

First Financial Northwest, Inc.
Form 10-Q
May 06, 2016

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

FORM 10-Q

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

For the quarterly period ended March 31, 2016

or

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

For the transition period from _____ to _____

Commission File Number: 001-33652

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

Washington 26-0610707
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

201 Wells Avenue South, Renton, Washington 98057
(Address of principal executive offices) (Zip Code)

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

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

YES NO

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

YES NO

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of May 3, 2016, 13,388,342 shares of the issuer's common stock, \$0.01 par value per share, were outstanding.

FIRST FINANCIAL NORTHWEST, INC.
FORM 10-Q
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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in thousands, except share data)

Part 1. Financial Information

Item 1. Financial Statements

| Assets | March 31, 2016 (Unaudited) | December 31, 2015 |
|--|----------------------------------|----------------------|
| Cash on hand and in banks | \$ 6,552 | \$ 5,713 |
| Interest-earning deposits with banks | 21,706 | 99,998 |
| Investments available-for-sale, at fair value | 135,133 | 129,565 |
| Loans receivable, net of allowance of \$9,471 and \$9,463 | 717,483 | 685,072 |
| Federal Home Loan Bank ("FHLB") stock, at cost | 4,831 | 6,137 |
| Accrued interest receivable | 3,114 | 2,968 |
| Deferred tax assets, net | 3,917 | 4,556 |
| Other real estate owned ("OREO") | 3,405 | 3,663 |
| Premises and equipment, net | 18,166 | 17,707 |
| Bank owned life insurance ("BOLI"), net | 23,474 | 23,309 |
| Prepaid expenses and other assets | 1,462 | 1,225 |
| Total assets | \$ 939,243 | \$ 979,913 |
| Liabilities and Stockholders' Equity | | |
| Deposits: | | |
| Noninterest-bearing deposits | \$ 21,186 | \$ 29,392 |
| Interest-bearing deposits | 647,370 | 646,015 |
| Total deposits | 668,556 | 675,407 |
| Advances from the FHLB | 91,500 | 125,500 |
| Advance payments from borrowers for taxes and insurance | 3,624 | 1,794 |
| Accrued interest payable | 106 | 135 |
| Other liabilities | 6,279 | 6,404 |
| Total liabilities | 770,065 | 809,240 |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Preferred stock, \$0.01 par value; authorized 10,000,000 shares; no shares issued or outstanding | — | — |
| Common stock, \$0.01 par value; authorized 90,000,000 shares; issued and outstanding 13,510,400 shares at March 31, 2016, and 13,768,814 shares at December 31, 2015 | 135 | 138 |
| Additional paid-in capital | 132,564 | 136,338 |
| Retained earnings, substantially restricted | 43,954 | 42,892 |
| Accumulated other comprehensive loss, net of tax | (140) | (1,077) |
| Unearned Employee Stock Ownership Plan ("ESOP") shares | (7,335) | (7,618) |
| Total stockholders' equity | 169,178 | 170,673 |
| Total liabilities and stockholders' equity | \$ 939,243 | \$ 979,913 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Income Statements

(Dollars in thousands, except per share data)

(Unaudited)

| | Three Months Ended March 31, | |
|--|---------------------------------|------------|
| | 2016 | 2015 |
| Interest income | | |
| Loans, including fees | \$8,727 | \$ 8,576 |
| Investments available-for-sale | 675 | 512 |
| Interest-earning deposits | 113 | 64 |
| Dividends on FHLB stock | 47 | 2 |
| Total interest income | 9,562 | 9,154 |
| Interest expense | | |
| Deposits | 1,483 | 1,314 |
| FHLB advances | 298 | 318 |
| Total interest expense | 1,781 | 1,632 |
| Net interest income | 7,781 | 7,522 |
| Recapture of provision for loan losses | (100) | (100) |
| Net interest income after recapture of provision for loan losses | 7,881 | 7,622 |
| Noninterest income | | |
| BOLI income | 165 | 20 |
| Other | 315 | 71 |
| Total noninterest income | 480 | 91 |
| Noninterest expense | | |
| Salaries and employee benefits | 3,774 | 3,414 |
| Occupancy and equipment | 508 | 338 |
| Professional fees | 468 | 354 |
| Data processing | 190 | 160 |
| Gain on sale of OREO property, net | (1) | (529) |
| OREO market value adjustments | 258 | 50 |
| OREO related reimbursements, net | (20) | (48) |
| Regulatory assessments | 120 | 116 |
| Insurance and bond premiums | 88 | 92 |
| Marketing | 36 | 33 |
| Other general and administrative | 352 | 310 |
| Total noninterest expense | 5,773 | 4,290 |
| Income before federal income tax provision | 2,588 | 3,423 |
| Federal income tax provision | 763 | 1,194 |
| Net income | \$1,825 | \$ 2,229 |
| Basic earnings per share | \$0.14 | \$ 0.16 |
| Diluted earnings per share | \$0.14 | \$ 0.16 |
| Weighted average number of common shares outstanding | 12,744,694 | 14,036,959 |
| Weighted average number of diluted shares outstanding | 12,905,527 | 14,199,715 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

| | Three Months Ended March 31, | |
|---|------------------------------------|---------|
| | 2016 | 2015 |
| Net income | \$1,825 | \$2,229 |
| Other comprehensive income, before tax: | | |
| Unrealized holding gains on investments available-for-sale (net of tax provision of \$506 and \$169 for the first quarter of 2016 and 2015, respectively) | 937 | 312 |
| Other comprehensive income, net of tax | 937 | 312 |
| Total comprehensive income | \$2,762 | \$2,541 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity

(Dollars in thousands except share data)

(Unaudited)

| | Shares | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), net of tax | Unearned ESOP Shares | Total Stockholders' Equity |
|--|------------|-----------------|----------------------------------|----------------------|--|----------------------------|----------------------------------|
| Balances at December 31, 2014 | 15,167,381 | \$ 151 | \$ 153,395 | \$ 36,969 | \$ (357) | \$ (8,746) | \$ 181,412 |
| Other comprehensive income | — | — | — | 2,229 | 312 | — | 2,541 |
| Cash dividend declared and paid (\$0.06 per share) | — | — | — | (843) | — | — | (843) |
| Exercise of stock options | 50,000 | 1 | 488 | — | — | — | 489 |
| Repurchase and retirement of common stock | (268,300) | (2) | (3,227) | — | — | — | (3,229) |
| Compensation related to stock options and restricted stock awards | — | — | 109 | — | — | — | 109 |
| Allocation of 28,213 ESOP shares | — | — | 61 | — | — | 282 | 343 |
| Balances at March 31, 2015 | 14,949,081 | \$ 150 | \$ 150,826 | \$ 38,355 | \$ (45) | \$ (8,464) | \$ 180,822 |

| | Shares | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), net of tax | Unearned ESOP Shares | Total Stockholders' Equity |
|---|------------|-----------------|----------------------------------|----------------------|--|----------------------------|----------------------------------|
| Balances at December 31, 2015 | 13,768,814 | \$ 138 | \$ 136,338 | \$ 42,892 | \$ (1,077) | \$ (7,618) | \$ 170,673 |
| Other comprehensive income | — | — | — | 1,825 | 937 | — | 2,762 |
| Cash dividend declared and paid (\$0.06 per share) | — | — | — | (763) | — | — | (763) |
| Exercise of stock options | 55,673 | — | 1,348 | — | — | — | 1,348 |
| Repurchase and retirement of common stock | (314,087) | (3) | (5,310) | — | — | — | (5,313) |
| Compensation related to stock options and restricted stock awards | — | — | 93 | — | — | — | 93 |
| Allocation of 28,213 ESOP shares | — | — | 95 | — | — | 283 | 378 |
| Balances at March 31, 2016 | 13,510,400 | \$ 135 | \$ 132,564 | \$ 43,954 | \$ (140) | \$ (7,335) | \$ 169,178 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

| | Three Months Ended March 31, | |
|---|---------------------------------|----------|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$1,825 | \$2,229 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Recapture of provision for loan losses | (100) | (100) |
| OREO market value adjustments | 258 | 50 |
| Gain on sale of OREO property, net | (1) | (529) |
| Depreciation of premises and equipment | 251 | 182 |
| Amortization of premiums and discounts on investments available-for-sale, net | 250 | 299 |
| Deferred federal income taxes | 133 | 1,120 |
| Allocation of ESOP shares | 378 | 343 |
| Stock compensation expense | 93 | 109 |
| Change in cash surrender value of BOLI | (165) | (20) |
| Changes in operating assets and liabilities: | | |
| Prepaid expenses and other assets | (237) | (4,360) |
| Net increase in advance payments from borrowers for taxes and insurance | 1,830 | 1,368 |
| Accrued interest receivable | (146) | 159 |
| Accrued interest payable | (29) | 9 |
| Other liabilities | (125) | 343 |
| Net cash provided by operating activities | 4,215 | 1,202 |
| Cash flows from investing activities: | | |
| Proceeds from sales of OREO properties | 1 | 4,328 |
| Proceeds from calls and sales of investments available-for-sale | 45 | 50 |
| Principal repayments on investments available-for-sale | 3,864 | 4,292 |
| Purchases of investments available-for-sale | (8,285) | (1,897) |
| Net increase in loans receivable | (32,311) | (4,817) |
| FHLB stock redemption | 1,306 | 73 |
| Purchases of premises and equipment | (709) | (289) |
| Proceeds from sale or disposal of premises and equipment, net | — | — |
| Net cash (used) provided by investing activities | (36,089) | 1,740 |
| Cash flows from financing activities: | | |
| Net increase (decrease) in deposits | (6,851) | 16,877 |
| Repayments of advances from the FHLB | (34,000) | — |
| Proceeds from stock options exercises | 1,348 | 489 |
| Repurchase and retirement of common stock | (5,313) | (3,229) |
| Dividends paid | (763) | (843) |
| Net cash (used) provided by financing activities | (45,579) | 13,294 |

Continued

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2016 | 2015 |
| Net (decrease) increase in cash and cash equivalents | \$(77,453) | \$16,236 |
| Cash and cash equivalents at beginning of quarter | 105,711 | 104,050 |
| Cash and cash equivalents at end of quarter | \$28,258 | \$120,286 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest paid | \$1,810 | \$1,623 |
| Federal income taxes paid | 500 | 76 |
| Noncash items: | | |
| Loans transferred to OREO, net of deferred loan fees and allowance for loan losses | \$— | \$141 |
| Change in unrealized loss on investments available for sale | 1,443 | 481 |

See accompanying selected notes to consolidated financial statements.

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

Note 1 - Description of Business

First Financial Northwest, Inc. ("First Financial Northwest"), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Financial Northwest Bank ("the Bank") in connection with the conversion from a mutual holding company structure to a stock holding company structure completed on October 9, 2007. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Financial Northwest Bank. Accordingly, the information presented in the consolidated financial statements and accompanying data, relates primarily to First Financial Northwest Bank. First Financial Northwest is a bank holding company, having converted from a savings and loan holding company on March 31, 2015, and as a bank holding company is subject to regulation by the Federal Reserve Bank of San Francisco. First Financial Northwest Bank is regulated by the Federal Deposit Insurance Corporation ("FDIC") and the Washington State Department of Financial Institutions ("DFI").

First Financial Northwest Bank is headquartered in Renton, Washington, where its main, full service retail branch is located. In addition, the Bank opened branches located in Mill Creek, Washington on September 1, 2015 and Edmonds, Washington on March 21, 2016. Regulatory approval has been received to open an additional branch at The Landing in Renton, Washington, which is expected to open in the second quarter of 2016. The Bank's primary market area consists of King, Snohomish, Pierce and Kitsap counties, Washington.

The Bank is a portfolio lender, originating one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Loans are primarily funded by deposits from the general public, supplemented by borrowings from the Federal Home Loan Bank of Des Moines ("FHLB") and deposits raised in the national brokered deposit market.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to First Financial Northwest, Inc. and its consolidated subsidiary First Financial Northwest Bank, unless the context otherwise requires.

Note 2 - Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles ("GAAP") for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the unaudited interim consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the three months ended March 31, 2016, are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan and lease losses ("ALLL"), the valuation of other real estate owned ("OREO") and the underlying collateral of impaired loans, deferred tax assets, and the fair value of financial instruments.

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

Certain amounts in the unaudited interim consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation with no effect on consolidated net income or stockholders' equity.

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

Note 3 - Recently Issued Accounting Pronouncements

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-01, Financial Instruments--Overall, Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 requires equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. The amendments in this update also require an entity 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 instrument-specific credit risk. In addition, the ASU eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The ASU also clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early application is permitted for fiscal years or interim periods that have not yet been issued if adopted at the beginning of the fiscal year. The adoption of ASU 2016-01 is not expected to have a material impact 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 ASU is permitted. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. The term novation refers to replacing one counterparty to a derivative instrument with another counterparty. The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has previously been designated as the hedging instrument does not require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. The amendments in ASU 2016-05 are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. An entity has an option to apply the amendments in this ASU on either a prospective basis or a modified retrospective basis. The Company expects to adopt ASU 2016-05 on a prospective basis and the adoption of ASU 2016-05 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments. Topic 815 requires that embedded derivatives be separated from the host contract and accounted for separately as derivatives if certain criteria are met, including the "clearly and closely related" criterion. The amendments in this ASU clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The amendments in this ASU apply to all entities that are issuers of

or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. This ASU applies to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. The ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Adoption of ASU 2016-06 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-09, Compensation--Stock Compensation (Topic 718). This ASU was issued as part of the FASB's Simplification Initiative and addresses accounting for share-based payment transactions, including income tax consequences and classification on the statement of cash flows. Under this ASU, all excess tax benefits and deficiencies should be recognized as income tax expense or benefit in the income statement. The tax effect of vested or exercised awards should be reported separately in the period in which they occur. In the statement of cash flows, excess tax benefits should be classified with other income tax cash flows as an operating activity. Entities have the option of accounting for forfeitures when they occur or to estimate the number of awards that are expected to vest. The amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted in any interim or annual

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

period. First Financial Northwest has adopted ASU 2016-09 with no material impact on the Company's consolidated financial statements.

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

Note 4 - Investments

Investments available-for-sale are summarized as follows at the dates indicated:

| | March 31, 2016 | | | |
|------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (In thousands) | | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | \$50,019 | \$ 778 | \$ (30) | \$50,767 |
| Freddie Mac | 25,065 | 530 | (1) | 25,594 |
| Ginnie Mae | 13,097 | 95 | (84) | 13,108 |
| Municipal bonds | 13,242 | 446 | — | 13,688 |
| U.S. Government agencies | 13,132 | 153 | (23) | 13,262 |
| Corporate bonds | 19,009 | 34 | (329) | 18,714 |
| Total | \$133,564 | \$ 2,036 | \$ (467) | \$135,133 |

| | December 31, 2015 | | | |
|------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (In thousands) | | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | \$50,288 | \$ 260 | \$ (227) | \$50,321 |
| Freddie Mac | 26,011 | 243 | (117) | 26,137 |
| Ginnie Mae | 13,802 | 44 | (114) | 13,732 |
| Municipal bonds | 11,787 | 277 | — | 12,064 |
| U.S. Government agencies | 13,541 | 89 | (88) | 13,542 |
| Corporate bonds | 14,010 | 4 | (245) | 13,769 |
| Total | \$129,439 | \$ 917 | \$ (791) | \$129,565 |

The tables below summarize the aggregate fair value and gross unrealized loss by length of time those investment securities have been continuously in an unrealized loss position at the dates indicated. At both March 31, 2016 and December 31, 2015, we had no municipal bonds in an unrealized loss position.

| | March 31, 2016 | | | | | |
|------------------------------|------------------------|--------------------|------------------------|--------------------|---------------|--------------------|
| | Less Than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| (In thousands) | | | | | | |
| Mortgage-backed investments: | | | | | | |
| Fannie Mae | \$5,964 | \$ (30) | \$— | \$ — | \$5,964 | \$ (30) |
| Freddie Mac | 1,603 | (1) | — | — | 1,603 | (1) |
| Ginnie Mae | 1,011 | (4) | 3,056 | (80) | 4,067 | (84) |
| U.S. Government agencies | 2,234 | (23) | — | — | 2,234 | (23) |
| Corporate bonds | 10,678 | (329) | — | — | 10,678 | (329) |

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Total \$21,490 \$ (387) \$3,056 \$ (80) \$24,546 \$ (467)

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

| | December 31, 2015 | | | | | |
|------------------------------|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
| | Less Than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| | (In thousands) | | | | | |
| Mortgage-backed investments: | | | | | | |
| Fannie Mae | \$37,593 | \$ (227) | \$— | \$ — | \$37,593 | \$ (227) |
| Freddie Mac | 12,115 | (117) | — | — | 12,115 | (117) |
| Ginnie Mae | 5,508 | (29) | 3,233 | (85) | 8,741 | (114) |
| U.S. Government agencies | 9,605 | (88) | — | — | 9,605 | (88) |
| Corporate bonds | 10,263 | (245) | — | — | 10,263 | (245) |
| Total | \$75,084 | \$ (706) | \$3,233 | \$ (85) | \$78,317 | \$ (791) |

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. The Company considers many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be an other-than-temporary impairment ("OTTI") are written down to fair value. If the Company intends to sell a debt security, or it is likely that the Company will be required to sell the debt security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the debt security and it is not likely that it will be required to sell the debt security but does not expect to recover the entire amortized cost basis of the debt security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a debt security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the debt security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ("OCI"). Impairment losses related to all other factors are presented as separate categories within OCI. At March 31, 2016, the Company had 17 securities in an unrealized loss position, of which three have been in an unrealized loss position for 12 months or more. Management reviewed the financial condition of the entities issuing municipal or corporate bonds at March 31, 2016 and December 31, 2015, and determined that an OTTI charge was not warranted.

The amortized cost and estimated fair value of investments available-for-sale at March 31, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments, are shown separately.

| | March 31, 2016 | |
|--|----------------|------------|
| | Amortized Cost | Fair Value |
| | (In thousands) | |
| Due within one year | \$— | \$— |
| Due after one year through five years | 9,791 | 9,814 |
| Due after five years through ten years | 21,059 | 20,981 |
| Due after ten years | 14,533 | 14,869 |

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| | | |
|-----------------------------|-----------|-----------|
| | 45,383 | 45,664 |
| Mortgage-backed investments | 88,181 | 89,469 |
| Total | \$133,564 | \$135,133 |

Under Washington state law, in order to participate in the public funds program the Company is required to pledge eligible securities as collateral in an amount equal to 100% of the public deposits held. Investment securities with market values of \$16.9 million and \$17.4 million were pledged as collateral for public deposits at March 31, 2016 and December 31, 2015, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

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For the three months ended March 31, 2016, and March 31, 2015, we had calls on investment securities of \$45,000, and \$50,000, respectively, with no gains or losses. There were no sales of investment securities during the first quarter of 2016 or 2015.

During the three months ended March 31, 2016, we purchased \$8.3 million of investment securities, consisting of a \$5.0 million variable rate corporate bond, \$1.5 million of fixed rate municipal bonds, and a \$1.8 million fixed rate mortgage backed security. During the three months ended March 31, 2015, we purchased fixed rate investment securities of \$1.9 million consisting of a \$1.6 million mortgage-backed security and a \$280,000 municipal bond.

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Note 5 - Loans Receivable

Loans receivable are summarized as follows at the dates indicated:

| | March 31, December 31, 2016 2015 | |
|---|--|------------|
| | (In thousands) | |
| One-to-four family residential: | | |
| Permanent owner occupied | \$ 147,912 | \$ 147,229 |
| Permanent non-owner occupied | 108,905 | 106,543 |
| | 256,817 | 253,772 |
| Multifamily: | | |
| Permanent | 129,553 | 122,747 |
| Construction ⁽¹⁾ | 21,115 | 21,115 |
| | 150,668 | 143,862 |
| Commercial real estate: | | |
| Permanent | 258,946 | 244,211 |
| Land ⁽²⁾ | 14,700 | 8,290 |
| | 273,646 | 252,501 |
| Construction/land development: | | |
| One-to-four family residential ⁽¹⁾ | 50,770 | 52,233 |
| Multifamily ⁽¹⁾ | 35,436 | 25,551 |
| Land development ⁽²⁾ | 7,513 | 8,768 |
| | 93,719 | 86,552 |
| Business | | |
| Consumer | 6,548 | 7,604 |
| | 5,972 | 6,979 |
| Total loans | 787,370 | 751,270 |
| Less: | | |
| Loans in process ("LIP") | 58,172 | 53,854 |
| Deferred loan fees, net | 2,244 | 2,881 |
| Allowance for loan and lease losses ("ALLL") | 9,471 | 9,463 |
| Loans receivable, net | \$ 717,483 | \$ 685,072 |

⁽¹⁾ Construction/land development excludes construction loans that will convert to permanent loans. The Company considers these loans to be "rollovers" in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying collateral. At March 31, 2016 the Company had \$21.1 million or 14.0% of its total multifamily portfolio in these rollover loans, as compared to \$21.1 million or 14.7% at December 31, 2015. At March 31, 2016, and December 31, 2015, none of the Company's commercial real estate portfolio or one-to-four family residential portfolio included these rollover loans.

⁽²⁾ At March 31, 2016, and December 31, 2015, \$14.7 million and \$8.3 million, respectively, of commercial real estate loans were not included in the construction/land development category because the Company classifies raw land or buildable lots (where we do not intend to finance the construction) as commercial real estate land loans.

ALLL. The Company maintains an ALLL as a reserve against probable and inherent risk of losses in its loan portfolios. The ALLL is comprised of a general reserve component for loans evaluated collectively for loss and a specific reserve component for loans evaluated individually. We continually monitor our loan portfolio for delinquent loans and changes in our borrower's financial condition. When an issue is identified and it is determined that the loan needs to be classified as nonperforming and/or

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impaired, an evaluation of the collateral is performed and, if necessary, an appraisal is ordered in accordance with our appraisal policy guidelines. Based on this evaluation, any additional provision for loan loss or charge-offs is recorded prior to the end of the financial reporting period.

The following tables summarize changes in the ALLL and loan portfolio by loan type and impairment method at the dates and for the periods shown:

| | At or For the Three Months Ended March 31, 2016 | | | | | | |
|---|--|-------------|---------------------------|--------------------------------------|----------|----------|-----------|
| | One-to-Four Family Residential (In thousands) | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| ALLL: | | | | | | | |
| Beginning balance | \$3,028 | \$ 1,298 | \$ 3,542 | \$ 941 | \$ 229 | \$ 425 | \$9,463 |
| Charge-offs | — | — | — | — | — | (19 |) (19 |
| Recoveries | 22 | — | 104 | — | — | 1 | 127 |
| Provision (recapture) | (210 |) 75 | 73 | 40 | (32 |) (46 |) (100 |
| Ending balance | \$2,840 | \$ 1,373 | \$ 3,719 | \$ 981 | \$ 197 | \$ 361 | \$9,471 |
| ALLL by category: | | | | | | | |
| General reserve | \$2,389 | \$ 1,373 | \$ 3,549 | \$ 981 | \$ 197 | \$ 323 | \$8,812 |
| Specific reserve | 451 | — | 170 | — | — | 38 | 659 |
| Loans: ⁽¹⁾ | | | | | | | |
| Total loans | \$256,817 | \$ 141,235 | \$ 273,646 | \$ 44,980 | \$ 6,548 | \$ 5,972 | \$729,198 |
| Loans with general valuation allowance ⁽²⁾ | 223,549 | 139,648 | 268,682 | 44,980 | 6,548 | 5,785 | 689,192 |
| Loans with specific reserves ⁽³⁾ | 33,268 | 1,587 | 4,964 | — | — | 187 | 40,006 |

(1) Net of LIP.

(2) Loans collectively evaluated for general reserves.

(3) Loans individually evaluated for specific reserves.

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| | At or For the Three Months Ended March 31, 2015 | | | | | | |
|---|---|-------------|---------------------------|--------------------------------------|----------|----------|----------|
| | One-to-Four Family Residential (In thousands) | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| ALLL: | | | | | | | |
| Beginning balance | \$3,694 | \$ 1,646 | \$ 4,597 | \$ 355 | \$ 47 | \$ 152 | \$10,491 |
| Charge-offs | (25) | (281) | — | — | — | (34) | (340) |
| Recoveries | 173 | — | — | — | 3 | 281 | 457 |
| Provision (recapture) | (154) | (342) | 38 | 386 | 4 | (32) | (100) |
| Ending balance | \$3,688 | \$ 1,023 | \$ 4,635 | \$ 741 | \$ 54 | \$ 367 | \$10,508 |
| ALLL by category: | | | | | | | |
| General reserve | \$3,027 | \$ 1,002 | \$ 4,242 | \$ 741 | \$ 54 | \$ 323 | \$9,389 |
| Specific reserve | 661 | 21 | 393 | — | — | 44 | 1,119 |
| Loans: ⁽¹⁾ | | | | | | | |
| Total loans | 265,822 | 121,715 | 249,398 | 32,868 | 5,313 | 6,716 | 681,832 |
| Loans with general valuation allowance ⁽²⁾ | 224,385 | 117,869 | 240,732 | 32,868 | 5,313 | 6,520 | 627,687 |
| Loans with specific reserves ⁽³⁾ | 41,437 | 3,846 | 8,666 | — | — | 196 | 54,145 |

(1) Net of LIP.

(2) Loans collectively evaluated for general reserves.

(3) Loans individually evaluated for specific reserves.

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Past Due Loans. Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At March 31, 2016, total past due loans comprised 0.19% of total loans receivable, net of LIP, as compared to 0.18% at December 31, 2015. The following tables represent a summary of the aging of loans by type at the dates indicated:

| | Loans Past Due as of March 31, 2016 | | | Total Past Due | Current | Total ⁽¹⁾ ₍₂₎ |
|---------------------------------|--|---------------|------------------------------|----------------------|-----------|--|
| | 30-59 Days | 60-89 Days | 90 Days and Greater | | | |
| (In thousands) | | | | | | |
| Real estate: | | | | | | |
| One-to-four family residential: | | | | | | |
| Owner occupied | \$481 | \$331 | \$475 | \$1,287 | \$146,625 | \$147,912 |
| Non-owner occupied | — | — | — | — | 108,905 | 108,905 |
| Multifamily | — | — | — | — | 141,235 | 141,235 |
| Commercial real estate | — | — | — | — | 273,646 | 273,646 |
| Construction/land development | — | — | — | — | 44,980 | 44,980 |
| Total real estate | 481 | 331 | 475 | 1,287 | 715,391 | 716,678 |
| Business | — | — | — | — | 6,548 | 6,548 |
| Consumer | 53 | 69 | — | 122 | 5,850 | 5,972 |
| Total loans | \$534 | \$400 | \$475 | \$1,409 | \$727,789 | \$729,198 |

(1) There were no loans 90 days and greater past due and still accruing interest at March 31, 2016.

(2) Net of LIP.

| | Loans Past Due as of December 31, 2015 | | | Total Past Due | Current | Total ⁽¹⁾ ₍₂₎ |
|---------------------------------|---|---------------|------------------------------|----------------------|-----------|--|
| | 30-59 Days | 60-89 Days | 90 Days and Greater | | | |
| (In thousands) | | | | | | |
| Real estate: | | | | | | |
| One-to-four family residential: | | | | | | |
| Owner occupied | \$678 | \$483 | \$— | \$1,161 | \$146,068 | \$147,229 |
| Non-owner occupied | — | — | — | — | 106,543 | 106,543 |
| Multifamily | — | — | — | — | 133,388 | 133,388 |
| Commercial real estate | — | — | — | — | 252,501 | 252,501 |
| Construction/land development | — | — | — | — | 43,172 | 43,172 |
| Total real estate | 678 | 483 | — | 1,161 | 681,672 | 682,833 |
| Business | — | — | — | — | 7,604 | 7,604 |
| Consumer | — | 78 | 19 | 97 | 6,882 | 6,979 |

Total loans \$678 \$561 \$ 19 \$1,258 \$696,158 \$697,416

- (1) There were no loans 90 days and greater past due and still accruing interest at December 31, 2015.
- (2) Net of LIP.

Nonaccrual Loans. Loans are placed on nonaccrual when they are 90 days delinquent or when, in management's opinion, the borrower is unable to meet scheduled payment obligations.

In order to return a nonaccrual loan to accrual status, the Company evaluates the borrower's financial condition to ensure that future loan payments are reasonably assured. The Company also takes into consideration the borrower's willingness and ability

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to make the loan payments, as well as historical repayment performance. The Company requires the borrower to make loan payments consistently for a period of at least six months as agreed to under the terms of the loan agreement before the Company will consider reclassifying the loan to accrual status.

The following table is a summary of nonaccrual loans by loan type at the dates indicated:

| | March 31, 2016 | December 31, 2015 |
|--------------------------------|----------------------|----------------------|
| | (In thousands) | |
| One-to-four family residential | \$985 | \$ 996 |
| Consumer | 69 | 89 |
| Total nonaccrual loans | \$1,054 | \$ 1,085 |

During the three months ended March 31, 2016, interest income that would have been recognized had these nonaccrual loans been performing in accordance with their original terms was \$14,000. For the three months ended March 31, 2015, foregone interest on nonaccrual loans was \$26,000.

The following tables summarize the loan portfolio by type and payment status at the dates indicated:

| | March 31, 2016 | | | | | | |
|------------------------------|--------------------------------------|-------------|-----------------------------|--|----------|----------|----------------------|
| | One-to-Four Family Residential | Multifamily | Commercial / Real Estate | Construction / Land Development | Business | Consumer | Total ⁽¹⁾ |
| | (In thousands) | | | | | | |
| Performing ⁽²⁾ | \$255,832 | \$ 141,235 | \$ 273,646 | \$ 44,980 | \$ 6,548 | \$ 5,903 | \$728,144 |
| Nonperforming ⁽³⁾ | 985 | — | — | — | — | 69 | 1,054 |
| Total loans | \$256,817 | \$ 141,235 | \$ 273,646 | \$ 44,980 | \$ 6,548 | \$ 5,972 | \$729,198 |

⁽¹⁾ Net of LIP.

⁽²⁾ There were \$146.9 million of owner-occupied one-to-four family residential loans and \$108.9 million of non-owner occupied one-to-four family residential loans classified as performing.

⁽³⁾ There were \$985,000 of owner-occupied one-to-four family residential loans and no non-owner occupied one-to-four family residential loans classified as nonperforming.

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| | December 31, 2015 | | | | | | |
|------------------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------------------|
| | One-to-Four Family Residential (In thousands) | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total ⁽¹⁾ |
| Performing ⁽²⁾ | \$252,776 | \$133,388 | \$252,501 | \$43,172 | \$7,604 | \$6,890 | \$696,331 |
| Nonperforming ⁽³⁾ | 996 | — | — | — | — | 89 | 1,085 |
| Total loans | \$253,772 | \$133,388 | \$252,501 | \$43,172 | \$7,604 | \$6,979 | \$697,416 |

⁽¹⁾ Net of LIP.

⁽²⁾ There were \$146.2 million of owner-occupied one-to-four family residential loans and \$106.5 million of non-owner occupied one-to-four family residential loans classified as performing.

⁽³⁾ There were \$996,000 of owner-occupied one-to-four family residential loans and no non-owner occupied one-to-four family residential loans classified as nonperforming.

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 original loan document. When identifying loans as impaired, management takes 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 by management on a case-by-case basis after taking into consideration the circumstances surrounding the loan and the borrower, including payment history and the amounts of any payment shortfall, length and reason for delay and the likelihood of a return to stable performance. Impairment is measured on a loan-by-loan basis for all loans in the portfolio. We obtain annual updated appraisals for impaired collateral dependent loans that exceed \$1.0 million.

There were no funds committed to be advanced in connection with impaired loans at either March 31, 2016, or December 31, 2015.

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The following tables present a summary of loans individually evaluated for impairment by loan type at the dates indicated:

| | March 31, 2016 | | |
|----------------------------------|----------------------------|---------------------------------|-------------------|
| | Recorded Investment (1) | Unpaid Principal Balance (2) | Related Allowance |
| (In thousands) | | | |
| Loans with no related allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | \$2,575 | \$ 2,856 | \$ — |
| Non-owner occupied | 22,930 | 22,948 | — |
| Multifamily | 1,587 | 1,587 | — |
| Commercial real estate | 2,257 | 2,335 | — |
| Consumer | 112 | 164 | — |
| Total | 29,461 | 29,890 | — |
| Loans with an allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 2,111 | 2,181 | 76 |
| Non-owner occupied | 5,652 | 5,704 | 375 |
| Commercial real estate | 2,707 | 2,707 | 170 |
| Consumer | 75 | 75 | 38 |
| Total | 10,545 | 10,667 | 659 |
| Total impaired loans: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 4,686 | 5,037 | 76 |
| Non-owner occupied | 28,582 | 28,652 | 375 |
| Multifamily | 1,587 | 1,587 | — |
| Commercial real estate | 4,964 | 5,042 | 170 |
| Consumer | 187 | 239 | 38 |
| Total | \$40,006 | \$ 40,557 | \$ 659 |

(1) Represents the loan balance less charge-offs.

(2) Contractual loan principal balance.

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| | December 31, 2015 | | |
|----------------------------------|----------------------------|---------------------------------|-------------------|
| | Recorded Investment (1) | Unpaid Principal Balance (2) | Related Allowance |
| | (In thousands) | | |
| Loans with no related allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | \$3,169 | \$ 3,441 | \$ — |
| Non-owner occupied | 23,285 | 23,310 | — |
| Multifamily | 415 | 414 | — |
| Commercial real estate | 2,675 | 2,857 | — |
| Consumer | 132 | 183 | — |
| Total | 29,676 | 30,205 | — |
| Loans with an allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 2,120 | 2,189 | 85 |
| Non-owner occupied | 7,521 | 7,573 | 427 |
| Multifamily | 1,180 | 1,180 | 3 |
| Commercial real estate | 2,716 | 2,717 | 178 |
| Consumer | 76 | 76 | 39 |
| Total | 13,613 | 13,735 | 732 |
| Total impaired loans: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 5,289 | 5,630 | 85 |
| Non-owner occupied | 30,806 | 30,883 | 427 |
| Multifamily | 1,595 | 1,594 | 3 |
| Commercial real estate | 5,391 | 5,574 | 178 |
| Consumer | 208 | 259 | 39 |
| Total | \$43,289 | \$ 43,940 | \$ 732 |

(1) Represents the loan balance less charge-offs.

(2) Contractual loan principal balance.

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The following table presents the average recorded investment in loans individually evaluated for impairment and the interest income recognized for the three months ended March 31, 2016 and 2015:

| | Three Months Ended March 31, 2016 | | Three Months Ended March 31, 2015 | |
|----------------------------------|--------------------------------------|------------|--------------------------------------|------------|
| | Average Interest Recorded | | Average Interest Recorded | |
| | Income Recognized | | Income Recognized | |
| | Investment | Recognized | Investment | Recognized |
| | (In thousands) | | | |
| Loans with no related allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | \$2,872 | \$ 60 | \$3,315 | \$ 47 |
| Non-owner occupied | 23,108 | 321 | 28,527 | 430 |
| Multifamily | 1,001 | 27 | 842 | — |
| Commercial real estate | 2,466 | 39 | 4,543 | 70 |
| Consumer | 122 | 2 | 118 | 1 |
| Total | 29,569 | 449 | 37,345 | 548 |
| Loans with an allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 2,116 | 29 | 2,349 | 30 |
| Non-owner occupied | 6,587 | 78 | 8,397 | 119 |
| Multifamily | 590 | — | 2,167 | 33 |
| Commercial real estate | 2,712 | 40 | 4,566 | 58 |
| Consumer | 76 | 1 | 79 | 1 |
| Total | 12,081 | 148 | 17,558 | 241 |
| Total impaired loans: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 4,988 | 89 | 5,664 | 77 |
| Non-owner occupied | 29,695 | 399 | 36,924 | 549 |
| Multifamily | 1,591 | 27 | 3,009 | 33 |
| Commercial real estate | 5,178 | 79 | 9,109 | 128 |
| Consumer | 198 | 3 | 197 | 2 |
| Total | \$41,650 | \$ 597 | \$54,903 | \$ 789 |

Troubled Debt Restructurings. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). In general, the modification or restructuring of a debt is considered a TDR if, for economic or legal reasons related to the borrower's financial difficulties, a concession is granted to the borrower that the Company would not otherwise consider. Once the loan is restructured, a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment are performed to assess the likelihood that all principal and interest payments required under the terms of the modified agreement will be collected in full. A loan that is classified as a

TDR is generally reported as a TDR until the loan is paid in full or otherwise settled, sold, or charged-off.

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The accrual status of a loan may change after it has been classified as a TDR. Management considers the following in determining the accrual status of restructured loans: (1) if the loan was on accrual status prior to the restructuring, the borrower has demonstrated performance under the previous terms, and a credit evaluation shows the borrower's capacity to continue to perform under the restructured terms (both principal and interest payments), the loan will remain on accrual at the time of the restructuring; (2) if the loan was on nonaccrual status before the restructuring, and the Company's credit evaluation shows the borrower's capacity to meet the restructured terms, the loan would remain as nonaccrual for a minimum of six months after restructuring until the borrower has demonstrated a reasonable period of sustained repayment performance, thereby providing reasonable assurance as to the ultimate collection of principal and interest in full under the modified terms.

At March 31, 2016 and December 31, 2015, the TDR portfolio totaled \$39.0 million and \$42.3 million, respectively, of which one loan of \$131,000 was not performing in accordance with the terms of its restructure and was on nonaccrual status.

The following table presents loans that were modified as TDRs within the periods indicated, and their recorded investment both prior to and after the modification:

| | Three Months Ended March 31, 2016 | | Three Months Ended March 31, 2015 | |
|---|---|---|---|---|
| | Pre-Modification Number of Outstanding Recorded Loans | Post-Modification Outstanding Recorded Investment | Pre-Modification Number of Outstanding Recorded Loans | Post-Modification Outstanding Recorded Investment |
| (Dollars in thousands) | | | | |
| One-to-four family residential: | | | | |
| Principal and interest with interest rate concession | 1 | \$ 558 | — | \$ — |
| Advancement of maturity date | — | — | 2 | 248 |
| Commercial real estate: | | | | |
| Interest-only payments with interest rate concession and advancement of maturity date | 1 | 495 | — | — |
| Advancement of maturity date | — | — | 1 | 454 |
| Interest-only payments with advancement of maturity date | — | — | 1 | 2,004 |
| Total | 2 | \$ 1,053 | 4 | \$ 2,706 |

At March 31, 2016, the Company had no commitments to extend additional credit to borrowers whose loan 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 ALLL.

The TDRs that occurred during the three months ended March 31, 2016 and 2015, were the result of granting the borrower interest rate concessions and/or interest-only payments and advancing the maturity date for a period of time ranging from one to three years. The impaired portion of the loan with an interest rate concession and/or interest-only payments for a specific period of time are calculated based on the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate is the rate of return implicit on the original loan. This impaired amount increases the ALLL and is expensed

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to earnings. As loan payments are received in future periods, the impairment is amortized over the life of the concession, reducing ALLL and recapturing provision expense. No loans accounted for as a TDR were charged-off to the ALLL for the three months ended March 31, 2016 and 2015.

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment is charged to the ALLL. For the three months ended March 31, 2016 and 2015, one commercial loan of \$495,000 that had been modified with an interest rate concession and advancement of maturity date within the previous 12 months missed one payment, but was current as of March 31, 2016.

Credit Quality Indicators. The Company utilizes a nine-category risk rating system and assigns a risk rating for all credit exposures. The risk rating system is designed to define the basic characteristics and identify risk elements of each credit extension. Credits risk rated 1 through 5 are considered to be “pass” credits. Pass credits include assets, such as cash secured loans with funds on deposit with the Bank, where there is virtually no credit risk. Pass credits also include credits that are on the Company's watch list, where the borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower's financial capacity and threaten their ability to fulfill debt obligations in the future. Credits classified as special mention are risk rated 6 and possess weaknesses that deserve management's close attention. Special mention assets do not expose the Company to sufficient risk to warrant adverse classification in the substandard, doubtful or loss categories. Substandard credits are risk rated 7. 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 the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful are risk rated 8 and have all the weaknesses inherent in those credits classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss are risk rated 9 and are considered uncollectible and cannot be justified as a viable asset for the Company. There were no loans classified as doubtful or loss at March 31, 2016 and December 31, 2015.

The following tables represent a summary of loans by type and risk category at the dates indicated:

| | March 31, 2016 | | | | | | |
|-----------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------------------|
| | One-to-Four Family Residential (In thousands) | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total ⁽¹⁾ |
| Risk Rating: | | | | | | | |
| Pass | \$250,241 | \$ 141,235 | \$ 269,359 | \$ 44,980 | \$ 6,548 | \$ 5,715 | \$718,078 |
| Special mention | 3,903 | — | 3,791 | — | — | 188 | 7,882 |
| Substandard | 2,673 | — | 496 | — | — | 69 | 3,238 |
| Total loans | \$256,817 | \$ 141,235 | \$ 273,646 | \$ 44,980 | \$ 6,548 | \$ 5,972 | \$729,198 |

(1) Net of LIP.

| | December 31, 2015 | | | | | | |
|--|-----------------------|-------------|---------------------------|-------------------|----------|----------|----------------------|
| | One-to-Four Family | Multifamily | Commercial Real Estate | Construction / | Business | Consumer | Total ⁽¹⁾ |

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| | Residential | | Land Development | | | | |
|-----------------|----------------|------------|---------------------|-----------|----------|----------|-----------|
| | (In thousands) | | | | | | |
| Risk Rating: | | | | | | | |
| Pass | \$247,239 | \$ 133,388 | \$ 248,196 | \$ 43,172 | \$ 7,604 | \$ 6,702 | \$686,301 |
| Special mention | 3,840 | — | 3,809 | — | — | 188 | 7,837 |
| Substandard | 2,693 | — | 496 | — | — | 89 | 3,278 |
| Total loans | \$253,772 | \$ 133,388 | \$ 252,501 | \$ 43,172 | \$ 7,604 | \$ 6,979 | \$697,416 |

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

(1) Net of LIP.

Note 6 - Other Real Estate Owned

OREO includes properties acquired by the Company through foreclosure and deed in lieu of foreclosure. The following table is a summary of OREO activity during the periods shown:

| | Three Months Ended March 31, 2016 2015 (In thousands) | |
|----------------------------------|--|----------|
| Balance at beginning of period | \$3,663 | \$9,283 |
| Loans transferred to OREO | — | 141 |
| Gross proceeds from sale of OREO | (1) | (4,328) |
| Gain on sale of OREO | 1 | 529 |
| Market value adjustments | (258) | (50) |
| Balance at end of period | \$3,405 | \$5,575 |

There were no sales of OREO property during the first quarter of 2016. However, there was a \$1,000 refund of selling costs for an OREO property sold in a previous quarter. Market valuation adjustments were made on two properties based on appraisals or other market data. A contract was entered in to sell one commercial real estate property that supported a write down of \$248,000. OREO at March 31, 2016 consisted of \$3.2 million in commercial real estate properties and \$164,000 in construction and land development projects.

Note 7 - Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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

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

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

Level 1 - Quoted prices for identical instruments in active markets.

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

Level 3 - Instruments whose significant value drivers are unobservable.

The tables below present the balances of assets measured at fair value on a recurring basis (there were no transfers between Level 1, Level 2 and Level 3 recurring measurements) at the dates indicated:

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
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 (Unaudited)

Fair Value Measurements at March 31, 2016

| | Fair Value Measurements for Identical Assets (Level 1) | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|--|--|---|---|
|--|--|--|---|---|

(In thousands)

Investments available-for-sale:

Mortgage-backed investments:

| | | | | | |
|--------------------------|-----------|----|-------------|----|---|
| Fannie Mae | \$50,767 | \$ | —\$ 50,767 | \$ | — |
| Freddie Mac | 25,594 | — | 25,594 | — | |
| Ginnie Mae | 13,108 | — | 13,108 | — | |
| Municipal bonds | 13,688 | — | 13,688 | — | |
| U.S. Government agencies | 13,262 | — | 13,262 | — | |
| Corporate bonds | 18,714 | — | 18,714 | — | |
| Total | \$135,133 | \$ | —\$ 135,133 | \$ | — |

Fair Value Measurements at December 31, 2015

| | Fair Value Measurements for Identical Assets (Level 1) | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--|--|--|---|---|
|--|--|--|---|---|

(In thousands)

Investments available-for-sale:

Mortgage-backed investments:

| | | | | | |
|--------------------------|-----------|----|-------------|----|---|
| Fannie Mae | \$50,321 | \$ | —\$ 50,321 | \$ | — |
| Freddie Mac | 26,137 | — | 26,137 | — | |
| Ginnie Mae | 13,732 | — | 13,732 | — | |
| Municipal bonds | 12,064 | — | 12,064 | — | |
| U.S. Government agencies | 13,542 | — | 13,542 | — | |
| Corporate bonds | 13,769 | — | 13,769 | — | |
| Total | \$129,565 | \$ | —\$ 129,565 | \$ | — |

The estimated fair value of Level 2 investments is based on quoted prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

The tables below present the balances of assets measured at fair value on a nonrecurring basis at March 31, 2016 and December 31, 2015.

Fair Value Measurements at March 31, 2016

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| | Fair Value Measurements for Identical Assets (Level 1) | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|--|--|---|---|
| | (In thousands) | | | |
| Impaired loans (included in loans receivable, net) ⁽¹⁾ | \$39,347 | \$ | —\$ | —\$ 39,347 |
| OREO | 3,405 | — | — | 3,405 |
| Total | \$42,752 | \$ | —\$ | —\$ 42,752 |

⁽¹⁾ Total fair value of impaired loans is net of \$659,000 of specific reserves on performing TDRs.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
 SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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| | Fair Value Measurements at December 31, 2015 | | | |
|---|--|--|---|---|
| | Fair Value Measurements for Identical Assets (Level 1) | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (In thousands) | | | |
| Impaired loans (included in loans receivable, net) ⁽¹⁾ | \$42,557 | \$ — | \$ — | \$ 42,557 |
| OREO | 3,663 | — | — | 3,663 |
| Total | \$46,220 | \$ — | \$ — | \$ 46,220 |

⁽¹⁾ Total fair value of impaired loans is net of \$732,000 of specific reserves on performing TDRs.

The fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. Inputs used in the collateral value method include appraised values, less estimated costs to sell. Some of these inputs may not be observable in the marketplace. Appraised values may be discounted based on management's knowledge of the marketplace, subsequent changes in market conditions, or management's knowledge of the borrower.

OREO properties are measured at the lower of their carrying amount or fair value, less estimated costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at March 31, 2016 and December 31, 2015.

| | March 31, 2016 | | | |
|----------------|------------------------|---------------------|---|--------------------------|
| | Fair Value | Valuation Technique | Unobservable Input(s) | Range (Weighted Average) |
| | (Dollars in thousands) | | | |
| Impaired Loans | \$39,347 | Market approach | Appraised value discounted by market or borrower conditions | 0%-3.1% (0.02%) |
| OREO | \$3,405 | Market approach | Appraised value less selling costs | 0% - 32.9% (7.0%) |
| | December 31, 2015 | | | |
| | Fair Value | Valuation Technique | Unobservable Input(s) | Range (Weighted Average) |
| | (Dollars in thousands) | | | |
| | \$42,557 | Market approach | | 0% - 2.1% |

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| | | | | |
|-------------------|---------|-----------------|--|----------------------|
| Impaired Loans | | | Appraised value discounted by market or borrower conditions | (0.3%) |
| OREO | \$3,663 | Market approach | Appraised value less selling costs | 0% - 13.6% (1.0%) |

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

The carrying amounts and estimated fair values of financial instruments were as follows at the dates indicated:

| March 31, 2016 | | | | | |
|-----------------------------------|----------------|----------|-------------------------|---------|---------|
| | Estimated | | Fair Value Measurements | | |
| | Carrying | Fair | Using: | | |
| | Value | Value | Level 1 | Level 2 | Level 3 |
| | (In thousands) | | | | |
| Financial Assets: | | | | | |
| Cash on hand and in banks | \$6,552 | \$ 6,552 | \$ 6,552 | \$ — | — |
| Interest-earning deposits | 21,706 | 21,706 | 21,706 | — | — |
| Investments available-for-sale | 135,133 | 135,133 | — | 135,133 | — |
| Loans receivable, net | 717,483 | 736,420 | — | — | 736,420 |
| FHLB stock | 4,831 | 4,831 | — | 4,831 | — |
| Accrued interest receivable | 3,114 | 3,114 | — | 3,114 | — |
| Financial Liabilities: | | | | | |
| Deposits | 278,748 | 278,748 | 278,748 | — | — |
| Certificates of deposit, retail | 324,196 | 326,315 | — | 326,315 | — |
| Certificates of deposit, brokered | 65,612 | 66,670 | — | 66,670 | — |
| Advances from the FHLB | 91,500 | 91,830 | — | 91,830 | — |
| Accrued interest payable | 106 | 106 | — | 106 | — |
| December 31, 2015 | | | | | |
| | Estimated | | Fair Value Measurements | | |
| | Carrying | Fair | Using: | | |
| | Value | Value | Level 1 | Level 2 | Level 3 |
| | (In thousands) | | | | |
| Financial Assets: | | | | | |
| Cash on hand and in banks | \$5,713 | \$ 5,713 | \$ 5,713 | \$ — | — |
| Interest-earning deposits | 99,998 | 99,998 | 99,998 | — | — |
| Investments available-for-sale | 129,565 | 129,565 | — | 129,565 | — |
| Loans receivable, net | 685,072 | 693,480 | — | — | 693,480 |
| FHLB stock | 6,137 | 6,137 | — | 6,137 | — |
| Accrued interest receivable | 2,968 | 2,968 | — | 2,968 | — |
| Financial Liabilities: | | | | | |
| Deposits | 285,416 | 285,416 | 285,416 | — | — |
| Certificates of deposit, retail | 323,840 | 324,135 | — | 324,135 | — |
| Certificates of deposit, brokered | 66,151 | 66,947 | — | 66,947 | — |
| Advances from the FHLB | 125,500 | 125,466 | — | 125,466 | — |
| Accrued interest payable | 135 | 135 | — | 135 | — |

Fair value estimates, methods, and assumptions are set forth below for the Company's financial instruments:

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Financial instruments with book value equal to fair value: The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value. These instruments include cash on hand and in banks, interest-earning deposits, FHLB stock, accrued interest receivable, accrued interest payable, and investment transactions payable. FHLB stock is not publicly-traded, however it may be

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redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold, subject to the FHLB's discretion. The fair value is therefore equal to the book value.

Investments available-for-sale: The fair value of all investments, excluding FHLB stock, was based upon quoted market prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

Loans receivable: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans is estimated using discounted cash flow analysis, utilizing interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of current market conditions, cash flow estimates have been further discounted to include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

Liabilities: The fair value of deposits with no stated maturity, such as statement savings, NOW and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using current interest rates for certificates of deposit with similar remaining maturities. The fair value of FHLB advances is estimated based on discounting the future cash flows using current interest rates for debt with similar remaining maturities.

Off balance sheet commitments: No fair value adjustment is necessary for commitments made to extend credit, which represents commitments for loan originations or for outstanding commitments to purchase loans. These commitments are at variable rates, are for loans with terms of less than one year and have interest rates which approximate prevailing market rates, or are set at the time of loan closing.

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

Note 8 - Stock-Based Compensation

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

For the three months ended March 31, 2016 and 2015, total compensation expense for the Plan was \$93,000 and \$109,000, respectively, and the related income tax benefit was \$32,000 and \$38,000, respectively.

Stock Options

The Plan authorizes the grant of stock options totaling 2,285,280 shares to Company directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of First Financial Northwest's common stock at the grant date. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Any unexercised stock options will expire ten years after the grant date or sooner in the event of the award recipient's death, disability or termination of service with the Company or the Bank. First Financial Northwest has a policy of issuing new shares from authorized but unissued common stock upon the exercise of stock options. At March 31, 2016, remaining options for

611,756 shares of common stock were available for grant under the Plan.

The fair value of each option award is estimated on the grant date using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The historical volatility of the Company's stock price over a specified period of time is used for the expected volatility assumption. First Financial Northwest bases the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. First Financial Northwest elected to use the "Share-Based Payments" method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at the midpoint.

A summary of the Company's stock option plan awards and activity for the three months ended March 31, 2016, follows:

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

| | For the Three Months Ended March 31, 2016 | | | Aggregate Intrinsic Value |
|--|---|------------------------------------|---|---------------------------------|
| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term in Years | |
| Outstanding at January 1, 2016 | 884,260 | \$ 10.11 | | |
| Exercised | (137,940) | 9.78 | | |
| Forfeited or expired | (20,000) | 12.05 | | |
| Outstanding at March 31, 2016 | 726,320 | 10.12 | 5.03 | 2,227,725 |
| Vested and expecting to vest assuming a 3% forfeiture rate over the vesting term | 719,060 | 10.11 | 5.00 | 2,211,308 |
| Exercisable at March 31, 2016 | 484,320 | 9.70 | 3.49 | 1,680,485 |

As of March 31, 2016, there was \$789,455 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.37 years. There were no stock options granted during the three months ended March 31, 2016.

Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards amounting to 914,112 shares to directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the grant date. The restricted stock awards' fair value is equal to the stock price on the grant date. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date. At March 31, 2016, remaining restricted stock awards for 74,478 shares were available to be awarded. Shares that have been awarded but have not yet vested are held in a reserve account until they are vested.

A summary of changes in nonvested restricted stock awards for the three months ended March 31, 2016, follows:

| | For the Three Months Ended March 31, 2016 | |
|--|--|--|
| | Shares | Weighted-Average Grant Date Fair Value |
| Nonvested at January 1, 2016 | 47,800 | \$ 8.95 |
| Granted | — | |
| Vested | — | |
| Nonvested at March 31, 2016 | 47,800 | 8.95 |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 46,366 | |

As of March 31, 2016, there was \$312,970 of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.81 years.

Note 9 - Federal Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
 SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws, and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At March 31, 2016, it was determined that the full deferred tax asset would be realized in future periods and no valuation allowance was required.

Our effective tax rate for the first three months of 2016 was 29.5% partially as a result of permanent tax exclusions of the noninterest income from BOLI and an additional tax benefit as a result of the exercise of certain stock options. Estimated compensation expense is accrued to the deferred tax asset over the vesting period of the options. When these options were exercised, the actual stock price for our common stock was higher than previously estimated, resulting in an increase to actual compensation expense above the amount previously accrued and recognition of a tax benefit.

The Company has prepared federal tax returns through December 31, 2015, at which time the Company has an alternative minimum tax credit carryforward totaling \$1.4 million which has no expiration date.

Note 10 - Earnings Per Share

Per the provisions of FASB ASC 260, Earnings Per Share, nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of EPS pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. ESOP shares are considered outstanding for basic and diluted earnings per share when the shares are committed to be released. Certain of the Company's nonvested restricted stock awards qualify as participating securities.

Net income is allocated between the common stock and participating securities pursuant to the two-class method, based on their rights to receive dividends, participate in earnings, or absorb losses. Basic earnings per common shares is computed by dividing net earnings available to common shareholders by the weighted-average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the periods indicated:

| | Three Months Ended March 31, | |
|------------|---|----------|
| | 2016 | 2015 |
| | (Dollars in thousands, except share data) | |
| Net income | \$1,825 | \$ 2,229 |
| | (6 |) (11 |

| | | |
|--|------------|------------|
| Less: Earnings allocated to participating securities | | |
| Earnings allocated to common shareholders | \$ 1,819 | \$ 2,218 |
| Basic weighted average common shares outstanding | 12,744,694 | 14,036,959 |
| Dilutive stock options | 144,521 | 139,817 |
| Dilutive restricted stock grants | 16,312 | 22,939 |
| Diluted weighted average common shares outstanding | 12,905,527 | 14,199,715 |
| Basic earnings per share | \$0.14 | \$ 0.16 |
| Diluted earnings per share | \$0.14 | \$ 0.16 |

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
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Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended March 31, 2016, options to purchase an additional 60,000 shares of common stock were not included in the computation of diluted earnings per share because the incremental shares under the treasury stock method of calculation resulted in them being anti-dilutive. For the three months ended March 31, 2015, options to purchase an additional 225,000 were excluded as their effect would be anti-dilutive.

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

Forward-Looking Statements

Certain matters discussed in this Quarterly Report on Form 10-Q 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 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: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, that may be affected by deterioration in the housing and commercial real estate markets, and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve Bank of San Francisco and our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks (“DFI”) or other regulatory authorities, including the possibility that any such regulatory authority may initiate an enforcement action against the Company or the Bank which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements or restrictions on us, any of which could adversely affect our liquidity and earnings; our ability to pay dividends on our common stock; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining the 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 implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within

expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; 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, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") and the implementing regulations; 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 filings with the U.S. Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2015 ("2015 Form 10-K"). Any of the forward-looking statements that we make in this

Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

Overview

First Financial Northwest Bank ("the Bank") is a wholly-owned subsidiary of First Financial Northwest, Inc. ("the Company") and, as such, comprises substantially all of the activity for First Financial Northwest. First Financial Northwest Bank was a community-based savings bank until February 4, 2016, when the Bank converted to a Washington chartered commercial bank reflecting the commercial banking services it now provides to its customers. Our full-service banking office in Renton, Washington serves primarily King County, and also Pierce, Snohomish and Kitsap counties. Additional branches opened in Mill Creek, Washington in September 2015 and Edmonds, Washington in March 2016. Further expanding our market presence in King County, the Bank has received regulatory approval to open a fourth location at The Landing, in Renton, Washington, which is expected to open in the second quarter of 2016. Improved technology from the conversion to a new core data processor in August 2015 allows the Bank to better meet the needs of our customers as we seek to broaden the demographics of our customer base.

First Financial Northwest Bank's business consists predominantly of attracting deposits from the general public, combined with borrowing from the Federal Home Loan Bank of Des Moines ("FHLB") and raising funds in the wholesale market, then utilizing these funds to originate one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Our current business strategy emphasizes commercial real estate, construction, one-to-four family residential, and multifamily lending. Recently, improvements in the economy, employment rates, stronger real estate prices, and a general lack of new housing inventory in certain areas in the Puget Sound region have led to our significantly increasing originations of construction loans for properties located in our market area. We anticipate that construction lending will continue to be a strong element of our total loan portfolio in future periods. We will continue to take a disciplined approach in our construction and land development lending by concentrating our efforts on smaller one-to-four residential loans to builders known to us. On a limited basis, we also will provide multifamily loans to developers with proven success in this type of construction. In addition, we are geographically expanding our loan portfolio through loan purchases or loan participations of commercial and multifamily real estate loans that are outside of our primary market area.

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

An offset to net interest income is the provision for loan losses which is required to establish the allowance for loan and lease losses ("ALLL") at a level that adequately provides for probable losses inherent in our loan portfolio. As a loan's risk rating improves, property values increase, or recoveries of amounts previously charged off are received, the overall ALLL may decline and a recapture of previously recognized provision for loan losses may be added to net interest income.

Noninterest income is generated from various loan or deposit fees, increases in the cash surrender value of bank owned life insurance ("BOLI"), and commissions earned on our investment services brokerage relationship. This income is increased or partially offset by net gain or loss on sales of investment securities.

Our noninterest expenses consist primarily of salaries and employee benefits, OREO-related expenses, professional fees, regulatory assessments, occupancy and equipment, and other general and administrative expenses. Salaries and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement, and other employee benefits. OREO-related expenses consist primarily of maintenance and costs of utilities for the OREO inventory, market valuation adjustments, build-out expenses, gains and losses from OREO sales, legal fees, real estate taxes, and insurance related to the properties included in the OREO inventory. Professional fees include legal services, auditing and accounting services, computer support services, and other professional services in support of strategic plans. Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of real estate taxes, depreciation expenses, maintenance, and costs of utilities.

Critical Accounting Policies

Our significant accounting policies are fundamental to understanding our results of operations and financial condition because they require that we use estimates and assumptions that may affect the value of our assets or liabilities and our financial

results. These policies are critical because they require management to make difficult, subjective, and complex judgments about matters that are inherently uncertain and because it is likely that materially different amounts would be reported under different conditions or by using different assumptions. These policies govern the ALLL, the valuation of OREO, and the calculation of deferred taxes, fair values, and other-than-temporary impairments on the market value of investments. These policies and estimates are described in further detail in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies with the 2015 Form 10-K. There have not been any material changes in the Company's critical accounting policies and estimates as compared to the disclosure contained in the 2015 Form 10-K.

Comparison of Financial Condition at March 31, 2016 and December 31, 2015

Total assets were \$939.2 million at March 31, 2016, a decrease of 4.2%, from \$979.9 million at December 31, 2015. The following table details the \$40.7 million net change in the composition of our assets at March 31, 2016 from December 31, 2015.

| | Balance at March 31, 2016 | Change from December 31, 2015 | Percent Change |
|---|---------------------------------|--|-------------------|
| (Dollars in thousands) | | | |
| Cash on hand and in banks | \$6,552 | \$839 | 14.7 % |
| Interest-earning deposits | 21,706 | (78,292) | (78.3) |
| Investments available-for-sale, at fair value | 135,133 | 5,568 | 4.3 |
| Loans receivable, net | 717,483 | 32,411 | 4.7 |
| Premises and equipment, net | 18,166 | 459 | 2.6 |
| FHLB stock, at cost | 4,831 | (1,306) | (21.3) |
| Accrued interest receivable | 3,114 | 146 | 4.9 |
| Deferred tax assets, net | 3,917 | (639) | (14.0) |
| OREO | 3,405 | (258) | (7.0) |
| BOLI, net | 23,474 | 165 | 0.7 |
| Prepaid expenses and other assets | 1,462 | 237 | 19.3 |
| Total assets | \$939,243 | \$(40,670) | (4.2)% |

Interest-earning deposits. Our interest-earning deposits, consisting primarily of funds held at the Federal Reserve Bank of San Francisco, decreased \$78.3 million, or 78.3%, at March 31, 2016, as compared to December 31, 2015. During the first quarter of 2016, cash was reduced by the payoff of a \$34.0 million FHLB advance at maturity. In addition, we transferred our cash from lower rate interest-earning deposits to higher yielding assets by using \$32.3 million to increase loans receivable and \$4.4 million to increase our investment securities.

Investments available-for-sale. Our investments available-for-sale portfolio increased by \$5.6 million during the first three months of 2016. To enhance interest income, we purchased one variable rate corporate bond, three fixed rate municipal bonds and one fixed rate mortgage-backed security with a combined yield of 4.62%. We did not sell any securities during the first quarter of 2016, however, we received partial calls on three securities for a total of \$45,000. At March 31, 2016, corporate bonds issued by financial institutions represented 13.8% of our investments available-for-sale and municipal bonds represented 10.1% of our investments available-for-sale. These purchases were part of our investment portfolio restructuring strategy to transition our investment portfolio to securities with longer maturity periods, higher yields, and primarily fixed rates in order to enhance our interest income.

In addition to the purchase and call activity, we received principal repayments of \$3.9 million on our investments available-for-sale. The net unrealized gain of our investments available-for-sale had a pre-tax increase of \$1.4 million during the three months ended March 31, 2016.

The effective duration of the investments available-for-sale at March 31, 2016, was 3.0% as compared to 3.2% at December 31, 2015. Effective duration is a measure that attempts to quantify the anticipated percentage change in the value of an investment security (or portfolio) in the event of a 100 basis point change in market yields. Since the Bank's portfolio includes securities with embedded options (including call options on bonds and prepayment options on mortgage-backed securities),

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management believes that effective duration is an appropriate metric to use as a tool when analyzing the Bank's investment securities portfolio, as effective duration incorporates assumptions relating to such embedded options, including changes in cash flow assumptions as interest rates change.

Loans receivable. Net loans receivable increased \$32.4 million during the first quarter of 2016. Late in the quarter, we supplemented our loan originations by purchasing a pool of \$30.0 million of performing commercial real estate and multifamily loans from another financial institution. The loans were purchased at a 2% premium of \$588,000 and are intended to be held to maturity. The purchase consisted of eight loans ranging in size from \$1.3 million to \$8.2 million secured by properties in Washington, Oregon, Utah, Colorado and Arizona. Partially as a result of this purchase, during the first quarter of 2016, multifamily loans increased by \$6.8 million and commercial real estate loans increased by \$21.1 million. In addition, one-to-four family residential loans increased \$3.0 million and construction loans increased \$7.2 million, while business and consumer loans decreased by \$1.1 million and \$1.0 million, respectively, during the first quarter of 2016. The Company plans to continue to purchase loan pools, secured by properties outside of its primary market area, to augment its loan originations.

The majority of our loan portfolio continues to be focused in our primary market area, however we are also seeking geographic diversification of our loan portfolio. The pool of loans purchased during the first quarter is distributed throughout the West Coast. In addition, we are pursuing opportunities for loan participations outside our primary market area that meet our investment and credit quality objectives. During the first quarter of 2016, we hired an employee in the state of California whose focus will be both directly originating new commercial and multifamily real estate loans as well as analyzing loan participation and loan purchase opportunities in the San Francisco Bay area.

At March 31, 2016, we had \$58.2 million in committed but undisbursed funds for construction loans, a \$4.3 million increase from December 31, 2015. Our construction and land loans consist primarily of \$50.8 million in one-to-four family residential construction loans and \$35.4 million of multifamily real estate loans. We also have \$21.1 million in "rollover" multifamily construction loans included in our multifamily loan portfolio.

Our five largest borrowing relationships, which represent 10.4% of our net loans, had a small increase of \$23,000 from December 31, 2015 to March 31, 2016. At March 31, 2016 all five borrowers were current on their loan payments. We monitor the performance of these borrowing relationships very closely due to their concentration risk in relation to the entire loan portfolio. The following table details our five largest lending relationships at March 31, 2016:

| Borrower ⁽¹⁾ | Number of Loans | One-to-Four | | Commercial Real Estate | Construction/Land Development | Consumer | Aggregate Balance of Loans ⁽³⁾ |
|-------------------------|-----------------|-----------------------------------|-------------|------------------------|-------------------------------|----------|---|
| | | Family Residential ⁽²⁾ | Multifamily | | | | |
| (Dollars in thousands) | | | | | | | |
| Real estate investor | 4 | \$500 | \$ — | \$ 18,263 | \$ — | \$ — | \$ 18,763 |
| Real estate investor | 5 | 476 | — | 15,079 | — | 48 | 15,603 |
| Real estate investor | 2 | — | — | 14,411 | — | — | 14,411 |
| Real estate investor | 3 | — | 2,021 | 11,832 | — | — | 13,853 |
| Real estate builder | 57 | 13,184 | — | — | 327 | — | 13,511 |
| Total | 71 | \$14,160 | \$ 2,021 | \$ 59,585 | \$ 327 | \$ 48 | \$ 76,141 |

(1) The composition of borrowers represented in the table may change between periods.

(2) One-to-four family residential includes \$1.0 million of owner occupied and \$13.1 million of non-owner occupied.

(3) Net of LIP.

The ALLL remained stable at \$9.5 million at March 31, 2016 and December 31, 2015 and represented 1.3% and 1.4% of total loans receivable at March 31, 2016 and December 31, 2015, respectively. We believe that the ALLL at March 31, 2016 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will be proven correct in the future, that the actual amount of future losses will not exceed the amount of past provisions, or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. Future additions to the allowance may become necessary based upon changing economic conditions, the level of problem loans, business conditions, credit concentrations, increased loan balances, or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of our ALLL is subject to review by bank regulators as part

of the routine examination process, which may result in the establishment of additional loss reserves or the charge-off of specific loans against established loss reserves based upon their judgment of information available to them at the time of their examination.

As we work with our borrowers that face difficult financial circumstances, we explore various options available to minimize our risk of loss. At times, the best option for our customers and the Bank is to modify the loan for a period of time, usually one year or less. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). These modifications have included a reduction in interest rate on the loan for a period of time, advancing the maturity date of the loan, or allowing interest-only payments for a specific time frame. These modifications are granted only when there is a reasonable and attainable restructured loan plan that has been agreed to by the borrower and is considered to be in the Bank's best interest.

The following table presents a breakdown of our TDRs at the dates indicated:

| | March 31, 2016 | December 31, 2015 | March 31, 2015 | Three Month Change | One Year Change |
|---------------------------------|-------------------|----------------------|-------------------|--------------------------|--------------------|
| (In thousands) | | | | | |
| Nonperforming TDRs: | | | | | |
| One-to-four family residential | \$ 131 | \$ 131 | \$— | \$— | \$ 131 |
| Total nonperforming TDRs | 131 | 131 | — | — | 131 |
| Performing TDRs: | | | | | |
| One-to-four family residential | 32,284 | 35,099 | 40,943 | (2,815) | (8,659) |
| Multifamily | 1,587 | 1,594 | 2,163 | (7) | (576) |
| Commercial real estate | 4,964 | 5,392 | 8,241 | (428) | (3,277) |
| Consumer | 43 | 43 | 43 | — | — |
| Total performing TDRs | 38,878 | 42,128 | 51,390 | (3,250) | (12,512) |
| Total TDRs | \$39,009 | \$ 42,259 | \$51,390 | \$(3,250) | \$(12,381) |
| % TDRs classified as performing | 99.7 | %99.7 | % 100.0 | % | % |

Our TDRs decreased \$3.3 million at March 31, 2016 compared to December 31, 2015 as a result of principal repayments and loan payoffs. There were no new TDRs added during the quarter. At March 31, 2016, one TDR was not performing according to its restructured payment terms. There were no committed but undisbursed funds in connection with our restructured and impaired loans. The largest TDR relationship at March 31, 2016, totaled \$10.6 million and was comprised of \$9.8 million in one-to-four family residential rental properties and \$766,000 in owner occupied commercial property, all located in King County.

Nonperforming assets decreased to \$4.5 million at March 31, 2016, compared to \$4.7 million at December 31, 2015. The following table presents detailed information on our nonperforming assets at the dates indicated:

| | March 31 2016 | December 31, 2015 | March 31, 2015 | Three Month Change | One Year Change |
|--------------------------------|------------------|----------------------|-------------------|--------------------------|-----------------------|
| (In thousands) | | | | | |
| Nonperforming loans: | | | | | |
| One-to-four family residential | \$985 | \$ 996 | \$494 | \$(11) | \$491 |
| Multifamily | — | — | 1,683 | — | (1,683) |
| Commercial real estate | — | — | 425 | — | (425) |
| Consumer | 69 | 89 | 74 | (20) | (5) |
| Total nonperforming loans | 1,054 | 1,085 | 2,676 | (31) | (1,622) |

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| | | | | | |
|---|---------|----------|---------|----------|-----------|
| OREO | 3,405 | 3,663 | 5,575 | (258) | (2,170) |
| Total nonperforming assets ⁽¹⁾ | \$4,459 | \$ 4,748 | \$8,251 | \$(289) | \$(3,792) |

| | | | | | |
|---|------|-------|--------|---|--|
| Nonperforming assets as a percent of total assets | 0.47 | %0.48 | % 0.86 | % | |
|---|------|-------|--------|---|--|

⁽¹⁾ The difference between nonperforming assets reported above, and the totals reported by other industry sources, is due to their inclusion of all TDRs as nonperforming loans, although 99.7% of our TDRs were performing in accordance with their restructured terms at March 31, 2016. The remaining 0.3% of TDRs at March 31, 2016 that were nonperforming are reported above as nonperforming loans.

Nonaccrual loans are loans that are 90 days or more delinquent or other loans which, in management's opinion, the borrower is unable to meet scheduled payment obligations. Nonaccrual loans remained stable at \$1.1 million at March 31, 2016, and December 31, 2015. During the first quarter of 2016, one loan of \$23,000 was transferred to nonaccrual status and was offset by \$54,000 in principal payments and payoffs of nonaccrual loans received during this period.

The three largest nonaccrual loans in the loan portfolio at March 31, 2016, included a \$328,000 owner occupied single family residence in Snohomish County, a \$169,000 owner occupied single family residence in King County, and a \$161,000 owner occupied single family residence in King County.

We continue to focus our efforts on converting nonaccrual loans to OREO and subsequently selling the properties. By taking ownership of these properties, we can generally convert nonearning assets into earning assets on a more timely basis than which may otherwise be the case. Our success in this area is reflected by the continued improved ratio of our nonperforming assets as a percent of total assets, which declined to 0.47% at March 31, 2016, compared to 0.48% at December 31, 2015.

OREO. OREO includes properties acquired by the Bank through foreclosure or deed in lieu of foreclosure. At March 31, 2016, OREO was \$3.4 million, a decrease of \$258,000 from \$3.7 million at December 31, 2015. The decrease in OREO during the first three months of 2016 is a result of market valuation adjustments on two properties. At the end of the first quarter of 2016, the Bank entered into a sales contract on a commercial property in Kitsap County and subsequently adjusted the carrying value of this property to the negotiated contract price, less estimated selling costs.

The three largest OREO properties at March 31, 2016 were an office and retail building valued at \$837,000 located in Pierce County, a multi-tenant retail building valued at \$728,000 located in Pierce County, and an office and retail building valued at \$687,000 in Mason County.

The following table presents a breakdown of our OREO by county and number of properties at March 31, 2016:

| | County | | | Total OREO | Number of Properties | Percent Total OREO |
|---------------------------------------|---------|--------|--------|------------|----------------------|--------------------|
| | Pierce | Kitsap | Mason | | | |
| (Dollars in thousands) | | | | | | |
| OREO: | | | | | | |
| Commercial real estate ⁽¹⁾ | \$2,212 | \$ 506 | \$ 687 | \$3,405 | 7 | 100.0% |
| Total OREO | \$2,212 | \$ 506 | \$ 687 | \$3,405 | 7 | 100.0% |

⁽¹⁾ Of the seven properties classified as commercial real estate, three are office/retail buildings, one is developed lots and three are undeveloped lots.

Deposits. During the first three months of 2016, deposits decreased \$6.9 million to \$668.6 million at March 31, 2016, compared to \$675.4 million at December 31, 2015. Deposit accounts consisted of the following:

| | Change | | Percent Change |
|------------------------|----------------|------------------------|----------------|
| | March 31, 2016 | from December 31, 2015 | |
| (Dollars in thousands) | | | |
| Noninterest-bearing | \$21,186 | \$ (8,206) | (27.9)% |

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| | | | |
|-----------------------------------|-----------|-------------|--------|
| NOW | 19,569 | 3,308 | 20.3 |
| Statement savings | 30,167 | 1,840 | 6.5 |
| Money market | 207,826 | (3,610) | (1.7) |
| Certificates of deposit, retail | 324,196 | 356 | 0.1 |
| Certificates of deposit, brokered | 65,612 | (539) | (0.8) |
| | \$668,556 | \$ (6,851) | (1.0) |

During the first quarter of 2016, noninterest-bearing checking accounts decreased by \$8.2 million and money market accounts decreased by \$3.6 million as construction customers withdrew funds in support of their projects. These money market

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accounts include short-term deposits from large construction developers that are part of the EB-5 Immigrant Investor Program to fund development projects. Withdrawals are expected to occur over the next 15 months.

Brokered certificates of deposits decreased by \$539,000 as we redeemed \$14.6 million of certificates, replacing them with \$14.1 of brokered certificates of deposit at lower rates and with the same maturity periods as the called certificates. These redemptions will have a favorable impact in future periods by decreasing future interest expense on these deposits. While brokered certificates of deposit may carry a higher cost than our retail certificates, their maturity periods of four to six years, along with the enhanced call features of these deposits, assist us in our efforts to manage interest rate risk.

At March 31, 2016 and December 31, 2015, we held \$16.1 million and \$16.0 million, respectively, in public funds, nearly all of which were retail certificates of deposit.

Advances. We use advances from the FHLB as an alternative funding source, to reduce interest rate risk, and to leverage our balance sheet. Total FHLB advances at March 31, 2016 and December 31, 2015 were \$91.5 million and \$125.5 million, respectively. On March 26, 2016, we paid off a \$34.0 million advance with a 0.81% interest rate at its scheduled maturity date, using excess cash on hand. Of the remaining FHLB advances, \$50.0 million is due to mature within one year, with the remaining \$41.5 million due in one to five years.

Stockholders' Equity. Total stockholders' equity decreased \$1.5 million during the first three months of 2016 to \$169.2 million at March 31, 2016, from \$170.7 million at December 31, 2015, primarily due to common stock repurchases. Retained earnings increased \$1.1 million during the first three months of 2016 due to \$1.8 million of net income offset by \$763,000 of shareholder dividends paid at \$0.06 per share.

The following table shows cash dividends paid per share and the related dividend payout ratio for the periods indicated:

| | Three Months Ended March 31, | |
|--------------------------------------|---------------------------------|--------|
| | 2016 | 2015 |
| Dividend declared per common share | \$0.06 | \$0.06 |
| Dividend payout ratio ⁽¹⁾ | 42.0 % | 37.5 % |

(1) Dividends paid per common share divided by basic earnings per common share

As part of the strategy to increase shareholder value, the Company has been repurchasing shares. In October 2015, the Company's board of directors authorized the purchase of an additional 1,410,000 shares of the Company's common stock, or 10% of the shares outstanding. In 2015, 364,054 shares were repurchased under this plan at an average price of \$12.61 per share. From January 1, 2016 through March 31, 2016, 314,087 additional shares were repurchased at an average price of \$13.36. As of April 27, 2016, the expiration date of this plan, a total of 800,199 shares were repurchased under this plan at an average price of \$13.02.

Additional paid-in-capital decreased \$3.8 million during the three months ended March 31, 2016 as a combined result of \$5.3 million used to repurchase the 314,087 shares, partially offset by a \$1.3 million increase from the exercise of stock options. Accumulated other comprehensive loss decreased \$937,000 as a result of improvements in the after-tax valuation adjustments on investments available-for-sale.

Comparison of Operating Results for the Three Months Ended March 31, 2016 and 2015

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General. Net income for the three months ended March 31, 2016 was \$1.8 million, or \$0.14 per diluted share as compared to net income of \$2.2 million, or \$0.16 per diluted share for the quarter ended March 31, 2015. The \$404,000 decline in net income during the first quarter of 2016 was primarily a result of an increase in noninterest expense of \$1.5 million, partially offset by a \$259,000 increase in net interest income, \$389,000 increase in noninterest income and \$431,000 decrease in federal income tax expense.

Net Interest Income. Net interest income for the quarter ended March 31, 2016 increased \$259,000 to \$7.8 million, as compared to \$7.5 million for the first quarter in 2015 due primarily to an increase in interest income due to an increase in the average balances of interest-earning assets and higher yielding investments.

The following table details the change in net interest income due to changes in yield or cost, or changes in the average balance of the related asset or liability:

| | Three Months Ended March 31, 2016 Compared to March 31, 2015 Net Change | | |
|---|---|--------|--------|
| | Rate | Volume | Total |
| | (In thousands) | | |
| Interest-earning assets: | | | |
| Loan receivable, net | \$(95) | \$ 246 | \$ 151 |
| Investments available-for-sale | 119 | 44 | 163 |
| Interest-earning deposits | 58 | (9) | 49 |
| FHLB stock | 45 | — | 45 |
| Total net change in income on interest-earning assets | 127 | 281 | 408 |
| Interest-bearing liabilities: | | | |
| Statement savings | 1 | 1 | 2 |
| Money market | 44 | 53 | 97 |
| Certificates of deposit, retail | 79 | (72) | 7 |
| Certificates of deposit, brokered | 49 | 14 | 63 |
| Advances from the FHLB | 10 | (30) | (20) |
| Total net change in expense on interest-bearing liabilities | 183 | (34) | 149 |
| Total net change in net interest income | \$(56) | \$ 315 | \$ 259 |

Loan interest income increased \$151,000 during the first quarter of 2016 as compared to the same period in 2015 as a result of a \$19.2 million increase in the average outstanding loan balance partially offset by a decrease in yield of six basis points. The addition of \$30.0 million in purchased loans late in the quarter contributed to the increase in the average loan balance.

During the first quarter of 2016, interest income from our investments available-for-sale increased by \$163,000 as compared to the same period in 2015. The average balance of our investments available-for-sale for the three months ended March 31, 2016, increased by \$10.3 million as compared to the same period last year as we reduced interest-earning deposits to fund purchases of higher yielding investment securities. During 2015 and the first quarter of 2016, we restructured our investments available-for-sale portfolio through the sale of lower yielding investments, utilizing the proceeds received to purchase higher yielding, long-term investment securities, resulting in an increase in the average yield of 37 basis points.

The Federal Reserve's rate increase in December 2015 positively impacted both the rate paid on our interest-earning deposits and dividend received on our FHLB stock. The average rate earned on interest-earning deposits increased 27

basis points

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for the quarter ended March 31, 2016, as compared to the same period last year. The merger of the FHLB Seattle with the FHLB Des Moines in the second quarter of 2015 also resulted in a significant increase in dividends received on the stock we are required to hold at the FHLB. FHLB dividends increased to \$47,000 for the first quarter of 2016 compared to \$2,000 for the first quarter of 2015.

Partially offsetting the increase in interest income, interest expense increased by \$149,000 for the three months ended March 31, 2016 as compared to the same period in 2015. Our average balance and average cost of money market accounts increased \$66.7 million and nine basis points, respectively, for the three months ended March 31, 2016 as compared to the same period last year resulting in an additional \$97,000 of interest expense during the three months ended March 31, 2016. Further contributing to the increase, our redemption of \$14.6 million of brokered certificates of deposit during the first quarter of 2016 resulted in amortizing the remaining \$68,000 of prepaid interest into interest expense, which is reflected in the 30 basis point increase in the average cost of these deposits. The lower cost of the \$14.1 million of replacement brokered certificates will be realized in future quarters. In addition, the average balance of brokered certificates of deposit increased by \$3.1 million in the first quarter of 2016 as compared to the first quarter of 2015. Partially offsetting these increases in interest expense, the reduction in our average balance of FHLB advances of \$12.6 million reduced the interest paid on these funds.

The following table compares detailed average balances, related interest income or interest expense, associated yields and rates, and the resulting net interest margin for the three months ended March 31, 2016 and 2015. Nonaccrual loans are included in the average balance of net loans receivable and are considered to carry a zero yield.

| | Three Months Ended March 31, | | | | | |
|---|------------------------------|------------------------|--------------|-----------------|------------------------|--------------|
| | 2016 | | | 2015 | | |
| | Average Balance | Interest Earned / Paid | Yield / Cost | Average Balance | Interest Earned / Paid | Yield / Cost |
| (Dollars in thousands) | | | | | | |
| Assets | | | | | | |
| Loans receivable, net | \$687,102 | \$8,727 | 5.15% | \$667,949 | \$8,576 | 5.21% |
| Investments available-for-sale | 130,332 | 675 | 2.10 | 120,029 | 512 | 1.73 |
| Interest-earning deposits | 88,383 | 113 | 0.52 | 103,370 | 64 | 0.25 |
| FHLB stock | 6,034 | 47 | 3.16 | 6,726 | 2 | 0.12 |
| Total interest-earning assets | 911,851 | 9,562 | 4.25 | 898,074 | 9,154 | 4.13 |
| Noninterest earning assets | 58,580 | | | 47,395 | | |
| Total average assets | \$970,431 | | | \$945,469 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| NOW | \$16,988 | \$4 | 0.10% | \$18,534 | \$4 | 0.09% |
| Statement savings | 27,018 | 11 | 0.17 | 24,997 | 9 | 0.15 |
| Money market | 211,197 | 212 | 0.41 | 144,541 | 115 | 0.32 |
| Certificates of deposit, retail | 323,659 | 906 | 1.14 | 351,762 | 899 | 1.04 |
| Certificates of deposit, brokered | 65,420 | 350 | 2.17 | 62,340 | 287 | 1.87 |
| Advances from the FHLB | 122,884 | 298 | 0.98 | 135,500 | 318 | 0.95 |
| Total interest-bearing liabilities | 767,166 | 1,781 | 0.94 | 737,674 | 1,632 | 0.90 |
| Noninterest bearing liabilities | 32,814 | | | 24,969 | | |
| Average equity | 170,451 | | | 182,826 | | |
| Total average liabilities and equity | \$970,431 | | | \$945,469 | | |
| Net interest income | | \$7,781 | | | \$7,522 | |
| Net interest margin | | | 3.46% | | | 3.40% |

Provision for Loan Losses. Management recognizes that loan losses may occur over the life of a loan and that the ALLL must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio.

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Our methodology for analyzing the ALLL consists of two components: general and specific reserves. The general reserve is determined by applying factors to our various groups of loans. Management considers factors such as charge-off history, the prevailing economy, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, managements' experience level, our loan review and grading systems, the value of underlying collateral and the level of problem loans in assessing the ALLL. The specific reserve component is created when management believes that the collectability of a specific loan has been impaired and a loss is probable. The specific reserves are computed using current appraisals, listed sales prices, and other available information, less costs to complete, if any, and costs to sell the property. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or if future events differ from current estimates.

During the quarter ended March 31, 2016, management evaluated the adequacy of the ALLL and concluded that a recapture of prior period provisions for loan loss in the amount of \$100,000 was appropriate for the quarter. The quarter ended March 31, 2015 also resulted in a \$100,000 recapture of the provision for loan losses. For the first quarter of 2016, the recapture was primarily a result of improved grades in our loan portfolio partially offset by an increase in the balance of our loans receivable. In comparison, the recapture reported in the first quarter of 2015 was primarily a result of reductions in borrowers' concessions, the upgrade of the risk rating on one commercial real estate loan, loan payoffs, and net recoveries during the quarter, partially offset by portfolio growth.

The following table summarizes selected financial data related to our ALLL and loan portfolio. All loan balances and ratios are calculated using loan balances that are net of LIP.

| | At or For the Three Months Ended March 31, 2016 2015 (Dollars in thousands) | |
|--|--|-----------|
| Total loans receivable, net of LIP, end of period | \$729,198 | \$668,714 |
| Average loans receivable during period | 687,102 | 667,949 |
| ALLL balance at beginning of period | 9,463 | 10,491 |
| Recapture of provision for loan losses | (100) | (100) |
| Charge-offs: | | |
| One-to-four family | — | (25) |
| Multifamily | — | (281) |
| Consumer | (19) | (34) |
| Total charge-offs | (19) | (340) |
| Recoveries: | | |
| One-to-four family | 22 | 173 |
| Commercial real estate | 104 | — |
| Business | — | 3 |
| Consumer | 1 | 281 |
| Total recoveries | 127 | 457 |
| Net recovery | 108 | 117 |
| ALLL balance at end of period | \$9,471 | \$10,508 |
| ALLL as a percent of total loans, net of LIP | 1.30 | % 1.54 % |
| Ratio of net recoveries to average net loans receivable (annualized) | 0.06 | 0.07 |

Noninterest Income. Noninterest income increased \$389,000 to \$480,000 for the quarter ended March 31, 2016, from \$91,000 for the same quarter in 2015. The following table provides a detailed analysis of the changes in the components of noninterest income:

| | Three Months Ended March 31, 2016 | Change from March 31, 2015 | Percent Change |
|-------------------------------------|--|--|-------------------|
| | (Dollars in thousands) | | |
| Service fees on deposit accounts | \$56 | \$ 12 | 27.3 % |
| Loan service fees | 48 | 30 | 166.7 |
| BOLI change in cash surrender value | 165 | 145 | 725.0 |
| Other | 211 | 202 | 2,244.4 |
| Total noninterest income | \$480 | \$ 389 | 427.5 |

The increase in the quarter ended March 31, 2016, compared to the quarter ended March 31, 2015, primarily related to an increase in other income from our wealth management services as a result of \$210,000 of investment sales commissions generated by referred accounts with a wealth management advisor through First Financial Wealth Services. This new relationship, which began in May 2015, allows us to offer a broader range of wealth management solutions to appropriately meet the needs of our customers.

In addition, we added \$20.0 million in new BOLI policies in April 2015, bringing our BOLI policy total to \$23.5 million as of March 31, 2016. We recognize the increase in cash surrender value of these policies as noninterest income, which assists in offsetting expenses for employee benefits. For the first quarter of 2016, noninterest income of \$165,000 was recognized on these policies as compared to \$20,000 in the first quarter of 2015.

Noninterest Expense. Noninterest expense increased \$1.5 million to \$5.8 million for the first quarter of 2016 from \$4.3 million for the comparable quarter in 2015.

The following table provides a detailed analysis of the changes in the components of noninterest expense:

| | Three Months Ended March 31, 2016 | Change from March 31, 2015 | Percent Change |
|--|--|--|-------------------|
| | (Dollars in thousands) | | |
| Salaries and employee benefits | \$3,774 | \$360 | 10.5 % |
| Occupancy and equipment | 508 | 170 | 50.3 |
| Professional fees | 468 | 114 | 32.2 |
| Data processing | 190 | 30 | 18.8 |
| (Gain) Loss on sales of OREO property, net | (1 |) 528 | (99.8) |
| OREO market value adjustments | 258 | 208 | 416.0 |
| OREO related expenses, net | (20 |) 28 | (58.3) |
| Regulatory assessments | 120 | 4 | 3.4 |
| Insurance and bond premiums | 88 | (4 |) (4.3) |
| Marketing | 36 | 3 | 9.1 |
| Other general and administrative | 352 | 42 | 13.5 |
| Total noninterest expense | \$5,773 | \$1,483 | 34.6 % |

Expenses for salaries and employee benefits increased \$360,000 for the first quarter of 2016 as compared to the same period in 2015 primarily as a result of increases in salaries and in the number of employees. In support of our new

branches and development of new products, the number of employees increased by 15 from March 31, 2015 to 115 total employees at March 31, 2016. In addition, annual increases were effective in the first quarter of 2016.

Gain on the sale of OREO property decreased by \$528,000 in the first quarter of 2016 compared to the first quarter of 2015. During this period in 2015, the sale of two OREO properties for \$3.8 million generated a \$529,000 gain. During the first quarter of 2016, there were no sales of OREO properties, however there was a \$1,000 gain recorded as a result of a refund of selling costs received on a past OREO sale.

OREO market value adjustments increased by \$208,000, primarily as a result of one property that is currently under contract for sale. A \$249,000 market value adjustment was made in the quarter ended March 31, 2016 to reflect the current market value of the property using the negotiated contract sales price. The sale is expected to close in the second quarter of 2016.

Occupancy and equipment expense increased by \$170,000 primarily as a result of the addition of lease expense related to the recent opening of new offices in Edmonds and Mill Creek, and the pending opening of the third new branch location at The Landing, in Renton, Washington.

Federal Income Tax Expense. Our statutory income tax rate is 35%. We recorded federal income tax provisions of \$763,000 and \$1.2 million for the quarters ended March 31, 2016, and 2015, respectively, as a result of our consolidated pretax net income. Our effective tax rate for the quarter ended March 31, 2016 decreased to 29% as a result of the exercise of stock options and the corresponding true-up of estimated compensation expense.

Liquidity

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

Our primary sources of funds are customer deposits, cash flow from the loan and investment portfolios, advances from the FHLB, and to a lesser extent, brokered certificates of deposit. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. At March 31, 2016, retail certificates of deposit scheduled to mature in one year or less totaled \$145.4 million. Management's practice is to maintain deposit rates at levels that are competitive with other local financial institutions. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions and competition. We measure our liquidity based on our ability to fund our assets and to meet liability obligations when they come due. Liquidity (and funding) risk occurs when funds cannot be raised at reasonable prices or in a reasonable time frame to meet our normal or unanticipated obligations. We regularly monitor the mix between our assets and our liabilities to manage effectively our liquidity and funding requirements.

When deposits are not readily available and/or cost effective to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB, wholesale funding, brokered deposits, federal funds purchased and dealer repurchase agreements, as well as other short-term alternatives. These funding sources are generally collateral dependent. We may also liquidate assets to meet our funding needs. At March 31, 2016, the balance of our investments available-for-sale was \$135.1 million and represents a ready source of cash if needed. While the balance of our interest-earning deposits decreased by \$78.3 million from December 31, 2015 to March 31, 2016, \$34.0 million of this decrease was the result of the payoff of a maturing FHLB advance, which directly increased our borrowing capacity with the FHLB. At March 31, 2016, the Bank maintained credit facilities with the FHLB totaling \$341.6 million with an outstanding balance of \$91.5 million. At March 31, 2016, we also had available a total of \$35.0 million credit facilities with other financial institutions, with no balance outstanding. For additional information, see the Consolidated Statements of Cash Flows in Item 1 of this Form 10-Q.

To assist in our funds acquisition and interest rate risk management efforts, management utilizes the national brokered deposit market and maintained a balance at March 31, 2016 of \$65.6 million of brokered certificates of deposit. In contrast to most retail certificate of deposit offerings which provide the depositor with an option to withdraw their funds prior to maturity, subject to an early withdrawal penalty, certificates of deposit acquired in the brokered market limits the depositor ability to withdraw the funds before the end of the term (except in the case of death or adjudication of incompetence of a depositor) which greatly reduces early redemption risk associated with retail deposits. This strategy may include, but is not necessarily limited to, raising longer term deposits (with terms greater than three years) that assist the Bank in its interest rate risk management efforts. At March 31, 2016, brokered certificates of deposit had a remaining weighted-average maturity of 3.4 years. These certificates also provide the

Bank the option to redeem the deposit after six months, a favorable distinction compared to retail certificate of deposit terms that are offered in our local market. With these redemption limitations and call features, the cost of these brokered deposits is generally higher than our retail certificate of deposit offerings. Consequently, as we increase our brokered deposits, our cost of funds may increase.

First Financial Northwest is a separate legal entity from the Bank and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. First Financial Northwest's primary sources of funds consist of dividends from the Bank, although there are regulatory restrictions on the ability of the Bank to pay dividends. At March 31, 2016, the Company (on an unconsolidated basis) had liquid assets of \$47.8 million and short-term liabilities of \$178,000.

On a monthly basis, we estimate our liquidity sources and needs for the next six months. Also, we determine funding concentrations and our need for sources of funds other than deposits. This information is used by our Asset/Liability Management

As of March 31, 2016, the Bank and consolidated Company exceeded all regulatory capital requirements and the Bank was considered "well capitalized" under regulatory capital guidelines of the FDIC. The following table provides our capital requirements and actual results.

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| | At March 31, 2016 | | | | | |
|---|------------------------|--------|---------------------------|-------|-----------------------------------|-------|
| | Actual | | For Minimum | | To be | |
| | | | Capital Adequacy Purposes | | Categorized as "Well Capitalized" | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (dollars in thousands) | | | | | |
| Tier I leverage capital (to average assets) | | | | | | |
| Bank only | \$113,965 | 11.81% | \$38,615 | 4.00% | \$48,268 | 5.00% |
| Consolidated | 168,693 | 17.41 | 38,749 | 4.00 | 48,437 | 5.00 |
| Common equity tier I ("CET1") (to risk-weighted assets) | | | | | | |
| Bank only | 113,965 | 15.55 | 32,979 | 4.50 | 47,636 | 6.50 |
| Consolidated | 168,693 | 22.90 | 33,152 | 4.50 | 47,886 | 6.50 |
| Tier I risk-based capital (to risk-weighted assets) | | | | | | |
| Bank only | 113,965 | 15.55 | 43,972 | 6.00 | 58,629 | 8.00 |
| Consolidated | 168,693 | 22.90 | 44,203 | 6.00 | 58,937 | 8.00 |
| Total risk-based capital (to risk-weighted assets) | | | | | | |
| Bank only | 123,137 | 16.80 | 58,629 | 8.00 | 73,286 | 10.00 |
| Consolidated | 177,915 | 24.15 | 58,937 | 8.00 | 73,672 | 10.00 |

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement is to be phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

General. Our Board of Directors has approved an asset/liability management policy to guide management in maximizing net interest income by managing the differences in terms between interest-earning assets and interest-bearing liabilities while maintaining acceptable levels of liquidity, capital adequacy, interest rate sensitivity, credit risk, and profitability. The policy established an ALCO, comprised of certain members of senior management and the Board of Directors. The Committee's purpose is to manage, coordinate, and communicate our asset/liability position consistent with our business plan and Board-approved policy. The ALCO meets quarterly to review various areas including:

- economic conditions;
- interest rate outlook;
- asset/liability mix;
- interest rate risk sensitivity;
- current market opportunities to promote specific products;
- historical financial results;
- projected financial results; and
- capital position.

Additionally, the Committee reviews current and projected liquidity needs. As part of its procedures, the ALCO regularly reviews our interest rate risk by modeling the impact that changes in interest rates may have on earnings, particularly net interest income. The market value of portfolio equity, which is the net present value of an institution's existing assets less its liabilities and off-balance sheet instruments, is also modeled under several scenarios of

changing interest rates. In both cases, results are evaluated and compared with the maximum potential change that is authorized by the Board of Directors.

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Our Risk When Interest Rates Change. The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Our loans generally have longer maturities than our deposits. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

We have utilized the following strategies in our efforts to manage interest rate risk:

- we have attempted, where possible, to extend the maturities of our deposits which typically fund our long-term assets;
- we have invested in securities with relatively short average lives, generally less than eight years;
- we have added adjustable-rate securities to our investment portfolio; and
- we have added fixed-rate, longer-term securities to mitigate risks in a declining rate environment.

Brokered Deposits. During the third quarter of 2014, management added the national brokered deposit market as an additional source of funds and to assist efforts in managing interest rate risk. Utilizing brokered deposits might result in increased regulatory scrutiny, as such deposits are not viewed as favorably as core retail deposits and there can be no assurance that the Bank will be allowed to include brokered deposits in its deposit mix in the future. While management will attempt to weigh the benefits of brokered deposits against the costs and risks, there can be no assurance that its conclusions will necessarily be aligned with those of the Bank's regulators.

How We Measure the Risk of Interest Rate Changes. We monitor our interest rate sensitivity on a quarterly basis to measure the change in net interest income in varying rate environments. Management uses various assumptions to evaluate the sensitivity of our operations to changes in interest rates. Although management believes these assumptions are reasonable, the interest rate sensitivity of our assets and liabilities on net interest income and the market value of portfolio equity could vary substantially if different assumptions were used or actual experience differs from these assumptions. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react differently to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities lag behind changes in market interest rates. Non-uniform changes and fluctuations in market interest rates across various maturities will also affect the results presented. In addition, certain assets, such as adjustable-rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. A portion of our adjustable-rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately 35.6% of our total loans were adjustable-rate loans at March 31, 2016. At that date, \$111.6 million, or 42.9% of these loans were at their floor, with a weighted-average interest rate of 4.3%. The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates. However, when loans are at their floors, there is a risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates. Furthermore, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate from those assumed. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. We consider all these factors in monitoring our interest rate exposure.

The assumptions we use are based upon a combination of proprietary and market data that reflect historical results and current market conditions. These assumptions relate to interest rates, loan prepayments, deposit decay rates and the market value of certain assets under the various interest rate scenarios. We use market data to determine prepayments and maturities of loans, investments and borrowings and use our own assumptions on deposit decay rates. The exception to this is time deposits, which are modeled to reprice to market rates upon their stated maturities. We also assume that non-maturity deposits can be maintained with rate adjustments not directly proportionate to the change in market interest rates, based upon our historical deposit decay rates which are substantially lower than market decay

rates. We have demonstrated in the past that the tiering structure of our deposit accounts during changing rate environments results in relatively lower volatility and less than market rate changes in our interest expense for deposits. We tier our deposit accounts by balance and rate, whereby higher balances within an account earn higher rates of interest. Therefore, deposits that are not very rate sensitive (generally, lower balance tiers) are separated from deposits that are rate sensitive (generally, higher balance tiers). When interest rates rise, we do not have to raise interest rates proportionately on less rate sensitive accounts to retain these deposits. These assumptions are based upon our analysis of our customer base, competitive factors and historical experience.

Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, instantaneously increase by 100, 200 and 300 basis points or decline immediately by 100 basis points. Reductions of rates by 200 and 300 basis points were not reported due to the current low rate environment.

The following table illustrates the change in our net interest income at March 31, 2016 that would occur in the event of an instantaneous change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

Net Interest Income Change at March 31, 2016

| Basis Point Change in Rates | Net Interest Income | % Change |
|-----------------------------|---------------------|----------|
| (Dollars in thousands) | | |
| +300 | \$29,346 | (5.06)% |
| +200 | 29,928 | (3.18) |
| +100 | 30,488 | (1.37) |
| Base | 30,910 | — |
| (100) | 29,890 | (3.30) |

The following table illustrates the change in our net portfolio value (“NPV”) at March 31, 2016 that would occur in the event of an immediate change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

| Basis Point Change in Rates | Net Portfolio Value ⁽¹⁾ | | | Net Portfolio as % of Portfolio Value of Assets NPV Ratio ⁽³⁾ | | Market Value of Assets ⁽⁵⁾ |
|-----------------------------|------------------------------------|--------------------------|----------|--|-------------------------|---------------------------------------|
| | Amount | \$ Change ⁽²⁾ | % Change | NPV Ratio ⁽³⁾ | % Change ⁽⁴⁾ | |
| (Dollars in thousands) | | | | | | |
| +300 | \$155,434 | \$(36,927) | (19.20)% | 17.62% | (3.85)% | \$882,282 |
| +200 | 168,684 | (23,677) | (12.31) | 18.58 | (2.47) | 907,930 |
| +100 | 182,274 | (10,087) | (5.24) | 19.50 | (1.05) | 934,516 |
| Base | 192,361 | — | — | 20.07 | — | 958,257 |
| (100) | 191,284 | (1,077) | (0.56) | 19.66 | (0.11) | 973,144 |

(1) The net portfolio value is the difference between the present value of the discounted cash flows of assets and liabilities and represents the market value of the Company's equity for any given interest rate scenario. Net portfolio value is useful for determining, on a market value basis, how equity changes in response to various interest rate scenarios. Large changes in net portfolio value reflect increased interest rate sensitivity and generally more volatile earnings streams.

(2) The increase or decrease in net portfolio value at the indicated interest rates compared to the net portfolio value assuming no change in interest rates.

(3) Net portfolio value divided by the market value of assets.

(4) The increase or decrease in the net portfolio value divided by the market value of assets.

(5) The market value of assets represents the value of assets under the various interest rate scenarios and reflects the sensitivity of those assets to interest rate changes.

The net interest income and net portfolio value tables presented above are predicated upon a stable balance sheet with no growth or change in asset or liability mix. In addition, the net portfolio value is based upon the present value of discounted cash flows using our estimates of current replacement rates to discount the cash flows. The effects of changes in interest rates in the net interest income table are based upon a cash flow simulation of our existing assets and liabilities and assuming that delinquency rates would not change as a result of changes in interest rates, although

there can be no assurance that this will be the case. Delinquency rates may change when interest rates change as a result of changes in the loan portfolio mix, underwriting conditions, loan terms or changes in economic conditions that have a delayed effect on the portfolio. Even if interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth above. Also, a change in U.S. Treasury rates in the designated amounts accompanied by a change in the shape of the Treasury yield curve would cause changes to the net portfolio value and net interest income other than those indicated above.

At March 31, 2016, we did not have any derivative financial instruments or trading accounts for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. However, we continue to review such instruments and may utilize them for interest rate risk management in the future. Interest rate risk continues to be one of our primary risks, as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

Item 4. Controls and Procedures

The management of First Financial Northwest, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (“Exchange Act”). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Additionally, in designing disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief (a) Financial Officer concluded that, as of March 31, 2016, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Controls: In the quarter ended March 31, 2016, there was no change in our internal control (b) over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our 2015 Form 10-K.

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

(a) Not applicable

(b) Not applicable

(c) The following table summarizes First Financial Northwest's common stock repurchases during the first quarter of 2016, under the repurchase plan effective November 2, 2015 through April 27, 2016:

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| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Repurchased as Part of Publicly Announced Plan | Maximum Number of Shares that May Yet Be Repurchased Under the Plan |
|--------------------------------|---|---------------------------------------|--|---|
| January 1 - January 31, 2016 | 110,182 | \$ 13.49 | 110,182 | 935,764 |
| February 1 - February 29, 2016 | 88,273 | 13.13 | 88,273 | 847,491 |
| March 1 - March 31, 2016 | 115,632 | 13.41 | 115,632 | 731,859 |
| | 314,087 | 13.36 | 314,087 | 731,859 |

On October 29, 2015, the Board of Directors authorized the repurchase of up to 1,410,000 shares of the Company's common stock, or 10% of the Company's outstanding shares. This plan expired on April 27, 2016, at which time 800,199 shares had been repurchased at an average price per share of \$13.02.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits and Financial Statement Schedules

(a) Exhibits

- 3.1 Articles of Incorporation of First Financial Northwest ⁽¹⁾
- 3.2 Amended and Restated Bylaws of First Financial Northwest ⁽²⁾
- 4.0 Form of stock certificate of First Financial Northwest ⁽¹⁾
- 10.1 Amended Employment Agreement between First Savings Bank Northwest and Joseph W. Kiley III ⁽³⁾
- 10.2 Form of Change in Control Severance Agreement for Executive Officers ⁽⁴⁾
- 10.3 Form of Supplemental Executive Retirement Agreement entered into by First Savings Bank with Joseph W. Kiley III ⁽⁵⁾
- 10.4 2008 Equity Incentive Plan ⁽⁶⁾
- 10.5 Forms of incentive and non-qualified stock option award agreements ⁽⁷⁾
- 10.6 Form of restricted stock award agreement ⁽⁷⁾
- 10.7 Settlement Agreement and Mutual Release with the Stilwell Group ⁽⁸⁾
- 10.8 Amendment No. 1 to the Settlement Agreement and Releases with the Stilwell Group ⁽⁹⁾
- 10.9 Amendment No. 2 to the Settlement Agreement and Releases with the Stilwell Group ⁽¹⁰⁾
- 10.10 Employment Agreement between First Savings Bank Northwest and Richard P. Jacobson ⁽³⁾
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act

101 The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2016, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements.

⁽¹⁾ Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-1 (333-143539)

⁽²⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated March 24, 2016.

⁽³⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 5, 2013.

⁽⁴⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated September 9, 2014.

⁽⁵⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 31, 2012.

⁽⁶⁾ Filed as Appendix A to First Financial Northwest's definitive proxy statement dated April 15, 2008.

⁽⁷⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated July 1, 2008.

⁽⁸⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 20, 2012.

⁽⁹⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated January 17, 2013.

⁽¹⁰⁾ Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated February 26, 2013.

SIGNATURES

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

FIRST FINANCIAL NORTHWEST, INC.

Date: May 6, 2016 By: /s/Joseph W. Kiley III
Joseph W. Kiley III
President and Chief Executive Officer (Principal Executive Officer)

Date: May 6, 2016 By: /s/Richard P. Jacobson
Richard P. Jacobson
Executive Vice President and Chief Financial Officer (Principal Financial Officer)

Date: May 6, 2016 By: /s/Christine A. Huestis
Christine A. Huestis
Vice President and Controller (Principal Accounting Officer)

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Exhibit Index

| Exhibit No. | Description |
|-------------|---|
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