288,996	25.91
		29.07		
<b>Construction/land development:</b>				
One-to-four family residential	42,266	4.40	95,699	8.58
Multifamily residential	1,283	0.13	3,624	0.33
Commercial	1,108	0.12	1,129	0.10
Land development	29,173	3.03	63,501	5.69
	73,830	7.68	163,953	14.70
Business	323	0.03	353	0.03
Consumer	19,239	2.00	18,678	1.68
	961,787			
<b>Total loans</b>	<b>\$ 961,787</b>	<b>100.00 %</b>	<b>\$ 1,115,29</b>	<b>100.00 %</b>
<b>Less:</b>				

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Loans in process	15,138	39,942
Deferred loan fees	2,687	2,938
Allowance for loan losses	28,400	33,039
Loans receivable, net	\$ 915,562	\$ 1,039,30

(1) Includes \$191.7 million and \$230.8 million of non-owner occupied loans at September 30, 2010 and December 31, 2009, respectively.

At September 30, 2010 and December 31, 2009 there were no loans classified as held for sale.

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A summary of changes in the allowance for loan losses for the three and nine months ended September 30, 2010 and 2009 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
(In thousands)				
Balance at the beginning of the period	\$ 29,858	32,450	33,039	16,982
Provision for loan losses	12,000	7,795	51,000	27,595
Charge-offs	(14,121)	(\$9,154)	(56,506)	(\$13,486)
Recoveries	663	43	867	43
Balance at the end of the period	\$ 28,400	\$ 31,134	\$ 28,400	\$ 31,134

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

	September 30, 2010 (In thousands)	December 31, 2009
Impaired loans without a valuation allowance	\$ 13,201	\$ 46,282
Impaired loans with a valuation allowance	123,134	109,897
Total impaired loans	\$ 136,335	\$ 156,161
Valuation allowance related to impaired loans	\$ 9,513	\$ 13,432
Average investment of impaired loans	\$ 151,627	\$ 117,644
Interest income recognized on a cash basis on impaired loans	\$ 2,205	\$ 2,134
Nonperforming assets:		
90 days or more past due and still accruing	\$ —	\$ —
Nonaccrual loans	65,056	94,682
Nonaccrual troubled debt restructured loans (1)	28,387	26,021
Total nonperforming loans	93,443	120,703
Other real estate owned	22,927	11,835
Total nonperforming assets	\$ 116,370	\$ 132,538

Performing troubled debt restructured loans (2)	\$	42,891	\$	35,458
Nonaccrual troubled debt restructured loans (1)		28,387		26,021
Total troubled debt restructured loans	\$	71,278	\$	61,479

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

(2) Performing troubled debt restructured loans are loans that have been modified due to financial difficulty of the borrower where the borrower has complied with the terms of the loan modification for a minimum of six months.

At September 30, 2010, the amounts committed to be advanced in connection with the impaired loans totaled \$2.6 million as compared to \$10.6 million at December 31, 2009.

Foregone interest on nonaccrual loans for the three and nine months ended September 30, 2010 was \$1.5 million and \$5.1 million, respectively. Foregone interest for the same periods in 2009 were \$2.1 million and \$5.4 million, respectively.



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A summary of our OREO is as follows:

	Nine Months Ended September 30, 2010		Twelve Months Ended December 31, 2009	
	Amount	Number of Properties (Dollars in thousands)	Amount	Number of Properties
Balance at the beginning of the period	\$ 11,835	32	\$ -	-
Loans transferred to OREO	34,843	121	11,835	32
Capitalized improvements	488	N/A	-	N/A
Market value adjustments	(5,184)	N/A	-	N/A
Dispositions of OREO	(19,055)	(52)	-	-
Balance at the end of the period	\$ 22,927	101	\$ 11,835	32

#### Note 6 – Fair Value

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

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

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

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

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

- Level  
3 – Instruments whose significant value drivers are unobservable.

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

	Fair Value Measurements at September 30, 2010			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1) (In thousands)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale investments				
Mortgage-backed investments				
Fannie Mae	\$ 100,631	\$ -	\$ 100,631	\$ -
Freddie Mac	41,053	-	41,053	-
Ginnie Mae	4,460	-	4,460	-
Tax-exempt municipal bonds	3,990	-	3,990	-
Taxable municipal bonds	660	-	660	-
U.S. Government agencies	2,037	-	2,037	-
Mutual Fund	4,732	4,732	-	-
	\$ 157,563	\$ 4,732	\$ 152,831	\$ -

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

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

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

	Fair Value Measurements at September 30, 2010				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (In thousands)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses(1)
Impaired loans including undisbursed but committed funds of \$2.6 million (included in loans receivable, net)	\$ 129,434	\$ -	\$ -	\$ 129,434	\$ (3,919)
Other real estate owned	22,927	-	-	22,927	5,184
	\$ 152,361	\$ -	\$ -	\$ 152,361	\$ 1,265

(1) This represents the (gain) loss for the quarter ended September 30, 2010.

	Fair Value Measurements at December 31, 2009				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (In thousands)	Significant Unobservable Inputs (Level 3)	Total Losses (1)
Impaired loans including undisbursed but committed funds of \$10.6 million	\$ 153,300	\$ -	\$ -	\$ 153,300	\$ 4,895

(included in loans receivable, net)							
Goodwill impairment	-	-	-	-			14,206
Other real estate owned	11,835	-	-	11,835			-
	\$ 165,135	\$ -	\$ -	\$ 165,135			\$ 19,101

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

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

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

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

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

	September 30, 2010		December 31, 2009	
	Carrying value	Estimated fair value	Carrying value	Estimated fair value
(In thousands)				
<b>Assets:</b>				
Cash on hand and in banks	\$ 7,809	\$ 7,809	\$ 8,937	\$ 8,937
Interest-bearing deposits	132,058	132,058	96,033	96,033
Investments available for sale	157,563	157,563	97,383	97,383
Loans receivable, net	915,562	897,583	1,039,300	1,001,562
Federal Home Loan Bank stock	7,413	7,413	7,413	7,413
Accrued interest receivable	4,711	4,711	4,880	4,880
OREO	22,927	22,927	11,835	11,835
<b>Liabilities:</b>				
Deposits	233,532	233,532	225,772	225,772
Certificates of deposit	719,216	738,391	713,651	727,250
Advances from the Federal Home Loan Bank	143,066	146,629	139,900	140,994
Accrued interest payable	395	395	457	457

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

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

analysis utilizing current interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of the current market conditions, cash flow estimates have been further discounted to include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

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

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



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Note 7 – Federal Home Loan Bank stock

At September 30, 2010, we held \$7.4 million in shares of FHLB stock. FHLB stock is carried at par and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par. As a result of ongoing turmoil in the capital and mortgage markets, the FHLB of Seattle has a risk-based capital deficiency largely as a result of write-downs on its private label mortgage-backed securities portfolio.

On October 25, 2010, the FHLB agreed to the stipulation and issuance of a Consent Order by its primary regulator, the Federal Housing Finance Agency (FHFA). The Consent Order sets forth requirements for capital management, asset composition, and other operational and risk management improvements. Additionally, the FHFA and the FHLB have agreed to a Stabilization Period that ends upon the filing of the FHLB's June 30, 2011 financial statement. During this period, the FHLB's classification as undercapitalized will remain in place. Subsequently, the FHLB may begin repurchasing member stock at par and paying dividends, upon achieving and maintaining financial thresholds established by the FHFA as part of the agency's supervisory process, subject to the FHFA's approval.

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

Under Federal Housing Finance Agency Regulations, a Federal Home Loan Bank that fails to meet any regulatory capital requirement may not declare a dividend or redeem or repurchase capital stock in excess of what is required for members' current loans. Based upon an analysis by Standard and Poors regarding the Federal Home Loan Banks they stated that the FHLB System has a special public status (organized under the Federal Home Loan Bank Act of 1932) and because of the extraordinary support offered to it by the U.S. Treasury in a crisis, (though not used), it can be considered an extension of the government. We believe the U.S. government would almost certainly support the credit obligations of the FHLB System. We have determined there is not an other-than-temporary impairment on the FHLB stock investment as of September 30, 2010.

Note 8 - Stock-Based Compensation

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

Total compensation expense for the Plan was \$464,000 and \$530,000 for the three months ended September 30, 2010 and 2009, respectively, and the related income tax benefit was \$162,000 and \$186,000 for the three months ended September 30, 2010 and 2009, respectively.

Total compensation expense for the Plan was \$1.4 and \$1.6 million for the nine months ended September 30, 2010 and 2009, respectively, and the related income tax benefit was \$504,000 and \$549,000 for the nine months ended September 30, 2010 and 2009, respectively.

## Stock Options

The Plan authorized the grant of stock options amounting to 2,285,280 shares to our directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of our common stock at the date of grant. These option awards have a vesting period of five years, with 20% vesting on

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the anniversary date of each grant date and a contractual life of ten years. Any unexercised stock options will expire ten years after the grant date or 90 days after employment or service ends. We have a policy of issuing new shares upon exercise. At September 30, 2010, remaining options for 866,756 shares of common stock were available for grant under the Plan.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The expected volatility is generally based on the historical volatility of our stock price over a specified period of time. Since becoming a publicly-held company in October 2007, the amount of historical stock price information is limited. As a result, we elected to use a weighted-average of our peers' historical stock prices as well as our own historical stock prices to estimate volatility. We base the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. We elected to use the "Share-Based Payments" method permitted by the Securities and Exchange Commission to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at a midpoint in between. There were no options granted during the third quarter ended September 30, 2010.

A summary of our stock option plan awards for the nine months ended September 30, 2010 follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at January 1, 2010	1,433,524	\$ 9.73	8.52	1.93
Granted	50,000	4.03	9.73	1.28
Exercised	-	-	-	-
Forfeited or expired	(65,000)	9.78	-	1.92
Outstanding at September 30, 2010	1,418,524	\$ 9.53	7.85	\$ 1.91
Expected to vest assuming a 3% forfeiture				
rate over the vesting term	843,032	\$ 9.38	7.90	\$ -
Exercisable at September 30, 2010	549,410	\$ 9.75	7.77	\$ -

As of September 30, 2010, there was \$1.5 million of total unrecognized compensation cost related to non-vested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 2.9 years.

#### Restricted Stock Awards

The Plan authorized the grant of restricted stock awards amounting to 914,112 shares to our directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the date of grant. The restricted stock awards' fair value is equal to the value on the date of grant. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20%

vesting on the anniversary date of each grant date. At September 30, 2010, remaining restricted awards for 161,078 shares were available to be issued. Shares that have been awarded but have not yet vested in accordance with the agreement are held in trust and totaled 462,140.

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A summary of changes in non-vested restricted stock awards for the nine months ended September 30, 2010 follows:

Non-vested Shares	Shares	Weighted-Average Grant-Date Fair Value
Non-vested at January 1, 2010	604,987	\$ 10.22
Granted	32,000	4.03
Vested	(141,247)	10.21
Forfeited	(33,600)	10.69
Non-vested at September 30, 2010	462,140	\$ 9.75
Expected to vest assuming a 3% forfeiture		
rate over the vesting term	448,274	

As of September 30, 2010, there was \$4.2 million of total unrecognized compensation costs related to non-vested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.1 years. There were 134,847 shares that vested during the quarter ended September 30, 2010 and 149,647 shares that vested during the quarter ended September 30, 2009.

#### Note 9 – Federal Taxes on Income

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

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

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At September 30, 2010, we considered positive and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty

regarding short-term future earnings. We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing these various factors, we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential, resulting in no deferred tax asset at September 30, 2010.

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## Note 10 – Loss Per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
	(Dollars in thousands, except share data)			
Net loss	\$ (12,071)	\$ (1,659)	\$ (54,704)	\$ (28,460)
Weighted-average common shares outstanding	17,432,309	18,735,393	17,411,169	18,960,280
Basic loss per share	\$ (0.69)	\$ (0.09)	\$ (3.14)	\$ (1.50)
Diluted loss per share	\$ (0.69)	\$ (0.09)	\$ (3.14)	\$ (1.50)

For the three and nine months ended September 30, 2010, 50,000 stock options were included in calculating the dilutive loss per share. For the same periods in 2009, no stock options were included in the diluted loss per share calculation because they were antidilutive.

## Note 11 – Segment Information

Our activities are considered to be a single industry segment for financial reporting purposes. We are engaged in the business of attracting deposits from the general public and originating loans for our portfolio in our primary market area. Substantially all income is derived from a diverse base of commercial and residential real estate loans, consumer lending activities and investments.

## Note 12 – Subsequent Events

In October 2010, we sold approximately \$18.0 million of investments for a gain of approximately \$525,000. We also prepaid a \$50.0 million FHLB fixed-rate advance that was scheduled to mature on January 7, 2011. The interest rate on the advance was 3.75%. The prepayment penalty on the advance totaled \$413,000, which was offset by the savings on the interest expense of \$509,000 during the fourth quarter of 2010.





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

Forward-looking statements:

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

Annual Report on Form 10-K for the year ended December 31, 2009. Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be

materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

## Recent Developments

On September 24, 2010, the Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (“Order”) with the FDIC and the Washington State Department of Financial Institutions (“DFI”). Under the terms of the Order, the Bank cannot declare dividends without the prior written approval of the FDIC. Other material provisions of the Order require the Bank to:

- Maintain and preserve qualified management;
- Increase the Board of Directors’ participation in the Bank’s affairs;
- Obtain an independent study of management and the personnel structure of the Bank;
  - Maintain specified capital levels;
- Eliminate loans classified as “Loss” at its regulatory examination, and reduce the loans classified as “Doubtful” and “Substandard” as a percent of capital;
  - Revise its policy with respect to the allowance for loan losses;
- Not extend additional credit to borrowers whose loan had been classified as “Loss” and is uncollected;
  - Revise its lending and collection policies and practices;
- Develop a plan to reduce the amount of commercial real estate loans;
  - Enhance its written funds management and liquidity policy;
    - Develop a three-year strategic plan;
- Not solicit brokered deposits and comply with certain deposit rate restrictions;
  - Eliminate and correct all violations of laws; and
- Prepare and submit progress reports to the FDIC and DFI.

The Bank has implemented a comprehensive plan in an attempt to achieve full compliance with the Order. The Order contains target dates to achieve the items listed above including that the Bank’s Tier 1 capital ratio and total risk-based capital ratio be at least 10% and 12%, respectively within 30 days of the date of the Order. At September 30, 2010, the Bank’s Tier 1 capital ratio was 10.95% and the total risk-based capital ratio was 18.63%, which exceeded the Order requirements. The Order also requires assets classified as substandard as a percentage of Tier 1 capital plus ALLL, at the time of the most recent examination, be below 65% by March 2011. As of September 30, 2010, the Bank met this requirement and continues to reduce these adversely classified assets.

A copy of the Order is attached to the Form 8-K that was filed with the SEC on September 27, 2010. The Order will remain in effect until modified or terminated by the FDIC and the DFI. For more information about the Order and its impact on the Company and the Bank, see “Item 1A, Risk Factors – Certain regulatory restrictions were recently imposed on us; lack of compliance could result in monetary penalties and/or additional regulatory actions.”

## Overview

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

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

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

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

We incurred a net loss for the third quarter ended September 30, 2010, of \$12.1 million, or \$0.69 per diluted share, as compared to a net loss of \$1.7 million or \$0.09 per diluted share for the quarter ended September 30, 2009. The change in operating results in the third quarter of 2010 as compared to the third quarter of 2009 was primarily the result of a \$4.2 million increase in the loan loss provision to \$12.0 million, an increase of \$3.6 million in noninterest expense primarily due to the increase in OREO related expenses, and a \$3.3 million decrease in federal income tax benefits offset by a \$742,000 increase in net interest income. For the nine months ended September 30, 2010, the Company incurred a net loss of \$54.7 million, or \$3.14 per diluted share as compared to a net loss of \$28.5 million or \$1.50 per diluted share for the comparable period in 2009. The change in operating results for the nine months ended September 30, 2010 as compared to the same period last year was primarily the result of a \$23.4 million increase in the provision for loan losses to \$51.0 million offset by an increase in net interest income of \$1.7 million and a \$6.4 million decline in noninterest expense. The decrease in noninterest expense was primarily due to a \$14.2 million goodwill impairment charge in the second quarter of 2009 with no comparable charge in 2010 offset by an increase in OREO related expense in 2010, of \$7.6 million. In addition, results for the nine months ended September 30, 2009 were increased by a \$7.0 million federal income tax benefit, while the Company recorded a federal tax provision of \$4.0 million for the same period of 2010, resulting in an \$11.0 million increase in the provision for federal income taxes for the nine months ended September 30, 2010.

During the nine months ended September 30, 2010, our total loan portfolio decreased \$153.4 million or 13.8% from December 31, 2009 primarily due to a \$90.1 million or 55.0% decrease in construction/land development loans. Our one-to-four family residential loans decreased \$65.1 million or 13.1%, multifamily loans increased \$10.7 million or 7.3% and commercial real estate loans decreased \$9.4 million, or 3.3%.



The five largest borrowing relationships, as of September 30, 2010, in descending order were:

Borrower (1)	September 30, 2010 Aggregate Amount of Loans (2)	Number of Loans
Real estate builder	\$ 34.5(3) million	134
Real estate builder	28.1million	111
Real estate builder	27.5(4) million	124
Real estate investor	17.5million	3
Real estate investor	17.5million	3
Total	\$ 125.1 million	375

(1) The composition of borrowers represented in the table may change from one period to the next.

(2) Net of undisbursed funds.

(3) Of this amount, \$33.5 million are considered impaired loans (of which \$13.3 million are performing and \$20.2 million are nonperforming)

(4) Of this amount, \$25.8 million are considered impaired loans (of which \$12.0 million are performing and \$13.8 million are nonperforming)

The total loan balance of our two merchant builders in the table above with impaired loans decreased \$6.1 million to \$62.0 million at September 30, 2010 from \$68.1 million at June 30, 2010. The decrease was principally the result of \$4.0 million in principal repayments.

The following table details the breakdown of the types of loans to our top five largest borrowing relationships at September 30, 2010:

Borrower	Permanent One-to-Four Family Residential Loans (Rental Properties)	Permanent Multifamily Loans (Rental Properties)	Permanent Commercial Loans (Rental Properties)	Construction/ Land Development (1)	Aggregate Amount of Loans (1)
Real estate builder (2)	\$ 17.4million	\$ -	\$ 1.7million	\$ 15.4million	\$ 34.5 million
Real estate builder	18.0million	1.0 million	0.1million	9.0million	28.1 million
Real estate builder (3)	21.4million	-	0.8million	5.3million	27.5 million

Real estate investor	-	-	17.5million	-	17.5 million
Real estate investor	-	-	17.5million	-	17.5 million
Total	\$ 56.8million	\$ 1.0 million	\$ 37.6million	\$ 29.7million	\$ 125.1 million

(1) Net of undisbursed funds.

(2) Of the \$33.5 million loans considered impaired, \$16.4 million are one-to-four family residential loans, \$15.4 million are construction/land development loans and \$1.7 million are commercial loans.

(3) Of the \$25.8 million loans considered impaired, \$20.5 million are one-to-four family residential loans and \$5.3 million are construction/land development loans.

The three largest builders listed in the above tables, have in the past, retained a certain percentage of their finished homes in their own inventory of permanent investment properties, (i.e. one-to-four family rental properties). These three builders are currently marketing these properties for sale. For the three builders included in the table above, the total one-to-four family rental properties decreased \$7.7 million, or 11.9% to \$56.8 million at September 30, 2010 from \$64.5 million at December 31, 2009, principally as a result of charge-offs during the nine months ended September 30, 2010.

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The following table includes construction/land development loans, net of undisbursed funds, by the five counties that contain our largest loan concentrations at September 30, 2010.

County	Loan Balance (1)	Percent of Loan Balance (1)	Nonperforming Loans	Nonperforming Loans as a Percent of Loan Balance (2)
(Dollars in thousands)				
King	\$ 31,244	45.6 %	\$ 22,030	70.5 %
Pierce	11,337	16.6	7,096	62.6
Kitsap	7,894	11.5	7,315	92.7
Thurston	6,680	9.7	2,313	34.6
Whatcom	4,381	6.4	4,381 (3)	100.0
All other counties	7,014	10.2	4,537	64.7
Total	\$ 68,550	100.0 %	\$ 47,672	69.5 %

(1) Net of undisbursed funds.

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

(3) Represents one loan.

#### Critical Accounting Policies

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

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

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

We believe that the accounting estimate related to the allowance for loan losses is a critical accounting estimate because it is highly susceptible to change from period-to-period requiring management to make assumptions about



probable losses inherent in the loan portfolio; and the impact of a sudden large loss could deplete the allowance and potentially require increased provisions to replenish the allowance, which would negatively affect earnings. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution's ALLL and carrying amounts of OREO. Such agencies may require the financial institution to recognize additions to the allowance based on their judgment and information available to them at the time of their examination. For additional information see Item 1A-Risk Factors: "Our provision for loan losses has increased substantially and we may be required to make further increases in our provision for loan

losses and to charge-off additional loans in the future, which could adversely affect our results of operations,” in this Form 10-Q.

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

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

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

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

Comparison of Financial Condition at September 30, 2010 and December 31, 2009

General. Total assets were \$1.3 billion at both September 30, 2010 and December 31, 2009. Increases in interest-bearing deposits of \$36.0 million, investments available for sale of \$60.2 million and OREO of \$11.1 million were offset by decreases in net loans receivable of \$123.7 million, federal income tax receivable of \$3.8 million and deferred tax assets of \$12.1 million. Total liabilities were \$1.1 billion at September 30, 2010, an increase of \$19.0 million or 1.8% from December 31, 2009. The increase in total liabilities was the result of a \$13.3 million increase in deposits. Stockholders' equity decreased \$53.8 million, primarily due to the 2010 year-to-date net loss of \$54.7 million.

Assets. Total assets remained relatively unchanged at \$1.3 billion at September 30, 2010 and December 31, 2009. The following table details the changes in the composition of our assets.

	Balance at September 30, 2010	Increase/(Decrease) from December 31, 2009 (Dollars in thousands)	Percentage Increase/(Decrease)
Cash on hand and in banks	\$ 7,809	\$ (1,128)	(12.62)%
Interest-bearing deposits	132,058	36,025	37.51
Investments available for sale	157,563	60,180	61.80
Loans receivable, net	915,562	(123,738)	(11.91)
Premises and equipment, net	20,077	492	2.51
Federal Home Loan Bank stock, at cost	7,413	-	-
Accrued interest receivable	4,711	(169)	(3.46)
Federal income tax receivable	5,720	(3,779)	(39.78)
Deferred tax assets, net	-	(12,139)	(100.00)
Other real estate owned	22,927	11,092	93.72
Prepaid expenses and other assets	6,617	(1,713)	(20.56)
<b>Total assets</b>	<b>\$ 1,280,457</b>	<b>\$ (34,877)</b>	<b>(2.65)%</b>

Interest-bearing deposits increased \$36.0 million to \$132.1 million at September 30, 2010 from \$96.0 million at December 31, 2009, as a result of \$19.1 million in OREO dispositions, \$115.4 million in loan repayments and a \$13.3 million increase in deposits. Investments available for sale increased \$60.2 million, or 61.8% to \$157.6 million at September 30, 2010 from \$97.4 million at December 31, 2009. During the nine months ended September 30, 2010, we purchased \$84.4 million of investments primarily in mortgage-backed securities issued by Freddie Mac and Fannie Mae. We purchased these securities to increase our return on investment by utilizing a portion of our interest-bearing deposits. Net loans receivable decreased \$123.7 million or 11.9% to \$915.6 million at September 30, 2010, from \$1.0

billion at December 31, 2009. This decrease in net loans was primarily the result of the \$65.8 million decrease in total construction/land development loans. The reduction in this portfolio was achieved by a decrease in new loan originations, cancelling the majority of unfunded land development construction commitments, charging-off \$30.3 million during the first nine months of 2010 and loan repayments. One-to-four family residential loans decreased \$59.0 million as result of loan repayments, lower loan demand and \$18.0 million in charge-offs during the nine month period ended September 30, 2010. The remainder of the loan portfolio had a net growth of \$1.1 million. OREO increased \$11.1 million, or 93.7% to \$22.9 million at September 30, 2010 from \$11.8 million at December 31, 2009. During the first nine months of 2010, OREO increased \$34.8 million and OREO sales totaled \$19.1 million generating a \$218,000 loss on these sales. Deposits increased \$13.3 million, or 1.4% to \$952.7 million at September 30, 2010, from \$939.4 million at December 31, 2009. The increase in deposits was used to fund the purchases of investments and contributed to the decrease in funding costs during the nine months ended September 30, 2010 from December 31, 2009.

Loan originations for the nine months ended September 30, 2010, totaled \$55.3 million and included: \$13.4 million in one-to-four family residential loans; \$16.1 million and \$12.4 million in multifamily and commercial real estate loans, respectively; and \$8.5 million in construction/land development loans to fulfill previous commitments to existing customers. Included in the one-to-four family loan originations are \$772,000 of permanent loans where the builders have financed homes that are being rented by third parties. We also originated \$4.9 million in consumer loans. Origination activity for the first nine months of 2010 was offset by repayments during the same period of \$115.4 million, transfers to OREO of \$34.8 million and charge-offs of \$46.6 million. The originations in the construction/land development loan portfolio were primarily to our merchant builders so they could continue to complete their projects and utilize their existing land inventory. We are concentrating on working with our existing builders and have limited new originations. We have not expanded our customer base for this type of lending.

Deposits. During the first nine months of 2010, deposits increased \$13.3 million to \$952.7 million. All of our deposit categories increased from December 31, 2009, the increases in certificates of deposit of \$5.6 million and money market accounts of \$5.1 million comprised the majority of the increase. In an effort to increase our core deposits, we have continued our marketing campaign to attract new customers to the Bank. We did not have any brokered deposits at September 30, 2010 or December 31, 2009. A breakdown of our deposits by type is as follows:

	September 30, 2010	December 31, 2009
	(In thousands)	
Noninterest-bearing accounts	\$ 5,010	\$ 3,294
NOW accounts	13,097	12,740
Statement savings accounts	16,052	15,423
		194,315
Money market accounts	199,373	713,651
Certificates of deposit	719,216	939,423
	\$ 952,748	\$

Advances. Total advances were \$143.1 million, increasing \$3.2 million at September 30, 2010 as compared to December 31, 2009. We funded \$3.2 million of low-income housing loans with low-cost advances from the FHLB during the third quarter of 2010.

Stockholders' Equity. Total stockholders' equity decreased \$53.8 million, or 23.6% to \$174.7 million at September 30, 2010 from \$228.5 million at December 31, 2009. The decrease was primarily the result of our net loss for the first nine months of 2010 of \$54.7 million.

#### Comparison of Operating Results for the Three and Nine Months Ended September 30, 2010 and 2009

General. We incurred a net loss of \$12.1 million for the third quarter of 2010, a decrease of \$10.4 million from the comparable quarter in the prior year. Net interest income was \$8.4 million for the third quarter of 2010, offset by the provision for loan losses of \$12.0 million and noninterest expense of \$8.5 million. For the nine months ended September 30, 2010, we incurred a net loss of \$54.7 million, an increase in the net loss of \$26.2 million as compared with the same period in 2009. The increase in net loss was primarily the result of increases in the provision for loan losses of \$23.4 million and provision for federal income taxes of \$11.0 million offset by a decrease of \$6.4 million in

noninterest expense.

Net Interest Income. Our net interest income for the quarter ended September 30, 2010, increased \$742,000 to \$8.4 million, as compared to \$7.6 million for the same quarter in the prior year. The reason for this increase was a decrease of \$2.0 million in interest expense partially offset by a decrease of \$1.2 million in interest income. Average interest-earning assets decreased \$36.3 million to \$1.2 billion for the three months ended September 30, 2010, compared to the same quarter in 2009. Average total interest-bearing liabilities increased \$53.6 million to \$1.1 billion for the third quarter of 2010 compared to the third quarter of 2009. During the same period our yield on interest-earning assets decreased 24 basis points while our cost of funds decreased 87 basis points. Our interest rate spread for the quarter ended September 30, 2010, increased 63 basis points to 2.43% from

1.80% during the same quarter in 2009. Our net interest margin for the third quarter of 2010 increased 31 basis points to 2.71% from 2.40% for the same quarter last year.

Our net interest income for the nine months ended September 30, 2010, increased \$1.7 million to \$24.5 million, as compared to \$22.8 million for the same period in 2009. The reason for this change was a decrease of \$4.3 million in interest expense partially offset by a decrease of \$2.6 million in interest income. Average total interest-earning assets remained relatively stable for the nine months ended September 30, 2010, at \$1.2 billion as compared to the same period in 2009. Average interest-bearing liabilities increased \$97.7 million to \$1.1 billion from the first nine months of 2009. During the same period, yield on our interest-earning assets decreased 30 basis points while our cost of funds decreased 84 basis points increasing our interest rate spread for the first nine months of 2010 by 54 basis points to 2.31% from 1.77% for the same period last year. Our net interest margin for the first nine months of 2010 increased to 2.63% as compared to 2.45% for the same period last year.

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

	Three Months Ended September 30, 2010			Nine Months Ended September 30, 2010		
	Compared to September 30, 2009 Increase (Decrease)			Compared to September 30, 2009 Increase (Decrease)		
	Rate	Volume	Total	Rate	Volume	Total
(Dollars in thousands)						
<b>Interest-earning assets:</b>						
Loans receivable, net	\$ 471	\$ (1,170)	\$ (699)	\$ 613	\$ (1,612)	\$ (999)
Investments available for sale	(262)	(297)	(559)	(621)	(1,141)	(1,762)
Federal funds sold and interest-bearing deposits with banks	(6)	54	48	43	117	160
<b>Total net change in income on interest-earning assets</b>	<b>203</b>	<b>(1,413)</b>	<b>(1,210)</b>	<b>35</b>	<b>(2,636)</b>	<b>(2,601)</b>
<b>Interest-bearing liabilities:</b>						
NOW accounts	(13)	2	(11)	(29)	11	(18)
Statement savings accounts	(26)	8	(18)	(63)	27	(36)
Money market accounts	(386)	34	(352)	(908)	571	(337)
Certificates of deposit	(1,792)	474	(1,318)	(4,989)	1,817	(3,172)
Advances from the Federal Home Loan Bank	(185)	(68)	(253)	(560)	(193)	(753)

Total net change in expense on interest-bearing liabilities	(2,402)	450	(1,952)	(6,549)	2,233	(4,316)
Net change in net interest income	\$ 2,605	\$ (1,863)	\$ 742	\$ 6,584	\$ (4,869)	\$ 1,715

Interest Income. Total interest income for the third quarter of 2010 decreased \$1.2 million, or 7.5%, to \$15.0 million from \$16.2 million as compared to the third quarter of 2009. Total interest income for the nine months ended September 30, 2010, decreased \$2.6 million or 5.3% to \$46.1 million from \$48.7 million as compared to the nine months ended September 30, 2009.



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The following table compares detailed average interest-earning asset balances, associated yields and resulting changes in interest income for the three months ended September 30, 2010 and 2009:

	Three Months Ended September 30,				Increase/ (Decrease) in Interest and Dividend Income
	2010		2009		
	Average Balance	Yield	Average Balance	Yield	
(Dollars in thousands)					
Loans receivable, net	\$ 957,529	5.71%	\$ 1,043,877	5.51%	\$ (699)
Investments available for sale	147,304	3.41	176,090	4.12	(559)
Federal funds sold and interest-bearing deposits	125,367	0.26	46,485	0.28	48
Federal Home Loan Bank stock	7,413	-	7,413	-	-
Total interest-earning assets	\$ 1,237,613	4.85%	\$ 1,273,865	5.09%	\$ (1,210)

Interest income from loans decreased \$699,000 during the third quarter of 2010 as compared to the same quarter in 2009. The decrease in loan interest income was primarily the result of a decrease in the balance of interest earning loans of \$86.3 million resulting in a \$1.2 million decrease in interest income for the quarter as compared to the third quarter of 2009. This decrease was partially offset by an increase in the average yield of the loan portfolio of 20 basis points, resulting in an increase of \$471,000 in interest income. The decrease in the average loan portfolio was due to charge-offs recorded in the period, loan repayments, short sales and transfers to OREO. Interest income on investments available for sale decreased \$559,000 to \$1.3 million for the quarter ended September 30, 2010, compared to \$1.8 million for the comparable quarter in 2009. The primary reason for the decline in interest income from investments available for sale was due to the decline in the average balance of investments available for sale of \$28.8 million, resulting in a decrease of \$297,000 in interest income. In addition, the yield earned declined to 3.41% during the third quarter of 2010 from 4.12% for the same quarter in 2009, resulting in a \$262,000 decrease in interest income.

The following table compares detailed average interest-earning asset balances, associated yields and resulting changes in interest income for the nine months ending September 30, 2010 and 2009:

	Nine Months Ended September 30,				Increase/ (Decrease) in Interest and Dividend Income
	2010		2009		
	Average Balance	Yield	Average Balance	Yield	
(Dollars in thousands)					
Loans receivable, net	\$ 999,414	5.67%	\$ 1,037,045	5.59%	\$ (999)
	123,654	3.63	159,011	4.30	(1,762)

Investments available for sale						
Federal funds sold and interest-bearing deposits	113,533	0.25	35,686	0.20	160	
Federal Home Loan Bank stock	7,413	-	7,413	-	-	
Total interest-earning assets	\$ 1,244,014	4.94%	\$ 1,239,155	5.24%	\$ (2,601)	

Interest income from loans decreased \$999,000 during the first nine months of 2010 compared to the same period in 2009. The decrease in interest income was due to a decrease in average loan balances of \$37.6 million resulting in a decrease in interest income of \$1.6 million, partially offset by an increase in the average yield of eight basis points or \$613,000. Interest income on investments available for sale decreased \$1.8 million to \$3.4 million for the nine months ended September 30, 2010 as compared to \$5.1 million for the comparable period in 2009. The primary reason for the decline in interest income from investments available for sale was due to the decrease in the

average balance which resulted in a \$1.1 million decrease in interest income. In addition, the yield on investments also decreased 67 basis points resulting in a \$621,000 decline in interest income.

Interest Expense. Total interest expense for the three months ended September 30, 2010 was \$6.6 million, a decrease of \$2.0 million compared to the third quarter of 2009. Total interest expense for the nine months ended September 30, 2010, was \$21.6 million, a decrease of \$4.3 million from \$25.9 million for the same nine month period in 2009.

The following table details average balances, cost of funds and the resulting decrease in interest expense for the three months ended September 30, 2010 and 2009:

	Three Months Ended September 30,				Increase/ (Decrease) in Interest Expense
	2010		2009		
	Average Balance	Cost	Average Balance (Dollars in thousands)	Cost	
NOW accounts	\$ 13,578	0.38 %	\$ 12,470	0.77 %	\$ (11)
Statement savings accounts	16,523	1.02	14,679	1.63	(18)
Money market accounts	196,945	1.03	189,400	1.81	(352)
Certificates of deposit	727,314	2.75	676,409	3.74	(1,318)
Advances from the Federal Home Loan Bank	142,069	2.98	149,900	3.50	(253)
Total interest-bearing liabilities	\$ 1,096,429	2.42 %	\$ 1,042,858	3.29 %	\$ (1,952)

Interest expense on our money market accounts decreased \$352,000, primarily as a result of a decrease in the average cost of these funds of 78 basis points or \$386,000 to 1.03% from 1.81% for the third quarter of 2010 compared to the same quarter in 2009. The average cost of our certificates of deposit decreased 99 basis points as compared to the third quarter of 2009 primarily due to maturing certificates repricing to lower rates which equates to a decline in interest expense of \$1.8 million. The decline in interest expense was offset by an increase in the average balance of certificates of deposit of \$50.9 million, which resulted in an additional \$474,000 of interest expense. Interest expense related to our average FHLB advances decreased \$253,000 primarily as a result of the decrease in the cost of funds of 52 basis points to 2.98% from 3.50% for the third quarter of 2010 compared to the same quarter in 2009.

The following table details average balances, cost of funds and the resulting decrease in interest expense for the nine months ended September 30, 2010 and 2009:

	Nine Months Ended September 30,				Increase/ (Decrease) in Interest Expense
	2010		2009		
	Average Balance	Cost	Average Balance (Dollars in thousands)	Cost	

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NOW accounts	\$	13,175	0.44 %	\$	11,147	0.73 %	\$	(18)
Statement savings accounts		15,711	1.16		13,557	1.70		(36)
Money market accounts		196,787	1.31		157,910	1.91		(337)
Certificates of deposit		726,313	3.00		664,239	3.92		(3,172)
Advances from the Federal Home Loan Bank		140,631	2.95		148,018	3.48		(753)
Total interest-bearing liabilities	\$	1,092,617	2.63 %	\$	994,871	3.47 %	\$	(4,316)

Our interest expense for the nine months ended September 30, 2010 decreased \$4.3 million to \$21.6 million from \$25.9 million for the same period in 2009. Interest expense on our money market accounts decreased \$337,000 primarily as a result of a decrease in the average cost of these funds of 60 basis points, or \$908,000 to 1.31% from 1.91% for the nine months ended September 30, 2010 from the comparable period in 2009. Interest expenses on our certificates of deposit decreased \$3.2 million. This decrease was primarily a result of a 92 basis point decrease in the average cost of these funds or \$5.0 million. This decrease was partially offset by an increase

in the average balance of certificates of deposit resulting in a \$1.8 million increase in interest expense for the nine month period ended September 30, 2010 as compared to the same period in 2009. Interest expense related to advances from the FHLB decreased \$753,000 for the nine months ended September 30, 2010, from the same period in 2009. The average balance of advances and the average cost of funds decreased \$7.4 million and 53 basis points, respectively.

**Provision for Loan Losses.** We establish the provision for loan losses at a level we believe is necessary to absorb known and inherent losses that are both probable and reasonably estimable at the date of the financial statements. Our methodology in assessing the allowance for loan losses places greater emphasis on factors such as charge-off history, the economy, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, management experience levels, our loan review and grading system and the value of underlying collateral. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or as future events differ from predictions.

During the quarter ended September 30, 2010, management continued to evaluate the adequacy of the allowance for loan losses and concluded that a provision of \$12.0 million was required for the quarter. The continued deterioration of the underlying collateral values of nonperforming loans was the primary reason for the provision. The effect of the \$12.0 million provision for loan losses combined with net charge-offs of \$13.5 million decreased the allowance for loan losses to \$28.4 million at September 30, 2010 from \$33.0 million at December 31, 2009. Allowance for loan losses as a percent of nonperforming loans improved to 30.4% at September 30, 2010 compared to 27.4% at December 31, 2009.

The following table presents a breakdown of our nonperforming assets:

	September 30, 2010	June 30, 2010	March 31, 2010	December 31, 2009	September 30, 2009 (2)
(In thousands)					
One-to-four family residential (1)\$	37,420 \$	48,246 \$	48,035 \$	36,874 \$	41,281
Commercial real estate	8,170	14,657	14,108	11,535	18,527
Construction/land development	47,672	56,995	83,016	71,780	88,757
Consumer	181	747	759	514	425
Total nonperforming loans	\$ 93,443 \$	120,645 \$	145,918 \$	120,703 \$	148,990
Other real estate owned	22,927	16,493	20,500	11,835	-
Total nonperforming assets	\$ 116,370 \$	137,138 \$	166,418 \$	132,538 \$	148,990

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

(2) Includes \$907,000 of loans 90 days or more past due and still accruing interest.

Nonperforming loans include loans to borrowers who are experiencing deteriorating financial conditions and there is doubt as to the ultimate recoverability of the full principal and interest due the Bank in accordance with the terms of the loan agreement. Nonperforming loans decreased \$27.3 million to \$93.4 million at September 30, 2010, from \$120.7 million at December 31, 2009. This decrease was achieved primarily by the transfer of nonperforming loans to OREO.

Nonperforming assets continued to decrease for the second quarter in a row. On a sequential quarterly basis nonperforming assets decreased \$29.3 million, or 17.6% from the first quarter to the second quarter of 2010 and \$20.8 million, or 15.1% from the second quarter to the third quarter of 2010. Nonperforming assets as a percent of total assets was 9.09%, 10.08% and 11.29% for the quarters ended September 30, 2010, December 31, 2009 and September 30, 2009, respectively.

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The three largest nonperforming loans in the commercial real estate portfolio at September 30, 2010, consisted of a \$1.9 million loan secured by an office building in Pierce County, a \$1.4 million loan secured by land located in Kitsap County, and a \$600,000 loan secured by a warehouse/office park in Pierce County.

The three largest nonperforming, construction/land development loans include a \$4.4 million loan on a 34-acre, 251-unit development in Whatcom County. The project consists of 77 detached condominium lots (single-family residences) and vacant land for 174 attached units (multifamily). All of the ground work has been completed and the property is ready for construction, although no vertical construction has taken place. The second largest nonperforming, construction/land development loan is a \$2.1 million loan on a 24-unit residential subdivision located in Thurston County. All of the houses are finished, and ten homes have been sold. We completed deeds in lieu of foreclosure on the remaining 14 houses in October 2010. The third largest nonperforming, construction/land development loan is a \$1.9 million loan secured by seven partially completed speculative townhomes located in King County.

The following table presents a breakdown of our OREO at September 30, 2010:

	King County	Pierce County	Snohomish County	Kitsap County	All other counties	Total Other Real Estate Owned	Percent of Total Other Real Estate Owned
(Dollars in thousands)							
One-to-four family residential	\$ 3,938	\$ 2,964	\$ 285	\$ 3,799	\$ 1,218	\$ 12,204	53.42 %
Commercial	573	1,995	-	155	-	2,723	11.76
Construction/land development	1,642	1,544	1,318	1,570	1,926	8,000	34.82
Total other real estate owned	\$ 6,153	\$ 6,503	\$ 1,603	\$ 5,524	\$ 3,144	\$ 22,927	100.00 %

OREO increased \$6.4 million or 38.8% to \$22.9 million at September 30, 2010 from \$16.5 million at June 30, 2010. We sold \$8.9 million of OREO during the third quarter of 2010 which was comprised of 23 properties and generated a net gain of \$205,000. We evaluate the market of our OREO inventory quarterly. As a result of the evaluation of our OREO properties, we expensed \$2.0 million related to the decline in the market value of our OREO during the quarter ended September 30, 2010. Additional expenses related to OREO were \$962,000 for the third quarter of 2010.

OREO increased \$11.1 million, or 93.7% to \$22.9 million at September 30, 2010 from \$11.8 million at December 31, 2009. We sold \$19.1 million of OREO during the nine months ended September 30, 2010 which was comprised of 52 properties and generated a net loss of \$218,000. We expensed \$5.2 million related to the decline in the market value of our OREO during the nine months ended September 30, 2010. Additional expenses related to OREO were \$2.4 million for the same period. We anticipate that our OREO inventory will continue to increase throughout the fourth quarter as we take possession of the underlying collateral of nonperforming loans.

The three largest properties included in terms of market value in OREO at September 30, 2010, were an office building valued at \$1.3 million located in Pierce County, a parcel of land with some improvements intended for a multifamily residential development valued at \$1.2 million located in Pierce County and a residential development with 15 completed lots valued at \$800,000 located in Snohomish County.

During the remainder of 2010 we will continue to focus our efforts on converting our nonperforming loans to OREO through foreclosure or deeds in lieu of foreclosure. These properties consist primarily of non-owner occupied and completed one-to-four family residential homes. By taking ownership of these properties, it will allow us to convert these nonearning assets to earning assets on a more timely basis.





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at the end of the period, net of undisbursed funds	3.00 %	2.86 %
Allowance for loan losses as a percent of nonperforming loans		
at the end of the period, net of undisbursed funds	30.39 %	20.90 %
Total nonaccrual and 90 days or more past due loans, net of undisbursed funds	\$ 93,443	\$ 148,990
Nonaccrual and 90 days or more past due loans as a percent of total loans, net of undisbursed funds	9.87 %	13.67 %
Total loans receivable, net of undisbursed funds	\$ 946,649	\$ 1,089,917
Total loans originated, net of undisbursed funds	\$ 55,339	\$ 156,576

Noninterest Income. Noninterest income decreased \$34,000 to \$38,000 for the three months ended September 30, 2010 from \$72,000 in the comparable quarter in 2009. This decrease was primarily due to a \$63,000 decrease in loan service fee income as a result of the decrease in the loans serviced for others portfolio as compared to the same period last year. Noninterest income for the nine months ended September 30, 2010 increased \$41,000 to \$146,000 from \$105,000 for the same period in 2009. The increase for the nine months ended September 30,

2010 from the comparable period in 2009 was the absence of other-than-temporary impairment charges on investments during 2010 as compared to \$152,000 in 2009. In addition, loan service fee income decreased \$114,000 as compared to the same period last year.

Noninterest Expense. Noninterest expense increased \$3.6 million during the quarter ended September 30, 2010 to \$8.5 million as compared to \$4.9 million for the same quarter in 2009. Noninterest expense for the nine months ended September 30, 2010 decreased \$6.3 million to \$24.4 million from \$30.7 million for the nine months ended September 30, 2009.

The following table provides the detail of the changes in noninterest expense:

	Three Months Ended September 30, 2010	Increase/(Decrease) from September 30, 2009 (Dollars in thousands)	Percentage Increase/(Decrease)
Compensation and benefits \$	3,258	\$ 181	5.88 %
Occupancy and equipment	411	68	19.83
Professional fees	664	332	100.00
Data processing	191	13	7.30
Marketing	49	(11)	(18.33)
Office supplies and postage	48	(4)	(7.69)
Gain on sale of OREO property, net	(205)	(205)	(100.00)
OREO valuation expense	2,016	2,016	100.00
OREO related expenses, net	962	925	2,500.00
FDIC/OTS assessments	910	558	158.52
Bank and ATM charges	33	(5)	(13.16)
Insurance/Bond premiums	150	133	782.35
Other	13	(390)	(96.77)
Total noninterest expense \$	8,500	\$ 3,611	73.86 %

The increase in noninterest expense for the third quarter of 2010 as compared to the same period in 2009 was primarily a result of the increase in OREO related expenses incurred during the third quarter of 2010, which were \$2.8 million (net of gain on sales of OREO) as compared to \$37,000 in the comparable period in 2009. In addition, FDIC/OTS assessments increased \$558,000 which was predominately related to the increase in our FDIC insurance deposit rates.

The following table provides the detail of the changes in noninterest expense:

	Nine Months Ended September 30, 2010	Increase/(Decrease) from September 30, 2009 (Dollars in thousands)	Percentage Increase/(Decrease)
Compensation and benefits	\$ 9,339	\$ 186	2.03 %
Occupancy and equipment	1,260	(726)	(36.56)
Professional fees	1,610	582	56.61
Data processing	533	61	12.92
Marketing	170	(25)	(12.82)
Office supplies and postage	180	6	3.45
Loss on sale of OREO property, net	218	218	100.00
OREO valuation expense	5,184	5,184	100.00
OREO related expenses, net	2,372	2,220	1,460.53
FDIC/OTS assessments	2,005	75	3.89
Goodwill	-	(14,206)	(100.00)
Bank and ATM charges	101	(8)	(7.34)
Insurance/Bond premiums	449	395	731.48
Other	956	(325)	(25.37)
Total noninterest expense	\$ 24,377	\$ (6,363)	(20.70) %

The decrease in noninterest expense was related to the \$14.2 million goodwill impairment charge recorded in the second quarter of 2009 with no comparable charge in 2010, partially offset by \$7.6 million of OREO related expenses and net losses recorded during the nine months ended September 30, 2010.

Federal Income Tax Expense. We have utilized all the tax benefits available to us at this time, as a result, no tax benefit was recorded for the third quarter of 2010.

Federal income tax expense increased \$11.0 million for the nine months ended September 30, 2010 to \$4.0 million as compared to a \$7.0 million tax benefit for the nine months ended September 30, 2009. The increase in the provision for federal income taxes was principally a result of the increase in the valuation allowance of \$21.0 million related to our deferred tax asset at September 30, 2010.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At September 30, 2010, we considered positive and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings due to market conditions. We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing all of the positive and negative evidence, we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential, resulting in no deferred tax asset at September 30, 2010.

Liquidity

We are required to have enough cash flow in order to maintain sufficient liquidity to ensure a safe and sound operation. Historically, we have maintained cash balances above the minimum level believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. On a daily basis, we review and update cash flow projections to ensure that adequate liquidity is maintained. See the “Consolidated Statements of Cash Flows” contained in Item 1 – Financial Statements, included herein.

Our primary sources of funds are from customer deposits, loan repayments, maturing investment securities and advances from the FHLB. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions and competition. At September 30, 2010, certificates of deposit scheduled to mature in one year or less totaled \$293.7 million. Historically, we have been able to retain a significant amount of the deposits as they mature. We believe that our current liquidity position and our forecasted operating results are sufficient to fund all of our existing commitments.

While our primary source of funds is our deposits, when deposits are not available to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB, wholesale funding, federal funds purchased, dealer repurchase agreements and other short-term alternatives as permissible by regulation. At September 30, 2010, the Bank maintained credit facilities with the FHLB totaling \$453.9 million with an outstanding balance of \$143.1 million. During the third quarter, our line of credit with the FHLB was reduced to 25% of assets from 35% as a result of our high level of nonperforming assets. We chose to discontinue our FRB line of credit because we had not utilized the line of credit and as a result of the change in terms of the agreement which required us to deliver the actual collateral to the FRB.

#### Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. Commitments to extend credit and lines of credit are not recorded as an asset or liability until the instrument is exercised. At September 30, 2010, we had no commitments to originate loans for sale.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of the collateral obtained, if deemed necessary, varies, but may include real estate and income-producing commercial properties.

The following table summarizes our outstanding commitments to originate loans and to advance additional amounts related to lines of credit and construction loans at September 30, 2010.

	Total Amounts Committed	Through One Year	Amount of Commitment Expiration - Per Period		
			After One Through Three Years	After Three Through Five Years	After Five Years
Commitments to originate loans	\$ 2,136	\$ 2,136	\$ -	\$ -	\$ -
Unused portion of lines of credit	9,315	308	-	2,617	6,390
	15,138	13,651	987	500	-

(In thousands)

Undisbursed portion  
of construction loans

Total commitments	\$	26,589	\$	16,095	\$	987	\$	3,117	\$	6,390
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We are from time to time involved in various claims and legal actions arising in the ordinary course of business. There are currently no matters that in the opinion of management would have a material adverse effect on our financial position, results of operations or liquidity.

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

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

### Capital

Consistent with our goal to operate a sound and profitable financial organization, we actively manage our capital levels in order to be considered “well capitalized” in accordance with established regulatory ratios. As of September 30, 2010, we exceeded all regulatory capital ratios. Regulatory capital ratios for the Bank only were as follows as of September 30, 2010: Tier 1 capital 10.95%; Tier 1 risk-based capital 17.34%; and Total risk-based capital 18.63%. Under the Order, we have agreed to maintain a Tier 1 capital ratio and a Total risk-based capital ratio in excess of 10% and 12%, respectively, at the Bank, see “Item 1A. Risk Factors – Certain regulatory restrictions were recently imposed on us: lack of compliance could result in monetary penalties and/or additional regulatory actions.” During the third quarter of 2010, the Company increased its investment in the Bank by \$30.0 million, utilizing a portion of the proceeds it received from the Company’s initial public offering. This downstream of capital was necessary for the Bank to exceed the capital levels stipulated in the Order. This contribution of capital did not dilute our shareholders ownership in the Company. In addition, at September 30, 2010, First Financial Northwest, the parent company of the Bank, had approximately \$16.3 million of available cash to increase its investment in the Bank.

At September 30, 2010, stockholders’ equity totaled \$174.7 million, or 13.6% of total assets. Our book value per share of common stock was \$9.29 as of September 30, 2010, as compared to \$12.14 as of December 31, 2009.

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

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

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

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





business model which calls for us to originate and hold fixed-rate, single-family loans, which by their nature are longer-term than the short-term liabilities of customer deposits and borrowed funds.

#### Net Interest Income

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

Our income simulation model, based on information as of September 30, 2010, indicated that our net interest income over the subsequent 12 months was projected to increase in the increasing rate scenarios of 100, 200 and 300 basis points and the decreasing rate scenario of 100 basis points. Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, gradually increase by 100, 200 and 300 basis points over a 12 month period, or decline assuming a gradual 100 basis point reduction in rates. Reductions of rates by 200 and 300 basis points were not reported due to the very low rate environment and the unlikely nature of rates declining further.

In a rising rate environment our net interest income increases in all three rising rate scenarios. Interest income increases due to our current level of liquidity, which is represented by our short-term investments in interest earning deposits in other banks. As interest rates rise these investments reprice to reflect higher yields and higher interest income. Our loan portfolio is comprised predominately of fixed rate products so interest rates have minimal affect on the change in interest income earned from our loan portfolio. Interest expense in the rising rate scenario decreases primarily due to higher costing certificates of deposits continuing to reprice to lower rates. If rates were to gradually increase 100 basis points over the next 12 months the weighted-average cost for renewed certificates of deposit would be approximately 2.13%. The current cost of these maturing certificates of deposit is 2.40%. If rates were to increase 100 basis points our cost for these deposits would decrease by approximately 27 basis points. We also receive a benefit from the sensitivity our interest bearing deposit liabilities, as the cost of these products does not increase at the same rate that prevailing interest rates increase.

In a declining interest rate environment of 100 basis points, net interest income increases. In this rate environment our interest earning deposits in other banks reprice to lower yields from the current yield of 25 basis points. Our interest income from our loan portfolio does not change significantly because of the fixed rate nature of our loan products. Our interest expense declines as our weighted-average cost for renewed certificates of deposit declines to approximately 1.75%, a decrease of 65 basis points over the current cost of 2.40%.

		September 30, 2010	
		Net Interest Income Change	
Basis Point			
Change in			
	Rates	% Change	
	+300	8.36	%
	+200	7.74	
	+100	6.80	
	Base	4.19	
	(100)	1.30	
(1)	(200)	N/A	
(1)	(300)	N/A	

- (1) The current federal funds rate is 0.25% making a 200 and 300 basis point drop impossible.

The changes indicated by the simulation model represent anticipated changes in net interest income over a 12 month period if rates were to gradually increase or decrease by the specified amount. The simulation assumes that the size of the balance sheet remains stable over the forecasted timeframe, with no growth or contraction regardless of interest rate movements. Additionally, the tendency for loan and investment prepayments to accelerate in falling interest rate scenarios and slow when interest rates rise are incorporated in the model assumptions. Included in the assumptions are increased investment purchases and loan originations at lower interest rate levels to offset accelerated prepayments and, conversely, reduced investment purchases and loan originations when rates increase and prepayments slow.

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

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

The following table illustrates the change in the net portfolio value at September 30, 2010 that would occur in the event of an immediate change in interest rates equally across all maturities. The simulation model results are reported quarterly and are predicated upon a stable balance sheet, with no growth or change in asset or liability mix. Although the net portfolio value measurement provides an indication of our interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide, a precise forecast.

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

Basis Point Change in Rates	September 30, 2010						
	Net Portfolio Value (2)			Portfolio Value of Assets NPV Ratio (3)		Market Value of Assets (5)	
	Amount	\$ Change	% Change	% Change (4)	% Change (4)		
	(Dollars in thousands)						
+300	\$ 115,456	\$ (58,808)	(33.75) %	9.68 %	(4.51) %	\$ 1,192,746	
+200	134,654	(39,610)	(22.73)	10.96	(3.04)	1,228,573	
+100	155,559	(18,705)	(10.73)	12.28	(1.44)	1,266,626	
Base	174,264	-	-	13.37	-	1,303,023	
(100)	183,089	8,825	5.06	13.78	0.68	1,328,840	
(200) (1)	N/A	N/A	N/A	N/A	N/A	N/A	
(300) (1)	N/A	N/A	N/A	N/A	N/A	N/A	

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

In the simulated upward rate shift of the yield curve, the discount rates used to calculate the present value of assets and liabilities will increase, causing the present values of fixed-rate assets to decline and fixed-rate liabilities to

increase. Our EVE simulation model results as of September 30, 2010 indicated that if rates increased 100, 200 or 300 basis points the market value of our assets would decrease. This decrease is largely because of the fixed-rate nature of our loan portfolio. The fair value of our equity would also decrease under all three rising rate shift scenarios. The opposite occurs if rates were to decline. The discount rates used to calculate the present value

of assets and liabilities will decrease, causing the present value of fixed-rate assets to increase and fixed-rate liabilities to decrease. If rates were to decrease by 100 basis points, the market value of our assets would increase and the fair value of equity would increase.

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

At September 30, 2010, we had no derivative financial instruments, we did not maintain a trading account for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. Interest rate risk continues to be our primary risk as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

#### Item 4. Controls and Procedures

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

- (a) Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial and Accounting Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2010, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.
- (b) Changes in Internal Controls: In the quarter ended September 30, 2010, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II

### Item 1. Legal Proceedings

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

### Item 1A. Risk Factors

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

Certain regulatory restrictions were recently imposed on us: lack of compliance could result in monetary penalties and/or additional regulatory actions.

On September 22, 2010, the Bank entered into a stipulation and consent to the issuance of a Consent Order (the "Order") by the FDIC and the DFI. Under the terms of the Order, the Bank is required, among other things, to take certain measures in the areas of management, capital, classified assets, loan loss allowance determination, lending, liquidity management, and board oversight. Specifically, the Order requires that the Bank maintain a Tier 1 capital ratio and a total risk-based capital ratio of at least 10% and 12%, respectively, and reduce assets classified as substandard at the time of its most recent examination to below 65% by March 2011. The Bank must also revise its lending and collection and written funds management and liquidity policies, including a plan to reduce its reliance on non-core funding sources, revise its policy for determining the allowance for loan losses, develop a plan to reduce its commercial real estate concentrations and submit to regulators a strategic business plan and independent management study. The Order specifies certain timeframes for meeting these requirements, and the Bank must furnish periodic progress reports to the FDIC and DFI regarding its compliance with the Order. In addition, the Bank will not be able to pay cash dividends to First Financial Northwest without prior approval from the FDIC and DFI.

On April 14, 2010, in connection with our most recent examination by the OTS, the members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement (a memorandum of understanding ("MOU)). Under the terms of the MOU, the Company agreed, among other things, to provide notice to and obtain written non-objection from the OTS prior to the Company (a) declaring a dividend or redeeming any capital stock; and (b) incurring, issuing, renewing or repurchasing any new debt. In addition, both the Company and the Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer or pay pursuant to or by entering into certain severance and other forms of compensation agreements.

The Order and MOU will remain in effect until stayed, modified, terminated or suspended by the FDIC and the DFI and OTS, as the case may be. If either the Company or the Bank failed to comply with the Order or MOU, respectively, it could be subject to various remedies, including among others, the power to enjoin "unsafe or unsound" practices, to require affirmative action to correct any conditions resulting from any violation or practice, to direct an increase in capital, to restrict growth, to remove officers and/or directors, and to assess civil monetary penalties. Management of the Bank has been taking action and implementing programs to comply with the requirements of the Order. Although compliance will be determined by the FDIC and the DFI, management believes that the Bank will comply in all material respects with the Order. Any of these regulators may determine at their sole discretion that the matters covered in the Order have not been addressed satisfactorily, or that any current or past actions, violations, or deficiencies could be the subject of further regulatory enforcement actions. Such enforcement actions could involve

penalties or limitations on our business and negatively affect our ability to implement our business plan, pay dividends on our common stock or the value of our common stock as well as our financial condition and results of operations.



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

For the nine months ended September 30, 2010, we recorded a provision for loan losses of \$51.0 million, compared to \$27.6 million for the nine months ended September 30, 2009. We also recorded net loan charge-offs of \$55.6 million for the nine months ended September 30, 2010, compared to \$13.4 million for the nine months ended September 30, 2009. We are experiencing loan delinquencies and credit losses. Slower sales and excess inventory in the housing market has been the primary cause of the increase in delinquencies and foreclosures for residential construction/land development and one-to-four family loans, which represent 91.1% of our nonperforming loans at September 30, 2010. Our total nonperforming assets has decreased to \$116.4 million at September 30, 2010 compared to \$149.0 million at September 30, 2009. Further, construction/land development and commercial real estate loans have a higher risk of loss than residential mortgage loans.

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

We may have continuing losses.

We reported a net loss of \$54.7 million for the nine months ended September 30, 2010 as compared to a net loss of \$28.5 million for the nine months ended September 30, 2009. This loss primarily resulted from our high level of nonperforming assets and the resultant increased provision for loan losses. We may continue to suffer further losses.

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

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

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

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

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

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio,

including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan

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

Our allowance for loan losses was 3.00% of loans, net of undisbursed funds, and 30.39% of nonperforming loans, net of undisbursed funds, at September 30, 2010. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. If charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and our capital.

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

At September 30, 2010, \$191.7 million, or 44.4% of our one-to-four family residential mortgage loan portfolio and 19.9% of our total loan portfolio, consisted of loans secured by non-owner occupied one-to-four family residential properties. At September 30, 2010, nonperforming, non-owner occupied one-to-four family residential loans amounted to \$27.6 million. Prior to foreclosure, loans that were classified as non-owner occupied one-to-four family residential properties and are now classified as OREO, amounted to \$10.0 million at September 30, 2010.

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

There were no repurchases of equity securities in the third quarter of 2010.

On February 18, 2009, the Board of Directors approved a second stock repurchase plan for the purchase of up to 2,056,752 shares, or approximately 10% of our outstanding shares of common stock. During the first quarter of 2010, we repurchased 17,900 shares at an average cost per share of \$5.92. There are 294,400 shares remaining to be repurchased under this plan at September 30, 2010. Any future repurchases of stock would require regulatory approval as required by the MOU.

## Item 3. Defaults Upon Senior Securities

Not applicable.

## Item 4. [Removed and Reserved]

## Item 5. Other Information

Not applicable.

## Item 6. Exhibits

- 3.1 Articles of Incorporation of First Financial Northwest (1)
- 3.2 Bylaws of First Financial Northwest (1)
- 4 Form of stock certificate of First Financial Northwest (1)

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

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

SIGNATURES

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

First Financial Northwest, Inc.

Date: November 5, 2010

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

Date: November 5, 2010

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

EXHIBIT INDEX

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

