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Sound Financial Bancorp, Inc.
Form 10-Q
August 11, 2017

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 June 30, 2017

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 001-35633

Sound Financial Bancorp, Inc.
(Exact Name of Registrant as Specified in its Charter)

Maryland 45-5188530
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

2400 3rd Avenue, Suite 150, Seattle, Washington 98121
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (206) 448-0884

None

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

Indicate by checkmark 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 checkmark whether the registrant has submitted electronically and posted on its corporate website, 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Emerging growth company

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

Indicate by checkmark 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 registrant's classes of common stock as of the latest practicable date.

As of August 10, 2017, there were 2,510,045 shares of the registrant's common stock outstanding.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Balance Sheets (unaudited)

(In thousands, except share and per share amounts)

	June 30, 2017	December 31, 2016
ASSETS		
Cash and cash equivalents	\$59,956	\$ 54,582
Available-for-sale securities, at fair value	6,200	6,604
Loans held for sale	720	871
Loans	493,896	500,001
Allowance for loan losses	(4,835)	(4,822)
Total loans, net	489,061	495,179
Accrued interest receivable	1,677	1,816
Bank-owned life insurance (“BOLI”), net	12,429	12,082
Other real estate owned (“OREO”) and repossessed assets, net	952	1,172
Mortgage servicing rights, at fair value	3,450	3,561
Federal Home Loan Bank (“FHLB”) stock, at cost	1,705	2,840
Premises and equipment, net	7,467	5,549
Other assets	4,634	4,127
Total assets	\$588,251	\$ 588,383
LIABILITIES		
Deposits		
Interest-bearing	\$418,724	\$ 403,990
Noninterest-bearing demand	75,020	63,741
Total deposits	493,744	467,731
Borrowings	25,000	54,792
Accrued interest payable	78	73
Other liabilities	6,011	4,874
Advance payments from borrowers for taxes and insurance	548	638
Total liabilities	525,381	528,108
COMMITMENTS AND CONTINGENCIES (NOTE 7)		
STOCKHOLDERS' EQUITY		
Preferred stock, \$0.01 par value, 10,000,000 shares authorized, none issued or outstanding	-	-
Common stock, \$0.01 par value, 40,000,000 shares authorized, 2,501,515 and 2,498,804 shares issued and outstanding as of June 30, 2017 and December 31, 2016, respectively	25	25
Additional paid-in capital	24,300	23,979
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(683)	(683)
Retained earnings	39,089	36,873
Accumulated other comprehensive income, net of tax	139	81
Total stockholders' equity	62,870	60,275
Total liabilities and stockholders' equity	\$588,251	\$ 588,383

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Income (unaudited)

(In thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
INTEREST INCOME				
Loans, including fees	\$6,358	\$6,051	\$12,798	\$12,003
Interest and dividends on investments, cash and cash equivalents	159	92	310	181
Total interest income	6,517	6,143	13,108	12,184
INTEREST EXPENSE				
Deposits	688	654	1,391	1,342
Borrowings	75	55	166	84
Total interest expense	763	709	1,557	1,426
Net interest income	5,754	5,434	11,551	10,758
PROVISION FOR LOAN LOSSES				
Net interest income after provision for loan losses	5,754	5,334	11,551	10,508
NONINTEREST INCOME				
Service charges and fee income	492	652	1,003	1,245
Earnings on cash surrender value of bank-owned life insurance	82	85	163	168
Mortgage servicing income	148	132	381	223
Net gain on sale of loans	261	341	433	551
Total noninterest income	983	1,210	1,980	2,187
NONINTEREST EXPENSE				
Salaries and benefits	2,662	2,618	5,353	5,181
Operations	1,029	1,084	2,050	2,056
Regulatory assessments	136	125	260	280
Occupancy	522	380	895	765
Data processing	438	444	845	830
Net loss on OREO and repossessed assets	11	6	14	6
Total noninterest expense	4,798	4,657	9,417	9,118
Income before provision for income taxes	1,939	1,887	4,114	3,577
Provision for income taxes	636	633	1,397	1,217
Net income	\$1,303	\$1,254	\$2,717	\$2,360
Earnings per common share:				
Basic	\$0.52	\$0.51	\$1.09	\$0.95
Diluted	\$0.50	\$0.49	\$1.04	\$0.92
Weighted-average number of common shares outstanding:				
Basic	2,500,752	2,481,093	2,500,131	2,479,422
Diluted	2,596,791	2,558,028	2,600,564	2,552,005

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(In thousands)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Net income	\$ 1,303	\$ 1,254	\$ 2,717	\$ 2,360
Available for sale securities:				
Unrealized gains arising during the period, net of tax provision of \$12, \$27, \$30 and \$30, respectively	24	52	58	58
Other comprehensive income, net of tax	24	52	58	58
Comprehensive income	\$ 1,327	\$ 1,306	\$ 2,775	\$ 2,418

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Stockholders' Equity
For the Six Months Ended June 30, 2017 and 2016 (unaudited)
(In thousands, except share and per share amounts)

	Shares	Common Stock	Additional Paid- in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income, net of tax	Total Stockholders' Equity
Balances at December 31, 2015	2,469,206	\$ 25	\$ 23,002	\$ (911)	\$ 32,240	\$ 164	\$ 54,520
Net income					2,360		2,360
Other comprehensive income, net of tax						58	58
Share-based compensation			228				228
Cash dividends paid on common stock (\$0.15 per share)					(372)		(372)
Restricted stock awards issued	11,606						-
Restricted stock forfeited and retired	(1,059)						-
Exercise of options	1,077		17				17
Balances at June 30, 2016	2,480,830	\$ 25	\$ 23,247	\$ (911)	\$ 34,228	\$ 222	\$ 56,811
	Shares	Common Stock	Additional Paid- in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income, net of tax	Total Stockholders' Equity
Balances at December 31, 2016	2,498,804	\$ 25	\$ 23,979	\$ (683)	\$ 36,873	\$ 81	\$ 60,275
Net income					2,717		2,717
Other comprehensive income, net of tax						58	58
Share-based compensation			288				288
Cash dividends paid on common stock (\$0.20 per share)					(501)		(501)
Restricted stock awards issued	576						-
Exercise of options	2,135		33				33
Balances at June 30, 2017	2,501,515	\$ 25	\$ 24,300	\$ (683)	\$ 39,089	\$ 139	\$ 62,870

See notes to condensed consolidated financial statements

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Condensed Consolidated Statements of Cash Flows (unaudited)
(In thousands)

	Six Months Ended June 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,717	\$ 2,360
Adjustments to reconcile net income to net cash from operating activities:		
Accretion of net discounts on investments	27	17
Dividends paid on FHLB stock	-	32
Provision for loan losses	-	250
Depreciation and amortization	455	394
Compensation expense related to stock options and restricted stock	288	228
Net change in mortgage servicing rights	111	223
Increase in cash surrender value of BOLI	(163)	(168)
Net gain on sale of loans	(433)	(551)
Proceeds from sale of loans	22,008	36,080
Originations of loans held-for-sale	(21,424)	(34,125)
Net (gain)/loss on sale and write-downs of OREO and repossessed assets	(3)	8
Change in operating assets and liabilities:		
Accrued interest receivable	139	16
Other assets	(535)	(282)
Accrued interest payable	5	18
Other liabilities	1,137	(267)
Net cash provided by operating activities	4,329	4,233
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from principal payments, maturities and sales of available-for-sale securities	463	737
Purchases of available-for-sale securities	-	(1,363)
FHLB stock redeemed	1,135	107
Net decrease/(increase) in loans	6,118	(5,378)
Purchase of BOLI	(184)	-
Proceeds from sale of OREO and other repossessed assets	223	132
Purchases of premises and equipment, net	(2,373)	(147)
Net cash received from branch acquisition	13,671	-
Net cash provided/(used) by investing activities	19,053	(5,912)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	12,342	3,843
Proceeds from borrowings	70,500	56,500
Repayment of borrowings	(100,292)	(61,322)
Dividends paid on common stock	(501)	(372)
Net change in advances from borrowers for taxes and insurance	(90)	(64)
Proceeds from stock option exercises	33	17
Net cash used by financing activities	(18,008)	(1,398)
Net change in cash and cash equivalents	5,374	(3,077)
Cash and cash equivalents, beginning of period	54,582	48,264
Cash and cash equivalents, end of period	\$ 59,956	\$ 45,187
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for income taxes	\$ 1,310	\$ 1,000

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Interest paid on deposits and borrowings	1,552	1,408
Noncash net transfer from loans to OREO and repossessed assets	-	712
Assets acquired in acquisition of branch	14,474	-

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial Bancorp, Inc., and its wholly owned subsidiary, Sound Community Bank. References in this document to Sound Financial Bancorp refer to Sound Financial Bancorp, Inc. and references to the “Bank” refer to Sound Community Bank. References to “we,” “us,” and “our” or the “Company” refers to Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank, unless the context otherwise requires.

These unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on March 27, 2017 (“2016 Form 10-K”). The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2016, included in the 2016 Form 10-K. Certain amounts in the prior quarters’ consolidated financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported consolidated net income, retained earnings, stockholders’ equity or earnings per share.

Note 2 – Accounting Pronouncements Recently Issued or Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which creates Topic 606 and supersedes Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of 2014-09. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net, which amended the principal versus agent implementation guidance set for in ASU 2014-09. Among other things, ASU 2016-08 clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The ASU amends certain aspects of the guidance set forth in the FASB’s new revenue standard related to identifying performance obligations and licensing implementation. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new ASU requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, which provides clarifying guidance in certain narrow areas and adds some practical expedients, but does not change the core revenue recognition principle in Topic 606. This ASU is effective for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. For financial reporting purposes, the ASU allows for either full retrospective adoption, meaning this ASU is applied to all of the periods presented, or modified retrospective adoption, meaning the ASU is applied only to the most current period presented in the financial statements with the

cumulative effect of initially applying the ASU recognized at the date of initial application. As a financial institution, the Company's largest component of revenue, interest income, is excluded from the scope of this ASU. Accordingly, the adoption of ASU No. 2014-09 is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the ASU requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The ASU also requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU No. 2016-01 is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted for certain provisions. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize, on the balance sheet, the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

ASU is permitted. Although an estimate of the impact of the new leasing standard has not yet been determined, once adopted, we expect to report higher assets and liabilities as a result of including right-of-use assets and lease liabilities related to certain banking offices and certain equipment under noncancelable operating lease agreements, however, based on current leases the adoption is not expected to have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU replaces the existing incurred loss impairment methodology that recognizes credit losses when a probable loss has been incurred with new methodology where loss estimates are based upon lifetime expected credit losses. The amendments in this ASU require a financial asset that is measured at amortized cost to be presented at the net amount expected to be collected. The income statement would then reflect the measurement of credit losses for newly recognized financial assets as well as changes to the expected credit losses that have taken place during the reporting period. The measurement of expected credit losses will be based on historical information, current conditions, and reasonable and supportable forecasts that impact the collectability of the reported amount. Available-for-sale securities will bifurcate the fair value mark and establish an allowance for credit losses through the income statement for the credit portion of that mark. The interest portion will continue to be recognized through accumulated other comprehensive income or loss. The change in allowance recognized as a result of adoption will occur through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the ASU is adopted. The amendments in this ASU are effective for fiscal years beginning after December 15, 2019 with early adoption permitted after December 15, 2018. The Company has begun the process to implement this new standard by working with a vendor that specializes in this area. While the Company has not quantified the impact of this ASU, it does expect changing from the current incurred loss model to an expected loss model will result in an earlier recognition of losses. The Company also expects that once adopted the allowance for loan losses will increase, however, until its evaluation is complete the magnitude of the increase will be unknown.

In August 2016, FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This ASU addresses the appropriate classification of eight specific cash flow issues on the cash flow statement. Debt prepayment costs should be classified as an outflow for financing activities. Settlement of zero-coupon debt instruments divides the interest portion as an outflow for operating activities and the principal portion as an outflow for financing activities. Contingent consideration payments made after a business combination should be classified as outflows for financing and operating activities. Proceeds from the settlement of bank-owned life insurance policies should be classified as inflows from investing activities. Other specific areas are identified in the ASU as to the appropriate classification of the cash inflows or outflows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and must be applied using a retrospective transition method to each period presented. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20). ASU 2017-08 is intended to amend the amortization period for certain purchased callable debt securities held at a premium. Under ASU 2017-08, the FASB is shortening the amortization period for the premium to the earliest call date. Under current GAAP, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. ASU 2017-08 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. The Company is reviewing its securities portfolio to assess the impact the adoption of this ASU will have on the Company's consolidated financial statements but does not expect this ASU to have a material impact.

In May 2017, the FASB issued ASU No. 2017-09, Compensation--Stock Compensation (Topic 718): Scope of Modification Accounting. The ASU was issued to provide clarity as to when to apply modification accounting when there is a change in the terms or conditions of a share-based payment award. According to this ASU, an entity should account for the effects of a modification unless the fair value, vesting conditions, and balance sheet classification of the award is the same after the modification as compared to the original award prior to the modification. The standard is effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The adoption of ASU No. 2017-09 is not expected to have a material impact on the Company's consolidated financial statements.

Note 3 – Investments

The amortized cost and fair value of our available-for-sale (“AFS”) securities and the corresponding amounts of gross unrealized gains and losses at the dates indicated were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2017				
Municipal bonds	\$ 3,251	\$ 184	\$ (7)	\$ 3,428
Agency mortgage-backed securities	2,404	51	(1)	2,454
Non-agency mortgage-backed securities	335	-	(17)	318
Total	\$ 5,990	\$ 235	\$ (25)	\$ 6,200
December 31, 2016				
Municipal bonds	\$ 3,262	\$ 127	\$ (36)	\$ 3,353
Agency mortgage-backed securities	2,858	49	(3)	2,904
Non-agency mortgage-backed securities	362	-	(15)	347
Total	\$ 6,482	\$ 176	\$ (54)	\$ 6,604

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The amortized cost and fair value of AFS securities at June 30, 2017, by contractual maturity, are shown below (in thousands). Expected maturities of AFS securities may 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, are shown separately.

	June 30, 2017	
	Amortized Cost	Fair Value
Due after one year through five years	\$1,338	\$1,331
Due after five years through ten years	414	445
Due after ten years	1,499	1,652
Mortgage-backed securities	2,739	2,772
Total	\$5,990	\$6,200

There were no pledged securities at June 30, 2017 and December 31, 2016.

There were no sales of AFS securities during the three or six months ended June 30, 2017 and 2016.

The following tables summarize the aggregate fair value and gross unrealized loss by length of time of those investments that have been in a continuous unrealized loss position (in thousands) at the dates indicated:

	June 30, 2017					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Municipal bonds	\$1,331	\$ (7)	\$ -	\$ -	\$1,331	\$ (7)
Agency mortgage-backed securities	953	(1)	-	-	953	(1)
Non-agency mortgage-backed securities	-	-	318	(17)	318	(17)
Total	\$2,284	\$ (8)	\$ 318	\$ (17)	\$2,602	\$ (25)

	December 31, 2016					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Municipal bonds	\$1,313	\$ (36)	\$ -	\$ -	\$1,313	\$ (36)
Agency mortgage-backed securities	-	-	1,125	(3)	1,125	(3)
Non-agency mortgage-backed securities	-	-	347	(15)	347	(15)
Total	\$1,313	\$ (36)	\$ 1,472	\$ (18)	\$2,785	\$ (54)

There were no credit losses recognized in earnings during the three and six months ended June 30, 2017 or 2016 relating to the Company's non-agency mortgage-backed securities.

At June 30, 2017, one agency mortgage-backed security and three municipal securities were in an unrealized loss position for less than 12 months. At December 31, 2016, three municipal securities were in an unrealized loss position for less than 12 months and one agency security was in a loss position for over 12 months. All of the agency mortgage-backed securities in an unrealized loss position at June 30, 2017 and December 31, 2016 were issued or guaranteed by U.S. governmental agencies. The unrealized losses were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities, and not related to the underlying credit of the issuers or the underlying collateral. It is expected that these securities will not be settled at a price less than the amortized cost of each investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because we do not intend to sell the securities in this class and it is not likely that we will be required to sell these securities before recovery of their amortized cost basis, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered an other-than-temporary impairment (“OTTI”) during the three and six months ended June 30, 2017 or the year ended December 31, 2016.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

As of June 30, 2017 and December 31, 2016, one non-agency mortgage-backed security was in an unrealized loss position for over 12 months. The unrealized loss was caused by changes in interest rates causing a decline in the fair value subsequent to the purchase. The contractual terms of this investment do not permit the issuer to settle the security at a price less than par. Management does not intend to sell this non-agency mortgage-backed security and it is unlikely that the Company will be required to sell this security before recovery of its amortized cost basis. Management's impairment evaluation indicated that this security possesses qualitative and quantitative factors that do not suggest an OTTI. These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. Based upon the results of the evaluation of the quantitative and qualitative factors, the non-agency mortgage-backed security does not reflect OTTI during the three and six months ended June 30, 2017 or the year ended December 31, 2016.

Note 4 – Loans

The composition of the loan portfolio at the dates indicated, excluding loans held-for-sale, was as follows (in thousands):

	June 30, 2017	December 31, 2016
Real estate loans:		
One- to four- family	\$ 147,848	\$ 152,386
Home equity	27,996	27,771
Commercial and multifamily	195,486	181,004
Construction and land	52,775	70,915
Total real estate loans	\$424,105	\$ 432,076
Consumer loans:		
Manufactured homes	16,300	15,494
Floating homes	25,225	23,996
Other consumer	4,639	3,932
Total consumer loans	46,164	43,422
Commercial business loans	25,314	26,331
Total loans	495,583	501,829
Deferred fees	(1,687)	(1,828)
Total loans, gross	493,896	500,001
Allowance for loan losses	(4,835)	(4,822)
Total loans, net	\$489,061	\$ 495,179

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2017 (in thousands):

	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Floating homes	Other consumer	Commercial business	Unallocated	Total
Allowance for loan losses: Individually evaluated for impairment	\$481	\$256	\$-	\$35	\$72	\$-	\$59	\$216	\$-	\$1,119
Collectively evaluated for impairment	821	175	1,153	317	106	146	39	148	811	3,716
Ending balance	\$1,302	\$431	\$1,153	\$352	\$178	\$146	\$98	\$364	\$811	\$4,835
Loans receivable: Individually evaluated for impairment	\$6,452	\$983	\$1,735	\$128	\$298	\$-	\$59	\$335	\$-	\$9,990
Collectively evaluated for impairment	141,396	27,013	193,751	52,647	16,002	25,225	4,580	24,979	-	485,593
Ending balance	\$147,848	\$27,996	\$195,486	\$52,775	\$16,300	\$25,225	\$4,639	\$25,314	\$-	\$495,583

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2016 (in thousands):

	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Floating homes	Other consumer	Commercial business	Unallocated	Total
Allowance for loan losses: Individually evaluated for impairment	\$536	\$121	\$24	\$35	\$59	\$-	\$65	\$23	\$-	\$863
	1,006	257	1,120	424	109	132	47	152	712	3,959

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Collectively evaluated for impairment Ending balance	\$1,542	\$378	\$1,144	\$459	\$168	\$132	\$112	\$175	\$712	\$4,822
Loans receivable: Individually evaluated for impairment	\$4,749	\$832	\$1,582	\$83	\$312	\$-	\$62	\$616	\$-	\$8,236
Collectively evaluated for impairment Ending balance	147,637	26,939	179,422	70,832	15,182	23,996	3,870	25,715	-	493,593
	\$152,386	\$27,771	\$181,004	\$70,915	\$15,494	\$23,996	\$3,932	\$26,331	\$-	\$501,829

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in the allowance for loan losses for the three months ended June 30, 2017 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One- to four- family	\$ 1,535	\$ -	\$ -	\$ (233)	\$ 1,302
Home equity	248	-	2	181	431
Commercial and multifamily	1,113	-	-	40	1,153
Construction and land	413	-	-	(61)	352
Manufactured homes	148	(6)	1	35	178
Floating homes	137	-	2	7	146
Other consumer	98	(2)	-	2	98
Commercial business	154	-	-	210	364
Unallocated	992	-	-	(181)	811
Total	\$ 4,838	\$ (8)	\$ 5	\$ -	\$ 4,835

The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2017 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One- to four- family	\$ 1,542	\$ -	\$ -	\$ (240)	\$ 1,302
Home equity	378	-	28	25	431
Commercial and multifamily	1,144	(24)	1	32	1,153
Construction and land	459	-	-	(107)	352
Manufactured homes	168	(5)	3	12	178
Floating homes	132	-	-	14	146
Other consumer	112	(7)	17	(24)	98
Commercial business	175	-	-	189	364
Unallocated	712	-	-	99	811
Total	\$ 4,822	\$ (36)	\$ 49	\$ -	\$ 4,835

The following table summarizes the activity in the allowance for loan losses for the three months ended June 30, 2016 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One- to four- family	\$ 1,733	\$ (7)	\$ -	\$ (13)	\$ 1,713
Home equity	597	-	63	(159)	501
Commercial and multifamily	1,267	-	-	110	1,377
Construction and land	463	-	-	(75)	388
Manufactured homes	202	-	3	(16)	189
Floating homes	132	-	-	-	132
Other consumer	101	(3)	2	(11)	89
Commercial business	164	(29)	-	36	171
Unallocated	50	-	-	228	278
Total	\$ 4,709	\$ (39)	\$ 68	\$ 100	\$ 4,838

The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2016 (in thousands):

	Beginning				Ending
	Allowance	Charge-offs	Recoveries	Provision	Allowance
One- to four- family	\$ 1,839	\$ (72)	\$ -	\$ (54)	\$ 1,713
Home equity	607	-	65	(171)	501
Commercial and multifamily	921	-	-	456	1,377
Construction and land	382	-	-	6	388
Manufactured homes	301	-	5	(117)	189
Floating homes	111	-	-	21	132
Other consumer	77	(21)	4	29	89
Commercial business	157	(29)	-	43	171
Unallocated	241	-	-	37	278
Total	\$ 4,636	\$ (122)	\$ 74	\$ 250	\$ 4,838

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

When we classify problem loans as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address the risk specifically (if the loan is impaired) or we may allow the loss to be addressed in the general allowance (if the loan is not impaired). General allowances represent loss reserves which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem loans. When the Company classifies problem loans as a loss, we charge-off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose us to sufficient risk to warrant classification as substandard, doubtful or loss, but possess identified weaknesses, are classified as either watch or special mention assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the Federal Deposit Insurance Corporation ("FDIC"), the Bank's federal regulator, and the Washington Department of Financial Institutions ("WDFI"), the Bank's state banking regulator, which can order the establishment of additional loss allowances. Pass rated loans are loans that are not otherwise classified or criticized.

The following table represents the internally assigned grades as of June 30, 2017 by type of loan (in thousands):

Grade:	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Floating homes	Other consumer	Commercial business	Total
Pass	\$ 142,686	\$ 26,794	\$ 184,343	\$ 49,705	\$ 16,122	\$ 25,225	\$ 4,535	\$ 24,730	\$ 474,140
Watch	544	362	9,408	3,021	52	-	45	339	13,771
Special Mention	138	-	362	-	23	-	-	106	629
Substandard	4,480	840	1,373	49	103	-	59	139	7,043
Doubtful	-	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-	-
Total	\$ 147,848	\$ 27,996	\$ 195,486	\$ 52,775	\$ 16,300	\$ 25,225	\$ 4,639	\$ 25,314	\$ 495,583

The following table represents the internally assigned grades as of December 31, 2016 by type of loan (in thousands):

Grade:	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Floating homes	Other consumer	Commercial business	Total
Pass	\$ 148,617	\$ 26,547	\$ 171,678	\$ 67,539	\$ 15,288	\$ 23,996	\$ 3,821	\$ 25,625	\$ 483,111
Watch	998	536	8,105	3,376	78	-	49	326	13,468
Special Mention	139	-	-	-	30	-	-	-	169
Substandard	2,632	688	1,221	-	98	-	62	380	5,081

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Doubtful	-	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-	-
Total	\$ 152,386	\$ 27,771	\$ 181,004	\$ 70,915	\$ 15,494	\$ 23,996	\$ 3,932	\$ 26,331	\$ 501,829

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

The following table presents the recorded investment in nonaccrual loans as of June 30, 2017 and December 31, 2016, by type of loan (in thousands):

	June 30, 2017	December 31, 2016
One- to four- family	\$ 720	\$ 2,169
Home equity	674	536
Commercial and multifamily	211	218
Manufactured homes	75	72
Commercial business	139	149
Total	\$ 1,819	\$ 3,144

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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The following table represents the aging of the recorded investment in past due loans as of June 30, 2017 by type of loan (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater Past Due	90 Days and Greater Past Due and Still Accruing	Total Past Due	Current	Total Loans
One- to four- family	\$ -	\$ 2,197	\$ 540	\$ -	\$ 2,737	\$145,111	\$ 147,848
Home equity	152	118	637	-	907	27,089	27,996
Commercial and multifamily	-	-	-	-	-	195,486	195,486
Construction and land	-	-	49	-	49	52,726	52,775
Manufactured homes	41	63	80	-	184	16,116	16,300
Floating homes	-	-	-	-	-	25,225	25,225
Other consumer	1	1	-	-	2	4,637	4,639
Commercial business	4	-	-	-	4	25,310	25,314
Total	\$ 198	\$ 2,379	\$ 1,306	\$ -	\$ 3,883	\$491,700	\$ 495,583

The following table represents the aging of the recorded investment in past due loans as of December 31, 2016 by type of loan (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater Past Due	90 Days and Greater Past Due and Still Accruing	Total Past Due	Current	Total Loans
One- to four- family	\$ 2,476	\$ 161	\$ 1,787	\$ -	\$ 4,424	\$147,962	\$ 152,386
Home equity	460	-	494	-	954	26,817	27,771
Commercial and multifamily	-	-	-	-	-	181,004	181,004
Construction and land	440	-	-	-	440	70,475	70,915
Manufactured homes	321	28	62	-	411	15,083	15,494
Floating homes	-	-	-	-	-	23,996	23,996
Other consumer	26	1	-	-	27	3,905	3,932
Commercial business	149	-	-	-	149	26,182	26,331
Total	\$ 3,872	\$ 190	\$ 2,343	\$ -	\$ 6,405	\$495,424	\$ 501,829

Nonperforming Loans. Loans are considered nonperforming when they are placed on nonaccrual and/or when they are considered to be nonperforming troubled debt restructurings (“TDRs”) and/or when they are 90 days or greater past due and still accruing interest. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company has granted the borrower a concession of some kind. Nonperforming TDRs include TDRs that do not have sufficient payment history (typically greater than six months) to be considered performing or TDRs that have become 30 or more days past due.

The following table represents the credit risk profile of our loan portfolio based on payment activity as of June 30, 2017 by type of loan (in thousands):

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	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufacture homes	Floating homes	Other consumer	Commercial business	Total
Performing	\$145,809	\$27,305	\$195,275	\$52,775	\$16,202	\$25,225	\$4,639	\$25,085	\$492,315
Nonperforming	2,039	691	211	-	98	-	-	229	3,268
Total	\$147,848	\$27,996	\$195,486	\$52,775	\$16,300	\$25,225	\$4,639	\$25,314	\$495,583

The following table represents the credit risk profile of our loan portfolio based on payment activity as of December 31, 2016 by type of loan (in thousands):

	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufacture homes	Floating homes	Other consumer	Commercial business	Total
Performing	\$150,170	\$27,218	\$180,786	\$70,915	\$15,374	\$23,996	\$3,932	\$26,089	\$498,480
Nonperforming	2,216	553	218	-	120	-	-	242	3,349
Total	\$152,386	\$27,771	\$181,004	\$70,915	\$15,494	\$23,996	\$3,932	\$26,331	\$501,829

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the loan. In the process of identifying loans as impaired, we take into consideration factors which include payment history and status, collateral value, financial condition of the borrower, and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered on a case by case basis, after taking into consideration the totality of circumstances surrounding the loan and the borrower, including payment history. Impairment is measured on a loan by loan basis for all loans in the portfolio. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the allowance for loan losses.

Impaired loans at June 30, 2017 and December 31, 2016 by type of loan were as follows (in thousands):

	June 30, 2017				
	Unpaid Principal Balance	Recorded Investment		Total Recorded Investment	Related Allowance
		Without Allowance	With Allowance		
One- to four- family	\$6,739	\$3,284	\$ 3,168	\$ 6,452	\$ 481
Home equity	1,096	515	468	983	256
Commercial and multifamily	1,746	1,735	-	1,735	-
Construction and land	127	59	69	128	35
Manufactured homes	313	116	182	298	72
Other consumer	58	-	59	59	59
Commercial business	286	-	335	335	216
Total	\$10,365	\$5,709	\$ 4,281	\$ 9,990	\$ 1,119
	December 31, 2016				
	Unpaid Principal Balance	Recorded Investment		Total Recorded Investment	Related Allowance
		Without Allowance	With Allowance		
One- to four- family	\$5,010	\$2,454	\$ 2,295	\$ 4,749	\$ 536
Home equity	913	446	386	832	121
Commercial and multifamily	1,582	1,221	361	1,582	24
Construction and land	83	-	83	83	35
Manufactured homes	326	91	221	312	59
Other consumer	62	-	62	62	65
Commercial business	616	143	473	616	23
Total	\$8,592	\$4,355	\$ 3,881	\$ 8,236	\$ 863

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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Income on impaired loans for the three and six months ended June 30, 2017 and December 31, 2016 by type of loan were as follows (in thousands):

	Three Months Ended June 30, 2017		Three Months Ended June 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
One- to four- family	\$ 6,464	\$ 68	\$ 5,539	\$ 72
Home equity	1,050	10	993	15
Commercial and multifamily	1,927	21	4,887	66
Construction and land	105	2	88	1
Manufactured homes	287	5	387	9
Other consumer	61	1	26	1
Commercial business	367	6	573	11
Total	\$ 10,261	\$ 113	\$ 12,493	\$ 175
	Six Months Ended June 30, 2017		Six Months Ended June 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
One- to four- family	\$ 5,635	\$ 152	\$ 5,619	\$ 140
Home equity	920	20	963	27
Commercial and multifamily	1,662	48	3,913	133
Construction and land	106	3	89	2
Manufactured homes	307	10	378	16
Other consumer	61	2	19	2
Commercial business	477	11	420	18
Total	\$ 9,168	\$ 246	\$ 11,401	\$ 338

Forgone interest on nonaccrual loans was \$10,000 and \$78,000 for the six months ended June 30, 2017 and 2016, respectively. There were no commitments to lend additional funds to borrowers whose loans were classified as nonaccrual or impaired at June 30, 2017 or December 31, 2016.

Troubled debt restructurings. Loans classified as TDRs totaled \$4.2 million and \$3.4 million at June 30, 2017 and December 31, 2016, respectively, and are included in impaired loans. The Company has granted, in its TDRs, a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

Rate Modification: A modification in which the interest rate is changed.

Term Modification: A modification in which the maturity date, timing of payments or frequency of payments is changed.

Payment Modification: A modification in which the dollar amount of the payment is changed. Interest only modifications in which a loan is converted to interest only payments for a period of time are included in this category.

Combination Modification: Any other type of modification, including the use of multiple categories above.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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There was one \$1.3 million one- to four- family residential loan modified as a TDR during the six months ended June 30, 2017. The following TDR loans paid off during the first six months of 2017: a \$125,000 one- to four- family residential loan, a \$14,000 manufactured home loan, a zero balance home equity loan and a \$359,000 commercial/multifamily loan. There were no new TDRs during the six months ended June 30, 2016.

There were no post-modification changes for the unpaid principal balance in loans, net of partial charge-offs, that were recorded as a result of the TDRs for the six months ended June 30, 2017 and 2016. There were no TDRs for which there was a payment default within the first 12 months of modification during the six months ended June 30, 2017 or 2016.

The Company had no commitments to extend additional credit to borrowers owing receivables whose terms have been modified in TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the allowance for loan losses.

Note 5 – Fair Value Measurements

The following tables present information about the level in the fair value hierarchy for the Company's financial assets and liabilities, whether or not recognized or recorded at fair value as of June 30, 2017 and December 31, 2016 (in thousands):

	June 30, 2017		Fair Value Measurements Using:		
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
FINANCIAL ASSETS:					
Cash and cash equivalents	\$59,956	\$59,956	\$59,956	\$-	\$-
Available-for-sale securities	6,200	6,200	-	5,882	318
Loans held-for-sale	720	720	-	720	-
Loans receivable, net	489,061	488,065	-	-	488,065
Accrued interest receivable	1,677	1,677	1,677	-	-
Mortgage servicing rights	3,450	3,450	-	-	3,450
FHLB stock	1,705	1,705	-	-	1,705
FINANCIAL LIABILITIES:					
Non-maturity deposits	336,908	336,908	-	336,908	-
Time deposits	156,836	156,406	-	156,406	-
Borrowings	25,000	25,003	-	25,003	-
Accrued interest payable	78	78	-	78	-

	December 31, 2016		Fair Value Measurements Using:		
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
FINANCIAL ASSETS:					
Cash and cash equivalents	\$54,582	\$54,582	\$54,582	\$-	\$-
Available-for-sale securities	6,604	6,604	-	6,257	347
Loans held for sale	871	871	-	871	-
Loans receivable, net	495,179	494,289	-	-	494,289
Accrued interest receivable	1,816	1,816	1,816	-	-
Mortgage servicing rights	3,561	3,561	-	-	3,561

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FHLB Stock	2,840	2,840	-	-	2,840
FINANCIAL LIABILITIES:					
Non-maturity deposits	307,989	307,989	-	307,989	-
Time deposits	159,742	159,333	-	159,333	-
Borrowings	54,792	54,805	-	54,805	-
Accrued interest payable	73	73	-	73	-

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following tables present the balance of assets measured at fair value on a recurring basis as of June 30, 2017 and December 31, 2016 (in thousands):

<u>Description</u>	Fair Value at June 30, 2017			
	Total	Level 1	Level 2	Level 3
Municipal bonds	\$3,428	\$ -	\$3,428	\$ -
Agency mortgage-backed securities	2,454	-	2,454	-
Non-agency mortgage-backed securities	318	-	-	318
Mortgage servicing rights	3,450	-	-	3,450

<u>Description</u>	Fair Value at December 31, 2016			
	Total	Level 1	Level 2	Level 3
Municipal bonds	\$3,353	\$ -	\$3,353	\$ -
Agency mortgage-backed securities	2,904	-	2,904	-
Non-agency mortgage-backed securities	347	-	-	347
Mortgage servicing rights	3,561	-	-	3,561

For the three and six months ended June 30, 2017 and 2016 there were no transfers between Level 1 and Level 2 nor between Level 2 and Level 3.

The following tables provide a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at June 30, 2017 and December 31, 2016:

June 30, 2017

Financial Instrument	Valuation Technique	Unobservable Input(s)	Range (Weighted-Average)
Mortgage Servicing Rights	Discounted cash flow	Prepayment speed assumption Discount rate	109-395% (156%) 13-15% (13%)
Non-agency mortgage-backed securities	Discounted cash flow	Discount rate	7-9% (8%)

December 31, 2016

Financial Instrument	Valuation Technique	Unobservable Input(s)	Range (Weighted-Average)
Mortgage Servicing Rights	Discounted cash flow	Prepayment speed assumption Discount rate	104-396% (152%) 13%-15% (13%)
Non-agency mortgage-backed securities	Discounted cash flow	Discount rate	7%-9% (8%)

Generally, any significant increases in the constant prepayment rate and discount rate utilized in the fair value measurement of the mortgage servicing rights will result in a negative fair value adjustment (and decrease in the fair value measurement). Conversely, a decrease in the constant prepayment rate and discount rate will result in a positive fair value adjustment (and increase in the fair value measurement). An increase in the weighted average life assumptions will result in a decrease in the constant prepayment rate and conversely, a decrease in the weighted-average life will result in an increase of the constant prepayment rate.

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The following table provides a reconciliation of assets and liabilities (excluding mortgage servicing rights) measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and six months ended June 30, 2017 and 2016 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Beginning balance, at fair value	\$ 322	\$ 415	\$ 347	\$ 428
OTTI impairment losses	-	-	-	-
Sales and principal payments	(5)	(37)	(31)	(52)
Change in unrealized loss	1	1	2	3
Ending balance, at fair value	\$ 318	\$ 379	\$ 318	\$ 379

Mortgage servicing rights are measured at fair value using significant unobservable input (Level 3) on a recurring basis - additional information is included in Note 6 – Mortgage Servicing Rights.

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The following tables present the balance of assets measured at fair value on a nonrecurring basis at the dates indicated (in thousands):

	Fair Value at June 30, 2017			
	Total	Level 1	Level 2	Level 3
OREO and repossessed assets	\$ 952	\$ -	\$ -	\$ 952
Impaired loans	9,990	-	-	9,990

	Fair Value at December 31, 2016			
	Total	Level 1	Level 2	Level 3
OREO and repossessed assets	\$ 1,172	\$ -	\$ -	\$ 1,172
Impaired loans	8,236	-	-	8,236

There were no liabilities carried at fair value, measured on a recurring or nonrecurring basis, at June 30, 2017 or December 31, 2016.

The following tables provide a description of the valuation technique, observable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a nonrecurring basis at June 30, 2017 and December 31, 2016:

June 30, 2017

Financial Instrument	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
OREO	Market approach	Adjustment for differences between comparable sales	0-0% (0%)
Impaired loans	Market approach	Adjustment for differences between comparable sales	0-100% (11%)

December 31, 2016

Financial Instrument	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
OREO	Market approach	Adjusted for difference between comparable sales	0-0% (0%)
Impaired loans	Market approach	Adjusted for difference between comparable sales	0-100% (10.5%)

A description of the valuation methodologies used for impaired loans and OREO is as follows:

Impaired Loans - The fair value of collateral dependent loans is based on the current appraised value of the collateral or internally developed models utilizing a calculation of expected discounted cash flows which contain management's assumptions.

OREO and Repossessed Assets – The fair value of OREO and repossessed assets is based on the current appraised value of the collateral.

The following methods and assumptions were used to estimate the fair value of other financial instruments:

Cash and cash equivalents, and accrued interest receivable and payable - The estimated fair value is equal to the carrying amount.

AFS Securities – AFS securities are recorded at fair value based on quoted market prices, if available. If quoted market prices are not available, management utilizes third-party pricing services or broker quotations from dealers in the specific instruments. Level 2 securities include those traded on an active exchange, as well as U.S. government and its agencies securities. Level 3 securities include private label mortgage-backed securities.

Loans Held-for-Sale - Loans held-for-sale are recorded at the lower of cost or fair value. The fair value of fixed-rate residential loans is based on whole loan forward prices obtained from government sponsored enterprises. At June 30, 2017 and December 31, 2016, loans held-for-sale were carried at cost, as no impairment was required.

Loans - The estimated fair value for all fixed-rate loans is determined by discounting the estimated cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and maturities. The estimated fair value for variable rate loans is the carrying amount. The fair value for all loans also takes into account projected loan losses as a part of the estimate.

Mortgage Servicing Rights –The fair value of mortgage servicing rights is determined through a discounted cash flow analysis, which uses interest rates, prepayment speeds, discount rates, and delinquency rate assumptions as inputs.

FHLB stock - The estimated fair value is equal to the par value of the stock, which approximates fair value.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Deposits - The estimated fair value of deposit accounts (savings, demand deposit, and money market accounts) is the carrying amount. The fair values of fixed-maturity time deposits are estimated by discounting the estimated cash flows using the current rate at which similar time deposits would be issued.

Borrowings - The fair value of borrowings are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Off-balance sheet financial instruments - The fair value of the off-balance sheet loan commitments are estimated based on fees charged to others to enter into similar agreements taking into account the remaining terms of the agreements and credit standing of the customers. The estimated fair value of these commitments is not significant.

We assume interest rate risk (the risk that general interest rate levels will change) as a result of our normal operations. As a result, the fair values of our financial instruments will change when interest rate levels change, which may be favorable or unfavorable to us. Management attempts to match maturities of assets and liabilities to the extent necessary or possible to minimize interest rate risk. However, borrowers with fixed-rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed-rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by establishing early withdrawal penalties for time deposits, creating interest rate floors for certain variable rate loans, adjusting terms of new loans and deposits, by borrowing at fixed-rates for fixed-terms and investing in securities with terms that mitigate our overall interest rate risk.

Note 6 – Mortgage Servicing Rights

The unpaid principal balances of loans serviced for Federal National Mortgage Association (“Fannie Mae”) at June 30, 2017 and December 31, 2016, totaled \$398.2 million and \$410.1 million, respectively, and are not included in the Company's financial statements. We also service loans for other financial institutions for which a servicing fee is received. The unpaid principal balances of loans serviced for other financial institutions at June 30, 2017 and December 31, 2016, totaled \$17.5 million and \$13.8 million, respectively, and are not included in the Company's financial statements.

The key economic assumptions used in determining the fair value of mortgage servicing rights at the dates indicated are as follows:

	June 30, 2017		December 31, 2016	
Prepayment speed (Public Securities Association “PSA” model)	156	%	152	%
Weighted-average life	7.0	years	7.2	years
Yield to maturity discount rate	13	%	13	%

The amounts of contractually specified servicing, late and ancillary fees earned and recorded, net of fair value market adjustments to the mortgage servicing rights, is included in mortgage servicing income on the Condensed Consolidated Statements of Income which were \$148,000 and \$381,000 for the three and six months ended June 30, 2017, respectively, and \$132,000 and \$223,000 for the three and six months ended June 30, 2016, respectively.

The gross amount of contractually specified servicing, late and ancillary fees earned and recorded in mortgage servicing income were \$384,000 and \$637,000 for the three and six months ended June 30, 2017, respectively, and

\$208,000 and \$413,000 for the three and six months ended June 30, 2016, respectively.

Note 7 – Commitments and Contingencies

In the normal course of operations, the Company engages in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit.

Note 8 – Borrowings and FHLB Stock

The Company utilizes a loan agreement with the FHLB of Des Moines. The terms of the agreement call for a blanket pledge of a portion of the Company's mortgage and commercial and multifamily loan portfolio based on the outstanding balance. At June 30, 2017 and December 31, 2016, the amount available to borrow under this credit facility was \$201.2 million and \$197.9 million, respectively. At June 30, 2017, the credit facility was collateralized as follows: one- to four- family mortgage loans with an advance equivalent of \$100.9 million, commercial and multifamily mortgage loans with an advance equivalent of \$102.0 million and home equity loans with an advance equivalent of \$15.3 million. At December 31, 2016, the credit facility was collateralized as follows: one- to four- family mortgage loans with an advance equivalent of \$107.2 million, commercial and multifamily mortgage loans with an advance equivalent of \$94.4 million and home equity loans with an advance equivalent of \$15.9 million. The Company had outstanding borrowings under this arrangement of \$25.0 million and \$54.8 million at June 30, 2017 and December 31, 2016, respectively. Additionally, the Company had outstanding letters of credit from the FHLB of Des Moines with a notional amount of \$16.0 million and \$21.0 million at June 30, 2017 and December 31, 2016, respectively, to secure public deposits. The remaining amount available to borrow as of June 30, 2017 and December 31, 2016, was \$160.2 million and \$122.2 million, respectively.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB of Des Moines stock based on specific percentages of its outstanding FHLB advances. At June 30, 2017 and December 31, 2016, the Company had an investment of \$1.7 million and \$2.8 million, respectively, in FHLB of Des Moines stock.

The Company participates in the Federal Reserve Bank Borrower-in-Custody program, which gives the Company access to the discount window. The terms of the program call for a pledge of specific assets. The Company had unused borrowing capacity of \$44.6 million and \$42.0 million and no outstanding borrowings under this program at June 30, 2017 and December 31, 2016, respectively.

The Company has access to a Fed Funds line of credit from Pacific Coast Banker's Bank. The line has a one-year term maturing on June 30, 2018 and is renewable annually. As of June 30, 2017, the amount available under this line of credit was \$2.0 million. There was no balance on this line of credit as of June 30, 2017 and December 31, 2016, respectively.

The Company has access to a Fed Funds line of credit from Zions Bank under a Fed Funds Sweep and Line Agreement. The agreement allows access to a Fed Funds line of up to \$9.0 million and requires the Company to maintain cash balances with Zions Bank of \$250,000. The agreement has no maturity date. There was no balance on this line of credit as of June 30, 2017 and December 31, 2016, respectively.

The Company has access to an unsecured line of credit from The Independent Bank (TIB). As of June 30, 2017, the amount available under this line of credit was \$10.0 million. The line matures on November 1, 2017. There was no balance on this line of credit as of June 30, 2017 and December 31, 2016, respectively.

Note 9 – Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted-average number of common shares outstanding for the period, reduced for average unallocated ESOP shares and average unvested restricted stock awards. Unvested share-based awards contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method described in ASC 260-10-45-60B. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock (such as stock awards and options) were exercised or converted to common stock, or resulted in the issuance of common stock that then shared in the Company's earnings. Diluted earnings per common share is computed by dividing net income by the weighted-average number of common shares outstanding for the period increased for the dilutive effect of unexercised stock options and unvested restricted stock awards. The dilutive effect of the unexercised stock options and unvested restricted stock awards is calculated under the treasury stock method utilizing the average market value of the Company's stock for the period.

Earnings per share are summarized for the periods presented in the following table (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	\$ 1,303	\$ 1,254	\$ 2,717	\$ 2,360
Weighted-average number of shares outstanding, basic	2,501	2,481	2,500	2,479
Effect of potentially dilutive common shares ⁽¹⁾	96	77	100	73
	2,597	2,558	2,600	2,552

Weighted-average number of shares outstanding,
diluted

Earnings per share, basic	\$ 0.52	\$ 0.51	\$ 1.09	\$ 0.95
Earnings per share, diluted	\$ 0.50	\$ 0.49	\$ 1.04	\$ 0.92

⁽¹⁾ Represents the effect of the assumed exercise of stock options and vesting of non-participating restricted shares, based on the treasury stock method.

There were no anti-dilutive securities at either June 30, 2017 or June 30, 2016.

Note 10 – Stock-based Compensation

Stock Options and Restricted Stock

The Company currently has two existing Equity Incentive Plans, a 2008 Equity Incentive Plan (the “2008 Plan”) and a 2013 Equity Incentive Plan (the “2013 Plan”, and together with the 2008 Plan (the “Plans”), both of which were approved by shareholders. The Plans permit the grant of restricted stock, restricted stock units, stock options, and stock appreciation rights. Under the 2008 Plan, 126,287 shares of common stock were approved for awards for stock options and stock appreciation rights and 50,514 shares of common stock were approved for awards for restricted stock and restricted stock units. Under the 2013 Plan, 141,750 shares of common stock were approved for awards for stock options and stock appreciation rights and 56,700 shares of common stock were approved for awards for restricted stock and restricted stock units.

As of June 30, 2017, on an adjusted basis, awards for stock options totaling 265,799 shares and awards for restricted stock totaling 107,214 shares of Company common stock have been granted, net of any forfeitures, to participants in the Plans. During the three months ended June 30, 2017 and 2016, share-based compensation expense totaled \$144,000 and \$126,000, respectively. During the six months ended June 30, 2017 and 2016, share-based compensation expense totaled \$288,000 and \$228,000, respectively.

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Notes to Condensed Consolidated Financial Statements (unaudited)

Stock Option Awards

The stock option awards granted to date under the 2008 Plan vest in 20 percent annual increments commencing one year from the grant date in accordance with the requirements of the 2008 Plan. The stock option awards granted to date under the 2013 Plan vest in equal annual installments of either two or four years. All of the options granted under the Plans are exercisable for a period of 10 years from the date of grant, subject to vesting. The following is a summary of the Company's stock option award activity during the six months ended June 30, 2017:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2017	170,057	\$ 15.41	6.44	\$2,141,018
Granted	32,010	28.34		
Exercised	(2,135)	15.43		
Forfeited	(602)	28.28		
Expired	-	-		
Outstanding at June 30, 2017	199,330	17.45	6.52	2,599,263
Exercisable	131,770	15.60	5.86	\$1,962,055
Expected to vest, assuming a 0% forfeiture rate over the vesting term	67,560	\$ 21.06	7.81	\$637,208

As of June 30, 2017, there was \$393,000 of total unrecognized compensation cost related to non-vested stock options granted under the Plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.8 years.

The fair value of each option grant is estimated as of the grant date using the Black-Scholes option-pricing model. The fair value of options granted for the six months ended June 30, 2017 was determined using the following weighted-average assumptions as of the grant date.

Annual dividend yield	1.28 %
Expected volatility	22.99%
Risk-free interest rate	2.20 %
Expected term	6.50 years
Weighted-average grant date fair value per option granted	\$6.62

The fair value of options granted for the six months ended June 30, 2016 was determined using the following weighted-average assumptions as of the grant date.

Annual dividend yield	1.03 %
Expected volatility	25.48%
Risk-free interest rate	1.64 %
Expected term	6.92 years
Weighted-average grant date fair value per option granted	\$5.78

Restricted Stock Awards

The fair value of the restricted stock awards is equal to the fair value of the Company's stock at the date of grant. Compensation expense is recognized over the vesting period that the awards are based. The restricted stock awards granted to date under the 2008 Plan provide for vesting in 20% annual increments commencing one year from the grant date. The restricted stock awards granted to date under the 2013 Plan provide for immediate vesting of 33.33% of a recipient's award with the balance of an individual's award under the 2013 Plan vesting in two equal annual installments commencing one year from the grant date.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following is a summary of the Company's restricted stock award activity during the six months ended June 30, 2017:

	Shares	Weighted-Average Grant-Date Fair Value Per Share
Non-vested at January 1, 2017	26,138	\$ 18.08
Granted	576	28.34
Vested	(14,929)	17.61
Forfeited	-	-
Expired	-	-
Non-vested at June 30, 2017	11,785	19.05
Expected to vest assuming a 0% forfeiture rate over the vesting term	11,785	\$ 19.05

As of June 30, 2017, there was \$171,000 of unrecognized compensation cost related to non-vested restricted stock granted under the Plans. The cost is expected to be recognized over the weighted-average vesting period of 0.78 years. The total fair value of shares vested for the six months ended June 30, 2017 and 2016 was \$430,000 and \$345,000, respectively.

Employee Stock Ownership Plan

In January 2008, the ESOP borrowed \$1.2 million from the Company to purchase common stock of the Company. In August 2012, in conjunction with the Company's conversion to a full stock company from the mutual holding company structure, the ESOP borrowed an additional \$1.1 million from the Company to purchase common stock of the Company. Both loans are being repaid by the Bank through contributions to the ESOP over a period of ten years. The interest rate on the loans is fixed at 4.00% and 2.25%, per annum, respectively. As of June 30, 2017, the remaining balances of the ESOP loans were \$136,000 and \$590,000, respectively.

Neither the loan balances nor the related interest expense are reflected on the condensed consolidated financial statements.

At June 30, 2017, the ESOP was committed to release 21,443 shares of the Company's common stock to participants and held 66,800 unallocated shares remaining to be released in future years. The fair value of the 183,469 restricted shares held by the ESOP trust was \$5.6 million at June 30, 2017. ESOP compensation expense included in salaries and benefits was \$170,000 and \$338,000 for the three and six months ended June 30, 2017 and \$135,000 and \$271,000 for the three and six months ended June 30, 2016, respectively.

Note 11 – Acquisition of Sunwest Bank Branch

On June 30, 2017, the Bank completed its acquisition of the University Place branch from Sunwest Bank ("Sunwest"), located at 4922 Bridgeport Way West, University Place, Washington 98467. This branch acquisition was completed under a Purchase and Assumption Agreement between the Company and Sunwest. Under the terms of the agreement, the Bank paid a deposit premium of \$485,000 equal to 3.35% of the assumed deposits and acquired the branch lease, certain personal property and records of the former Sunwest branch.

The branch acquisition was accounted for as a business combination under the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at acquisition date fair

values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as additional information regarding the closing date fair values becomes available.

The estimated fair value of the assets purchased and liabilities assumed in the acquisition of the University Place Branch on June 30, 2017 are presented in the following table:

	June 30,
Fair value of assets acquired:	2017
Cash and cash equivalents	\$ 13,671
Loans	24
Premises and equipment	312
Core deposit intangible	155
Goodwill	312
Total fair value of assets acquired	\$ 14,474
Fair value of liabilities assumed:	
Deposits	14,474
Total fair value of liabilities assumed	\$ 14,474

Note 12 – Subsequent Event

On July 25, 2017, the Company declared a quarterly cash dividend of \$0.10 per common share and a special dividend of \$0.20 per share, payable August 25, 2017 to shareholders of record at the close of business August 11, 2017.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain matters discussed in this Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, 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:

- changes in economic conditions, either nationally or in our market area;
- fluctuations in interest rates;
- the risks of lending and investing activities, including changes in the level and direction of loan delinquencies and write-offs and changes in estimates of the adequacy of our allowance for loan losses;
- the possibility of other-than-temporary impairments of securities held in our securities portfolio;
- our ability to access cost-effective funding;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values and both residential and commercial and multifamily real estate market conditions in our market area;
- secondary market conditions for loans and our ability to sell loans in the secondary market;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all, including the recent University Place branch acquisition;
- legislative or regulatory changes such as the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including changes related to Basel III;
- monetary and fiscal policies of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the U.S. Government and other governmental initiatives affecting the financial services industry;

results of examinations of Sound Financial Bancorp and Sound Community Bank by their regulators, including the possibility that the regulators may, among other things, require us to increase our allowance for loan losses or to write-down assets, change Sound Community Bank's regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;

·increases in premiums for deposit insurance;

·our ability to control operating costs and expenses;

·the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;

·difficulties in reducing risks associated with the loans on our balance sheet;

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- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
 - our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, “denial of service” attacks, “hacking” and identity theft;
 - 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 business strategies;
 - increased competitive pressures among financial services companies;
 - changes in consumer spending, borrowing and savings habits;
 - the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
 - our ability to pay dividends on our common stock;
 - adverse changes in the securities markets;
 - the 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; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described from time to time in our filings with the SEC, including this Form 10-Q and our 2016 Form 10-K.

We wish to advise readers not to place undue reliance on any forward-looking statements and that the factors listed above could materially affect our financial performance and could cause our actual results for future periods to differ materially from any such forward-looking statements expressed with respect to future periods and could negatively affect our stock price performance.

We do not undertake and specifically decline any obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

General

Sound Financial Bancorp, a Maryland corporation, is a bank holding company for its wholly owned subsidiary, Sound Community Bank. Substantially all of Sound Financial Bancorp's business is conducted through Sound Community Bank, a Washington state-chartered commercial bank. As a Washington commercial bank, the Bank's regulators are the WDFI and the FDIC. The Federal Reserve is the primary federal regulator for Sound Financial Bancorp.

Sound Community Bank's deposits are insured up to applicable limits by the FDIC. At June 30, 2017, Sound Financial Bancorp had total consolidated assets of \$588.3 million, net loans of \$489.1 million, deposits of \$493.7

million and stockholders' equity of \$62.9 million. The shares of Sound Financial Bancorp are traded on The NASDAQ Capital Market under the symbol "SFBC." Our executive offices are located at 2400 3rd Avenue, Suite 150, Seattle, Washington, 98121.

Our principal business consists of attracting retail and commercial deposits from the general public and investing those funds, along with borrowed funds, in loans secured by first and second mortgages on one- to four- family residences (including home equity loans and lines of credit), commercial and multifamily real estate, construction and land, consumer and commercial business loans. Our commercial business loans include unsecured lines of credit and secured term loans and lines of credit secured by inventory, equipment and accounts receivable. We also offer a variety of secured and unsecured consumer loan products, including manufactured home loans, floating home loans, automobile loans, boat loans and recreational vehicle loans. As part of our business, we focus on residential mortgage loan originations, the majority of which we sell to the Fannie Mae and a portion of which we retain for our loan portfolio consistent with our asset/liability objectives. We sell loans which conform to the underwriting standards of Fannie Mae ("conforming") in which we retain the servicing of the loan in order to maintain the direct customer relationship and to generate noninterest income. Residential loans which do not conform to the underwriting standards of Fannie Mae ("non-conforming"), are either held in our loan portfolio or sold with servicing released. We originate and retain a significant amount of commercial real estate loans, including those secured by owner-occupied and nonowner-occupied commercial real estate, multifamily property, mobile home parks and construction and land development loans.

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Critical Accounting Policies

Certain of our accounting policies are important to an understanding of our financial condition, since they require management to make difficult, complex or subjective judgments, which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances that could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, accounting for other-than-temporary impairment of securities, accounting for mortgage servicing rights, accounting for other real estate owned and accounting for deferred income taxes. Our methodologies for analyzing the allowance for loan losses, other-than-temporary impairment, mortgage servicing rights, other real estate owned and deferred tax asset accounts are described in our 2016 Form 10-K. There have been no significant changes in the Company's application of accounting policies since December 31, 2016.

Comparison of Financial Condition at June 30, 2017 and December 31, 2016

General. Total assets remained stable at \$588.3 million at both June 30, 2017 and December 31, 2016. During the six months ended June 30, 2017, cash and cash equivalents increased \$5.4 million and premises and equipment increased \$1.9 million while the net loan portfolio decreased \$6.1 million and FHLB stock decreased \$1.1 million. The \$26.0 million, or 5.6%, increase in deposits was primarily used to pay down FHLB borrowings which declined \$29.8 million or 54.4% from December 31, 2016 to June 30, 2017. The acquisition of the University Place branch, located in Pierce County, WA, which closed on June 30, 2017, resulted in an increase in deposits and cash balances of \$14.5 million. The purchase of property in Sequim, WA as a future loan production office was the primary reason for the increase in premises and equipment.

Cash and Securities. Cash and cash equivalents increased \$5.4 million, or 9.8%, to \$60.0 million at June 30, 2017 from \$54.6 million at December 31, 2016. Available-for-sale securities, which consist primarily of agency mortgage-backed securities, decreased \$404,000, or 6.1%, to \$6.2 million at June 30, 2017 from \$6.6 million at December 31, 2016 as a result of principal repayments on securities during the first six months of 2017.

Loans. Our gross loan portfolio decreased \$6.1 million, or 1.2%, to \$493.9 million at June 30, 2017 from \$500.0 million at December 31, 2016.

The following table reflects the changes in the types of loans in our portfolio at June 30, 2017, as compared to December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016	Amount Change	Percent Change
One- to four- family	\$ 147,848	\$ 152,386	\$(4,538)	(3.0)%
Home equity	27,996	27,771	225	0.8
Commercial and multifamily	195,486	181,004	14,482	8.0
Construction and land	52,775	70,915	(18,140)	(25.6)
Manufactured homes	16,300	15,494	806	5.2
Floating homes	25,225	23,996	1,229	5.1
Other consumer	4,639	3,932	707	18.0
Commercial business	25,314	26,331	(1,017)	(3.9)
Deferred loan fees	(1,687)	(1,828)	141	(7.7)
Total loans, gross	\$493,896	\$ 500,001	\$(6,105)	(1.2)%

The decrease in our loan portfolio was primarily a result of an \$18.1 million, or 25.6%, decline in construction and land loans due to loan repayments in the normal course, partially offset by an increase of \$14.5 million, or 8.0%, in our commercial and multifamily loans. At June 30, 2017, our loan portfolio remained well-diversified with commercial and multifamily real estate loans accounting for 39.5% of the portfolio. One- to four- family loans accounted for 29.8% of the portfolio and home equity, manufactured and floating homes, and other consumer loans accounted for 15.0% of the portfolio at June 30, 2017. Construction and land loans accounted for 10.6% of the portfolio and commercial business loans accounted for the remaining 5.1% of total loans at June 30, 2017.

Loans held-for-sale decreased \$151,000, or 17.3%, to \$720,000 at June 30, 2017 from \$871,000 at December 31, 2016. The decrease in loans held-for-sale was a result of the timing of originations and delivery of the loans.

Mortgage Servicing Rights. At June 30, 2017 and December 31, 2016, we had \$3.5 million and \$3.6 million, respectively, in mortgage servicing rights recorded at fair value. We record mortgage servicing rights on loans sold to Fannie Mae and other financial institutions with servicing retained and upon acquisition of a servicing portfolio. We stratify our capitalized mortgage servicing rights based on the type, term and interest rates of the underlying loans. Mortgage servicing rights are carried at fair value. If the fair value of our mortgage servicing rights fluctuates significantly, our financial results could be materially impacted.

Nonperforming Assets. At June 30, 2017, nonperforming assets totaled \$4.2 million, or 0.72% of total assets, compared to \$4.5 million, or 0.77% of total assets, at December 31, 2016.

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The table below sets forth the amounts and categories of nonperforming assets at the dates indicated (dollars in thousands):

	Nonperforming Assets			
	June 30, 2017	December 31, 2016	Amount Change	Percent Change
Nonaccrual loans	\$ 1,819	\$ 3,144	\$(1,325)	(42.1)%
Nonperforming TDRs	1,449	205	1,244	606.8
Total nonperforming loans	3,268	3,349	(81)	(2.4)
OREO and repossessed assets	952	1,172	(220)	(18.8)
Total nonperforming assets	\$ 4,220	\$ 4,521	\$(301)	(6.7)%

Nonperforming loans, consisting of nonaccrual loans and nonperforming TDRs, declined slightly to \$3.3 million, or 0.66% of total loans, at June 30, 2017 compared to 0.67% at December 31, 2016. Nonaccrual loans decreased and nonperforming TDRs increased during the six months ended June 30, 2017 primarily due to a \$1.3 million nonaccrual one- to four- family residential loan which was modified as a TDR during the period.

OREO and repossessed assets decreased \$220,000, or 18.8%, to \$952,000 at June 30, 2017 from \$1.2 million at December 31, 2016. This decrease was due to the sale of two one- to four- family residential properties totaling \$220,000, resulting in a net gain on sale of \$3,000. During the three and six months ended June 30, 2017, we did not repossess any assets. At June 30, 2017, our largest OREO property was a commercial building with a recorded value of \$600,000 located in Clallam County, Washington, which was acquired in 2015 as a part of three branches purchased from another financial institution. It is currently leased to a not-for-profit organization headquartered in our market area at a below market rate. Our remaining two OREO properties were a \$342,000 one- to four- family property located in Suffolk County, New York, and a \$10,000 manufactured home located in King County, Washington. The property in Suffolk County, New York was a repurchase of a loan from the portfolio of mortgage servicing rights we acquired in 2009.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover losses that are probable and can be estimated on the date of evaluation in accordance with generally accepted accounting principles in the United States. It is our best estimate of probable credit losses inherent in our loan portfolio. The following table reflects the adjustments in our allowance during the periods indicated (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Balance at beginning of period	\$ 4,838	\$ 4,709	\$ 4,822	\$ 4,636
Charge-offs	(8)	(39)	(36)	(122)
Recoveries	5	68	49	74
Net (charge-offs)/recoveries	(3)	29	13	(48)
Provisions charged to operations	-	100	-	250
Balance at end of period	\$ 4,835	\$ 4,838	\$ 4,835	\$ 4,838

Ratio of net charge-offs/(recoveries) during the period to average loans outstanding during the period	0.00	%	(0.02)	%	(0.01)	%	0.02	%
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Allowance as a percentage of nonperforming loans (end of period)	June 30, 2017	December 31, 2016	
	147.95 %	143.98	%

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Allowance as a percentage of total loans (end of period)	0.98	%	0.96	%
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Our allowance for loan losses at June 30, 2017 and December 31, 2016 was \$4.8 million. There was no provision for loan losses recorded for the first six months of June 30, 2017 as a result of lower loan portfolio balances as compared to December 31, 2016, stable nonperforming loan balances, and minimal charge-offs recognized during the six months ended June 30, 2017.

Specific loan loss reserves increased to \$1.1 million at June 30, 2017 compared to \$863,000 at December 31, 2016, while general loan loss reserves decreased to \$3.7 million at June 30, 2017, compared to \$4.0 million at December 31, 2016. The increase in specific loan loss reserves was primarily due to the \$1.8 million increase in impaired loans since December 31, 2016. There were 17 loans totaling \$2.8 million (of which \$1.9 million were one- to four- family residential loans) reported as impaired at June 30, 2017 which were not impaired at December 31, 2016, partially offset by six loans totaling \$896,000 reported as impaired at December 31, 2016 which were not impaired at June 30, 2017. The six previously impaired loans at December 31, 2016 that were no longer impaired at June 30, 2017 consisted of one, one- to four- family residential loan, three manufactured home loans, one commercial business loan and one commercial real estate loan. The three largest impaired loans at June 30, 2017 were two one- to four- family residential loans totaling \$2.6 million, including one for \$1.3 million which became impaired due to its modification as a TDR in 2017, and one \$759,000 loan secured by a commercial building, all located in King County, Washington. Net charge-offs/recoveries for the three and six months ended June 30, 2017 were charge-offs of \$3,000 and recoveries of \$13,000, respectively, compared to recoveries of \$29,000 and charge-offs of \$48,000 for the three and six months ended June 30, 2016, respectively. As of June 30, 2017, the allowance for loan losses as a percentage of total loans receivable and as a percentage of nonperforming loans were 0.98% and 147.95%, respectively, compared to 0.96% and 143.98%, respectively, at December 31, 2016.

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Deposits. Total deposits increased \$26.0 million, or 5.6%, to \$493.7 million at June 30, 2017 from \$467.7 million at December 31, 2016, primarily as a result of an \$11.3 million, or 17.7%, increase in noninterest-bearing demand accounts, a \$9.0 million, or 6.0% increase in interest-bearing demand accounts, and an \$8.7 million, or 9.2%, increase in savings and money market accounts. These increases were partially offset by a \$2.9 million, or 1.8%, decrease in certificates of deposit. Deposits increased \$14.5 million due to the University Place branch acquisition with the remainder of the increase due to organic growth from our ongoing deposit gathering efforts to obtain low cost deposit accounts from retail and small business customers.

A summary of deposit accounts with the corresponding weighted-average cost of funds at the dates indicated is presented below (dollars in thousands):

	June 30, 2017		December 31, 2016		
	Amount	Wtd. Avg. Rate	Amount	Wtd. Avg. Rate	
Noninterest-bearing demand ⁽¹⁾	\$72,343	0.00	% \$ 60,566	0.00	%
Interest-bearing demand	159,291	0.39	150,327	0.34	
Savings	47,375	0.21	44,879	0.22	
Money market	55,222	0.20	49,042	0.17	
Time deposits	156,836	1.29	159,742	1.12	
Escrow ⁽¹⁾	2,677	0.00	3,175	0.00	
Total deposits	\$493,744	0.59	% \$ 467,731	0.53	%

⁽¹⁾ Escrow balances shown in noninterest-bearing deposits on the consolidated balance sheets.

Borrowings. FHLB advances decreased \$29.8 million, or 54.4%, to \$25.0 million at June 30, 2017, with a weighted-average cost of 1.16%, from \$54.8 million at December 31, 2016, with a weighted-average cost of 0.82%. FHLB borrowings declined utilizing the cash received from the University Place branch acquisition and organic deposit growth. The increase in the cost of the borrowings was a result of the general increase in rates over the last year. We rely on FHLB advances to supplement deposits to fund interest-earning asset growth.

Stockholders' Equity. Total stockholders' equity increased \$2.6 million, or 4.3%, to \$62.9 million at June 30, 2017 from \$60.3 million at December 31, 2016. This increase primarily reflects \$2.7 million in net income for the six months ended June 30, 2017, partially offset by the payment of cash dividends of \$501,000 to common stockholders.

Comparison of Results of Operation for the Three and Six Months Ended June 30, 2017 and 2016

General. Net income was \$1.3 million, or \$0.50 per diluted common share, for the three months ended June 30, 2017, an increase of \$49,000 from the three months ended June 30, 2016. Net income increased \$357,000 to \$2.7 million, or \$1.04 per diluted common share, for the six months ended June 30, 2017, compared to \$2.4 million, or \$0.92 per diluted common share, for the same period in 2016. The primary reason for the increase in net income for both periods was an increase in net interest income after provision for loan losses, which was partially offset by a decrease in noninterest income and an increase in noninterest expense.

Interest Income. Interest income increased \$374,000, or 6.1%, to \$6.5 million for the three months ended June 30, 2017, from \$6.1 million for the three months ended June 30, 2016. Interest income increased \$924,000, or 7.6%, to \$13.1 million for the six months ended June 30, 2017, from \$12.2 million for the six months ended June 30, 2016. The increases in interest income for the three and six months ended June 30, 2017, primarily reflect the increase in the average balance of interest-earning assets, in particular loans receivable, and a higher weighted-average yield on interest-earning assets in the current three and six month periods. The average balance of gross loans receivable

increased \$27.8 million, or 6.0% for the three months ended June 30, 2017, as compared to the same period last year.

Our weighted-average yield on interest-earning assets was 4.86% and 4.88% for the three and six months ended June 30, 2017, respectively, compared to 4.78% for both the three and six months ended June 30, 2016, respectively. The weighted-average yield on loans increased to 5.21% and 5.20% for the three and six months ended June 30, 2017, respectively, from 5.17% for both the three and six months ended June 30, 2016. The weighted-average yield on available-for-sale securities was 1.33% and 1.27% for the three and six months ended June 30, 2017, respectively, compared to 0.83% for both the three and six months ended June 30, 2016, respectively. The increase in the average yields for both the interest-bearing cash and the securities portfolio was due to the increase in the average balance of investments coupled with the recent increases in the federal funds rate.

Interest Expense. Interest expense increased \$54,000, or 7.6%, to \$763,000 for the three months ended June 30, 2017, from \$709,000 for the three months ended June 30, 2016 due to the increase in the average balance of deposits during the three months ended June 30, 2017 to \$474.9 million as compared to \$443.9 million for the same quarter in 2016. Our weighted-average cost of deposits was 0.58% and 0.59% for the three and six months ended June 30, 2017, compared to 0.59% and 0.60% for the three and six months ended June 30, 2016, respectively. The total cost of borrowings increased \$20,000, or 36.4%, to \$75,000 during the quarter ended June 30, 2017 from \$55,000 for the quarter ended June 30, 2016 primarily as a result of an increase in the overnight borrowing rates reflecting recent increases in the federal funds rate. Average borrowings, consisting of FHLB advances, decreased to \$25.3 million for the quarter ended June 30, 2017, compared to \$38.9 million during the quarter ended June 30, 2016 due to the repayment of FHLB advances, discussed above. Interest expense increased \$131,000, or 9.2%, to \$1.6 million for the six months ended June 30, 2017, from \$1.4 million for the six months ended June 30, 2016. The increase in interest expense for the first six months of 2017 compared to the like period in 2016 was primarily a result of both an increase in the average balance of borrowings and in the cost of FHLB borrowings during the period. Average borrowings outstanding during the six months ended June 30, 2017 were \$33.6 million compared to \$24.6 million outstanding during the six months ended June 30, 2016. The cost of those borrowings was 0.99% during the first half of 2017 compared to 0.55% for the first half of 2016. Our overall weighted-average cost of interest-bearing liabilities was 0.71% for both the three and six months ended June 30, 2017, compared to 0.66% and 0.68% for the three and six months ended June 30, 2016, respectively.

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Net Interest Income. Net interest income increased \$320,000, or 5.9%, to \$5.8 million for the three months ended June 30, 2017, from \$5.4 million for the three months ended June 30, 2016. Net interest income increased \$793,000, or 7.4%, to \$11.6 million for the six months ended June 30, 2017, from \$10.8 million for the six months ended June 30, 2016. The increase for both the three and six months ended June 30, 2017 resulted from increased interest income due to higher average loan balances and higher yields on our loan portfolio. Our average yield on loans receivable increased during the three and six months ended June 30, 2017, as compared to the same periods last year as rates have increased compared to a year ago. Our net interest margin was 4.33% and 4.30% for the three and six months ended June 30, 2017, respectively, compared to 4.26% for both the three and six months ended June 30, 2016.

Provision for Loan Losses. We establish provisions for loan losses, which are charged to earnings, at a level required to reflect management's best estimate of the probable incurred credit losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect borrowers' ability to repay, estimated value of any underlying collateral, peer group data, prevailing economic conditions, and current factors. Large groups of smaller balance homogeneous loans, such as one- to four- family, small commercial and multifamily, home equity and consumer loans, are evaluated in the aggregate using historical loss factors adjusted for current economic conditions and other relevant data. Loan's for which management has concerns about the borrowers' ability to repay, are evaluated individually, and specific loss allocations are provided for these loans when necessary.

There was no provision for loan losses for both the three and six months ended June 30, 2017, compared to provisions of \$100,000 and \$250,000 during the three and six months ended June 30, 2016, respectively. The reduced provision for both periods reflects a decline in the nonperforming loans to total loans ratio, and lower historical loss ratios. Nonperforming loans decreased to \$3.3 million at June 30, 2017 compared to \$4.5 million at June 30, 2016. Nonperforming loans to total loans was 0.66% at June 30, 2017 as compared to 0.96% at June 30, 2016. Net charge-offs for the second quarter of 2017 totaled \$3,000 compared to net recoveries of \$29,000 during the quarter ended June 30, 2016. Net recoveries for the six months ended June 30, 2017 totaled \$13,000 compared to net charge-offs of \$48,000 during the six months ended June 30, 2016. Impaired loans increased \$1.8 million, or 21.3% to \$10.0 million at June 30, 2017 as compared to \$8.2 million at December 31, 2016 principally as a result of the addition of four, one- to four- family residential loans totaling \$1.9 million. The allowance for loan losses remained stable at \$4.8 million at June 30, 2017 compared to December 31, 2016.

The ratio of nonperforming assets to total assets decreased to 0.72% at June 30, 2017 from 0.97% at June 30, 2016. This decrease is the result of the reduction in our nonperforming assets principally due to the payoff of a \$2.1 million multifamily loan.

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of our allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Noninterest Income. Noninterest income decreased \$227,000, or 18.8%, to \$983,000 for the three months ended June 30, 2017, as compared to \$1.2 million for the three months ended June 30, 2016 as reflected below (dollars in thousands):

	Three Months Ended June 30,		Amount	Percent
	2017	2016	Change	Change
Service charges and fee income	\$ 492	\$ 652	\$ (160)	(24.5)%

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Earnings on cash surrender value of BOLI	82	85	(3)	(3.5)
Mortgage servicing income	384	208	176	84.6
Fair value adjustment on mortgage servicing rights	(236)	(76)	(160)	210.5
Net gain on sale of loans	261	341	(80)	(23.5)
Total noninterest income	\$ 983	\$ 1,210	\$ (227)	(18.8)%

The primary reasons for the decrease in noninterest income during the three months ended June 30, 2017 compared to the same period last year was the continued decline in the fair value adjustment on mortgage servicing rights and the decline in service charges and fee income. The decreases were partially offset by an increase in mortgage servicing income. The decline in the fair value adjustment on mortgage servicing rights was a result of normal fluctuations in the pricing of this asset based on prepayment speeds and expected cash flows from this asset. The increase in mortgage servicing income was due to higher mortgage interest rates in the second quarter of 2017 as compared to the same period last year. Service charges and fee income decreased primarily due to lower loan fees. Lower gains on the sale of loans were due to fewer loan originations in the second quarter of 2017 as compared to the same period last year.

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Noninterest income decreased \$207,000, or 9.5%, to \$2.0 million for the six months ended June 30, 2017, as compared to \$2.2 million for the six months ended June 30, 2016 as reflected below (dollars in thousands):

	Six Months Ended June 30,		Amount	Percent
	2017	2016	Change	Change
Service charges and fee income	\$ 1,003	\$ 1,245	\$ (242)	(19.4)%
Earnings on cash surrender value of BOLI	163	168	(5)	(3.0)
Mortgage servicing income	637	413	224	54.2