

First Financial Northwest, Inc.
Form 10-K
March 11, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2009 OR

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

Commission File Number: 000-33652

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

Washington
(State or other jurisdiction of incorporation or
organization)

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

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

98057
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$.01 par value per share
(Title of Each Class)

The Nasdaq Stock Market LLC
(Name of Each Exchange on Which
Registered)

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

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

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

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

X NO _____

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

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

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

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

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

The aggregate market value of the Common Stock outstanding held by nonaffiliates of the Registrant based on the closing sales price of the Registrant's Common Stock as quoted on The Nasdaq Stock Market LLC on June 30, 2009 was \$155,876,615 (19,933,071) shares at \$7.82 per share). For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates. As of March 5, 2010, the Registrant had outstanding 18,805,168 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Registrant's Definitive Proxy Statement for the 2010 Annual Meeting of Shareholders (Part III).
-

FIRST FINANCIAL NORTHWEST, INC.
2009 ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

	Page
Forward-Looking Statements	(iii)
Internet Website	(iv)
PART I.	
Item 1. Business	
General	1
Market Area	1
Lending Activities	2
Asset Quality	14
Investment Activities	23
Deposit Activities and Other Sources of Funds	27
Subsidiaries and Other Activities	30
Competition	30
Employees	31
How We Are Regulated	31
Taxation	40
Executive Officers of First Financial Northwest, Inc.	41
Item 1A. Risk Factors	42
Item 1B. Unresolved Staff Comments	52
Item 2. Properties	52
Item 3. Legal Proceedings	52
Item 4. [Reserved]	52
PART II.	
Item 5. Market for Registrants Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	52
Item 6. Selected Financial Data	56
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations	58
Overview	58
Business Strategy	59
Critical Accounting Policies	59
Comparison of Financial Condition at December 31, 2009 and December 31, 2008	61
Comparison of Operating Results for the Years Ended December 31, 2009 and December 31, 2008	63
Comparison of Financial Condition at December 31, 2008 and December 31, 2007	67
Comparison of Operating Results for the Years Ended December 31, 2008 and December 31, 2007	69

Edgar Filing: First Financial Northwest, Inc. - Form 10-K

Average Balances, Interest and Average Yields/Costs	73
Yields Earned and Rates Paid	75
Rate/Volume Analysis	76
Asset and Liability Management and Market Risk	76
Liquidity	79
Capital	80
Commitments and Off-Balance Sheet Arrangements	80
Impact of Inflation	81
Recent Accounting Pronouncements	82
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	82
Item 8. Financial Statements and Supplementary Data	82

(Table of Contents continued on following page)

(i)

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	127
Item 9A. Controls and Procedures	127
Item 9B. Other Information	128
PART III.	
Item 10. Directors, Executive Officers and Corporate Governance	128
Item 11. Executive Compensation	129
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	129
Item 13. Certain Relationships and Related Transactions, and Director Independence	130
Item 14. Principal Accountant Fees and Services	130
PART IV.	
Item 15. Exhibits and Financial Statement Schedules	130
Signatures	131

(ii)

Forward-Looking Statements

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

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

(iii)

As used throughout this report, the terms "we", "our", or "us" refer to First Financial Northwest, Inc. and our consolidated subsidiaries.

Internet Website

We maintain a website with the address www.fsbnw.com. The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own Internet access charges, we make available free of charge through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports, on our investor information page. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission ("SEC"). All of our SEC filings are also available free of charge at the SEC's website at www.sec.gov or by calling the SEC at 1-800-SEC-0330.

(iv)

PART I

Item 1. Business

General

First Financial Northwest, Inc. ("First Financial Northwest"), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest ("First Savings Bank") in connection with the conversion from a mutual holding company structure to a stock holding company structure. The mutual to stock conversion was completed on October 9, 2007 through the sale and issuance of 22,852,800 shares of common stock by First Financial Northwest including 1,692,800 shares contributed to our charitable foundation the First Financial Northwest Foundation, Inc. that was established in connection with the mutual to stock conversion. At December 31, 2009, we had total assets of \$1.3 billion, total deposits of \$939.4 million and total stockholders' equity of \$228.5 million. As part of our various stock buy back programs, a significant amount of shares were repurchased leaving the outstanding shares at December 31, 2009 at 18,823,068. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to First Savings Bank.

First Savings Bank was organized in 1923 as a Washington state chartered savings and loan association, converted to a federal mutual savings and loan association in 1935, and converted to a Washington state chartered mutual savings bank in 1992. In 2002, First Savings Bank reorganized into a two-tier mutual holding company structure, became a stock savings bank and became the wholly-owned subsidiary of First Financial of Renton. In connection with the conversion, First Savings Bank changed its name to "First Savings Bank Northwest."

First Savings Bank is examined and regulated by the Washington State Department of Financial Institutions and by the Federal Deposit Insurance Corporation ("FDIC"). First Savings Bank is required to have certain reserves set by the Board of Governors of the Federal Reserve System and is a member of the Federal Home Loan Bank of Seattle ("FHLB"), which is one of the 12 regional banks in the Federal Home Loan Bank System.

First Savings Bank is a community-based savings bank primarily serving King and, to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington through our full-service banking office located in Renton, Washington. Our current business strategy includes an emphasis on one-to-four family residential mortgage, multifamily and commercial real estate lending. Until recently, we had also included construction/land development lending in our business strategy. We have deemphasized this type of lending over the past two years as a result of market conditions although these types of loans represented 14.7% of our loan portfolio at December 31, 2009. First Savings Bank's business consists of attracting deposits from the public and utilizing these funds to originate one-to-four family, multifamily, construction/land development, commercial real estate, business and consumer loans.

At December 31, 2009, \$496.7 million or 44.5% of our total loan portfolio was comprised of one-to-four family loans; commercial real estate loans were \$289.0 million or 25.9%; construction/land development loans were \$164.0 million or 14.7%; multifamily residential loans were \$146.5 million or 13.1%; and consumer and business loans were \$18.7 million and \$353,000, or 1.7% and 0.03%, respectively. Included in our construction/land development and one-to-four family residential loan portfolios at December 31, 2009, were \$57.1 million and \$75.7 million of total loans, respectively, to our five largest borrowing relationships. In addition, \$71.8 million, net of undisbursed funds, of the construction/land development portfolio were classified as nonperforming.

The principal executive offices of First Savings Bank are located at 201 Wells Avenue South, Renton, Washington, 98057 and its telephone number is (425) 255-4400.

Market Area

We consider our primary market area to be the Puget Sound Region, which consists primarily of King, Pierce, Snohomish and Kitsap counties. The economies of King, Pierce, Kitsap and Snohomish counties have continued to experience economic challenges during 2009. Home prices have continued to experience downward pressure caused by increased foreclosure activity and short sales during the year.

King County has the largest population of any county in the State of Washington, covering approximately 2,134 square miles. It has a population of approximately 1.9 million residents according to the U.S. Census Bureau 2008 estimates, and a median household income of approximately \$84,000 according to the 2009 U.S. Department of Housing and Urban Development estimates. King County has a diversified economic base with many nationally recognized firms including Boeing, Microsoft, Paccar and Amazon. According to the Washington State Employment Security Department, the unemployment rate for King County increased to 8.5% at December 31, 2009 from 5.6% at December 31, 2008 compared to the national average of 10.0%. Residential housing values depreciated in the King County market by 5.6% during the year ended 2009, with a median home price of \$350,000. Residential sales volumes increased by 51.4% in December 2009 as compared to December 2008 as inventory levels are projected to be 5.4 months according to the Northwest Multiple Listing Service.

Pierce County has the second largest population of any county in the State of Washington, covering approximately 1,790 square miles. It has approximately 786,000 residents according to the U.S. Census Bureau 2008 estimates, and a median household income of approximately \$68,000 according to the 2009 U.S. Department of Housing and Urban Development estimates. The Pierce County economy is diversified with the presence of military related government employment (Fort Lewis Army Base and McChord Air Force Base), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). According to the Washington State Employment Security Department the unemployment rate for Pierce County increased to 9.5% in December 2009 from 7.1% in December 2008. Residential housing values depreciated in the Pierce County market by 8.5% during the year ended 2009 with a median home price of \$215,000 according to the Northwest Multiple Listing Service.

Snohomish County has the third largest population of any county in the State of Washington, covering approximately 2,090 square miles. It has approximately 684,000 residents according to the U.S. Census Bureau 2008 estimates, and a median household income of approximately \$84,000 according to the 2009 U.S. Department of Housing and Urban Development estimates. The economy of Snohomish County is diversified with the presence of military related government employment (Everett Homeport Naval Base), aerospace related employment (Boeing) and retail trade. According to the Washington State Employment Security Department, the unemployment rate for Snohomish County increased to 10.3% in December 2009 from 7.0% in December 2008. Residential housing values depreciated in the Snohomish County market by 8.8% during the year ended December 31, 2009 with a median home price of \$280,000. Residential sales volumes increased by 31.4% in 2009 as compared to 2008 as inventory levels are projected to be 5.7 months according to the Northwest Multiple Listing Service.

Kitsap County has the sixth largest population of any county in the state of Washington, covering approximately 566 square miles. It has approximately 240,000 residents according to the U.S. Census Bureau 2008 estimates, and a median household income of approximately \$71,000 according to the 2009 U.S. Department of Housing and Urban Development estimates. The Kitsap County economy is diversified with the presence of military related government employment (Naval Base Kitsap, Puget Sound Naval Shipyard), health care, retail and education. According to the Washington State Employment Security Department, the unemployment rate for Kitsap County increased to 7.6% in December 2009 from 5.9% in December 2008. Residential housing values appreciated in the Kitsap County housing market by 8.3% in 2009 as compared to 2008 with a median home price of \$240,000 according to Northwest Multiple Listing Service.

For a discussion regarding the competition in our primary market area, see "- Competition."

Lending Activities

General. We focus our lending activities primarily on loans secured by first mortgages on one-to-four family residences, commercial and multifamily real estate. In the past, our focus has also included construction/land development lending. Over the past two years we have deemphasized this type of lending as a result of market conditions. We offer a limited variety of consumer secured loans, including savings account loans and home equity

loans, which include lines of credit and second mortgage loans. As of December 31, 2009, our net loan portfolio totaled \$1.0 billion and represented 79.0% of our total assets.

Our loan policy limits the maximum amount of loans we can make to one borrower to 20% of First Savings Bank's risk-based capital. As of December 31, 2009, the maximum amount which we could lend to any one borrower was \$34.9 million based on our policy. Exceptions may be made to this policy with the prior approval of the Executive Committee (comprised of the Chief Executive Officer and two outside Directors) and ratification by the Board of Directors if the borrower exhibits financial strength or compensating factors to sufficiently offset any weaknesses based on the loan-to-value ratio, borrower's financial condition, net worth, credit history, earnings capacity, installment obligations, and current payment habits. The five largest borrowing relationships as of December 31, 2009 in descending order are:

Borrower (1)	Aggregate Amount of Loans at December 31, 2009 (2)	Number of Loans
Real estate builder	\$47.9 million(3)	150
Real estate builder	39.5 million	144
Real estate builder	28.7 million	120
Real estate builder	19.0 million(4)	71