

First Financial Northwest, Inc.
Form 10-K
March 14, 2013

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2012

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

Commission File Number: 000-33652

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

Washington
(State or other jurisdiction of incorporation or organization)

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

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

98057
(Zip Code)

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

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

Common Stock, \$0.01 par value per share
(Title of Each Class)

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

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

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

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

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. _____

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

Large accelerated 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 Act). YES

NO

The aggregate market value of the Common Stock outstanding held by nonaffiliates of the Registrant based on the closing sales price of the Registrant's Common Stock as quoted on The Nasdaq Stock Market LLC on June 30, 2012 was \$148,097,651 (18,238,627) shares at \$8.12 per share. For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates. As of March 2, 2013, the Registrant had outstanding 18,805,168 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Registrant's Definitive Proxy Statement for the 2013 Annual Meeting of Shareholders (Part III).
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FIRST FINANCIAL NORTHWEST, INC.
2012 ANNUAL REPORT ON FORM 10-K
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Forward-Looking Statements

Certain matters discussed in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” or similar expressions or future or conditional verbs such as “may,” “will,” “should,” “would” and “could.” Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: 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, or 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 (“Federal Reserve”) 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 additional enforcement actions against the Company or the Bank to take additional corrective action and refrain from unsafe and unsound practices which also may, among other things, 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, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including the requirements and restrictions that have been imposed upon First Financial Northwest under the memorandum of understanding with the Federal Reserve and the memorandum of understanding the Bank entered into with the FDIC and the DFI and the possibility that First Financial Northwest and the Bank will be unable to fully comply with these informal enforcement actions which could result in the imposition of additional requirements or restrictions; 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; our ability to reduce our noninterest expenses; 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 this Form 10-K and our other reports filed with the U.S. Securities and Exchange Commission (“SEC”). Any of the forward-looking statements that we make in this Form 10-K 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.

As used throughout this report, the terms “we”, “our”, or “us” refer to First Financial Northwest, Inc. and our consolidated subsidiaries, including First Savings Bank Northwest and First Financial Diversified Corporation.

Internet Website

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

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PART I

Item 1. Business

General

First Financial Northwest, Inc. (“First Financial Northwest” or “the Company”), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest (“First Savings Bank” or “the Bank”) in connection with the conversion from a mutual holding company structure to a stock holding company structure completed on October 9, 2007. At December 31, 2012, we had total assets of \$942.7 million, net loans of \$650.5 million, deposits of \$665.8 million and stockholders’ equity of \$187.1 million. First Financial Northwest’s business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to First Savings Bank.

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

First Financial Northwest is a savings and loan holding company and is subject to regulation by the Federal Reserve Bank of San Francisco (“Federal Reserve”) as the successor to the Office of Thrift Supervision (“OTS”) in the oversight and regulation of savings and loan holding companies. First Savings Bank is examined and regulated by the Washington State Department of Financial Institutions (“DFI”) and by the Federal Deposit Insurance Corporation (“FDIC”). First Savings Bank is required to have certain reserves set by the Board of Governors of the Federal Reserve System and is a member of the Federal Home Loan Bank of Seattle (“FHLB”), which is one of the 12 regional banks in the Federal Home Loan Bank System (“FHLB System”).

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

At December 31, 2012, \$307.0 million, or 45.6% of our total loan portfolio was comprised of one-to-four family residential loans; multifamily loans were \$111.5 million, or 16.5%; commercial real estate loans were \$221.9 million, or 32.9%; construction/land development loans were \$19.4 million, or 2.9%; and business and consumer loans were \$3.0 million and \$11.1 million, or 0.4% and 1.7%, respectively. Included in our one-to-four family residential, multifamily, commercial real estate and construction/land development portfolios at December 31, 2012, were \$57.5 million, \$3.4 million, \$20.1 million and \$4.6 million of total loans, respectively, to our five largest borrowing relationships.

The principal executive office of First Savings Bank is located at 201 Wells Avenue South, Renton, Washington, 98057; our telephone number is (425) 255-4400.

Regulatory Actions

On April 14, 2010, the OTS and members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement or Memorandum of Understanding ("MOU"), which is now enforced by the Federal Reserve, the successor to the OTS as a regulator of the holding company. Under the terms of the MOU, the Company agreed, among other things, to provide notice to and obtain a written non-objection from the Federal Reserve prior to the Company (a) declaring a dividend or redeeming any capital stock and (b) incurring, issuing, renewing or repurchasing any new debt.

On March 27, 2012, the Bank's regulators, the FDIC and the DFI, terminated the Consent Order ("Order") which became effective on September 24, 2010. In place of the Order, the Bank entered into an MOU, which is an informal regulatory action, with the FDIC and the DFI. The Order was terminated as a result of the steps the Bank took in complying with the Order, including reducing its level of classified assets, increasing earnings, augmenting management and improving the overall condition of the Bank.

The MOU with the Bank contains provisions concerning the management and directors of the Bank, interest rate risk, minimum capital levels, the allowance for loan and lease losses ("ALLL"), lending and collection policies, policies concerning the Bank and its affiliates, restrictions on paying dividends and a requirement to furnish progress reports to the FDIC and the DFI.

A copy of the MOU with the Bank is attached to the Form 8-K that was filed with the SEC on April 2, 2012. The MOUs will remain in effect until modified or terminated by the FDIC and the DFI in the case of the Bank and the Federal Reserve with respect to the Company. For more information regarding the MOUs and their impact on First Financial Northwest and the Bank, see Item 1A. "Risk Factors - Certain regulatory restrictions are imposed on us; lack of compliance could result in monetary penalties and/or additional regulatory actions."

Proxy Contest and Related Litigation

On March 29, 2012, Stilwell Value Partners II, L.P., one of a group of funds controlled by Joseph Stilwell (the "Stilwell Group"), submitted to First Financial Northwest a notice of the Stilwell Group's intent to nominate Joseph Stilwell and Spencer L. Schneider for election to the Company's Board of Directors at the Company's May 24, 2012 Annual Meeting of Shareholders ("Annual Meeting"). The Federal Reserve subsequently advised the Stilwell Group that the solicitation of proxies to elect two directors to the Company's Board of Directors, along with other actions the Stilwell Group had taken in connection with the proxy contest, could result in a controlling interest that would not be permitted under federal law. As a result, the Stilwell Group determined to nominate only Mr. Schneider for election to the Company's Board of Directors at the Annual Meeting.

Following the Annual Meeting, the independent inspector of election, Raymond Riley of Carl T. Hagberg and Associates ("Inspector of Election"), issued his Final Report which stated that (1) a quorum was present for the transaction of business at the Annual Meeting; and (2) the opposition proxy holders did not submit an executed master ballot for the Stilwell Group's nominee prior to the closing of the polls. Thus, the Company's nominees, Victor Karpiak, M. Scott Gaspard and Daniel L. Stevens, were each duly elected to serve for a three year term; the Stilwell Group's nominee did not receive the votes required for election to the Company's Board of Directors.

On June 7, 2012, the Stilwell Group filed a lawsuit in the Superior Court of the State of Washington for King County (the "Court") against First Financial Northwest, Raymond Riley (the independent Inspector of Election) and Victor Karpiak, seeking to overturn the outcome of the election of directors at the Annual Meeting. The Stilwell Group's complaint alleged, among other things, that (i) proxy cards and proxy reporting service tabulations showed that the Stilwell Group's nominee, Spencer L. Schneider, received more shareholder support than Mr. Karpiak; (ii) the Inspector of Election should have determined the outcome of the election based on proxy cards and proxy reporting service tabulations alone and that submission of a master ballot by the opposition proxy holders was unnecessary; (iii) alternatively, the opposition group's master ballot should have been accepted late, after the polls had been declared closed; and (iv) if the absence of a timely master ballot means shareholders that returned proxies to the Stilwell Group did not vote, then those shareholders were not present for quorum purposes either, and the election was invalid for lack of a quorum. The Company denied all of the Stilwell Group's allegations.

On October 5, 2012, the Court heard oral argument concerning a motion for summary judgment filed by the Stilwell Group and the cross-motions for summary judgment filed by (1) First Financial Northwest and Victor Karpiak and (2) Raymond J. Riley (collectively, the "Defendants").

On October 9, 2012, the Court issued an order in which it denied the Stilwell Group's motion for summary judgment and granted in part the Defendants' cross-motions. The Court agreed with the Defendants that the Inspector of Election correctly determined that the Stilwell Group did not cast a ballot before the time to vote had closed. The Court concluded, however, that certain material facts were in dispute that precluded