

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2023

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: 001-35589

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of incorporation or organization)

45-4585178

(IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043

(Address of principal executive offices; Zip Code)

(425) 771-5299

(Registrant's telephone number, including area code)

None

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

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, par value \$.01 per share	FSBW	The NASDAQ Stock Market LLC

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, every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 3, 2023, there were 7,797,923 outstanding shares of the registrant's common stock.

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FS Bancorp, Inc.
Form 10-Q

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When we refer to "FS Bancorp" in this report, we are referring to FS Bancorp, Inc. When we refer to "Bank" or "1st Security Bank" in this report, we are referring to 1st Security Bank of Washington, the wholly owned subsidiary of FS Bancorp. As used in this report, the terms "we," "our," "us," and "Company" refer to FS Bancorp, Inc. and its consolidated subsidiary, 1st Security Bank of Washington, unless the context indicates otherwise.

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Item 1. Financial Statements

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share amounts) (Unaudited)

	September 30, 2023	December 31, 2022
ASSETS		
Cash and due from banks	\$ 18,137	\$ 10,525
Interest-bearing deposits at other financial institutions	62,536	30,912
Total cash and cash equivalents	80,673	41,437
Certificates of deposit at other financial institutions	17,636	4,712
Securities available-for-sale, at fair value	251,917	229,252
Securities held-to-maturity, net of allowance for credit losses of \$ 45 and \$31, respectively (fair value of \$7,424 and \$7,929, respectively)	8,455	8,469
Loans held for sale, at fair value	18,636	20,093
Loans receivable, net (includes \$15,176 and \$14,035, at fair value, respectively)	2,375,572	2,190,860
Accrued interest receivable	13,925	11,144
Premises and equipment, net	30,926	25,119
Operating lease right-of-use ("ROU") assets	7,042	6,226
Federal Home Loan Bank ("FHLB") stock, at cost	3,696	10,611
Other real estate owned ("OREO")	570	570
Deferred tax asset, net	7,424	6,670
Bank owned life insurance ("BOLI"), net	37,480	36,799
Servicing rights, held at the lower of cost or fair value	17,657	18,017
Goodwill	3,592	2,312
Core deposit intangible, net	18,323	3,369
Other assets	26,548	17,238
TOTAL ASSETS	\$ 2,920,072	\$ 2,632,898
LIABILITIES		
Deposits:		
Noninterest-bearing accounts	\$ 670,158	\$ 554,174
Interest-bearing accounts	1,784,286	1,573,567
Total deposits	2,454,444	2,127,741
Borrowings	121,895	186,528
Subordinated notes:		
Principal amount	50,000	50,000
Unamortized debt issuance costs	(489)	(539)
Total subordinated notes less unamortized debt issuance costs	49,511	49,461
Operating lease liabilities	7,269	6,474
Other liabilities	36,288	30,997
Total liabilities	2,669,407	2,401,201
COMMITMENTS AND CONTINGENCIES (NOTE 10)		
STOCKHOLDERS' EQUITY		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.01 par value; 45,000,000 shares authorized; 7,796,095 and 7,736,185 shares issued and outstanding at September 30, 2023 and December 31, 2022, respectively	78	77
Additional paid-in capital	57,464	55,187
Retained earnings	222,532	202,065
Accumulated other comprehensive loss, net of tax	(29,409)	(25,632)
Total stockholders' equity	250,665	231,697
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 2,920,072	\$ 2,632,898

See accompanying notes to these consolidated financial statements.

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except per share amounts) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2023	2022	2023	2022
INTEREST INCOME				
Loans receivable, including fees	\$ 39,874	\$ 29,563	\$ 114,082	\$ 77,885
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	3,396	1,741	8,667	4,990
Total interest and dividend income	<u>43,270</u>	<u>31,304</u>	<u>122,749</u>	<u>82,875</u>
INTEREST EXPENSE				
Deposits	10,462	2,596	24,696	5,438
Borrowings	1,689	696	3,749	1,003
Subordinated notes	485	485	1,456	1,456
Total interest expense	<u>12,636</u>	<u>3,777</u>	<u>29,901</u>	<u>7,897</u>
NET INTEREST INCOME	<u>30,634</u>	<u>27,527</u>	<u>92,848</u>	<u>74,978</u>
PROVISION FOR CREDIT LOSSES	<u>548</u>	<u>1,718</u>	<u>3,372</u>	<u>4,632</u>
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>30,086</u>	<u>25,809</u>	<u>89,476</u>	<u>70,346</u>
NONINTEREST INCOME				
Service charges and fee income	2,882	2,327	8,352	6,121
Gain on sale of loans	1,875	1,402	5,298	7,325
Earnings on cash surrender value of BOLI	233	221	681	654
Other noninterest income	(8)	231	703	312
Total noninterest income	<u>4,982</u>	<u>4,181</u>	<u>15,034</u>	<u>14,412</u>
NONINTEREST EXPENSE				
Salaries and benefits	13,503	11,402	40,880	35,110
Operations	3,409	2,812	9,744	7,656
Occupancy	1,588	1,344	4,670	3,825
Data processing	1,841	1,548	5,092	4,363
Loan costs	564	746	2,077	2,020
Professional and board fees	666	631	2,001	2,387
Federal Deposit Insurance Corporation ("FDIC") insurance	561	462	1,732	804
Marketing and advertising	452	220	1,072	652
Acquisition cost	—	—	1,562	—
Amortization of core deposit intangible	1,002	173	2,484	518
Recovery of servicing rights	—	—	—	(1)
Total noninterest expense	<u>23,586</u>	<u>19,338</u>	<u>71,314</u>	<u>57,334</u>
INCOME BEFORE PROVISION FOR INCOME TAXES	<u>11,482</u>	<u>10,652</u>	<u>33,196</u>	<u>27,424</u>
PROVISION FOR INCOME TAXES	<u>2,529</u>	<u>2,194</u>	<u>6,915</u>	<u>5,397</u>
NET INCOME	<u><u>\$ 8,953</u></u>	<u><u>\$ 8,458</u></u>	<u><u>\$ 26,281</u></u>	<u><u>\$ 22,027</u></u>
Basic earnings per share	<u><u>\$ 1.15</u></u>	<u><u>\$ 1.09</u></u>	<u><u>\$ 3.38</u></u>	<u><u>\$ 2.77</u></u>
Diluted earnings per share	<u><u>\$ 1.13</u></u>	<u><u>\$ 1.08</u></u>	<u><u>\$ 3.33</u></u>	<u><u>\$ 2.73</u></u>

See accompanying notes to these consolidated financial statements.

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2023	2022	2023	2022
Net income	\$ 8,953	\$ 8,458	\$ 26,281	\$ 22,027
Other comprehensive loss:				
Securities available-for-sale:				
Unrealized loss during period	(11,762)	(14,567)	(9,341)	(47,046)
Income tax benefit related to unrealized holding loss	2,528	3,131	2,007	10,115
Derivative financial instruments:				
Unrealized derivative gain during period	4,337	5,107	8,155	9,651
Income tax provision related to unrealized derivative gain	(933)	(1,098)	(1,753)	(2,075)
Reclassification adjustment for realized gain, net included in net income	(1,446)	(278)	(3,624)	(232)
Income tax provision related to reclassification, net	311	60	779	50
Other comprehensive loss, net of tax	(6,965)	(7,645)	(3,777)	(29,537)
COMPREHENSIVE INCOME (LOSS)	\$ 1,988	\$ 813	\$ 22,504	\$ (7,510)

See accompanying notes to these consolidated financial statements .

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Dollars in thousands, except share amounts) (Unaudited)

Three Months Ended September 30, 2023 and 2022

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, Net of Tax	Total Stockholders' Equity
	Shares	Amount				
BALANCE, July 1, 2022	<u>7,726,232</u>	<u>\$ 77</u>	<u>\$ 55,129</u>	<u>\$ 189,075</u>	<u>\$ (21,640)</u>	<u>\$ 222,641</u>
Net income	—	—	—	8,458	—	\$ 8,458
Dividends paid (\$0.20 per share)	—	—	—	(1,547)	—	\$ (1,547)
Share-based compensation	—	—	500	—	—	\$ 500
Issuance of common stock-employee stock purchase plan	7,068	\$ —	211	—	—	\$ 211
Restricted stock awards	35,050	\$ —	—	—	—	\$ —
Common stock repurchased - repurchase plan	(67,923)	\$ —	(1,732)	—	—	\$ (1,732)
Common stock repurchased for employee/director taxes paid on restricted stock awards	(6,150)	\$ —	(190)	—	—	\$ (190)
Stock options exercised, net	10,096	\$ —	(149)	—	—	\$ (149)
Other comprehensive loss, net of tax	—	\$ —	—	—	(7,645)	\$ (7,645)
BALANCE, September 30, 2022	<u>7,704,373</u>	<u>\$ 77</u>	<u>\$ 53,769</u>	<u>\$ 195,986</u>	<u>\$ (29,285)</u>	<u>\$ 220,547</u>
BALANCE, July 1, 2023	<u>7,753,607</u>	<u>\$ 77</u>	<u>\$ 56,781</u>	<u>\$ 215,519</u>	<u>\$ (22,444)</u>	<u>\$ 249,933</u>
Net income	—	—	—	8,953	—	\$ 8,953
Dividends paid (\$0.25 per share)	—	—	—	(1,940)	—	\$ (1,940)
Share-based compensation	—	—	590	—	—	\$ 590
Issuance of common stock- employee stock purchase plan	7,710	\$ 1	241	—	—	\$ 242
Restricted stock awards	37,600	\$ —	—	—	—	\$ —
Restricted stock awards forfeited	(4,712)	\$ —	—	—	—	\$ —
Common stock repurchased for employee/director taxes paid on restricted stock awards	(11,006)	\$ —	(339)	—	—	\$ (339)
Stock options exercised, net	12,896	\$ —	191	—	—	\$ 191
Other comprehensive loss, net of tax	—	\$ —	—	—	(6,965)	\$ (6,965)
BALANCE, September 30, 2023	<u>7,796,095</u>	<u>\$ 78</u>	<u>\$ 57,464</u>	<u>\$ 222,532</u>	<u>\$ (29,409)</u>	<u>\$ 250,665</u>

See accompanying notes to these consolidated financial statements.

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Nine Months Ended September 30, 2022 and 2023

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Total Stockholders' Equity
	Shares	Amount				
BALANCE, January 1, 2022	8,169,887	\$ 82	\$ 67,958	\$ 179,215	\$ 252	\$ 247,507
Net income	—	—	—	22,027	—	\$ 22,027
Dividends paid (\$0.70 per share)	—	—	—	(5,553)	—	\$ (5,553)
Share-based compensation	—	—	1,432	—	—	\$ 1,432
New credit standard (Topic 326) - impact in year of adoption	—	—	—	297	—	\$ 297
Issuance of common stock-employee stock purchase plan	7,068	\$ —	211	—	—	\$ 211
Restricted stock awards	35,050	\$ —	—	—	—	\$ —
Common stock repurchased - repurchase plan	(544,530)	\$ (5)	(15,623)	—	—	\$ (15,628)
Common stock repurchased for employee/director taxes paid on restricted stock awards	(6,150)	\$ —	(190)	—	—	\$ (190)
Stock options exercised, net	43,048	\$ —	(19)	—	—	\$ (19)
Other comprehensive loss, net of tax	—	—	—	—	(29,537)	\$ (29,537)
BALANCE, September 30, 2022	7,704,373	\$ 77	\$ 53,769	\$ 195,986	\$ (29,285)	\$ 220,547
BALANCE, January 1, 2023	7,736,185	\$ 77	\$ 55,187	\$ 202,065	\$ (25,632)	\$ 231,697
Net income	—	—	—	26,281	—	\$ 26,281
Dividends paid (\$0.75 per share)	—	—	—	(5,814)	—	\$ (5,814)
Share-based compensation	—	—	1,608	—	—	\$ 1,608
Issuance of common stock-employee stock purchase plan	24,159	\$ 1	780	—	—	\$ 781
Restricted stock awards	37,600	\$ —	—	—	—	\$ —
Restricted stock awards forfeited	(9,524)	\$ —	—	—	—	\$ —
Common stock repurchased for employee/director taxes paid on restricted stock awards	(11,446)	\$ —	(355)	—	—	\$ (355)
Stock options exercised, net	19,121	\$ —	244	—	—	\$ 244
Other comprehensive loss, net of tax	—	—	—	—	(3,777)	\$ (3,777)
BALANCE, September 30, 2023	7,796,095	\$ 78	\$ 57,464	\$ 222,532	\$ (29,409)	\$ 250,665

See accompanying notes to these consolidated financial statements.

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands) (Unaudited)

	Nine Months Ended September 30,	
	2023	2022
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 26,281	\$ 22,027
Adjustments to reconcile net income to net cash from operating activities		
Provision for credit losses	3,372	4,632
Depreciation, amortization and accretion	9,505	10,464
Compensation expense related to stock options and restricted stock awards	1,608	1,432
Change in cash surrender value of BOLI	(681)	(654)
Gain on sale of loans held for sale	(5,298)	(6,729)
Gain on sale of portfolio loans	—	(596)
Origination of loans held for sale	(292,309)	(498,975)
Proceeds from sale of loans held for sale	324,083	630,396
Recovery of servicing rights	—	(1)
Changes in operating assets and liabilities		
Accrued interest receivable	(2,251)	(2,813)
Other assets	(4,074)	3,527
Other liabilities	4,798	1,236
Net cash from operating activities	<u>65,034</u>	<u>163,946</u>
CASH FLOWS FROM (USED BY) INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Maturities, prepayments, and calls	13,492	17,829
Purchases	(46,906)	(22,968)
Activity in securities held-to-maturity:		
Purchases	—	(1,000)
Maturities of certificates of deposit at other financial institutions	—	5,582
Purchase of certificates of deposit at other financial institutions	(12,924)	—
Portfolio loan originations and principal collections, net	(150,385)	(420,094)
Net cash from acquisitions	336,157	—
Proceeds from sale of portfolio loans	—	39,034
Purchase of portfolio loans	(2,475)	(5,344)
Purchase of premises and equipment	(1,395)	(695)
Proceeds from bank owned life insurance death benefits	—	1,168
Change in FHLB stock, net	6,915	(8,813)
Net cash from (used by) investing activities	<u>142,479</u>	<u>(395,301)</u>
CASH FLOWS (USED BY) FROM FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(98,500)	167,540
Proceeds from borrowings	1,725,337	1,155,007
Repayments of borrowings	(1,789,970)	(936,707)
Dividends paid on common stock	(5,814)	(5,553)
Proceeds (disbursements) from stock options exercised, net	244	(19)
Common stock repurchased for employee/director taxes paid on restricted stock awards	(355)	(190)
Issuance of common stock - employee stock purchase plan	781	211
Common stock repurchased	—	(15,628)
Net cash (used by) from financing activities	<u>(168,277)</u>	<u>364,661</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	<u>39,236</u>	<u>133,306</u>
CASH AND CASH EQUIVALENTS, beginning of period	41,437	26,491
CASH AND CASH EQUIVALENTS, end of period	\$ 80,673	\$ 159,797

FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(In thousands) (Unaudited)

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the period for:			
Interest on deposits and borrowings	\$ 26,280	\$ 5,538	
Income taxes	8,355	2,897	

SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES

Change in unrealized loss on available-for-sale investment securities	\$ (9,341)	\$ (47,046)	
Change in unrealized gain on fair value and cash flow hedges	4,523	9,405	
Change in unrealized loss on portfolio loans measured under the fair value option	(285)	(1,780)	
Retention in gross mortgage servicing rights from loan sales	2,279	4,935	
OREO received in settlement of loans	—	145	
Right-of-use assets in exchange for lease liabilities	2,034	3,049	
Acquisitions:			
Non-cash assets acquired	87,512	—	
Non-cash liabilities assumed	424,949	—	

See accompanying notes to these consolidated financial statements.

FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Table Dollar Amounts in Thousands, Except Per Share Amounts)

NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the holding company for 1st Security Bank of Washington (the “Bank” or “1st Security Bank”) in connection with the Bank’s conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based savings bank with 27 full-service bank branches, a headquarters that also originates loans and accepts deposits, and loan production offices in suburban communities in the greater Puget Sound area, the Kennewick-Pasco-Richland metropolitan area of Washington, also known as the Tri-Cities, Goldendale, Vancouver, and White Salmon, Washington and Manzanita, Newport, Ontario, Tillamook, and Waldport, Oregon. The Bank’s branches located in the communities of Goldendale and White Salmon, Washington and Manzanita, Newport, Ontario, Tillamook, and Waldport, Oregon were acquired from Columbia State Bank on February 24, 2023, and opened as 1st Security Bank branches on February 27, 2023. The Bank provides loan and deposit services to customers who are predominantly small- and middle-market businesses and individuals. The Company and its subsidiary are subject to regulation by certain federal and state agencies and undergo periodic examination by these regulatory agencies.

Financial Statement Presentation – The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). These unaudited interim consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K which includes all the audited financial statements and footnotes required by U.S. GAAP for complete financial statements for the year ended December 31, 2022, as filed with the SEC on March 16, 2023. In the opinion of management, all normal adjustments and recurring accruals considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results for the three and nine months ended September 30, 2023, are not necessarily indicative of the results that may be expected for the year ending December 31, 2023, or any other future period. The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for credit losses (“ACL”), fair value of financial instruments, the valuation of servicing rights, business combinations, deferred income taxes, and if needed, a deferred tax asset valuation allowance.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented to the nearest thousands of dollars except per share amounts. If the amounts are above \$1.0 million, they are rounded one decimal point, and if they are above \$1.0 billion, they are rounded two decimal points.

Principles of Consolidation – The consolidated financial statements include the accounts of FS Bancorp and its wholly owned subsidiary, 1st Security Bank. All material intercompany accounts have been eliminated in consolidation.

Segment Reporting – The Company operates in two business segments through the Bank: commercial and consumer banking and home lending. The Company’s business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the way financial information is regularly reviewed for the purpose of allocating resources and evaluating performance of the Company’s businesses. The results for these business segments are based on management’s accounting process, which assigns income statement items and assets to each responsible operating segment. This process is dynamic and is based on management’s view of the Company’s operations. See “Note 15 – Business Segments.”

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Subsequent Events – The Company has evaluated events and transactions after September 30, 2023, for potential recognition or disclosure.

RECENT ACCOUNTING PRONOUNCEMENTS

In March 2020, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2020-04, *"Reference Rate Reform"* ("Topic 848"). This ASU provides optional guidance for a limited period to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting. The amendments in this ASU apply to modifications to agreements (e.g., loans, debt securities, derivatives, borrowings) that replace a reference rate affected by reference rate reform (including rates referenced in fallback provisions) and contemporaneous modifications of other contract terms related to the replacement of the reference rate (including contract modifications to add or change fallback provisions). The following optional expedients for applying the requirements of certain Topics or Industry Subtopics in the Codification are permitted for contracts that are modified because of reference rate reform and that meet certain scope guidance: 1) Modifications of contracts within the scope of Topics 310, Receivables, and 470, Debt, should be accounted for by prospectively adjusting the effective interest rate; 2) Modifications of contracts within the scope of Topics 840, Leases, and 842, Leases, should be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and the discount rate (for example, the incremental borrowing rate) or remeasurements of lease payments that otherwise would be required under those Topics for modifications not accounted for as separate contracts; and 3) Modifications of contracts do not require an entity to reassess its original conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract under Subtopic 815-15, Derivatives and Hedging – Embedded Derivatives. In January 2021, ASU 2021-01 updated amendments in the new ASU to clarify that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivative instruments that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform. Amendments in this ASU and the expedients and exceptions in Topic 848 capture the incremental consequences of the scope clarification and tailor the existing guidance to derivative instruments affected by the discounting transition. An entity may elect to apply the amendments in this ASU on a full retrospective basis as of any date from the effective dates. The amendments in this ASU have differing effective dates, beginning with an interim period including and subsequent to March 12, 2020 through December 31, 2022, deferred now until December 31, 2024. The Company does not expect the adoption of ASU 2020-04 to have a material impact on its consolidated financial statements.

Application of New Accounting Guidance Adopted in 2023

On January 1, 2023, the Company adopted ASU No. 2022-02, *Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*. This ASU eliminates the accounting guidance for troubled debt restructurings ("TDRs") for creditors, requires new disclosures for creditors for certain loan refinancings and restructurings when a borrower is experiencing financial difficulty, and requires public business entities to include current-period gross write-offs in the vintage disclosure tables. The amendments in this ASU are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. The adoption of ASU 2022-02 did not have a material impact on the Company's consolidated financial statements.

NOTE 2 – BUSINESS COMBINATION

On February 24, 2023, the Company's wholly-owned subsidiary, 1st Security Bank, completed the purchase of seven branches ("Branch Purchase") from Columbia State Bank to expand its franchise in Washington and Oregon. The Branch Purchase included seven retail bank branches located in the communities of Goldendale and White Salmon, Washington and Manzanita, Newport, Ontario, Tillamook, and Waldport, Oregon. In accordance with the Purchase and Assumption Agreement, dated as of November 7, 2022, between Columbia State Bank and 1st Security Bank, the Bank acquired \$425.5 million of deposits, a portfolio of performing loans, six owned bank branches, one lease associated with the bank branches and certain other assets of the branches. In consideration of the purchased assets and transferred liabilities, 1st Security Bank paid (a) the unpaid principal balance and accrued interest of \$66.6 million for the loans acquired, (b) the fair value, or approximately \$ 6.3 million, for the bank facilities and certain other assets associated with the acquired branches, and (c) a deposit premium of 4.15% for core deposits and 2.5% for public funds on substantially all of the deposits assumed, which equated to approximately \$16.4 million. The transaction was settled with Columbia State Bank paying cash of \$ 334.7 million to 1st Security Bank for the difference between the total assets purchased and the total liabilities assumed.

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The Branch Purchase was accounted for under the acquisition method of accounting and accordingly, the assets and liabilities were recorded at fair values on February 24, 2023, the date of acquisition. Determining the fair value of assets and liabilities is a complicated process involving significant judgement regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values become available. Due to the timing of the data conversion and the integration of operations of the branches onto the Company's existing operations, historical reporting of the acquired branches is impracticable, and therefore, disclosure of the amounts of revenue and expenses attributable to the acquired branches since the acquisition date are not available.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of acquisition:

February 24, 2023	Acquired Book Value	Fair Value Adjustments	Amount Recorded
Assets			
Cash and cash equivalents	\$ 336,157	\$ —	\$ 336,157
Loans receivable	66,093	(2,902) ⁽¹⁾	63,191
Premises and equipment	6,342	—	6,342
Accrued interest receivable	530	—	530
Core deposit intangible ("CDI")	—	17,438 ⁽²⁾	17,438
Goodwill	—	1,280 ⁽³⁾	1,280
Other assets	11	—	11
Total assets acquired	\$ 409,133	\$ 15,816	\$ 424,949
Liabilities			
Deposits:			
Noninterest-bearing accounts	\$ 225,567	\$ —	\$ 225,567
Interest-bearing accounts	199,898	(548) ⁽⁴⁾	199,350
Total deposits	425,465	(548)	424,917
Accrued interest payable	4	—	4
Other liabilities	28	—	28
Total liabilities assumed	\$ 425,497	\$ (548)	\$ 424,949

- (1) The fair value discount for acquired loans was determined by separate adjustments to reflect a credit risk and marketability component and a yield component reflecting the differential between portfolio and market yields. The discount on acquired loans will be accreted back into interest income using the effective yield method. None of the loans acquired are purchased financial assets with credit deterioration. The fair value of the loans is \$63.2 million and the gross amount due is \$ 66.1 million, none of which is expected to be uncollectable.
- (2) The fair value adjustment represents the value of the core deposit base assumed in the Branch Purchase based on a study performed by an independent consulting firm. This amount was recorded by the Company as an identifiable intangible asset and will be amortized as an expense on an accelerated basis over the average life of the core deposit base, which is estimated to be 10 years.
- (3) The fair value adjustment represents the value of the goodwill calculated from the purchase based on the purchase price, less the fair value of assets acquired net of liabilities assumed. The goodwill of \$1.3 million is attributable to the workforce and customer relationships associated with the branches. All the goodwill is deductible for tax purposes and will be amortized over a 15-year period. The goodwill was assigned to the Commercial and Consumer Banking segment.
- (4) The fair value of time deposits was calculated using a discounted cash flow analysis that calculated the present value of the projected cash flows from the portfolio versus the present value of a similar portfolio with a similar maturity profile at current market rates. This adjustment represents a difference in interest rates from the time deposits acquired and the estimated wholesale funding rates used in the application of fair value accounting. The discounted amount will be amortized into expense as an increase in interest expense over the maturity profile of the acquired time deposits.

The disclosures regarding pro-forma data and the results of operations after the acquisition date are omitted as this information is not practical to obtain. The branches' financial information is not reported on a stand-alone basis.

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NOTE 3 – INVESTMENTS

The following tables present the amortized costs, unrealized gains, unrealized losses, estimated fair values of securities available-for-sale and held-to-maturity, and ACL for securities held-to-maturity at September 30, 2023 and December 31, 2022:

	September 30, 2023				
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Values	Estimated ACL
SECURITIES AVAILABLE-FOR-SALE					
U.S. agency securities	\$ 21,152	\$ 42	\$ (4,098)	\$ 17,096	\$ —
Corporate securities	7,000	41	(687)	6,354	—
Municipal bonds	139,237	1	(30,617)	108,621	—
Mortgage-backed securities	104,097	45	(14,535)	89,607	—
U.S. Small Business Administration securities	32,313	—	(2,074)	30,239	—
Total securities available-for-sale	303,799	129	(52,011)	251,917	—

SECURITIES HELD-TO-MATURITY

Corporate securities	8,500	—	(1,076)	7,424	45
Total securities held-to-maturity	8,500	—	(1,076)	7,424	45
Total securities	\$ 312,299	\$ 129	\$ (53,087)	\$ 259,341	\$ 45

	December 31, 2022				
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Values	Estimated ACL
SECURITIES AVAILABLE-FOR-SALE					
U.S. agency securities	\$ 21,153	\$ —	\$ (3,865)	\$ 17,288	\$ —
Corporate securities	9,497	27	(979)	8,545	—
Municipal bonds	144,200	21	(23,619)	120,602	—
Mortgage-backed securities	82,424	—	(12,458)	69,966	—
U.S. Small Business Administration securities	14,519	—	(1,668)	12,851	—
Total securities available-for-sale	271,793	48	(42,589)	229,252	—

SECURITIES HELD-TO-MATURITY

Corporate securities	8,500	—	(571)	7,929	31
Total securities held-to-maturity	8,500	—	(571)	7,929	31
Total securities	\$ 280,293	\$ 48	\$ (43,160)	\$ 237,181	\$ 31

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The following table presents the activity in the ACL for securities held-to-maturity by major security type for the three and nine months ended September 30, 2023 and 2022:

		For the Three Months Ended September 30,	
		2023	2022
SECURITIES HELD-TO-MATURITY			
Corporate Securities			
Beginning allowance balance		\$ 31	\$ 31
Provision for credit losses		14	—
Total ending allowance balance		<u>\$ 45</u>	<u>\$ 31</u>
SECURITIES HELD-TO-MATURITY		For the Nine Months Ended September 30,	
Corporate Securities		2023	2022
Beginning allowance balance		\$ 31	\$ —
Impact of adopting ASU 2016-13		—	72
Provision (recapture) for credit losses		14	(41)
Total ending allowance balance		<u>\$ 45</u>	<u>\$ 31</u>

Management measures expected credit losses on held-to-maturity debt securities on an individual basis. The estimate of expected credit losses considers historical credit loss information that is adjusted for current conditions and reasonable and supportable forecasts. Accrued interest receivable on held-to-maturity debt securities totaled \$117,000 and \$116,000 at September 30, 2023 and December 31, 2022, and was \$2.0 million and \$1.2 million on available-for-sale debt securities as of September 30, 2023 and December 31, 2022, respectively. Accrued interest receivable on securities is reported in "Accrued interest receivable" on the Consolidated Balance Sheets and is excluded from the calculation of the ACL.

The Bank monitors the credit quality of debt securities held-to-maturity quarterly using credit rating, material event notices, and changes in market value. The following table summarizes the amortized cost of debt securities held-to-maturity at the dates indicated, aggregated by credit quality indicator:

	September 30, 2023	December 31, 2022
Corporate securities		
BBB/BBB-	\$ 7,000	\$ 8,500
BB+	1,500	—
Total	\$ 8,500	\$ 8,500

At September 30, 2023, there were no debt securities held-to-maturity that were classified as either nonaccrual or 90 days or more past due and still accruing interest.

The following table presents, as of September 30, 2023, investment securities which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law:

Purpose or beneficiary	September 30, 2023		
	Carrying Value	Amortized Cost	Fair Value
State and local government public deposits	\$ 36,866	\$ 45,834	\$ 36,866
Federal Reserve Bank - Bank Term Funding Program facility	73,722	90,399	73,722
Total pledged securities	\$ 110,588	\$ 136,233	\$ 110,588

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Investment securities that were in an unrealized loss position at the dates indicated are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position.

	September 30, 2023					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SELL						
U.S. agency securities	\$ —	\$ —	\$ 15,054	\$ (4,098)	\$ 15,054	\$ (4,098)
Corporate securities	—	—	4,313	(687)	4,313	(687)
Municipal bonds	5,599	(217)	102,969	(30,400)	108,568	(30,617)
Mortgage-backed securities	18,216	(84)	65,134	(14,451)	83,350	(14,535)
U.S. Small Business Administration securities	21,646	(382)	8,593	(1,692)	30,239	(2,074)
Total securities available-for-sale	45,461	(683)	196,063	(51,328)	241,524	(52,011)
SECURITIES HELD-TO-MATURITY						
Corporate securities	—	—	7,424	(1,076)	7,424	(1,076)
Total securities held-to-maturity	—	—	7,424	(1,076)	7,424	(1,076)
Total securities	\$ 45,461	\$ (683)	\$ 203,487	\$ (52,404)	\$ 248,948	\$ (53,087)
December 31, 2022						
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	\$ 3,823	\$ (118)	\$ 13,465	\$ (3,747)	\$ 17,288	\$ (3,865)
U.S. agency securities	2,494	(4)	4,026	(975)	6,520	(979)
Corporate securities	44,261	(5,794)	73,990	(17,825)	118,251	(23,619)
Municipal bonds	29,791	(3,188)	40,175	(9,270)	69,966	(12,458)
Mortgage-backed securities	10,807	(1,162)	2,044	(506)	12,851	(1,668)
Total securities available-for-sale	91,176	(10,266)	133,700	(32,323)	224,876	(42,589)
SECURITIES HELD-TO-MATURITY						
Corporate securities	7,929	(571)	—	—	7,929	(571)
Total securities held-to-maturity	7,929	(571)	—	—	7,929	(571)
Total securities	\$ 99,105	\$ (10,837)	\$ 133,700	\$ (32,323)	\$ 232,805	\$ (43,160)

There were no held-to-maturity debt securities in an unrealized loss position of less than one year and seven held-to-maturity debt securities in an unrealized loss position of more than one year at September 30, 2023. There were seven held-to-maturity debt securities in an unrealized loss position of less than one year and none in an unrealized loss position of more than one year at December 31, 2022.

There were 24 available-for-sale securities in an unrealized loss position of less than one year, and 181 available-for-sale securities in an unrealized loss position of more than one year at September 30, 2023. There were 88 available-for-sale securities in an unrealized loss position of less than one year, and 106 available-for-sale securities in an unrealized loss position of more than one year at December 31, 2022. The unrealized losses associated with these securities are believed to be caused by changing market conditions and considered to be temporary, and the Company does not intend and is not likely to be required to sell these securities prior to maturity. Management monitors the published credit ratings of the issuers of the debt securities for material ratings or outlook changes. Substantially all the Company's municipal bond portfolio is comprised of obligations of states and political subdivisions located within the Company's geographic footprint that are monitored through quarterly or annual financial review utilizing published credit ratings. All the municipal bond securities are investment grade.

All the available-for-sale mortgage-backed securities and U.S. Small Business Administration securities in an unrealized loss position are issued or guaranteed by government-sponsored enterprises, and the available-for-sale corporate securities are all investment grade and monitored for rating or outlook changes. Based on the Company's evaluation of these securities, no credit impairment was recorded for the nine months ended September 30, 2023, or for the year ended December 31, 2022.

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The contractual maturities of securities available-for-sale and held-to-maturity at the dates indicated are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	September 30,		December 31,	
	2023	Fair Value	2022	Fair Value
SECURITIES AVAILABLE-FOR-SALE				
U.S. agency securities				
Due within one year	\$ 927	\$ 912	\$ —	\$ —
Due after one year through five years	3,944	3,405	4,874	4,321
Due after five years through ten years	11,971	9,614	6,989	5,963
Due after ten years	4,310	3,165	9,290	7,004
Subtotal	21,152	17,096	21,153	17,288
Corporate securities				
Due within one year	1,000	1,009	1,000	997
Due after one year through five years	—	—	2,497	2,519
Due after five years through ten years	4,000	3,913	4,000	3,763
Due after ten years	2,000	1,432	2,000	1,266
Subtotal	7,000	6,354	9,497	8,545
Municipal bonds				
Due within one year	1,019	1,002	2,660	2,644
Due after one year through five years	37	36	1,038	1,012
Due after five years through ten years	6,255	5,525	6,341	5,771
Due after ten years	131,926	102,058	134,161	111,175
Subtotal	139,237	108,621	144,200	120,602
Mortgage-backed securities				
Federal National Mortgage Association ("FNMA")	71,822	59,197	68,421	57,358
Federal Home Loan Mortgage Corporation ("FHLMC")	28,032	26,907	9,290	8,424
Government National Mortgage Association ("GNMA")	4,243	3,503	4,713	4,184
Subtotal	104,097	89,607	82,424	69,966
U.S. Small Business Administration securities				
Due within one year	198	195	—	—
Due after one year through five years	1,889	1,777	2,553	2,407
Due after five years through ten years	13,685	13,105	4,461	3,996
Due after ten years	16,541	15,162	7,505	6,448
Subtotal	32,313	30,239	14,519	12,851
Total securities available-for-sale	303,799	251,917	271,793	229,252
SECURITIES HELD-TO-MATURITY				
Corporate securities				
Due after five years through ten years	8,500	7,424	8,500	7,929
Total securities held-to-maturity	8,500	7,424	8,500	7,929
Total securities	\$ 312,299	\$ 259,341	\$ 280,293	\$ 237,181

There were no sales proceeds, gains or losses from the sale of securities available-for-sale for the three and nine months ended September 30, 2023 and 2022.

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NOTE 4 – LOANS RECEIVABLE AND ALLOWANCE FOR CREDIT LOSSES – LOANS

The composition of the loan portfolio was as follows at the dates indicated:

	September 30, 2023	December 31, 2022
REAL ESTATE LOANS		
Commercial	\$ 364,673	\$ 334,059
Construction and development	289,873	342,591
Home equity	67,103	55,387
One-to-four-family (excludes loans held for sale)	540,670	469,485
Multi-family	243,661	219,738
Total real estate loans	<u>1,505,980</u>	<u>1,421,260</u>
CONSUMER LOANS		
Indirect home improvement	562,650	495,941
Marine	73,887	70,567
Other consumer	3,547	3,064
Total consumer loans	<u>640,084</u>	<u>569,572</u>
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	236,520	196,791
Warehouse lending	23,489	31,229
Total commercial business loans	<u>260,009</u>	<u>228,020</u>
Total loans receivable, gross	2,406,073	2,218,852
ACL for loans	(30,501)	(27,992)
Total loans receivable, net	<u>\$ 2,375,572</u>	<u>\$ 2,190,860</u>

Loan amounts are net of unearned loan fees in excess of unamortized costs and premiums of \$ 8.3 million as of September 30, 2023 and \$7.8 million as of December 31, 2022. Net loans include unamortized net discounts on acquired loans of \$ 2.8 million and \$437,000 as of September 30, 2023 and December 31, 2022, respectively. Net loans do not include accrued interest receivable. Accrued interest receivable on loans was \$ 11.0 million and \$9.6 million as of September 30, 2023 and December 31, 2022, respectively, and was reported in "Accrued interest receivable" on the Consolidated Balance Sheets.

Most of the Company's commercial and multi-family real estate, construction, residential, and/or commercial business lending activities are with customers located in Western Washington, the Oregon Coast, and near our loan production offices in Vancouver, Washington and the Tri-Cities, Washington. The Company originates real estate, consumer, and commercial business loans and has concentrations in these areas, however, indirect home improvement loans, including solar-related home improvement loans, are originated through a network of home improvement contractors and dealers located throughout Washington, Oregon, California, Idaho, Colorado, Arizona, Minnesota, Nevada, Texas, Utah, Massachusetts, Montana, and recently New Hampshire. Management reviewed dealer concentrations and determined as of September 30, 2023, any dealer owned by the same corporate entity will now be included under that corporate entity and not as a separate dealer. Loans are generally secured by collateral and rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

At September 30, 2023, the Bank held approximately \$ 1.03 billion in loans that are pledged as collateral for FHLB advances, compared to approximately \$840.2 million at December 31, 2022. The Bank held approximately \$ 629.3 million in loans that are pledged as collateral for the Federal Reserve Bank of San Francisco (the "FRB") line of credit at September 30, 2023, compared to approximately \$ 579.8 million at December 31, 2022.

The Company has defined its loan portfolio into three segments that reflect the structure of the lending function, the Company's strategic plan and the way management monitors performance and credit quality. The three loan portfolio segments are: (a) Real Estate Loans, (b) Consumer Loans, and (c) Commercial Business Loans. Each of these segments is disaggregated into classes based on the risk characteristics of the borrower and/or the collateral type securing the loan. The following is a summary of each of the Company's loan portfolio segments and classes:

Real Estate Loans

Commercial Lending. Loans originated by the Company primarily secured by income-producing properties, including retail centers, warehouses, and office buildings located in our market areas.

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Construction and Development Lending. Loans originated by the Company for the construction of, and secured by, commercial real estate, one-to-four-family, and multi-family residences and tracts of land for development that are not pre-sold. A portion of the one-to-four-family construction portfolio is custom construction loans to the intended occupant of the residence.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences, including home equity lines of credit in our market areas.

One-to-Four-Family Real Estate Lending. One-to-four-family residential loans include owner occupied properties (including second homes), and non-owner-occupied properties with four or less units. These loans originated by the Company or periodically purchased from banks are secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

Multi-Family Lending. Apartment term lending (five or more units) to current banking customers and community reinvestment loans for low to moderate income individuals in the Company's footprint.

Consumer Loans

Indirect Home Improvement. Fixture secured loans for home improvement are originated by the Company through its network of home improvement contractors and dealers and are secured by the personal property installed in, on, or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence. These indirect home improvement loans include replacement windows, siding, roofing, spas, and other home fixture installations, including solar related home improvement projects.

Marine. Loans originated by the Company, secured by boats, to borrowers primarily located in states where the Company originates consumer loans.

Other Consumer. Loans originated by the Company to consumers in our retail branch footprint, including automobiles, recreational vehicles, direct home improvement loans, loans on deposits, and other consumer loans, primarily consisting of personal lines of credit and credit cards.

Commercial Business Loans

Commercial and Industrial ("C&I") Lending. Loans originated by the Company to local small- and mid-sized businesses in our Puget Sound market area are secured primarily by accounts receivable, inventory, or personal property, plant and equipment. Some of the C&I loans purchased by the Company are outside of the greater Puget Sound market area. C&I loans are made based on the borrower's ability to make repayment from the cash flow of the borrower's business.

Warehouse Lending. Loans originated to non-depository financial institutions and secured by notes originated by the non-depository financial institution. The Company has two distinct warehouse lending divisions: commercial warehouse re-lending secured by notes on construction loans and mortgage warehouse re-lending secured by notes on one-to-four-family loans. The Company's commercial construction warehouse lines are secured by notes on construction loans and typically guaranteed by principals with experience in construction lending. Mortgage warehouse lending loans are funded through third-party residential mortgage bankers. Under this program the Company provides short-term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market.

Allowance for Credit Losses

Management identifies loans in the Company's portfolio that must be individually evaluated for loss due to disparate risk characteristics or information suggesting that the Company will be unable to collect all the principal and interest due. For loans individually evaluated, a specific reserve is estimated based on either the fair value of collateral or the discounted value of expected future cash flows. In estimating the fair value of real estate collateral, management utilizes appraisals or evaluations adjusted for costs to dispose and a distressed sale adjustment, if needed. Estimating the fair value of collateral other than real estate is also subjective in nature and sometimes requires difficult and complex judgements. Determining expected future cash flows can be more subjective than determining fair values. Expected future cash flows could differ significantly, both in timing and amount, from the cash flows received over the loan's remaining life. Individually evaluated loans are excluded from the estimation of credit losses for the pooled portfolio.

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Generally, collectively assessed loans are grouped by call report code and then risk-grade grouping. Risk grade is grouped within each call report code by pass, watch, special mention, substandard, and doubtful. Other loan types are separated into their own groups due to specific risk characteristics for that pool of loans.

The Company has elected a non-discounted cash flow methodology with probability of default ("PD") and loss given default ("LGD") for all call report code cohorts ("cohorts"), except for the indirect and marine portfolios which are evaluated under a vintage methodology. The vintage methodology measures the expected loss calculation for future periods based on historical performance by the origination period of loans with similar life cycles and risk characteristics. Guaranteed portions of loans are measured with zero risk due to cash collateral and full guaranty.

The PD calculation looks at the historical loan portfolio at points in time (each month during the lookback period) to determine the probability that loans in a certain cohort will default over the next 12-month period. A default is defined as a loan that has moved to past due 90 days and greater, nonaccrual status, or experienced a charge-off during the period. In cohorts where the Company's historical data is insufficient due to a minimal amount of default activity or zero defaults, management uses index PDs comprised of rates derived from the PD experience of other community banks in place of the Company's historical PDs. Additionally, management reviews all other cohorts to determine if index PDs should be used outside of these criteria.

The LGD calculation looks at actual losses (net charge-offs) experienced over the entire lookback period for each cohort of loans. The aggregate loss amount is divided by the exposure at default to determine an LGD rate. All defaults (non-accrual, charge-off, or greater than 90 days past due) occurring during the lookback period are included in the denominator, whether a loss occurred or not and exposure at default is determined by the loan balance immediately preceding the default event (i.e., nonaccrual or charge-off). Due to limited charge-off history, management uses index LGDs comprised of rates derived from the LGD experience of other community banks in place of the Company's historical LGDs.

The Company utilizes reasonable and supportable forecasts of future economic conditions when estimating the ACL for loans. The calculation includes a 12-month PD forecast based on the Company's regression model comparing peer nonperforming loan ratios to the national unemployment rate. After the forecast period, PD rates revert on a straight-line basis back to long-term historical average rates over a 12-month period. Due to limited default history, management uses index PDs comprised of rates derived from the PD experience of other community banks in place of the Company's historical PDs. The Company recognizes that all significant factors that affect the collectability of the loan portfolio must be considered to determine the estimated credit losses as of the evaluation date. Furthermore, the methodology, in and of itself and even when selectively adjusted by comparison to market and peer data, does not provide a sufficient basis to determine the estimated credit losses. The Company adjusts the modeled historical losses by qualitative and environmental adjustments to incorporate all significant risks to form a sufficient basis to estimate the credit losses.

Modifications to borrowers experiencing financial difficulty are included in loans collectively evaluated for credit loss. An assessment of whether a borrower is experiencing financial difficulty is made on the date of a modification. A charge to the allowance for credit losses is generally not recorded upon modification.

Management believes that the methods selected fairly reflect the historical loss component of expected losses inherent in the Company's loan portfolio. However, since future losses could vary significantly from those experienced in the past, on a quarterly basis management adjusts its historical loss experience to reflect current and forecasted conditions. In doing so, management considers a variety of general qualitative and quantitative factors ("Q-factors") and then subjectively determines the weight to assign to each in estimating losses. Qualitative characteristics include differences in underwriting standards, policies, lending staff and environmental risks. Management also considers whether further adjustments to historical loss information are needed to reflect the extent to which current conditions and reasonable and supportable forecasts over the forecasting horizon differ from the conditions that existed during the historical loss period. These quantitative adjustments reflect changes to relevant data such as changes in unemployment rates, average growth in pools of loans, concentrations of credit, delinquencies or other factors associated with the financial assets. The reversion method is applied for periods beyond the forecasting horizon. The Company's ACL allocable to pools of loans that are collectively evaluated for credit loss results primarily from these qualitative and quantitative adjustments to historical loss experience. Because of the nature of the Q-factors and the degree of judgement involved in assessing their impact, management's resulting estimate of losses may not accurately reflect current and future losses in the portfolio.

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The main drivers of the credit provision recorded in the first nine months of 2023 were increases in outstanding loans and net charge-offs, average growth rates and increases in specific reserves on individually evaluated loans.

The following tables detail activity in the ACL for loans by loan categories at or for the three and nine months ended September 30, 2023 and 2022:

	At or For the Three Months Ended September 30, 2023				
	Real Estate	Consumer	Commercial Business	Unallocated	Total
ACL FOR LOANS					
Beginning balance	\$ 12,307	\$ 14,017	\$ 4,026	\$ —	\$ 30,350
Provision (reversal of) for credit losses on loans	496	426	(238)	—	684
Charge-offs	—	(830)	—	—	(830)
Recoveries	—	297	—	—	297
Net charge-offs	—	(533)	—	—	(533)
Total ending ACL balance	<u>\$ 12,803</u>	<u>\$ 13,910</u>	<u>\$ 3,788</u>	<u>\$ —</u>	<u>\$ 30,501</u>
At or For the Three Months Ended September 30, 2022					
ACL FOR LOANS	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	\$ 11,512	\$ 10,605	\$ 2,850	\$ —	\$ 24,967
(Reversal of) provision for credit losses on loans	(213)	1,193	1,042	—	2,022
Charge-offs	—	(924)	—	—	(924)
Recoveries	—	361	—	—	361
Net charge-offs	—	(563)	—	—	(563)
Total ending ACL balance	<u>\$ 11,299</u>	<u>\$ 11,235</u>	<u>\$ 3,892</u>	<u>\$ —</u>	<u>\$ 26,426</u>
At or For the Nine Months Ended September 30, 2023					
ACL FOR LOANS	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	\$ 12,123	\$ 12,109	\$ 3,760	\$ —	\$ 27,992
Provision for credit losses on loans	690	3,383	29	—	4,102
Charge-offs	(10)	(2,415)	(1)	—	(2,426)
Recoveries	—	833	—	—	833
Net Charge-offs	(10)	(1,582)	(1)	—	(1,593)
Total ending ACL balance	<u>\$ 12,803</u>	<u>\$ 13,910</u>	<u>\$ 3,788</u>	<u>\$ —</u>	<u>\$ 30,501</u>
At or For the Nine Months Ended September 30, 2022					
ACL FOR LOANS	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance, prior to adoption of ASC 326	\$ 14,798	\$ 4,280	\$ 6,536	\$ 21	\$ 25,635
Impact of adopting ASC 326	(5,234)	6,078	(3,682)	(21)	(2,859)
Provision for credit losses on loans	1,735	1,720	1,038	—	4,493
Charge-offs	—	(1,744)	—	—	(1,744)
Recoveries	—	901	—	—	901
Net charge-offs	—	(843)	—	—	(843)
Total ending ACL balance	<u>\$ 11,299</u>	<u>\$ 11,235</u>	<u>\$ 3,892</u>	<u>\$ —</u>	<u>\$ 26,426</u>

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

Loan Modifications to Borrowers Experiencing Financial Difficulty

The Company may agree to modify the contractual terms of a loan to a borrower experiencing financial difficulty as a part of ongoing loss mitigation strategies. These modifications may result in an interest rate reduction, term extension, an other-than-insignificant payment delay, or a combination thereof. The Company typically does not offer principal forgiveness.

The Company restructured two related C&I loans during the first quarter of 2023. The restructuring included a consolidation of the loans into a single loan, an increase in contractual term of 60 months, and a reduction in the contractual interest rate from 7.5% to 4.1%. The loan had an amortized cost of \$3.1 million or 1.3% of C&I loans, at September 30, 2023. The restructured loan has been paying as agreed to subsequent to the restructuring and was classified as current and accruing as of September 30, 2023. There were no loans that were modified on or after January 1, 2023, the date the Company adopted ASU 2022-02, through September 30, 2023 that subsequently defaulted during the period presented.

Troubled Debt Restructurings ("TDRs")

At September 30, 2022, the Company had two TDRs, both of which were commercial business loans, on nonaccrual totaling \$ 3.8 million. The Company had no commitments to lend additional funds on these TDRs. The TDRs were the result of interest rate modifications and extended payment terms. The Company has not forgiven any principal on these loans. There were no TDRs which incurred a payment default within twelve months of the restructuring date during the three and nine months ended September 30, 2022.

The following tables provide information pertaining to the aging analysis of contractually past due loans and nonaccrual loans at September 30, 2023 and December 31, 2022:

	September 30, 2023						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non- Accrual (1)
REAL ESTATE LOANS							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 364,673	\$ 364,673	\$ 1,074
Construction and development	—	—	—	—	289,873	289,873	—
Home equity	37	154	12	203	66,900	67,103	48
One-to-four-family	—	—	306	306	540,364	540,670	306
Multi-family	—	—	—	—	243,661	243,661	—
Total real estate loans	37	154	318	509	1,505,471	1,505,980	1,428
CONSUMER LOANS							
Indirect home improvement	1,546	824	465	2,835	559,815	562,650	1,668
Marine	348	142	72	562	73,325	73,887	406
Other consumer	9	—	—	9	3,538	3,547	3
Total consumer loans	1,903	966	537	3,406	636,678	640,084	2,077
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	399	—	2,114	2,513	234,007	236,520	2,114
Warehouse lending	—	—	—	—	23,489	23,489	—
Total commercial business loans	399	—	2,114	2,513	257,496	260,009	2,114
Total loans	\$ 2,339	\$ 1,120	\$ 2,969	\$ 6,428	\$ 2,399,645	\$ 2,406,073	\$ 5,619

	December 31, 2022						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non- Accrual (1)
REAL ESTATE LOANS							
Commercial	\$ —	\$ —	\$ —	\$ —	\$ 334,059	\$ 334,059	\$ —
Construction and development	—	—	—	—	342,591	342,591	—
Home equity	29	104	16	149	55,238	55,387	46
One-to-four-family	—	—	463	463	469,022	469,485	920
Multi-family	—	—	—	—	219,738	219,738	—
Total real estate loans	29	104	479	612	1,420,648	1,421,260	966
CONSUMER LOANS							
Indirect home improvement	2,298	685	532	3,515	492,426	495,941	1,076
Marine	650	385	86	1,121	69,446	70,567	267
Other consumer	32	37	5	74	2,990	3,064	9
Total consumer loans	2,980	1,107	623	4,710	564,862	569,572	1,352
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	1	—	2,617	2,618	194,173	196,791	6,334
Warehouse lending	—	—	—	—	31,229	31,229	—
Total commercial business loans	1	—	2,617	2,618	225,402	228,020	6,334
Total loans	\$ 3,010	\$ 1,211	\$ 3,719	\$ 7,940	\$ 2,210,912	\$ 2,218,852	\$ 8,652

(1) Includes past due loans as applicable.

There were no loans 90 days or more past due and still accruing interest at both September 30, 2023 and December 31, 2022.

Credit Quality Indicators

As part of the Company's on-going monitoring of credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grading of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans, and (v) the general economic conditions in the Company's markets.

The Company utilizes a risk grading matrix to assign a risk grade to its real estate and commercial business loans. Loans are graded on a scale of 1 to 10, with loans in risk grades 1 to 6 considered "Pass" and loans in risk grades 7 to 10 are reported as classified loans in the Company's ACL loan analysis.

A description of the 10 risk grades is as follows:

- *Grades 1 and 2* - These grades include loans to very high-quality borrowers with excellent or desirable business credit.
- *Grade 3* - This grade includes loans to borrowers of good business credit with moderate risk.
- *Grades 4 and 5* - These grades include "Pass" grade loans to borrowers of average credit quality and risk.
- *Grade 6* - This grade includes loans on management's "Watch" list and is intended to be utilized on a temporary basis for "Pass" grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.
- *Grade 7* - This grade is for "Other Assets Especially Mentioned ("OAEM")" or "Special Mention" in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.
- *Grade 8* - This grade includes "Substandard" loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.
- *Grade 9* - This grade includes "Doubtful" loans in accordance with regulatory guidelines where a loss is highly probable.
- *Grade 10* - This grade includes "Loss" loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

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Homogeneous loans are risk rated based upon the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded "Pass" and risk rated "4" or "5" internally. Loans that are past due more than 90 days are classified "Substandard" risk graded "8" internally until the loan has demonstrated consistent performance, typically six months of contractual payments. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell. Management may choose to conservatively risk rate credits even if paying in accordance with the loan's repayment terms.

Commercial real estate, construction and development, multi-family and commercial business loans are evaluated individually for their risk classification and may be classified as "Substandard" even if current on their loan payment obligations. We regularly review our credits for accuracy of risk grades whenever we receive new information. Borrowers are generally required to submit financial information at regular intervals. Typically, commercial borrowers with lines of credit are required to submit financial information with reporting intervals ranging from monthly to annually depending on credit size, risk, and complexity. In addition, nonowner-occupied commercial real estate borrowers with loans exceeding a certain dollar threshold are usually required to submit rent rolls or property income statements annually. We monitor construction loans monthly. We also review loans graded "Watch" or worse, regardless of loan type, no less than quarterly.

The following tables summarize risk rated loan balances by category as of the dates indicated. Term loans that were renewed or extended for periods longer than 90 days are presented as a new origination in the year of the most recent renewal or extension.

REAL ESTATE LOANS	September 30, 2023								
	Term Loans by Year of Origination						Revolving Loans Converted		
	2023	2022	2021	2020	2019	Prior	Revolving Loans	to Term	Total Loans
Commercial									
Pass	\$ 41,310	\$ 91,503	\$ 62,998	\$ 46,486	\$ 28,149	\$ 63,178	\$ 2,373	\$ 328	\$ 336,325
Watch	3,209	5,459	12,952	—	453	2,239	17	—	24,329
Special mention	—	—	—	—	413	—	—	—	413
Substandard	—	—	—	1,658	—	1,948	—	—	3,606
Total commercial	44,519	96,962	75,950	48,144	29,015	67,365	2,390	328	364,673
Construction and development									
Pass	76,516	143,886	51,430	17,486	—	555	—	—	289,873
Total construction and development	76,516	143,886	51,430	17,486	—	555	—	—	289,873
Home equity									
Pass	3,702	1,144	1,595	6,639	11	2,228	51,736	—	67,055
Substandard	—	—	—	—	—	37	11	—	48
Total home equity	3,702	1,144	1,595	6,639	11	2,265	51,747	—	67,103
Home equity gross charge-offs	—	—	—	—	—	—	10	—	10
One-to-four-family									
Pass	85,810	164,378	124,098	80,260	31,569	50,992	—	475	537,582
Watch	—	—	—	—	—	—	—	—	—
Substandard	—	869	—	—	—	2,219	—	—	3,088
Total one-to-four-family	85,810	165,247	124,098	80,260	31,569	53,211	—	475	540,670
Multi-family									
Pass	4,478	34,134	91,253	47,666	38,198	27,932	—	—	243,661
Total multi-family	4,478	34,134	91,253	47,666	38,198	27,932	—	—	243,661
Total real estate loans	\$ 215,025	\$ 441,373	\$ 344,326	\$ 200,195	\$ 98,793	\$ 151,328	\$ 54,137	\$ 803	\$ 1,505,980

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September 30, 2023										
CONSUMER LOANS	Term Loans by Year of Origination						Revolving Loans Converted			
	2023	2022	2021	2020	2019	Prior	Revolving Loans	to Term	Total Loans	
Indirect home improvement										
Pass	\$ 140,778	\$ 224,259	\$ 99,785	\$ 38,229	\$ 25,370	\$ 32,555	\$ 6	\$ —	\$ 560,982	
Substandard	149	542	360	213	235	169	—	—	1,668	
Total indirect home improvement	<u>140,927</u>	<u>224,801</u>	<u>100,145</u>	<u>38,442</u>	<u>25,605</u>	<u>32,724</u>	<u>6</u>	<u>—</u>	<u>562,650</u>	
Indirect home improvement gross charge-offs	90	834	471	191	153	233	—	—	1,972	
Marine										
Pass	12,050	24,527	10,329	13,623	5,407	7,545	—	—	73,481	
Substandard	—	—	25	—	87	294	—	—	406	
Total marine	<u>12,050</u>	<u>24,527</u>	<u>10,354</u>	<u>13,623</u>	<u>5,494</u>	<u>7,839</u>	<u>—</u>	<u>—</u>	<u>73,887</u>	
Marine gross charge-offs	—	47	93	—	7	182	—	—	329	
Other consumer										
Pass	220	635	199	81	5	209	2,195	—	3,544	
Substandard	—	—	—	—	—	—	3	—	3	
Total other consumer	<u>220</u>	<u>635</u>	<u>199</u>	<u>81</u>	<u>5</u>	<u>209</u>	<u>2,198</u>	<u>—</u>	<u>3,547</u>	
Other consumer gross charge-offs	—	2	22	—	—	—	90	—	114	
Total consumer loans	<u>\$ 153,197</u>	<u>\$ 249,963</u>	<u>\$ 110,698</u>	<u>\$ 52,146</u>	<u>\$ 31,104</u>	<u>\$ 40,772</u>	<u>\$ 2,204</u>	<u>\$ —</u>	<u>\$ 640,084</u>	
September 30, 2023										
COMMERCIAL BUSINESS LOANS	Term Loans by Year of Origination						Revolving Loans Converted			
	2023	2022	2021	2020	2019	Prior	Revolving Loans	to Term	Total Loans	
Commercial and industrial										
Pass	\$ 13,252	\$ 31,185	\$ 22,174	\$ 12,181	\$ 5,401	\$ 10,999	\$ 111,899	\$ 879	\$ 207,970	
Watch	259	—	1,436	2,507	—	1,113	9,726	—	15,041	
Special mention	—	—	—	—	542	263	2,362	—	3,167	
Substandard	3,105	—	1,557	1,435	1,766	173	2,306	—	10,342	
Total commercial and industrial	<u>16,616</u>	<u>31,185</u>	<u>25,167</u>	<u>16,123</u>	<u>7,709</u>	<u>12,548</u>	<u>126,293</u>	<u>879</u>	<u>236,520</u>	
Commercial and industrial gross charge-offs	—	—	1	—	—	—	—	—	1	
Warehouse lending										
Pass	—	—	—	—	—	—	22,267	—	22,267	
Watch	—	—	—	—	—	—	1,222	—	1,222	
Total warehouse lending	—	—	—	—	—	—	23,489	—	23,489	
Total commercial business loans	<u>\$ 16,616</u>	<u>\$ 31,185</u>	<u>\$ 25,167</u>	<u>\$ 16,123</u>	<u>\$ 7,709</u>	<u>\$ 12,548</u>	<u>\$ 149,782</u>	<u>\$ 879</u>	<u>\$ 260,009</u>	
TOTAL LOANS RECEIVABLE, GROSS										
Pass	\$ 378,116	\$ 715,651	\$ 463,861	\$ 262,651	\$ 134,110	\$ 196,193	\$ 190,476	\$ 1,682	\$ 2,342,740	
Watch	3,468	5,459	14,388	2,507	453	3,352	10,965	—	40,592	
Special mention	—	—	—	—	955	263	2,362	—	3,580	
Substandard	3,254	1,411	1,942	3,306	2,088	4,840	2,320	—	19,161	
Total loans receivable, gross	<u>\$ 384,838</u>	<u>\$ 722,521</u>	<u>\$ 480,191</u>	<u>\$ 268,464</u>	<u>\$ 137,606</u>	<u>\$ 204,648</u>	<u>\$ 206,123</u>	<u>\$ 1,682</u>	<u>\$ 2,406,073</u>	
Total gross charge-offs	<u>\$ 90</u>	<u>\$ 883</u>	<u>\$ 587</u>	<u>\$ 191</u>	<u>\$ 160</u>	<u>\$ 415</u>	<u>\$ 100</u>	<u>\$ —</u>	<u>\$ 2,426</u>	

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December 31, 2022										
REAL ESTATE LOANS	Term Loans by Year of Origination							Revolving Loans Converted		
	2022	2021	2020	2019	2018	Prior	Revolving Loans	to Term	Total Loans	
Commercial										
Pass	\$ 86,189	\$ 76,030	\$ 46,125	\$ 38,930	\$ 14,101	\$ 55,271	\$ —	\$ —	\$ 316,646	
Watch	9,504	—	373	—	—	—	—	—	9,877	
Special mention	—	—	—	2,113	—	—	—	—	2,113	
Substandard	—	—	—	—	581	4,842	—	—	5,423	
Total commercial	95,693	76,030	46,498	41,043	14,682	60,113	—	—	334,059	
Construction and development										
Pass	193,084	118,724	21,966	8,379	—	438	—	—	342,591	
Total construction and development	193,084	118,724	21,966	8,379	—	438	—	—	342,591	
Home equity										
Pass	4,978	1,696	6,818	11	1,203	1,572	39,063	—	55,341	
Substandard	—	—	—	—	13	33	—	—	46	
Total home equity	4,978	1,696	6,818	11	1,216	1,605	39,063	—	55,387	
One-to-four-family										
Pass	166,388	129,282	82,461	31,878	15,837	40,526	—	199	466,571	
Substandard	—	—	—	—	1,941	973	—	—	2,914	
Total one-to-four-family	166,388	129,282	82,461	31,878	17,778	41,499	—	199	469,485	
Multi-family										
Pass	41,041	63,353	48,376	38,805	4,176	23,987	—	—	219,738	
Total multi-family	41,041	63,353	48,376	38,805	4,176	23,987	—	—	219,738	
Total real estate loans	\$ 501,184	\$ 389,085	\$ 206,119	\$ 120,116	\$ 37,852	\$ 127,642	\$ 39,063	\$ 199	\$ 1,421,260	
December 31, 2022										
CONSUMER LOANS	Term Loans by Year of Origination							Revolving Loans Converted		
	2022	2021	2020	2019	2018	Prior	Revolving Loans	to Term	Total Loans	
Indirect home improvement										
Pass	\$ 253,495	\$ 123,264	\$ 46,476	\$ 31,251	\$ 18,165	\$ 22,205	\$ 9	\$ —	\$ 494,865	
Substandard	347	213	137	62	169	148	—	—	1,076	
Total indirect home improvement	253,842	123,477	46,613	31,313	18,334	22,353	9	—	495,941	
Marine										
Pass	27,904	11,762	15,139	6,224	5,415	3,856	—	—	70,300	
Substandard	—	—	—	151	61	55	—	—	267	
Total marine	27,904	11,762	15,139	6,375	5,476	3,911	—	—	70,567	
Other consumer										
Pass	792	754	116	48	14	80	1,251	—	3,055	
Substandard	1	5	—	—	—	—	3	—	9	
Total other consumer	793	759	116	48	14	80	1,254	—	3,064	
Total consumer loans	\$ 282,539	\$ 135,998	\$ 61,868	\$ 37,736	\$ 23,824	\$ 26,344	\$ 1,263	\$ —	\$ 569,572	
December 31, 2022										
COMMERCIAL BUSINESS LOANS	Term Loans by Year of Origination							Revolving Loans Converted		
	2022	2021	2020	2019	2018	Prior	Revolving Loans	to Term	Total Loans	
Commercial and industrial										
Pass	\$ 24,337	\$ 22,561	\$ 12,461	\$ 3,940	\$ 3,074	\$ 7,701	\$ 104,524	\$ —	\$ 178,598	
Watch	—	1,127	2,932	—	—	746	1,327	—	6,132	
Special mention	—	—	—	634	—	—	963	—	1,597	
Substandard	—	1,586	1,265	2,291	190	3,739	1,093	300	10,464	
Total commercial and industrial	24,337	25,274	16,658	6,865	3,264	12,186	107,907	300	196,791	
Warehouse lending										
Pass	—	—	—	—	—	—	31,227	—	31,227	
Watch	—	—	—	—	—	—	2	—	2	
Total warehouse lending	—	—	—	—	—	—	31,229	—	31,229	
Total commercial business loans	\$ 24,337	\$ 25,274	\$ 16,658	\$ 6,865	\$ 3,264	\$ 12,186	\$ 139,136	\$ 300	\$ 228,020	
TOTAL LOANS RECEIVABLE, GROSS										
Pass	\$ 798,208	\$ 547,426	\$ 279,938	\$ 159,466	\$ 61,985	\$ 155,636	\$ 176,074	\$ 199	\$ 2,178,932	
Watch	9,504	1,127	3,305	—	—	746	1,329	—	16,011	
Special mention	—	—	—	2,747	—	—	963	—	3,710	
Substandard	348	1,804	1,402	2,504	2,955	9,790	1,096	300	20,199	
Total loans receivable, gross	\$ 808,060	\$ 550,357	\$ 284,645	\$ 164,717	\$ 64,940	\$ 166,172	\$ 179,462	\$ 499	\$ 2,218,852	

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The following table presents the amortized cost basis of loans on nonaccrual status as of the dates indicated:

	September 30, 2023			December 31, 2022		
	Nonaccrual with No ACL	Nonaccrual with ACL	Total Nonaccrual	Nonaccrual with No ACL	Nonaccrual with ACL	Total Nonaccrual
REAL ESTATE LOANS						
Commercial	\$ 1,074	\$ —	\$ 1,074	\$ —	\$ —	\$ —
Home equity	48	—	48	46	—	46
One-to-four-family	306	—	306	920	—	920
	<u>1,428</u>	<u>—</u>	<u>1,428</u>	<u>966</u>	<u>—</u>	<u>966</u>
CONSUMER LOANS						
Indirect home improvement	—	1,668	1,668	—	1,076	1,076
Marine	—	406	406	—	267	267
Other consumer	—	3	3	—	9	9
	<u>—</u>	<u>2,077</u>	<u>2,077</u>	<u>—</u>	<u>1,352</u>	<u>1,352</u>
COMMERCIAL BUSINESS LOANS						
Commercial and industrial	—	2,114	2,114	—	6,334	6,334
Total	\$ 1,428	\$ 4,191	\$ 5,619	\$ 966	\$ 7,686	\$ 8,652

The Company recognized interest income on a cash basis for nonaccrual loans of \$ 55,000 and \$144,000 during the three months ended September 30, 2023 and 2022, and \$164,000 and \$370,000 during the nine months ended September 30, 2023 and 2022, respectively.

The following table presents the amortized cost basis of collateral dependent loans by class of loans as of the dates indicated:

	September 30, 2023				December 31, 2022		
	Commercial	Residential	Other Non-Real Estate	Total	Residential	Other Non-Real Estate	Total
	Real Estate	Real Estate	Real Estate	Real Estate	Real Estate	Real Estate	Real Estate
REAL ESTATE LOANS							
Commercial	\$ 1,074	\$ —	\$ —	\$ 1,074	\$ —	\$ —	\$ —
Home equity	—	48	—	48	46	—	46
One-to-four-family	—	306	—	306	920	—	920
	<u>1,074</u>	<u>354</u>	<u>—</u>	<u>1,428</u>	<u>966</u>	<u>—</u>	<u>966</u>
CONSUMER LOANS							
Indirect home improvement	—	—	1,668	1,668	—	1,076	1,076
Marine	—	—	406	406	—	267	267
	<u>—</u>	<u>—</u>	<u>2,074</u>	<u>2,074</u>	<u>—</u>	<u>1,343</u>	<u>1,343</u>
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	—	—	2,114	2,114	—	6,334	6,334
Total	\$ 1,074	\$ 354	\$ 4,188	\$ 5,616	\$ 966	\$ 7,677	\$ 8,643

NOTE 5 – SERVICING RIGHTS

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balance of permanent loans serviced for others was \$2.83 billion and \$2.78 billion at September 30, 2023 and December 31, 2022, respectively.

The following table summarizes mortgage servicing rights ("MSR") activity at or for the dates indicated:

	At or For the Three Months Ended September 30,	
	2023	2022
Beginning balance, at the lower of cost or fair value	\$ 17,627	\$ 18,516
Additions	954	925
MSR amortized	(924)	(971)
Ending balance, at the lower of cost or fair value	<u>\$ 17,657</u>	<u>\$ 18,470</u>

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	At or For the Nine Months Ended September 30,	
	2023	2022
Beginning balance, at the lower of cost or fair value	\$ 18,017	\$ 16,970
Additions	2,279	4,935
MSR amortized	(2,639)	(3,436)
Recovery of servicing rights	—	1
Ending balance, at the lower of cost or fair value	<u>\$ 17,657</u>	<u>\$ 18,470</u>

The fair value of the servicing rights' assets was \$ 38.9 million and \$35.5 million at September 30, 2023 and December 31, 2022, respectively. Fair value adjustments to servicing rights are mainly due to market-based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following provides valuation assumptions used in determining the fair value of MSR at the dates indicated:

Key assumptions:	At September 30, 2023	At December 31, 2022
Weighted average discount rate	10.2%	9.6%
Conditional prepayment rate ("CPR")	6.3%	8.2%
Weighted average life in years	8.8	7.8

Key economic assumptions of the current fair value for single family MSR are presented in the table below. Also presented is the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four-family FNMA, FHLMC, GNMA, or FHLB serviced home loan. The table below references a 50 basis point and 100 basis point adverse rate change and the impact on prepayment speeds and discount rates at the dates indicated:

	Base	September 30, 2023		December 31, 2022	
		0.5% Adverse Rate Change	1.0% Adverse Rate Change	0.5% Adverse Rate Change	1.0% Adverse Rate Change
Aggregate portfolio principal balance		\$ 2,825,752	\$ 2,783,458		
Weighted average rate of loans in servicing portfolio		3.6%	3.4%		
At September 30, 2023	Base				
Conditional prepayment rate		6.3%	6.7%		7.2%
Fair value MSR	\$ 38,858	\$ 38,411	\$ 37,752		
Percentage of MSR	1.4%	1.4%	1.3%		
Discount rate		10.2%	10.7%		11.2%
Fair value MSR	\$ 38,858	\$ 37,978	\$ 37,133		
Percentage of MSR	1.4%	1.3%	1.3%		
At December 31, 2022	Base				
Conditional prepayment rate		8.2%	8.6%		9.3%
Fair value MSR	\$ 35,478	\$ 34,997	\$ 34,188		
Percentage of MSR	1.3%	1.3%	1.2%		
Discount rate		9.6%	10.1%		10.6%
Fair value MSR	\$ 35,478	\$ 34,715	\$ 33,984		
Percentage of MSR	1.3%	1.2%	1.2%		

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These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR which is extremely sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on the fair value of MSR. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance, however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of the fair value of MSR is limited by the conditions existing and assumptions made at a particular point in time. Those assumptions may not be appropriate if they are applied to a different time.

The Company recorded \$1.8 million of gross contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of loans for both the three months ended September 30, 2023 and 2022, and \$5.4 million and \$5.3 million for the nine months ended September 30, 2023 and 2022, respectively. The income, net of MSR amortization, is reported in "Service charges and fee income" on the Consolidated Statements of Income.

NOTE 6 – DERIVATIVES

The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates.

The Company's predominant derivative and hedging activities involve interest rate swaps related to certain borrowings, brokered deposits, investment securities, forward sales contracts, and commitments to extend credit associated with mortgage banking activities. Generally, these instruments help the Company manage exposure to market risk. Market risk represents the possibility that economic value or net interest income will be adversely affected by fluctuations in external factors such as market-driven interest rates and prices or other economic factors.

Mortgage Banking Derivatives Not Designated as Hedges

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has exposure to movements in interest rates associated with written interest rate lock commitments with potential borrowers to originate one-to-four-family loans that are intended to be sold and for closed one-to-four-family mortgage loans held for sale for which fair value accounting has been elected, that are awaiting sale and delivery into the secondary market. The Company economically hedges the risk of changing interest rates associated with these mortgage loan commitments by entering into forward sales contracts to sell one-to-four-family mortgage loans or into contracts to sell forward To-Be-Announced ("TBA") mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments for reporting purposes under U.S. GAAP. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income or noninterest expense. The Bank recognizes all derivative instruments as either "Other assets" or "Other liabilities" on the Consolidated Balance Sheets and measures those instruments at fair value.

Customer Swaps Not Designated as Hedges

The Company also enters into derivative contracts, which consist of interest rate swaps, to facilitate the needs of clients desiring to manage interest rate risk. These swaps are not designated as accounting hedges under ASC 815, Derivatives and Hedging. To economically hedge the interest rate risk associated with offering this product, the Company simultaneously enters into derivative contracts with third parties to offset the customer contracts such that the Company minimizes its net risk exposure resulting from such transactions. The derivative contracts are structured such that the notional amounts reduce over time to generally match the expected amortization of the underlying loans. These derivatives are not speculative and arise from a service provided to clients.

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Cash Flow Hedges

The Bank has entered into interest rate swaps to reduce the exposure to variability in interest-related cash outflows related to brokered deposits. These derivative instruments are designated as cash flow hedges. Changes to the amount of interest payment cash flows for the hedged transactions attributable to a change in credit risk are excluded from management's assessment of hedge effectiveness. The Bank tests hedging effectiveness on a quarterly basis. The accumulated other comprehensive income is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The Bank has not recorded any hedge ineffectiveness since inception.

The Bank expects that approximately \$5.1 million will be reclassified from accumulated other comprehensive loss as a decrease to interest expense over the next 12 months related to these cash flow hedges.

Fair Value Hedges

The Company is exposed to changes in the fair value of certain of its pools of prepayable fixed-rate assets due to changes in benchmark interest rates. The Company uses interest rate swaps to manage its exposure to changes in fair value on these instruments attributable to changes in the designated benchmark interest rate, the SOFR. Interest rate swaps designated as fair value hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without the exchange of the underlying notional amount. For derivatives designated and that qualify as fair value hedges, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in interest income.

The following amounts were recorded on the balance sheet related to cumulative-basis adjustment for fair value hedges for the dates indicated:

Line item in the statement of financial position in which the hedged item is included	Carrying Amount of the Hedged Assets	Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets
September 30, 2023		
Investment securities (1)	\$ 53,984	\$ 6,016
Total	\$ 53,984	\$ 6,016
December 31, 2022		
Investment securities (1)	\$ 55,893	\$ 4,107
Total	\$ 55,893	\$ 4,107

(1) These amounts include the amortized cost basis of closed portfolios used in designated hedging relationships in which the hedged item is the last layer expected to be remaining at the end of the hedging relationship. At September 30, 2023, the amortized cost basis of the closed portfolios used in these hedging relationships was \$237.8 million; the cumulative basis adjustments associated with these hedging relationships was \$ 6.0 million; and the amounts of the designated hedged items was \$60.0 million.

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The following tables summarize the Company's derivative instruments at the dates indicated. The Company has master netting agreements with derivative dealers with which it does business, but reflects gross assets and liabilities as "Other assets" and "Other liabilities," respectively, on the Consolidated Balance Sheets, as follows:

	September 30, 2023		
	Fair Value		
	Notional	Asset	Liability
Cash flow hedges:			
Interest rate swaps - brokered deposits	\$ 200,000	\$ 8,402	\$ —
Fair value hedges:			
Interest rate swaps - securities	60,000	5,991	—
Non-hedging derivatives:			
Fallout adjusted interest rate lock commitments with customers	26,982	175	—
Mandatory and best effort forward commitments with investors	5,919	21	—
Forward TBA mortgage-backed securities	34,000	355	—
Customer swap positions	882	—	90
Dealer offsets to customer swap positions	882	92	—

	December 31, 2022		
	Fair Value		
	Notional	Asset	Liability
Cash flow hedges:			
Interest rate swaps - brokered deposits	\$ 90,000	\$ 5,780	\$ —
Fair value hedges:			
Interest rate swaps - securities	60,000	4,090	—
Non-hedging derivatives:			
Fallout adjusted interest rate lock commitments with customers	8,837	107	—
Mandatory and best effort forward commitments with investors	4,558	—	38
Forward TBA mortgage-backed securities	27,000	164	—

The following table summarizes the effect of fair value and cash flow hedge accounting on the Consolidated Statements of Income for the three and nine months ended September 30, 2023 and 2022:

	Three Months Ended September 30,			
	2023		2022	
	Interest Expense Deposits	Interest Income Securities	Interest Expense Deposits	Interest Income Securities
Total amounts presented on the Consolidated Statements of Income	\$ 10,462	\$ 3,396	\$ 2,596	\$ 1,741
Net gains (losses) on fair value hedging relationships:				
Interest rate swaps - securities	—	(1,286)	—	(3,383)
Recognized on hedged items	—	1,842	—	3,313
Recognized on derivatives designated as hedging instruments	—	556	—	(70)
Net income (expense) recognized on fair value hedges	\$ —	\$ —	\$ —	\$ —
Net gain on cash flow hedging relationships:				
Interest rate swaps - brokered deposits and borrowings	Realized gains (pre-tax) reclassified from AOCI into net income	\$ 1,446	\$ 278	\$ —
Net income recognized on cash flow hedges		\$ 1,446	\$ 278	\$ —

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	Nine Months Ended September 30,			
	2023		2022	
	Interest Expense Deposits	Interest Income Securities	Interest Expense Deposits	Interest Income Securities
Total amounts presented on the Consolidated Statements of Income	\$ 24,696	\$ 8,667	\$ 5,438	\$ 4,990
Net gains (losses) on fair value hedging relationships:				
Interest rate swaps - securities				
Recognized on hedged items	—	(689)	—	(4,316)
Recognized on derivatives designated as hedging instruments	—	1,901	—	4,144
Net income (expense) recognized on fair value hedges	<u>\$ —</u>	<u>\$ 1,212</u>	<u>\$ —</u>	<u>\$ (172)</u>
Net gain on cash flow hedging relationships:				
Interest rate swaps - brokered deposits and borrowings				
Realized gains (pre-tax) reclassified from AOCI into net income	\$ 3,624	\$ —	\$ 232	\$ —
Net income recognized on cash flow hedges	<u>\$ 3,624</u>	<u>\$ —</u>	<u>\$ 232</u>	<u>\$ —</u>

Changes in the fair value of the non-hedging derivatives recognized in "Noninterest income" on the Consolidated Statements of Income and included in gain on sale of loans resulted in net losses of \$107,000 and net gains of \$34,000 for the three months ended September 30, 2023 and 2022, and net gains of \$266,000 and net losses of \$1.7 million for the nine months ended September 30, 2023 and 2022, respectively.

The following tables present a summary of amounts outstanding in derivative financial instruments including those entered into in connection with the same counter-party under master netting agreements at the dates indicated. While these agreements are typically over-collateralized, GAAP requires disclosures in this table to limit the amount of such collateral to the amount of the related asset or liability for each counter-party.

Offsetting of derivative assets	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets Presented in the Statement of Financial Position		Gross Amounts Not Offset in the Statement of Financial Position		
			Financial Instruments	Cash Collateral Received	Net Amount		
September 30, 2023							
Interest rate swaps	\$ 14,485	\$ —	\$ 14,485	\$ —	\$ —	\$ —	\$ 14,485
December 31, 2022							
Interest rate swaps	\$ 9,870	\$ —	\$ 9,870	\$ —	\$ —	\$ —	\$ 9,870

Credit–Risk–Related Contingent Features

The Company has interest rate swap agreements with certain of its derivative counterparties that contain a provision where if the Company either defaults or fails to maintain its status as a well or adequately capitalized institution, then the Company could be required to terminate the contracts or post additional collateral. At September 30, 2023, the Company had no derivatives in a net liability position related to these agreements, and therefore had no collateral posted. In certain cases, the Company will have posted excess collateral, compared to total exposure due to initial margin requirements or day-to-day rate volatility.

NOTE 7 – LEASES

The Company has operating leases for retail bank and home lending branches, loan production offices, and certain equipment. The Company's leases have remaining lease terms of six months to six years and nine months, some of which include options to extend the leases for up to five years.

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The components of lease cost (included in occupancy expense on the Consolidated Statements of Income) are as follows for the three and nine months ended September 30, 2023 and 2022:

	Three Months Ended September 30, 2023	Three Months Ended September 30, 2022
Lease cost:		
Operating lease cost	\$ 476	\$ 350
Short-term lease cost	5	8
Total lease cost	\$ 481	\$ 358
Lease cost:		
Operating lease cost	\$ 1,357	\$ 1,041
Short-term lease cost	14	16
Total lease cost	\$ 1,371	\$ 1,057

The following tables provide supplemental information related to operating leases at or for the three and nine months ended September 30, 2023 and 2022:

	At or For the Three Months Ended September 30, 2023	At or For the Three Months Ended September 30, 2022
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 486	\$ 360
Weighted average remaining lease term- operating leases (in years)	4.2	4.7
Weighted average discount rate- operating leases	2.93%	2.41%

	At or For the Nine Months Ended September 30, 2023	At or For the Nine Months Ended September 30, 2022
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 1,392	\$ 1,063
Weighted average remaining lease term- operating leases (in years)	4.2	4.7
Weighted average discount rate- operating leases	2.93%	2.41%

The Company's leases typically do not contain a discount rate implicit in the lease contract. As an alternative, the discount rate used in determining the lease liability for each individual lease was the FHLB of Des Moines' fixed-advance rate.

Maturities of operating lease liabilities at September 30, 2023 for future periods are as follows:

Remainder of 2023	\$ 483
2024	1,933
2025	1,628
2026	1,475
2027	1,173
Thereafter	1,383
Total lease payments	8,075
Less imputed interest	(806)
Total	\$ 7,269

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NOTE 8 – OTHER REAL ESTATE OWNED (“OREO”)

The following table presents the activity related to OREO at or for the three and nine months ended September 30, 2023 and 2022:

	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
	2023	2022	2023	2022
Beginning balance	\$ 570	\$ 145	\$ 570	\$ —
Additions	—	—	—	145
Loans transferred to OREO	—	—	—	—
Ending balance	<u>\$ 570</u>	<u>\$ 145</u>	<u>\$ 570</u>	<u>\$ 145</u>

There was one OREO property (a closed branch in Centralia, Washington) at September 30, 2023 and one at September 30, 2022. There were no OREO holding costs for the three and nine months ended September 30, 2023 and 2022.

There were \$317,000 and \$511,000 in portfolio mortgage loans collateralized by residential real estate in the process of foreclosure at September 30, 2023 and at December 31, 2022, respectively.

NOTE 9 – DEPOSITS

Deposits are summarized as follows at the dates indicated:

	September 30, 2023	December 31, 2022
Noninterest-bearing checking	\$ 643,670	\$ 537,938
Interest-bearing checking (1)	219,469	135,127
Savings	157,901	134,358
Money market (2)	389,962	574,290
Certificates of deposit less than \$100,000 (3)	527,032	440,785
Certificates of deposit of \$100,000 through \$250,000	406,545	195,447
Certificates of deposit of \$250,000 and over	83,377	93,560
Escrow accounts related to mortgages serviced (4)	26,488	16,236
Total	<u>\$ 2,454,444</u>	<u>\$ 2,127,741</u>

(1) Includes \$50.1 million and \$2.3 million of brokered deposits at September 30, 2023 and December 31, 2022, respectively.

(2) Includes \$51,000 and \$59.7 million of brokered deposits at September 30, 2023 and December 31, 2022, respectively.

(3) Includes \$323.3 million and \$332.0 million of brokered deposits at September 30, 2023 and December 31, 2022, respectively.

(4) Noninterest-bearing accounts.

Scheduled maturities of time deposits at September 30, 2023 for future periods ending are as follows:

	\$	338,756
Maturing in 2023		
Maturing in 2024		483,059
Maturing in 2025		128,932
Maturing in 2026		44,517
Maturing in 2027		20,739
Thereafter		951
Total	\$	<u>1,016,954</u>

Interest expense by deposit category for the periods indicated is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2023	2022	2023	2022
Interest-bearing checking	\$ 643	\$ 100	\$ 1,111	\$ 353
Savings and money market	1,529	1,303	4,071	2,397
Certificates of deposit	8,290	1,193	19,514	2,688
Total	<u>\$ 10,462</u>	<u>\$ 2,596</u>	<u>\$ 24,696</u>	<u>\$ 5,438</u>

NOTE 10 – COMMITMENTS AND CONTINGENCIES

Commitments – The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The following table provides a summary of the Company's commitments at the dates indicated:

	September 30, 2023	December 31, 2022
REAL ESTATE LOANS		
Commercial	\$ 4,584	\$ 1,260
Construction and development	161,247	201,708
One-to-four-family (includes locks for saleable loans)	30,895	10,713
Home equity	96,548	77,566
Multi-family	2,931	2,999
Total real estate loans	<u>296,205</u>	<u>294,246</u>
CONSUMER LOANS		
	<u>30,393</u>	<u>39,406</u>
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	164,727	150,109
Warehouse lending	57,158	64,781
Total commercial business loans	<u>221,885</u>	<u>214,890</u>
Total commitments to extend credit	<u>\$ 548,483</u>	<u>\$ 548,542</u>

Commitments to extend credit are agreements to lend to a customer provided there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the amount of the total commitments does not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon an extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit, revolving credit lines, and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company's ACL – unfunded loan commitments at September 30, 2023 and December 31, 2022 was \$1.8 million and \$2.5 million, respectively. The decline in the ACL was due to the Company recording a recovery from the ACL – unfunded loan commitments of \$745,000 for the nine months ended September 30, 2023, as compared to a provision for credit losses – unfunded loan commitments of \$180,000 for the nine months ended September 30, 2022. The Company recorded a recovery from the ACL – unfunded loan commitments of \$149,000 and \$305,000 for the three months ended September 30, 2023 and September 30, 2022, respectively, primarily attributable to a decline in unfunded construction loan commitments over the periods.

The Company also sells one-to-four-family loans to the FHLB of Des Moines that require a limited level of recourse if the loans default and exceed a certain loss exposure. Specific to that recourse, the FHLB of Des Moines established a first loss account ("FLA") related to the loans and required a credit enhancement ("CE") obligation by the Bank to be utilized after the FLA is used. Based on loans sold through September 30, 2023, total loans sold to the FHLB of Des Moines were \$9.5 million with the FLA totaling \$ 581,000 and the CE obligation at \$389,000 or 4.1% of the loans outstanding. Management has established a holdback of 10% of the outstanding CE, or \$ 39,000, which is a part of the off-balance sheet holdback for loans sold. At both September 30, 2023 and December 31, 2022, there were no loans sold to the FHLB of Des Moines that were greater than 90 days past their contractual payment due date.

Contingent liabilities for loans held for sale – In the ordinary course of business, loans are sold with limited recourse against the Company and may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payoff, early payment defaults, breach of representation or warranty, servicing errors, and/or fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a holdback reserve of \$2.1 million and \$2.3 million to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at September 30, 2023 and December 31, 2022, respectively, which is included in "Other liabilities" on the Consolidated Balance Sheets.

The Company has entered into a severance agreement with its Chief Executive Officer ("CEO"). The severance agreement, subject to certain requirements, generally includes a lump sum payment to the CEO equal to 24 months of base compensation in the event his employment is involuntarily terminated, other than for cause or the executive terminates his employment with good reason, as defined in the severance agreement.

The Company has entered into change of control agreements with its executives and select key personnel. The change of control agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the change of control agreements, the executive generally will be entitled to a change of control payment from the Company if the executive is involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the change of control agreements). In such an event, the executives would each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the change of control agreements.

As a result of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no material pending legal actions at September 30, 2023.

NOTE 11 – FAIR VALUE MEASUREMENTS

The Company determines fair value based on the requirements established in Accounting Standards Codification ("ASC") *Topic 820, Fair Value Measurements*, which provides a framework for measuring fair value in accordance with U.S. GAAP and requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. ASC *Topic 820* defines fair value as the exit price, or the price that would be received for an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date under current market conditions.

The following definitions describe the levels of inputs that may be used to measure fair value:

Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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The following methods were used to estimate the fair value of certain assets and liabilities on a recurring and nonrecurring basis:

Securities – The fair value of securities available-for-sale are recorded on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid, and other market information, and for structured securities, cash flow, and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios (Level 2). Transfers between the fair value hierarchy are determined through the third-party service provider which, from time to time will transfer between levels based on market conditions per the related security. All models and processes used consider market convention.

Mortgage Loans Held for Sale – The fair value of loans held for sale reflects the value of commitments with investors and/or the relative price as delivered into a TBA mortgage-backed security (Level 2).

Loans Receivable – Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type, including commercial, real estate and consumer loans. Each loan category is further segregated by fixed and adjustable-rate loans. The fair value of loans is calculated by discounting expected cash flows at rates at which similar loans are currently being made. These amounts are discounted further by embedded probable losses expected to be realized in the portfolio. Certain residential mortgage loans were initially originated for sale and measured at fair value; after origination, the loans were transferred to loans held for investment. As of September 30, 2023 and December 31, 2022, there were \$15.2 million and \$14.0 million, respectively, in residential mortgage loans accounted for under the fair value option as they were previously transferred from held for sale, at fair value to loans held for investment. The aggregate unpaid principal balance of these loans was \$17.1 million and \$15.6 million as of September 30, 2023 and December 31, 2022, respectively. Gains and losses from changes in fair value for these loans are reported in earnings as a component of “Other noninterest income” on the Consolidated Statements of Income. For the three months ended September 30, 2023, the Company recorded a net decrease in fair value of \$343,000, as compared to a net decrease in fair value of \$ 816,000 for the three months ended September 30, 2022. For the nine months ended September 30, 2023, the Company recorded a net decrease in fair value of \$ 285,000, as compared to a net decrease in fair value of \$1.8 million for the nine months ended September 30, 2022. For loans originated as held for sale and transferred into loans held for investment, the fair value is determined based on quoted secondary market prices for similar loans (Level 2).

Derivative Instruments – Fair values for derivative assets and liabilities are measured on a recurring basis. The primary use of derivative instruments is related to the mortgage banking activities of the Company. The fair value of the interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. TBA mortgage-backed securities are fair valued on similar contracts in active markets (Level 2), while locks and forwards with customers and investors are fair valued using similar contracts in the market and changes in the market interest rates (Level 2 and 3). Derivative instruments not related to mortgage banking activities include interest rate swap agreements. The fair values of interest rate swap agreements are based on valuation models using observable market data as of the measurement date (Level 2). The Company's derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of the market inputs we use are actively quoted and can be validated through external sources, including market transactions and third-party pricing services. The fair values of all interest rate swaps are determined from third-party pricing services without adjustment.

Other Real Estate Owned – Fair value adjustments to OREO are recorded at the lower of carrying amount of the loan or fair value of the collateral less selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the ACL for loans. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell (Level 3).

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Loans Individually Evaluated – Expected credit losses for loans evaluated individually are measured based on the present value of expected future cash flows discounted at the loan's original effective interest rate or when the Bank determines that foreclosure is probable, the expected credit loss is measured based on the fair value of the collateral as of the reporting date, less estimated selling costs, as applicable. As a practical expedient, the Bank measures the expected credit loss for a loan using the fair value of the collateral, if repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the Bank's assessment as of the reporting date. In both cases, if the fair value of the collateral is less than the amortized cost basis of the loan, the Bank will recognize an allowance as the difference between the fair value of the collateral, less costs to sell (if applicable) at the reporting date and the amortized cost basis of the loan. If the fair value of the collateral exceeds the amortized cost basis of the loan, any expected recovery added to the amortized cost basis will be limited to the amount previously charged-off by the subsequent changes in the expected credit losses for loans evaluated individually are included within the provision for credit losses in the same way the expected credit loss initially was recognized or as a reduction in the provision that would otherwise be reported (Level 3).

Servicing Rights – The fair value of MSR is estimated using net present value of expected cash flows using a third-party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information where appropriate (Level 3).

The following tables present securities available-for-sale, mortgage loans held for sale, loans receivable, at fair value, and derivative assets and liabilities measured at fair value on a recurring basis at the dates indicated:

Financial Assets

	At September 30, 2023			
	Level 1	Level 2	Level 3	Total
Securities available-for-sale:				
U.S. agency securities	\$ —	\$ 17,096	\$ —	\$ 17,096
Corporate securities	—	6,354	—	6,354
Municipal bonds	—	108,621	—	108,621
Mortgage-backed securities	—	89,607	—	89,607
U.S. Small Business Administration securities	—	30,239	—	30,239
Mortgage loans held for sale, at fair value	—	18,636	—	18,636
Loans receivable, at fair value	—	15,176	—	15,176
Derivatives:				
Interest rate lock commitments with customers	—	—	175	175
Forward TBA mortgage-backed securities	—	355	—	355
Mandatory and best effort forward commitments with investors	—	—	21	21
Interest rate swaps	—	14,485	—	14,485
Total assets measured at fair value	\$ —	\$ 300,569	\$ 196	\$ 300,765
Financial Liabilities				
Derivatives:				
Interest rate swaps	\$ —	\$ (90)	\$ —	\$ (90)
Total liabilities measured at fair value	\$ —	\$ (90)	\$ —	\$ (90)

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	At December 31, 2022			
	Level 1	Level 2	Level 3	Total
Financial Assets				
Securities available-for-sale:				
U.S. agency securities	\$ —	\$ 17,288	\$ —	\$ 17,288
Corporate securities	—	8,545	—	8,545
Municipal bonds	—	120,602	—	120,602
Mortgage-backed securities	—	69,966	—	69,966
U.S. Small Business Administration securities	—	12,851	—	12,851
Mortgage loans held for sale, at fair value	—	20,093	—	20,093
Loans receivable, at fair value	—	14,035	—	14,035
Derivatives:				
Forward TBA mortgage-backed securities	—	164	—	164
Interest rate swaps	—	9,870	—	9,870
Interest rate lock commitments with customers	—	—	107	107
Total assets measured at fair value	\$ —	\$ 273,414	\$ 107	\$ 273,521
Financial Liabilities				
Derivatives:				
Mandatory and best effort forward commitments with investors	\$ —	\$ —	\$ (38)	\$ (38)
Total liabilities measured at fair value	\$ —	\$ —	\$ (38)	\$ (38)

The following table presents financial assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy at September 30, 2023. There were no financial assets measured at fair value on a nonrecurring basis as of December 31, 2022.

	September 30, 2023			
	Level 1	Level 2	Level 3	Total
MSR	\$ —	\$ —	\$ 38,858	\$ 38,858

Quantitative Information about Level 3 Fair Value Measurements – Shown in the table below is the fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at the dates indicated:

Level 3 Fair Value Instruments	Valuation Techniques	Significant Unobservable Inputs	Range	Weighted Average Rate September 30, 2023	December 31, 2022
RECURRING					
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	91.4%	92.5%
Individual forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	91.4%	92.5%
NONRECURRING					
MSR	Industry sources	Pre-payment speeds	0% - 50%	6.3%	8.2%

The pull-through rate is based on historical loan closing rates for similar interest rate lock commitments. An increase or decrease in the pull-through rate would have a corresponding positive or negative fair value adjustment.

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The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the dates indicated:

Three Months Ended	Beginning		Purchases and		Sales and		Ending		Net change in fair value for gains/(losses) (1)	Net change in fair value for gains/(losses) (2)
	Balance	Issuances	Settlements	Balance						
September 30, 2023										
Interest rate lock commitments with customers	\$ 273	\$ 1,109	\$ (1,207)	\$ 175	\$ (98)	\$ —				
Individual forward sale commitments with investors	123	—	(102)	21	(102)	—				
September 30, 2022										
Interest rate lock commitments with customers	\$ 184	\$ 472	\$ (828)	\$ (172)	\$ (356)	\$ —				
Individual forward sale commitments with investors	518	899	(1,123)	294	(224)	—				
Nine Months Ended	Beginning		Purchases and		Sales and		Ending		Net change in fair value for gains/(losses) (1)	Net change in fair value for gains/(losses) (2)
	Balance	Issuances	Settlements	Balance						
September 30, 2023										
Interest rate lock commitments with customers	\$ 107	\$ 3,051	\$ (2,983)	\$ 175	\$ 68	\$ —				
Individual forward sale commitments with investors	(38)	410	(351)	21	(59)	—				
September 30, 2022										
Interest rate lock commitments with customers	\$ 757	\$ 2,589	\$ (3,518)	\$ (172)	\$ (929)	\$ —				
Individual forward sale commitments with investors	808	5,972	(6,486)	294	(514)	—				

(1) Relating to items held at end of period included in income.

(2) Relating to items held at end of period included in other comprehensive income (loss).

(Losses) gains on interest rate lock commitments and on forward sale commitments with investors carried at fair value are recorded in "Gain on sale of loans" on the Consolidated Statements of Income.

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The following table provides estimated fair values of the Company's financial instruments at the dates indicated, whether recognized at fair value or not on the Consolidated Balance Sheets:

	September 30, 2023		December 31, 2022	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Level 1 inputs:				
Cash and cash equivalents	\$ 80,673	\$ 80,673	\$ 41,437	\$ 41,437
Certificates of deposit at other financial institutions	17,636	17,636	4,712	4,712
Level 2 inputs:				
Securities available-for-sale, at fair value	251,917	251,917	229,252	229,252
Securities held-to-maturity, gross	8,500	7,424	8,500	7,929
Loans held for sale, at fair value	18,636	18,636	20,093	20,093
FHLB stock, at cost	3,696	3,696	10,611	10,611
Forward TBA mortgage-backed securities	355	355	164	164
Loans receivable, at fair value	15,176	15,176	14,035	14,035
Interest rate swaps	14,485	14,485	9,870	9,870
Accrued interest receivable	13,925	13,925	11,144	11,144
Level 3 inputs:				
Loans receivable, gross	2,390,897	2,279,968	2,204,817	2,153,769
MSR, held at lower of cost or fair value	17,657	38,858	18,017	35,478
Fair value interest rate locks with customers	175	175	107	107
Mandatory and best effort forward commitments with investors	21	21	—	—
Financial Liabilities				
Level 2 inputs:				
Deposits	2,454,444	2,437,603	2,127,741	2,105,926
Borrowings	121,895	121,382	186,528	186,188
Subordinated notes, excluding unamortized debt issuance costs	50,000	42,743	50,000	44,500
Accrued interest payable	3,966	3,966	2,270	2,270
Interest rate swaps	90	90	—	—
Level 3 inputs:				
Mandatory and best effort forward commitments with investors	—	—	38	38

NOTE 12 – EARNINGS PER SHARE

The Company computes earnings per share using the two-class method, which is an earnings allocation method for computing earnings per share that treats a participating security as having rights to earnings that would otherwise have been available to common shareholders. Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Unvested share-based awards containing non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

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

Numerator	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
	2023	2022	2023	2022
Net income	\$ 8,953	\$ 8,458	\$ 26,281	\$ 22,027
Dividends and undistributed earnings allocated to participating securities	(143)	(153)	(423)	(414)
Net income available to common shareholders	<u>\$ 8,810</u>	<u>\$ 8,305</u>	<u>\$ 25,858</u>	<u>\$ 21,613</u>
Denominator (shown as actual):				
Basic weighted average common shares outstanding	7,667,981	7,605,360	7,643,086	7,800,390
Dilutive shares	<u>112,449</u>	<u>102,402</u>	<u>125,662</u>	<u>122,456</u>
Diluted weighted average common shares outstanding	<u>7,780,430</u>	<u>7,707,762</u>	<u>7,768,748</u>	<u>7,922,846</u>
Basic earnings per share	\$ 1.15	\$ 1.09	\$ 3.38	\$ 2.77
Diluted earnings per share	\$ 1.13	\$ 1.08	\$ 3.33	\$ 2.73
Potentially dilutive weighted average share options that were not included in the computation of diluted earnings per share because to do so would be anti-dilutive.	<u>64,256</u>	<u>84,540</u>	<u>55,174</u>	<u>62,544</u>

NOTE 13 – STOCK-BASED COMPENSATION

Stock Options and Restricted Stock

On May 17, 2018, the shareholders of FS Bancorp approved the 2018 Equity Incentive Plan (the "2018 Plan") that authorized 1.3 million shares of the Company's common stock to be awarded. The 2018 Plan provides for the grant of incentive stock options, nonqualified stock options, and up to 326,000 shares as restricted stock awards ("RSAs") to directors, emeritus directors, officers, employees or advisory directors of the Company. At September 30, 2023, there were 253,532 stock option awards and 76,622 RSAs available for future grants under the 2018 Plan.

Total share-based compensation expense was \$590,000 and \$1.6 million for the three and nine months ended September 30, 2023, and \$500,000 and \$1.4 million for the three and nine months ended September 30, 2022, respectively.

Stock Options

The 2018 Plan consists of stock option awards that may be granted as incentive stock options or nonqualified stock options. Stock option awards generally vest over a one- or three-year period for independent directors or over a five-year period for employees and officers with 20% vesting on the anniversary date of each grant date as long as the award recipient remains in service to the Company. The options are exercisable after vesting for up to the remaining term of the original grant. The maximum term of the options granted is 10 years. Any unexercised stock options will expire 10 years after the grant date or sooner in the event of the award recipient's termination of service with the Company or the Bank. The fair value of each stock option award is estimated on the grant date using a Black-Scholes Option pricing 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 Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for 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 5.5 years for one-year vesting, 6.0 years for three-year vesting, and 6.5 years for five-year vesting.

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The following table presents a summary of the Company's stock option awards during the dates indicated (shown as actual):

	Shares	Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2023	647,832	\$ 26.67	6.84	\$ 4,627,255
Granted	103,000	\$ 30.73	—	—
Less exercised	19,121	\$ 12.76	—	\$ 337,279
Less forfeited or expired	35,119	33.25	—	—
Outstanding at September 30, 2023	<u>696,592</u>	\$ 27.36	6.61	\$ 2,073,328
Expected to vest, assuming a 0.31% annual forfeiture rate at September 30, 2023 (1)	682,861	\$ 27.32	6.52	\$ 2,057,735
Exercisable at September 30, 2023	417,775	\$ 25.76	5.33	\$ 1,679,133

(1) Forfeiture rate has been calculated and estimated to assume a forfeiture of 3.1% of the options over 10 years.

At September 30, 2023, there was \$1.8 million of total unrecognized forfeiture adjusted compensation cost related to nonvested stock options granted under the 2018 plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.6 years.

Restricted Stock Awards

The RSAs' fair value is equal to the value of the market price of FS Bancorp's common stock on the grant date and compensation expense is recognized over the vesting period of the awards based on the fair value of the restricted stock. Shares for the 2018 Plan generally vest over a one- or three-year period for independent directors or over a five-year period for employees and officers beginning on the grant date. Any unvested RSAs will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.

The following table presents a summary of the Company's nonvested awards during the dates indicated (shown as actual):

	Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share
Nonvested at January 1, 2023		118,530	\$ 28.85
Granted		37,600	30.73
Less vested		44,462	28.24
Less forfeited or expired		9,524	30.96
Nonvested at September 30, 2023	<u>102,144</u>	\$	<u>29.61</u>

At September 30, 2023, there was \$2.7 million of total unrecognized forfeiture adjusted compensation cost related to nonvested shares granted under the 2018 Plan as RSAs. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.5 years.

NOTE 14 – REGULATORY CAPITAL

The Bank is subject to various regulatory capital requirements administered by the Federal Reserve and the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Under the risk-based capital adequacy framework, quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 total capital (as defined) and common equity Tier 1 ("CET 1") capital to risk-weighted assets (as defined).

The Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage, and CET 1 capital ratios as set forth in the table below to be categorized as well capitalized. At September 30, 2023, the Bank was categorized as well capitalized under applicable regulatory requirements. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes, at September 30, 2023, that the Bank met all capital adequacy requirements.

The following table compares the Bank's actual capital amounts and ratios at September 30, 2023 to their minimum regulatory capital requirements and well capitalized regulatory capital at that date:

Bank Only	Actual		For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
At September 30, 2023								
Total risk-based capital (to risk-weighted assets)	\$ 330,533	13.06%	\$ 202,483	8.00%	\$ 265,759	10.50%	\$ 253,104	10.00%
Tier 1 risk-based capital (to risk-weighted assets)	\$ 298,887	11.81%	\$ 151,862	6.00%	\$ 215,138	8.50%	\$ 202,483	8.00%
Tier 1 leverage capital (to average assets)	\$ 298,887	10.26%	\$ 116,478	4.00%	\$ N/A	N/A	\$ 145,598	5.00%
CET 1 capital (to risk-weighted assets)	\$ 298,887	11.81%	\$ 113,897	4.50%	\$ 177,173	7.00%	\$ 164,518	6.50%

In addition to the minimum CET 1, Tier 1, total capital and leverage ratios, the Bank is required to maintain a capital conservation buffer consisting of additional CET 1 capital greater than 2.5% of risk-weighted assets above the required minimum capital levels 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. At September 30, 2023, the Bank's capital exceeded the conservation buffer.

The Company is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. Bank holding companies with less than \$3.0 billion in assets are generally not subject to compliance with the Federal Reserve's capital regulations, which are generally the same as the capital regulations applicable to the Bank. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to the holding company's subsidiary bank and expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. If the Company were subject to regulatory guidelines for bank holding companies with \$3.0 billion or more in assets at September 30, 2023, it would have exceeded all regulatory capital requirements. For informational purposes, the regulatory capital ratios calculated for the Company at September 30, 2023 were 8.9% for Tier 1 leverage-based capital, 10.2% for Tier 1 risk-based capital, 13.4% for total risk-based capital, and 10.2% for CET 1 capital ratio. The regulatory capital ratios calculated for the Company at December 31, 2022 were 9.7% for Tier 1 leverage-based capital, 10.7% for Tier 1 risk-based capital, 14.0% for total risk-based capital, and 10.7% for CET 1 capital ratio.

NOTE 15 – BUSINESS SEGMENTS

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the way financial information is currently evaluated by management. This process is dynamic and is based on management's current view of the Company's operations and is not necessarily comparable with similar information for other financial institutions. The Company defines its business segments by product type and customer segment which it has organized into two lines of business: commercial and consumer banking and home lending.

The Company uses various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

- a funds transfer pricing ("FTP") system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets. The FTP methodology is based on management's estimated cost of originating funds including the cost of overhead for deposit generation;
- a cost per loan serviced allocation based on the number of loans being serviced on the balance sheet and the number of loans serviced for third parties;
- an allocation based upon the approximate square footage utilized by the home lending segment in Company owned locations;
- an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on the number of full-time employees ("FTEs") in each segment; and
- an allocation of the Company's consolidated income taxes which are based on the effective tax rate applied to the segment's pretax income or loss.

A description of the Company's business segments and the products and services that they provide is as follows:

Commercial and Consumer Banking Segment

The commercial and consumer banking segment provides diversified financial products and services to our commercial and consumer customers through Bank branches, online banking platforms, mobile banking apps, and telephone banking. These products and services include deposit products, residential, consumer, business and commercial real estate lending portfolios and cash management services. The Company originates consumer loans, commercial and multi-family real estate loans, construction loans for residential and multi-family construction, and commercial business loans. At September 30, 2023, the Company's retail deposit branch network consisted of 27 branches in the Pacific Northwest. This segment is also responsible for the management of the investment portfolio and other assets of the Bank.

Home Lending Segment

The home lending segment originates one-to-four-family residential mortgage loans primarily for sale in the secondary markets as well as loans held for investment. A majority of these mortgage loans are sold to or securitized by FNMA, FHLMC, GNMA, or the FHLB of Des Moines, while the Company generally retains the right to service these loans. Loans originated under the guidelines of the Federal Housing Administration or ("FHA"), US Department of Veterans Affairs or VA, and United States Department of Agriculture or USDA are generally sold servicing released to a correspondent bank or mortgage company. The Company has the option to sell loans on a servicing-released or servicing-retained basis to securitizers and correspondent lenders. A small percentage of its loans are brokered to other lenders. On occasion, the Company may sell a portion of its MSR portfolio and may sell small pools of loans initially originated to be held in the loan portfolio. The Company manages the loan funding and the interest rate risk associated with the secondary market loan sales and the retained one-to-four-family mortgage servicing rights within this business segment. One-to-four-family loans originated for investment and held in this segment are allocated to the home lending segment with a corresponding provision expense and FTP for cost of funds.

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Segment Financial Results

The tables below summarize the financial results for each segment based on the factors mentioned above within each segment for the three and nine months ended September 30, 2023 and 2022:

	At or For the Three Months Ended September 30, 2023		
	Commercial and Consumer Banking	Home Lending	Total
Condensed income statement:			
Net interest income (1)	\$ 27,563	\$ 3,071	\$ 30,634
Provision for credit losses	(437)	(111)	(548)
Noninterest income (2)	2,680	2,302	4,982
Noninterest expense (3)	(18,539)	(5,047)	(23,586)
Income before provision for income taxes	11,267	215	11,482
Provision for income taxes	(2,480)	(49)	(2,529)
Net income	\$ 8,787	\$ 166	\$ 8,953
Total average assets for period ended	\$ 2,361,014	\$ 540,372	\$ 2,901,386
FTEs ("FTEs")	434	128	562
	At or For the Three Months Ended September 30, 2022		
	Commercial and Consumer Banking	Home Lending	Total
Condensed income statement:			
Net interest income (1)	\$ 24,620	\$ 2,907	\$ 27,527
(Provision) recovery for credit losses	(1,811)	93	(1,718)
Noninterest income (2)	3,314	867	4,181
Noninterest expense (3)	(14,471)	(4,867)	(19,338)
Income (loss) before (provision) benefit for income taxes	11,652	(1,000)	10,652
(Provision) benefit for income taxes	(2,400)	206	(2,194)
Net income (loss)	\$ 9,252	\$ (794)	\$ 8,458
Total average assets for period ended	\$ 2,072,614	\$ 427,368	\$ 2,499,982
FTEs	389	140	529
	At or For the Nine Months Ended September 30, 2023		
	Commercial and Consumer Banking	Home Lending	Total
Condensed income statement:			
Net interest income (1)	\$ 83,332	\$ 9,516	\$ 92,848
Provision for credit losses	(2,555)	(817)	(3,372)
Noninterest income (2)	7,766	7,268	15,034
Noninterest expense (3)	(56,099)	(15,215)	(71,314)
Income before provision for income taxes	32,444	752	33,196
Provision for income taxes	(6,758)	(157)	(6,915)
Net income	\$ 25,686	\$ 595	\$ 26,281
Total average assets for period ended	\$ 2,288,996	\$ 520,513	\$ 2,809,509
FTEs	434	128	562

	At or For the Nine Months Ended September 30, 2022		
	Commercial and Consumer Banking	Home Lending	Total
Condensed income statement:			
Net interest income (1)	\$ 66,983	\$ 7,995	\$ 74,978
Provision for credit losses	(3,727)	(905)	(4,632)
Noninterest income (2)	7,944	6,468	14,412
Noninterest expense (3)	(42,878)	(14,456)	(57,334)
Income (loss) before (provision) benefit for income taxes	28,322	(898)	27,424
(Provision) benefit for income taxes	(5,583)	186	(5,397)
Net income (loss)	\$ 22,739	\$ (712)	\$ 22,027
Total average assets for period ended	\$ 1,972,376	\$ 403,990	\$ 2,376,366
FTEs	389	140	529

(1) Net interest income is the difference between interest earned on assets and the cost of liabilities to fund those assets. Interest earned includes actual interest earned on segment assets and, if the segment has excess liabilities, interest credits for providing funding to the other segment. The cost of liabilities includes interest expense on segment liabilities and, if the segment does not have enough liabilities to fund its assets, a funding charge based on the cost of assigned liabilities to fund segment assets.

(2) Noninterest income includes activity from certain residential mortgage loans that were initially originated for sale and measured at fair value, and subsequently transferred to loans held for investment. Gains and losses from changes in fair value for these loans are reported in earnings as a component of noninterest income. For the three and nine months ended September 30, 2023, the Company recorded a net decrease in fair value of \$343,000 and \$285,000, as compared to a net decrease in fair value of \$ 816,000 and \$1.8 million for the three and nine months ended September 30, 2022, respectively. As of September 30, 2023 and 2022, there were \$15.2 million and \$14.2 million, respectively, in residential mortgage loans recorded at fair value as they were previously transferred from loans held for sale to loans held for investment.

(3) Noninterest expense includes allocated overhead expense from general corporate activities. Allocation is determined based on a combination of segment assets and FTEs. For the three and nine months ended September 30, 2023 and 2022, the Home Lending segment included allocated overhead expenses of \$1.5 million and \$4.7 million, respectively.

NOTE 16 – GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and certain other intangibles generally arise from business combinations accounted for under the acquisition method of accounting. Goodwill totaled \$3.6 million at September 30, 2023, and \$2.3 million at December 31, 2022, and represents the excess of the total acquisition price paid over the fair value of the assets acquired, net of the fair values of liabilities assumed in the Branch Purchase on February 24, 2023, and the purchase of four retail bank branches from Bank of America on January 22, 2016. Goodwill is not amortized but is evaluated for impairment on an annual basis at December 31 of each year or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The Company performed an impairment analysis at September 30, 2023, and determined that no impairment of goodwill existed.

Core deposit intangible ("CDI") is evaluated for impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable, with any changes in estimated useful life accounted for prospectively over the revised remaining life. As of September 30, 2023, management believes that there have been no events or changes in the circumstances that would indicate a potential impairment of CDI.

The following table summarizes the changes in the Company's other intangible assets comprised solely of CDI for the year ended September 30, 2023, and the nine months ended September 30, 2023.

	Other Intangible Assets		
	Gross CDI	Accumulated Amortization	Net CDI
Balance, December 31, 2021	\$ 7,490	\$ (3,430)	\$ 4,060
Amortization	—	(691)	(691)
Balance, December 31, 2022	7,490	(4,121)	3,369
Additions as a result of the Branch Purchase	17,438	—	17,438
Amortization	—	(2,484)	(2,484)
Balance, September 30, 2023	\$ 24,928	\$ (6,605)	\$ 18,323

The CDI represents the fair value of the intangible core deposit base acquired in business combinations. The CDI will be amortized on an accelerated basis over 10 years for the CDI related to the Branch Purchase, on a straight-line basis over 10 years for the CDI related to the Anchor Bank acquisition in November 2018 ("Anchor Acquisition") and on an accelerated basis over approximately nine years for the CDI related to the four retail bank purchase from Bank of America on January 22, 2016. Total amortization expense was \$1.0 million and \$2.5 million for the three and nine months ended September 30, 2023, and \$173,000 and \$518,000 for the same periods in 2022, respectively.

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Amortization expense for CDI is expected to be as follows at September 30, 2023:

Remainder of 2023	\$ 980
2024	3,633
2025	3,191
2026	2,846
2027	2,500
Thereafter	5,173
Total	\$ 18,323

NOTE 17 – REVENUE FROM CONTRACTS WITH CUSTOMERS

Revenue Recognition

In accordance with Topic 606, revenues are recognized when control of promised goods or services is transferred to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation. The Company only applies the five-step model to contracts when it is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. At contract inception, once the contract is determined to be within the scope of Topic 606, the Company assesses the goods or services that are promised within each contract and identifies those that contain performance obligations and assesses whether each promised good or service is distinct. The Company then recognizes as revenue the amount of the transaction price that is allocated to the respective performance obligation when (or as) the performance obligation is satisfied.

All the Company's revenue from contracts with customers in-scope of ASC 606 is recognized in noninterest income and included in our commercial and consumer banking segment. The following table presents noninterest income, segregated by revenue streams in-scope and out-of-scope and/or immaterial to Topic 606, for the dates indicated.

	At or For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2023	2022	2023	2022
Noninterest income				
In-scope of Topic 606:				
Debit card interchange fees	\$ 867	\$ 575	\$ 2,388	\$ 1,702
Deposit service and account maintenance fees	373	237	1,036	678
Noninterest income (in-scope of Topic 606)	1,240	812	3,424	2,380
Noninterest income (out-of-scope and/or immaterial to Topic 606)	3,742	3,369	11,610	12,032
Total noninterest income	\$ 4,982	\$ 4,181	\$ 15,034	\$ 14,412

Deposit Service and Account Maintenance Fees

The Bank earns fees from its deposit customers for account maintenance, transaction-based services, and overdraft charges. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts monthly. The performance obligation is satisfied and the fees are recognized monthly as the service period is completed. Transaction-based fees on deposit accounts are charged to deposit customers for specific services provided to the customer, such as wire fees, as well as charges against the account, such as fees for non-sufficient funds and overdrafts. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

Debit Interchange Income

Debit and ATM interchange income represent fees earned when a debit card issued by the Bank is used. The Bank earns interchange fees from debit cardholder transactions through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' debit card.

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

Forward-Looking Statements

This report contains forward-looking statements, which can be identified by the use of words such as "believes," "expects," "anticipates," "estimates," or similar expressions. Forward-looking statements include, but are not limited to:

- statements of our goals, intentions, and expectations;
- statements regarding our business plans, prospects, growth, and operating strategies;
- statements regarding the quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- expected revenues, cost savings, synergies and other benefits from our recently completed branch purchase, might not be realized within the expected time frames or at all and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, might be greater than expected;
- potential adverse impacts to economic conditions in the Company's local market areas, other markets where the Company has lending relationships, or other aspects of the Company's business operations or financial markets, including, without limitation, as a result of employment levels, labor shortages, the effects of inflation, a potential recession or slowed economic growth;
- changes in the interest rate environment, including the recent increases in the Board of Governors of the Federal Reserve System ("Federal Reserve") benchmark rate and duration at which such increased interest rate levels are maintained, which could adversely affect our revenues and expenses, the values of our assets and obligations, and the availability and cost of capital and liquidity;
- the impact of continuing high inflation and the current and future monetary policies of the Federal Reserve in response thereto;
- the effects of any federal government shutdown;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies, write offs, changes in our allowance for credit losses ("ACL") for loans, and provision for credit losses on loans that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to originate loans for sale and sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our home lending operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;
- our ability to control operating costs and expenses;
- our ability to retain key members of our senior management team;
- changes in consumer spending, borrowing, and savings habits;
- our ability to successfully manage our growth;
- the impact of bank failures or adverse developments at other banks and related negative press about the banking industry in general on investor and depositor sentiment;
- legislative or regulatory changes that adversely affect our business including changes in banking, securities and tax law, and in regulatory policies and principles, or the interpretation of regulatory capital or other rules;

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- our ability to pay dividends on our common stock;
- the quality and composition of our securities portfolio and the impact of any adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board ("FASB");
- costs and effects of litigation, including settlements and judgments;
- disruptions, security breaches, or other adverse events, failures, or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- inability of key third-party vendors to perform their obligations to us;
- the economic impact of climate change, severe weather events, natural disasters, pandemics, epidemics and other public health crises, acts of war or terrorism, and other external events on our business;
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products and services, and
- other risks described elsewhere in this Form 10-Q and our other reports filed with or furnished to SEC, including our Annual Report on Form 10-K for the year ended December 31, 2022.

Any of the forward-looking statements made in this Form 10-Q and in other public statements may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Forward-looking statements are based upon management's beliefs and assumptions at the time they are made. The Company undertakes no obligation to update or revise any forward-looking statement included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward-looking statements.

Overview

FS Bancorp and its subsidiary bank, 1st Security Bank have been serving the Puget Sound area since 1936. Originally chartered as a credit union, known as Washington's Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp.

The Company is relationship-driven, delivering banking and financial services to local families, local and regional businesses and industry niches in suburban communities in the greater Puget Sound area, the Kennewick-Pasco-Richland metropolitan area of Washington, also known as the Tri-Cities, Goldendale, Vancouver, and White Salmon, Washington and Manzanita, Newport, Ontario, Tillamook and Waldport, Oregon. On February 24, 2023, the Company completed its purchase of seven retail bank branches from Columbia State Bank (the "Branch Purchase") and acquired approximately \$425.5 million in deposits and \$66.1 million in loans. The seven acquired branches are in the communities of Goldendale, and White Salmon, Washington, and Manzanita, Newport, Ontario, Tillamook, and Waldport, Oregon. The Branch Purchase expanded our Puget Sound-focused retail footprint into southeast Washington and the state of Oregon as well as providing an opportunity to extend our unique brand of community banking into those communities.

The Company also maintains its long-standing indirect consumer lending platform which operates primarily throughout the Western United States and has been expanding its partnership with companies present in other areas of the country as well. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is also actively involved in community activities and events within these market areas, which further strengthens our relationships within those markets.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

- Growing and diversifying our loan portfolio;
- Maintaining strong asset quality;
- Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;
- Capturing our customers' full relationship by offering a wide range of products and services by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers' banking needs; and
- Expanding the Company's markets.

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The Company is a diversified lender with a focus on the origination of one-to-four-family loans, commercial real estate mortgage loans, second mortgage or home equity loan products, consumer loans including indirect home improvement ("fixture secured") loans which also include solar-related home improvement loans, marine lending, and commercial business loans. As part of our expanding lending products, the Company additionally offers residential mortgage and commercial construction warehouse lending consistent with our business plan to further diversify revenues. Historically, consumer loans, in particular, fixture secured loans had represented the largest portion of the Company's loan portfolio and had traditionally been the mainstay of the Company's lending strategy. At September 30, 2023, consumer loans represented 26.6% of the Company's total gross loan portfolio, compared to 24.6% at September 30, 2022. In recent years, the Company has placed more of an emphasis on real estate lending products, such as one-to-four-family loans, commercial real estate loans, including speculative residential construction loans, and commercial business loans, while growing the current size of the consumer loan portfolio.

Fixture secured loans to finance window, gutter, siding replacement, solar panels, spas, and other improvement renovations are a large and regionally expanding segment of the consumer loan portfolio. These fixture-secured consumer loans are dependent on the Bank's contractor/dealer network of 92 active dealers located throughout Washington, Oregon, California, Idaho, Colorado, Nevada, Arizona, Minnesota, Texas, Utah, Massachusetts, Montana, and most recently, New Hampshire with five contractor/dealers responsible for 65.5% of the dollar volume of funded loans for the three months ended September 30, 2023. Management reviewed dealer concentrations and determined, as of September 30, 2023, any dealer owned by the same corporate entity will now be included under that corporate entity and not as a separate dealer. The Company funded \$39.0 million or approximately 1,700 loans during the quarter ended September 30, 2023. The following table details fixture secured loan originations by state for the periods indicated:

(Dollars in thousands)

State	For the Nine Months Ended September 30, 2023		For the Year Ended December 31, 2022	
	Amount	Percent	Amount	Percent
Washington	\$ 56,814	34.5%	\$ 102,981	32.7%
Oregon	38,002	23.1	73,110	23.2
California	28,557	17.3	59,175	18.8
Idaho	11,573	7.0	22,744	7.2
Colorado	5,489	3.3	14,584	4.6
Arizona	4,935	3.0	5,029	1.6
Nevada	4,070	2.5	4,869	1.5
Minnesota	7,777	4.7	28,503	9.1
Texas	1,246	0.8	572	0.2
Utah	3,887	2.3	2,674	0.9
Massachusetts	453	0.3	137	—
Montana	1,769	1.1	577	0.2
New Hampshire	110	0.1	—	—
Total fixture secured loans	<u>\$ 164,682</u>	<u>100.0%</u>	<u>\$ 314,955</u>	<u>100.0%</u>

The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Retail banking customers are also an important source of the Company's loan originations. The Company originated \$151.3 million of one-to-four-family loans (which included loans held for sale, loans held for investment and fixed seconds) in addition to \$4.4 million of loans brokered to other institutions through the home lending segment during the three months ended September 30, 2023, of which \$117.6 million were sold to investors. Of the loans sold to investors, \$76.6 million were sold to the FNMA, FHLMC, FHLB, and/or GNMA with servicing rights retained for the purpose of further developing these customer relationships. At September 30, 2023, one-to-four-family residential mortgage loans held for investment, which excludes loans held for sale of \$18.6 million, totaled \$540.7 million, or 22.5%, of the total gross loan portfolio.

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For the three months ended September 30, 2023, one-to-four-family loan originations and refinancing activity decreased as a result of increased market interest rates. Residential construction and development lending, while not as common as other loan origination options like one-to-four-family loans, will continue to be an important element in our total loan portfolio, and we will continue to take a disciplined approach by concentrating our efforts on loans to builders and developers in our market areas known to us. These short-term loans typically mature in six to 18 months. In addition, the funding is usually not fully disbursed at origination, thereby reducing our net loans receivable in the short term.

The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by several factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans, and income provided from operations.

The Company's earnings are primarily dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings.

The Company's earnings are also significantly affected by fee income from mortgage banking activities, the provision for (recovery of) credit losses, service charges and fees, gains from sales of assets, operating expenses and income taxes. Most notable of these factors, the Company recorded a provision for credit losses \$548,000 for the three months ended September 30, 2023, compared to \$1.7 million for the same period one year ago. The decreased provision in the current period was primarily due to a decrease in net loan growth, particularly in consumer loans.

Critical Accounting Estimates

We prepare our consolidated financial statements in accordance with GAAP. In doing so, we must make estimates and assumptions. Our critical accounting estimates are those estimates that involve a significant level of uncertainty at the time the estimate was made, and changes in the estimate that are reasonably likely to occur from period to period, or use of different estimates that we reasonably could have used in the current period, would have a material impact on our financial condition or results of operations. Accordingly, actual results could differ materially from our estimates. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. Management believes that its critical accounting policies include the following:

Allowance for Credit Losses on Held-to-Maturity Securities. Management measures expected credit losses on held-to-maturity securities by individual security. Accrued interest receivable on held-to-maturity debt securities is excluded from the estimate of credit losses. The estimate of expected credit losses considers credit ratings and historical credit loss information that is adjusted for current conditions and reasonable and supportable forecasts.

The held-to-maturity portfolio consists entirely of corporate securities. Securities are generally rated investment grade or higher. Securities are analyzed individually to establish a reserve.

Allowance for Credit Losses on Available-for-Sale Securities. For available-for-sale securities in an unrealized loss position, management first assesses whether it intends to sell, or is more likely than not to be required to sell, the security before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the security's amortized cost basis is written down to fair value through income. For debt securities available-for-sale that do not meet the aforementioned criteria, the Company evaluates whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by a rating agency, and adverse conditions specifically related to the security, among other factors. If this assessment indicates that a credit loss exists, the present value of cash flows expected to be collected from the security are compared to the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an ACL is recorded, limited by the amount that the fair value is less than the amortized cost basis.

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Changes in the ACL are recorded as a provision for (or reversal of) credit loss expense. Losses are charged against the allowance when management believes the uncollectibility of an available-for-sale security is confirmed or when either of the criteria regarding intent or requirement to sell is met. Accrued interest receivable on available-for-sale debt securities is not included in the estimate of credit losses.

Allowance for Credit Losses on Loans. The ACL for loans is a valuation account that is deducted from the loans' amortized cost basis to present the net amount expected to be collected on the loans. Loans are charged off against the allowance when management believes the uncollectibility of a loan balance is confirmed and recoveries are credited to the allowance when received. In the case of recoveries, amounts may not exceed the aggregate of amounts previously charged off.

Management utilizes relevant available information, from internal and external sources, relating to past events, current conditions, historical loss experience, and reasonable and supportable forecasts. The lookback period in the analysis includes historical data from 2009 to present. Adjustments to historical loss information are made when management determines historical data is not likely reflective of the current portfolio such as limited data sets or lack of default or loss history. Management may selectively apply external market data to subjectively adjust the Company's own loss history including index or peer data. Accrued interest receivable is excluded from the estimate of credit losses for loans.

Collective Assessment. The ACL for loans is measured on a collective cohort basis when similar risk characteristics exist. Generally, collectively assessed loans are grouped by call report code and then risk-grade grouping. Risk grade is grouped within each call report code by pass, watch, special mention, substandard, and doubtful. Other loan types are separated into their own cohorts due to specific risk characteristics for that pool of loans.

The Company has elected a non-discounted cash flow methodology with probability of default ("PD") and loss given default ("LGD") for all call report code cohorts ("cohorts"), except for the indirect and marine portfolios which are evaluated under a vintage methodology. The vintage methodology measures the expected loss calculation for future periods based on historical performance by the origination period of loans with similar life cycles and risk characteristics. Guaranteed portions of loans are measured with zero risk due to cash collateral and full guaranty.

The PD calculation looks at the historical loan portfolio at points in time (each month during the lookback period) to determine the probability that loans in a certain cohort will default over the next 12-month period. A default is defined as a loan that has moved to past due 90 days and greater, nonaccrual status, or experienced a charge-off during the period. In cohorts where the Company's historical data is insufficient due to a minimal amount of default activity or zero defaults, management uses index PDs comprised of rates derived from the PD experience of other community banks in place of the Company's historical PDs. Additionally, management reviews all other cohorts to determine if index PDs should be used outside of these criteria.

The LGD calculation looks at actual losses (net charge-offs) experienced over the entire lookback period for each cohort of loans. The aggregate loss amount is divided by the exposure at default to determine an LGD rate. All defaults (non-accrual, charge-off, or greater than 90 days past due) occurring during the lookback period are included in the denominator, whether a loss occurred or not and exposure at default is determined by the loan balance immediately preceding the default event (i.e., nonaccrual or charge-off). Due to limited charge-off history, management uses index LGDs comprised of rates derived from the LGD experience of other community banks in place of the Company's historical LGDs.

The Company utilizes reasonable and supportable forecasts of future economic conditions when estimating the ACL for loans. The calculation includes a 12-month PD forecast based on the Company's regression model comparing peer nonperforming loan ratios to the national unemployment rate. After the forecast period, PD rates revert on a straight-line basis back to long-term historical average rates over a 12-month period. Due to limited default history, management uses index PDs comprised of rates derived from the PD experience of other community banks in place of the Company's historical PDs.

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The Company recognizes that all significant factors that affect the collectability of the loan portfolio must be considered to determine the estimated credit losses as of the evaluation date. Furthermore, the methodology, in and of itself and even when selectively adjusted by comparison to market and peer data, does not provide a sufficient basis to determine the estimated credit losses. The Company adjusts the modeled historical losses by qualitative and environmental adjustments to incorporate all significant risks to form a sufficient basis to estimate the credit losses.

Individual Assessment. Loans classified as nonaccrual, are reviewed quarterly for potential individual assessment. Any loan classified as a nonaccrual that is not determined to need individual assessment is evaluated collectively within its respective cohort.

Where the primary and/or expected source of repayment of a specific loan is believed to be the future liquidation of available collateral, impairment will generally be measured based upon expected future collateral proceeds, net of disposition expenses including sales commissions as well as other costs potentially necessary to sell the asset(s) (i.e., past due taxes, liens, etc.). Estimates of future collateral proceeds will be based upon available appraisals, reference to recent valuations of comparable properties, use of consultants or other professionals with relevant market and/or property-specific knowledge, and any other sources of information believed appropriate by management under the specific circumstances. When appraisals are ordered to support the impairment analysis of an impaired loan, the appraisal is reviewed by the Company's internal appraisal reviewer.

Where the primary and/or expected source of repayment of a specific loan is believed to be the receipt of principal and interest payments from the borrower and/or the refinancing of the loan by another creditor, impairment will generally be measured based upon the present value of expected proceeds discounted at the contractual interest rate. Expected refinancing proceeds may be estimated from review of term sheets received by the borrower from other creditors and/or from the Company's knowledge of terms generally available from other banks.

Determining the Contractual Term. Expected credit losses are estimated over the contractual term of the loans, adjusted for expected prepayments when appropriate. The contractual term excludes expected extensions, renewals and modifications. Prepayment assumptions will be determined by analysis of historical behavior by loan cohort.

Allowance for Credit Losses on Unfunded Commitments. The Company estimates expected credit losses over the contractual period in which the Company is exposed to credit risk via a contractual obligation to extend credit unless that obligation is unconditionally cancellable by the Company. The ACL for unfunded commitments is adjusted through a provision for credit loss expense. The estimate includes consideration of the likelihood that funding will occur and an estimate of expected credit losses on commitments expected to be funded over its estimated life. The estimate utilizes the same factors and assumptions as the ACL for loans and is applied at the same collective cohort level.

Mortgage Servicing Rights. Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of MSR is capitalized during the month of sale. Fair value is based on market prices for comparable mortgage contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses.

Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the Consolidated Balance Sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

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Derivatives and Hedging Activity. ASC 815, "Derivatives and Hedging," requires that derivatives of the Company be recorded in the consolidated financial statements at fair value. Management considers its accounting policy for derivatives to be a critical accounting policy because these instruments have certain interest rate risk characteristics that change in value based upon changes in the capital markets. Fair values for derivative assets and liabilities are measured on a recurring basis. The Company's primary use of derivative instruments is related to the mortgage banking activities in the form of commitments to extend credit, commitments to sell loans, TBA mortgage-backed securities trades and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded on the Consolidated Statements of Income with offsets to other assets or other liabilities on the Consolidated Balance Sheets.

Derivative instruments not related to mortgage banking activities primarily relate to interest rate swap agreements accounted for as cash flow hedges and fair value hedges. To qualify for hedge accounting, derivatives must be highly effective at reducing the risk associated with the exposure being hedged and must be designated as a hedge at the inception of the derivative contract. If derivative instruments are designated as fair value hedges, and such hedges are highly effective, both the change in the fair value of the hedge and the hedged item are included in current earnings. If derivative instruments are designated as cash flow hedges, fair value adjustments related to the effective portion are recorded in other comprehensive income and are reclassified to earnings when the hedged transaction is reflected in earnings. If derivative instruments are designated as cash flow hedges, fair value adjustments related to the effective portion are recorded in other comprehensive income and are reclassified to earnings when the hedged transaction is reflected in earnings. Ineffective portions of cash flow hedges are reflected in earnings as they occur. Actual cash receipts and/or payments and related accruals on derivatives related to hedges are recorded as adjustments to the interest income or interest expense associated with the hedged item. During the life of the hedge, the Company formally assesses whether derivatives designated as hedging instruments continue to be highly effective in offsetting changes in the fair value or cash flows of hedged items. If it is determined that a hedge has ceased to be highly effective, the Company will discontinue hedge accounting prospectively. At such time, previous adjustments to the carrying value of the hedged item are reversed into current earnings and the derivative instrument is reclassified to a trading position recorded at fair value. For derivatives not designated as hedges, changes in fair value are recognized in earnings, in noninterest income.

Fair Value. ASC 820, "Fair Value Measurements and Disclosures," establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by several factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). For additional details, see "Note 11 – Fair Value Measurements" of the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

Business Combinations and Goodwill. Pursuant to applicable accounting guidance, we recognize assets acquired, including identified intangible assets, and the liabilities assumed in acquisitions at their fair values as of the acquisition date, with the related transaction costs expensed in the period incurred. Determining the fair value of assets acquired and liabilities assumed often involves estimates based on internal or third-party valuations which include appraisals, discounted cash flow analysis, or other valuation techniques that may include estimates of attrition, inflation, asset growth rates, discount rates, credit risk, multiples of earnings, or other relevant factors. The determination of fair value may require us to make point-in-time estimates about discount rates, future expected cash flows, market conditions, and other future events that can be volatile in nature and challenging to assess. While we use the best estimates and assumptions to accurately value assets acquired and liabilities assumed at the acquisition date, the estimates are inherently uncertain and subject to refinement.

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The primary identifiable intangible asset we typically record in connection with a whole bank or bank branch acquisition is the value of the core deposit intangibles which represents the estimated value of the long-term deposit relationships acquired in the transaction. Determining the amount of identifiable intangible assets and their average lives involves multiple assumptions and estimates and is typically determined by performing a discounted cash flow analysis, which involves a combination of any or all the following assumptions: customer attrition/runoff, alternative funding costs, deposit servicing costs, and discount rates. The core deposit intangibles are amortized over the estimated useful lives of the deposit accounts based on a method that we believe reasonably approximates the anticipated benefit stream from this intangible. The estimated useful lives are periodically reviewed for reasonableness and have generally been estimated to have a life ranging from seven to ten years, with an accelerated rate of amortization. We review identifiable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our policy is that an impairment loss is recognized, equal to the difference between the asset's carrying amount and its fair value, if the sum of the expected undiscounted future cash flows is less than the carrying amount of the asset. Estimating future cash flows involves the use of multiple estimates and assumptions, such as those listed above.

The ACL for purchase credit deteriorated ("PCD") assets is recognized within business combination accounting with no initial impact to net income. Changes in estimates of expected credit losses on PCD loans after acquisition are recognized as provision expense (or reversal of provision expense) in subsequent periods as they arise. The ACL for non-PCD assets is recognized as provision expense in the same reporting period as the business combination. Estimated loan losses for acquired loans are determined using methodologies and applying estimates and assumptions that were described previously in the Allowance for Credit Losses on Loans section.

Non-PCD loans acquired are generally estimated at fair value using a discounted cash flow approach with assumptions of discount rate, remaining life, prepayments, probability of default, and loss given default. The actual cash flows on these loans could differ materially from the fair value estimates. The amount we record as the fair values for the loans is generally less than the contractual unpaid principal balance due from the borrowers, with the difference being referred to as the "discount" on the acquired loans. Discounts on acquired non-PCD loans are accreted to interest income over their estimated remaining lives, which may include prepayment estimates in certain circumstances.

Similarly, premiums or discounts on acquired debt are accreted or amortized to interest expense over their remaining lives. Actual accretion or amortization of premiums and discounts from a business acquisition may differ materially from our estimates impacting our operating results.

Goodwill arising from business combinations represents the excess of the purchase price over the sum of the estimated fair values of the tangible and identifiable intangible assets acquired less the estimated fair value of the liabilities assumed. Goodwill has an indefinite useful life and is evaluated for impairment annually or more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. We believe that the accounting for goodwill also involves a higher degree of judgment than most other significant accounting policies. ASC 350-10 establishes standards for an impairment assessment of goodwill.

At each reporting date between annual goodwill impairment tests, we consider potential indicators of impairment. Generally, absent potential impairment indicators, we perform an annual assessment of whether the events and circumstances resulted in it being more likely than not that the fair value of any reporting unit was less than its carrying value. Impairment indicators considered include the condition of the economy and banking industry; government intervention and regulatory updates; the impact of recent events to financial performance and cost factors of the reporting unit; performance of the Company's stock, and other relevant events.

Income Taxes. Income taxes are reflected in the Company's consolidated financial statements to show the tax effects of the operations and transactions reported in the consolidated financial statements and consist of taxes currently payable plus deferred taxes. ASC 740, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income tax provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate income and taxes in the jurisdiction in which the Company operates. This process involves estimating the actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for credit losses, for tax and financial reporting purposes.

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Deferred tax assets and liabilities occur when taxable income is larger or smaller than reported income on the income statements due to accounting valuation methods that differ from tax, as well as tax rate estimates and payments made quarterly and adjusted to actual at the end of the year. Deferred tax assets and liabilities are temporary differences deductible or payable in future periods. The Company had net deferred tax assets of \$7.4 million and \$6.7 million, at September 30, 2023 and December 31, 2022, respectively.

Comparison of Financial Condition at September 30, 2023 and December 31, 2022

Assets. Total assets increased \$287.2 million to \$2.92 billion at September 30, 2023, from \$2.63 billion at December 31, 2022, primarily due to an increase in loans receivable, net of \$184.7 million, approximately \$60.1 million of which was acquired in the Branch Purchase, as well as increases in total cash and cash equivalents of \$39.2 million, securities available-for-sale of \$22.7 million, CDI, net of \$15.0 million, certificates of deposit ("CDs") at other financial institutions of \$12.9 million, other assets of \$9.3 million, premises and equipment of \$5.8 million, accrued interest receivable of \$2.8 million, and goodwill of \$1.3 million. These increases were partially offset by decreases in FHLB stock of \$6.9 million and loans held for sale of \$1.5 million.

Loans receivable, net increased \$184.7 million to \$2.38 billion at September 30, 2023, from \$2.19 billion at December 31, 2022, which included approximately \$60.1 million in loans acquired in the Branch Purchase. Total real estate loans increased \$84.7 million, including increases in one-to-four-family loans of \$71.2 million, commercial real estate loans of \$30.6 million, multi-family loans of \$23.9 million, and home equity loans of \$11.7 million, partially offset by a decrease in construction and development loans of \$52.7 million. Undisbursed construction and development loan commitments decreased \$40.5 million, to \$161.2 million at September 30, 2023, as compared to \$201.7 million at December 31, 2022. Consumer loans increased \$70.5 million primarily due to an increase of \$66.7 million in indirect home improvement loans and \$3.3 million in marine loans. Commercial business loans increased \$32.0 million as a result of an increase in commercial and industrial lending of \$39.7 million, partially offset by a decrease in warehouse lending of \$7.7 million.

Loans held for sale, consisting of one-to-four-family loans, decreased by \$1.5 million to \$18.6 million at September 30, 2023, from \$20.1 million at December 31, 2022. The Company continues to invest in its home lending operations and strategically add production staff in the markets we serve.

One-to-four-family loan originations for the nine months ended September 30, 2023, included \$292.3 million of loans originated for sale, \$117.3 million of portfolio loans including first and second liens, and \$12.3 million of loans brokered to other institutions.

Originations of one-to-four-family loans for the periods indicated were as follows:

(Dollars in thousands)	For the Nine Months Ended September 30,					
	2023		2022		\$ Change	% Change
	Amount	Percent	Amount	Percent		
Purchase	\$ 387,211	91.8%	\$ 549,259	78.7%	\$ (162,048)	(29.5)%
Refinance	34,635	8.2	148,335	21.3	(113,700)	(76.7)%
Total	\$ 421,846	100.0%	\$ 697,594	100.0%	\$ (275,748)	(39.5)%

During the nine months ended September 30, 2023, the Company sold \$320.9 million of one-to-four-family loans compared to sales of \$639.0 million for the same period one year ago. Gross margin on home loan sales increased to 3.07% for the nine months ended September 30, 2023, compared to 2.85% for the nine months ended September 30, 2022. Gross margin is defined as the margin on loans sold (cash sales) without the impact of deferred costs.

The ACL for loans was \$30.5 million or 1.27% of gross loans receivable (excluding loans held for sale), at September 30, 2023, compared to \$28.0 million or 1.26% of gross loans receivable (excluding loans held for sale), at December 31, 2022. The increase was primarily due to an increase in loans and increased reserves on individually evaluated nonaccrual loans.

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Loans classified as substandard decreased \$1.0 million to \$19.2 million at September 30, 2023, compared to \$20.2 million at December 31, 2022. The decrease was primarily due to a decrease of \$1.8 million in commercial real estate loans, partially offset by increases of \$600,000 in indirect home improvement loans and \$200,000 in one-to-four-family loans. Nonperforming loans, consisting solely of nonaccrual loans, decreased \$3.1 million to \$5.6 million at September 30, 2023, from \$8.7 million at December 31, 2022. The ratio of nonperforming loans to total gross loans was 0.23% at September 30, 2023, compared to 0.39% at December 31, 2022. There was one OREO property in the amount of \$570,000 (a closed branch in Centralia, Washington) at both September 30, 2023 and December 31, 2022.

Liabilities. Total liabilities increased \$268.2 million to \$2.67 billion at September 30, 2023, from \$2.40 billion at December 31, 2022, primarily due to increases of \$326.7 million in deposits, \$5.3 million in other liabilities and \$795,000 in operating lease liability, offset by a decrease of \$64.6 million in borrowings.

Total deposits increased \$326.7 million to \$2.45 billion at September 30, 2023, from \$2.13 billion at December 31, 2022, due to the Branch Purchase in which we acquired approximately \$424.9 million in deposits. CDs increased \$287.2 million to \$1.02 billion at September 30, 2023, from \$729.8 million at December 31, 2022. Transactional accounts (noninterest-bearing checking, interest-bearing checking and escrow accounts) increased \$200.3 million to \$889.6 million at September 30, 2023, from \$689.3 million at December 31, 2022, due to increases of \$105.7 million in noninterest-bearing checking, \$84.3 million in interest-bearing checking and \$10.3 in escrow accounts related to mortgages serviced. Money market and savings accounts decreased \$160.8 million to \$547.9 million at September 30, 2023, from \$708.6 million at December 31, 2022 as depositors shifted funds to higher yielding CDs and other investment alternatives.

Deposits are summarized as follows at the dates indicated:

(Dollars in thousands)	September 30, 2023	December 31, 2022
Noninterest-bearing checking	\$ 643,670	\$ 537,938
Interest-bearing checking (1)	219,469	135,127
Savings	157,901	134,358
Money market (2)	389,962	574,290
CDs less than \$100,000 (3)	527,032	440,785
CDs of \$100,000 through \$250,000	406,545	195,447
CDs of \$250,000 and over (4)	83,377	93,560
Escrow accounts related to mortgages serviced (5)	26,488	16,236
Total	\$ 2,454,444	\$ 2,127,741

(1) Includes \$50.1 million and \$2.3 million of brokered deposits at September 30, 2023 and December 31, 2022, respectively.

(2) Includes \$51,000 and \$59.7 million of brokered deposits at September 30, 2023 and December 31, 2022, respectively.

(3) Includes \$323.3 million and \$332.0 million of brokered CDs at September 30, 2023 and December 31, 2022, respectively.

(4) CDs that meet or exceed the FDIC insurance limit.

(5) Noninterest-bearing checking.

The Bank had uninsured deposits of approximately \$591.6 million or 24.1% of total deposits, at September 30, 2023, compared to approximately \$560.0 million or 26.3% of total deposits at December 31, 2022. The uninsured amounts are estimates based on the methodologies and assumptions used for the Bank's regulatory reporting requirements.

At September 30, 2023, borrowings totaled \$121.9 million and were comprised of advances from the Federal Reserve Bank's Term Funding Program of \$90.0 million, overnight funding of \$28.0 million, and advances from the and FHLB fixed-rate advances of \$3.9 million. Borrowings decreased \$64.6 million to \$121.9 million at September 30, 2023, from \$186.5 million of FHLB advances at December 31, 2022. The decrease was partially attributable to a shift in funding mix to brokered CDs.

Stockholders' Equity. Total stockholders' equity increased \$19.0 million to \$250.7 million at September 30, 2023, from \$231.7 million at December 31, 2022. The increase in stockholders' equity at September 30, 2023, compared to December 31, 2022, was primarily due to net income of \$26.3 million, partially offset by dividends paid of \$5.8 million. In addition, stockholders' equity was positively impacted by unrealized gains on fair value and cash flow hedges of \$3.6 million, net of tax, and unrealized net losses in securities available-for-sale of \$7.3 million, net of tax, reflecting changes in market interest rates during the period, resulting in a \$3.8 million decrease in accumulated other comprehensive income. Book value per common share was \$32.58 at September 30, 2023, compared to \$30.42 at December 31, 2022.

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We calculated book value per share at September 30, 2023, based on 7,693,951 common shares, which was the difference between the 7,796,095 reported common shares and 102,144 unvested restricted stock shares outstanding as of that date. We calculated book value per share at December 31, 2022, based on 7,617,655 common shares, which was the difference between the 7,736,185 reported common shares and 118,530 unvested restricted stock shares outstanding as of that date.

Comparison of Results of Operations for the Three Months Ended September 30, 2023 and 2022

General. Net income was \$9.0 million for the three months ended September 30, 2023, and \$8.5 million for the three months ended September 30, 2022. The increase in net income for the three months ended September 30, 2023, was primarily due to a \$3.1 million or 11.3% increase in net interest income, a \$1.2 million or 68.1% decrease in the provision for credit losses, and an \$801,000 or 19.2% increase in noninterest income, partially offset by a \$4.2 million or 22.0% increase in noninterest expense and a \$335,000 or 15.3% increase in provision for income taxes.

Average Balances, Interest and Average Yields/Cost

The following table sets forth for the periods indicated, information regarding average balances of assets and liabilities, as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin (otherwise known as net yield on interest-earning assets), and the ratio of average interest-earning assets to average interest-bearing liabilities. Also presented is the weighted average yield on interest-earning assets, rates paid on interest-bearing liabilities and the resultant spread at for the periods presented. Average balances are daily average balances. Nonaccrual loans have been included in the table as loans carrying a zero yield. The yields on tax-exempt municipal bonds have not been computed on a tax equivalent basis.

(Dollars in thousands)	For the Three Months Ended September 30, 2023			For the Three Months Ended September 30, 2022		
	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate
Average Balances						
ASSETS						
Loans receivable, net and loans held for sale (1) (2)	\$ 2,423,691	\$ 39,874	6.53%	\$ 2,083,561	\$ 29,563	5.63%
Taxable AFS mortgage-backed securities (3)	99,575	416	1.66%	83,981	440	2.08%
Taxable AFS investment securities (3)	66,237	1,433	8.58%	61,052	301	1.96%
Tax-exempt AFS investment securities (3)	128,336	621	1.92%	131,973	633	1.90%
Taxable HTM investment securities	8,500	107	4.99%	8,500	108	5.04%
FHLB stock	4,626	53	4.55%	7,924	113	5.66%
Interest-bearing deposits at other financial institutions	68,369	766	4.45%	29,080	146	1.99%
Total interest-earning assets	2,799,334	43,270	6.13%	2,406,071	31,304	5.16%
Noninterest-earning assets	102,052			69,601		
Total assets	\$ 2,901,386			\$ 2,475,672		
LIABILITIES						
Savings and money market	\$ 570,786	1,529	1.06%	\$ 829,460	1,303	0.62%
Interest-bearing checking	187,746	643	1.36%	153,054	100	0.26%
Certificates of deposit	982,725	8,290	3.35%	475,533	1,193	1.00%
Borrowings	138,013	1,689	4.86%	119,150	696	2.32%
Subordinated notes	49,500	485	3.89%	49,434	485	3.89%
Total interest-bearing liabilities	1,928,770	12,636	2.60%	1,626,631	3,777	0.92%
Noninterest-bearing accounts	676,000			588,492		
Other noninterest-bearing liabilities	39,365			32,663		
Total liabilities	\$ 2,644,135			\$ 2,247,786		
Net interest income		\$ 30,634			\$ 27,527	
Net interest rate spread			3.53%			4.24%
Net earning assets	\$ 870,564			\$ 779,440		
Net interest margin			4.34%			4.54%
Average interest-earning assets to average interest-bearing liabilities	145.14%			147.92%		

(1) The average loans receivable, net balances include nonaccrual loans.

(2) Includes net deferred fee recognition of \$1.4 million and \$2.0 million for the three months ended September 30, 2023 and 2022, respectively.

(3) Shown at amortized cost.

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Net Interest Income. Net interest income increased \$3.1 million to \$30.6 million for the three months ended September 30, 2023, from \$27.5 million for the three months ended September 30, 2022, as a result of an increase in interest income on loans, taxable AFS investment securities and interest-bearing deposits at other financial institutions, partially offset by an increase in interest expense. Total interest income increased \$12.0 million for the three months ended September 30, 2023, compared to the same period in 2022, primarily due to an increase of \$10.3 million in interest income on loans receivable, including fees, primarily due to new loans being originated at higher rates and variable-rate loans repricing higher following recent increases in market interest rates. In addition, interest income on taxable AFS investment securities and interest-bearing deposits at other financial institutions increased \$1.1 million and \$620,000, respectively, during the three months ended September 30, 2023, compared to the same period in 2022, primarily due to recent increases in market interest rates. Total interest expense increased \$8.9 million for the three months ended September 30, 2023, primarily as a result of higher market interest rates, higher utilization of borrowings and a shift in deposit mix from transactional accounts to higher cost CDs.

Net interest margin ("NIM") decreased 20 basis points to 4.34% for the three months ended September 30, 2023, from 4.54% for the same quarter in the prior year. The decrease in NIM reflects the rise of average balances of higher costing CDs and borrowings which reduced the impact of new loan originations at higher interest rates and variable rate interest-earning assets repricing higher following recent increases in market interest rates.

Interest Income. Interest income for the three months ended September 30, 2023, increased \$12.0 million to \$43.3 million, from \$31.3 million for the three months ended September 30, 2022. The increase during the period was primarily attributable to the \$393.3 million increase in the average balance of total interest-earning assets and a 97-basis point increase in the average yield on total interest-earning assets.

The following table compares average interest-earning asset balances, associated yields, and resulting changes in interest income for the three months ended September 30, 2023 and 2022:

(Dollars in thousands)	Three Months Ended September 30,					
	2023		2022		\$ Change in Interest Income	
	Average Balance Outstanding	Yield	Average Balance Outstanding	Yield		
Loans receivable, net and loans held for sale (1)	\$ 2,423,691	6.53%	\$ 2,083,561	5.63%	\$ 10,311	
Taxable AFS mortgage-backed securities (2)	99,575	1.66	83,981	2.08	(24)	
Taxable AFS investment securities (2)	66,237	8.58	61,052	1.96	1,132	
Tax-exempt AFS investment securities (2)	128,336	1.92	131,973	1.90	(12)	
Taxable HTM investment securities	8,500	4.99	8,500	5.04	(1)	
FHLB stock	4,626	4.55	7,924	5.66	(60)	
Interest-bearing deposits at other financial institutions	68,369	4.45	29,080	1.99	620	
Total interest-earning assets	<u>\$ 2,799,334</u>	<u>6.13%</u>	<u>\$ 2,406,071</u>	<u>5.16%</u>	<u>\$ 11,966</u>	

(1) The average loans receivable, net balances include nonaccrual loans.

(2) Shown at amortized cost.

Interest Expense. Interest expense increased \$8.9 million to \$12.6 million for the three months ended September 30, 2023, from \$3.8 million for the same prior year quarter, primarily due to an increase of interest expense on deposits of \$7.9 million and on borrowings of \$993,000. The average cost of funds for total interest-bearing liabilities increased 168 basis points to 2.60% for the three months ended September 30, 2023, from 0.92% for the three months ended September 30, 2022. The increase in interest expense was predominantly due to an increase in cost for deposits and borrowings as well as an increase in the average balances of CDs and borrowings. The average cost of total interest-bearing deposits increased 167 basis points to 2.38%, for the three months ended September 30, 2023, compared to 0.71%, for the three months ended September 30, 2022. The average cost of funds, including noninterest-bearing checking, increased 124 basis points to 1.92% for the three months ended September 30, 2023, from 0.68% for the three months ended September 30, 2022.

The following table details average balances of interest-bearing liabilities, associated rates, and resulting change in interest expense for the three months ended September 30, 2023 and 2022:

(Dollars in thousands)	Three Months Ended September 30,					
	2023		2022		\$ Change in Interest Expense	
	Average Balance Outstanding	Rate	Average Balance Outstanding	Rate		
Savings and money market	\$ 570,786	1.06%	\$ 829,460	0.62%	\$ 226	
Interest-bearing checking	187,746	1.36	153,054	0.26	543	
Certificates of deposit	982,725	3.35	475,533	1.00	7,097	
Borrowings	138,013	4.86	119,150	2.32	993	
Subordinated note	49,500	3.89	49,434	3.89	—	
Total interest-bearing liabilities	<u>\$ 1,928,770</u>	<u>2.60%</u>	<u>\$ 1,626,631</u>	<u>0.92%</u>	<u>\$ 8,859</u>	

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Provision for Credit Losses. For the three months ended September 30, 2023, the provision for credit losses was \$548,000, consisting of a \$684,000 provision for credit losses on loans and a \$14,000 provision for credit losses on securities held-to-maturity, partially offset by a \$149,000 reversal of the allowance for credit losses on unfunded loan commitments, compared to \$1.7 million provision for credit losses for the three months ended September 30, 2022, consisting of a \$2.0 million provision for credit losses on loans, offset by a \$305,000 reversal of credit losses on unfunded loan commitments. The provision for credit losses on loans reflects the increase in total loans receivable and net charge-offs for the three months ended September 30, 2023, while the reversal of the allowance for credit losses on unfunded loan commitments for the three months ended September 30, 2023, was a result of a decrease in total unfunded commitments during current quarter.

During the three months ended September 30, 2023, net loan charge-offs totaled \$533,000, compared to \$563,000 during the three months ended September 30, 2022. The decrease was primarily due to decreases in net charge-offs of \$388,000 in deposit overdrafts and \$35,000 in marine loans, partially offset by net increases of \$387,000 in indirect home improvement loans and \$3,000 in other loans. A further decline in national and local economic conditions, as a result the effects of inflation, a potential recession or slowed economic growth, among other economic factors, could result in a material increase in the ACL for loans and may adversely affect the Company's financial condition and result of operations.

Noninterest Income. Noninterest income increased \$801,000 to \$5.0 million for the three months ended September 30, 2023, from \$4.2 million for the three months ended September 30, 2022. The increase reflects a \$555,000 increase in service charges and fee income, primarily as a result of a \$588,000 increase in deposit fees, including interchange income, and an increase of \$473,000 in gain on sale of loans, partially offset by a \$239,000 decrease other noninterest income. As of September 30, 2023, the servicing rights were being amortized over an approximate six-year period. Gross margin on home loan sales increased to 3.08% for the three months ended September 30, 2023, from 2.85% for the three months ended September 30, 2022.

Noninterest Expense. Noninterest expense increased \$4.2 million to \$23.6 million for the three months ended September 30, 2023, from \$19.3 million for the three months ended September 30, 2022. The increase was primarily the result a \$2.1 million increase in salaries and benefits, largely due to an increase in the number of FTEs as a result of the Branch Acquisition. Other increases included \$829,000 in amortization of CDI, \$597,000 in operations expense, \$293,000 in data processing, \$244,000 in occupancy expense, and \$232,000 in marketing and advertising, offset by a decrease of \$182,000 in loan costs.

The efficiency ratio, which is calculated by dividing noninterest expense by total net interest income and noninterest income, worsened to 66.22% for the three months ended September 30, 2023, compared to 60.99% for the three months ended September 30, 2022, primarily due to the increase in noninterest expenses, much of which was related to the Branch Acquisition.

Provision for Income Taxes. For the three months ended September 30, 2023, the Company recorded a provision for income taxes of \$2.5 million as compared to \$2.2 million for the three months ended September 30, 2022. The increase in the income taxes provision was primarily due to an \$830,000 increase in pre-tax income during the three months ended September 30, 2023, as compared to the same quarter last year. The effective corporate income tax rates for the three months ended September 30, 2023 and 2022 were 22.0% and 20.6%, respectively. The increase in the effective corporate income tax rate was attributable to a decrease in nontaxable income between periods.

Comparison of Results of Operations for the Nine Months Ended September 30, 2023 and 2022

General. Net income was \$26.3 million for the nine months ended September 30, 2023, and \$22.0 million for the nine months ended September 30, 2022. The increase in net income for the nine months ended September 30, 2023 compared to the same period in 2022, was primarily due to a \$17.9 million, or 23.8%, increase in net interest income and a \$1.3 million, or 27.2%, decrease in the provision for credit losses, partially offset by a \$14.0 million, or 24.4%, increase in noninterest expense and a \$1.5 million, or 28.1%, increase in provision for income taxes.

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Average Balances, Interest and Average Yields/Cost

The following table sets forth for the periods indicated, information regarding average balances of assets and liabilities, as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin (otherwise known as net yield on interest-earning assets), and the ratio of average interest-earning assets to average interest-bearing liabilities. Also presented is the weighted average yield on interest-earning assets, rates paid on interest-bearing liabilities and the resultant spread at for the periods presented. Average balances are daily average balances. Nonaccrual loans have been included in the table as loans carrying a zero yield. The yields on tax-exempt municipal bonds have not been computed on a tax equivalent basis.

(Dollars in thousands)	For the Nine Months Ended September 30, 2023			For the Nine Months Ended September 30, 2022		
	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned/ Paid	Yield/ Rate
Average Balances						
ASSETS						
Loans receivable, net and loans held for sale (1) (2)	\$ 2,362,885	\$ 114,082	6.46%	\$ 1,953,305	\$ 77,885	5.33%
Taxable AFS mortgage-backed securities (3)	87,357	1,162	1.78%	87,687	1,466	2.24%
Taxable AFS investment securities (3)	60,283	2,961	6.57%	61,103	852	1.86%
Tax-exempt AFS investment securities (3)	129,195	1,885	1.95%	130,605	1,858	1.90%
Taxable HTM investment securities	8,500	322	5.06%	7,943	301	5.07%
FHLB stock	5,190	210	5.41%	5,716	212	4.96%
Interest-bearing deposits at other financial institutions	67,163	2,127	4.23%	34,705	301	1.16%
Total interest-earning assets	2,720,573	122,749	6.03%	2,281,064	82,875	4.86%
Noninterest-earning assets	88,936			79,273		
Total assets	\$ 2,809,509			\$ 2,360,337		
LIABILITIES						
Savings and money market	\$ 640,461	4,071	0.85%	\$ 792,036	2,397	0.40%
Interest-bearing checking	171,192	1,111	0.87%	186,856	353	0.25%
Certificates of deposit	892,035	19,514	2.92%	412,289	2,688	0.87%
Borrowings	107,254	3,749	4.67%	64,855	1,003	2.07%
Subordinated notes	49,484	1,456	3.93%	49,417	1,456	3.94%
Total interest-bearing liabilities	1,860,426	29,901	2.15%	1,505,453	7,897	0.70%
Noninterest-bearing accounts	664,319			588,172		
Other noninterest-bearing liabilities	36,095			31,346		
Total liabilities	\$ 2,560,840			\$ 2,124,971		
Net interest income		\$ 92,848			\$ 74,978	
Net interest rate spread			3.88%			4.16%
Net earning assets	\$ 860,147			\$ 775,611		
Net interest margin			4.56%			4.39%
Average interest-earning assets to average interest-bearing liabilities						
		146.23%			151.52%	

(1) The average loans receivable, net balances include nonaccrual loans.

(2) Includes net deferred fee recognition of \$4.7 million and \$6.2 million for the nine months ended September 30, 2023 and 2022, respectively.

(3) Shown at amortized cost.

Net Interest Income. Net interest income increased \$17.9 million to \$92.8 million for the nine months ended September 30, 2023, from \$75.0 million for the nine months ended September 30, 2022. This increase was primarily the result of an increase in loans and variable rate loans repricing higher and, to a lesser extent, increases in interest income from taxable AFS investment securities and interest-bearing deposits at other financial institutions, partially offset by an increase in interest expense.

Total interest income increased \$39.9 million for the nine months ended September 30, 2023, compared to the same period in 2022, primarily due to an increase of \$36.2 million in interest income on loans receivable, including fees, primarily due to new loans being originated at higher rates and variable-rate loans repricing higher following recent increases in market interest rates. In addition, interest income on taxable AFS investment securities and interest-bearing deposits at other financial institutions increased \$1.8 million and \$1.8 million, respectively, during the three months ended September 30, 2023 compared to the same period in 2022, primarily due to recent increases in market interest rates. Total interest expense increased \$22.0 million for the nine months ended September 30, 2023, compared to the same period in 2022, primarily as a result of higher interest rates, higher utilization of borrowings and a shift in deposit mix from transactional accounts to higher cost CDs.

NIM increased 17 basis points to 4.56% for the nine months ended September 30, 2023, from 4.39% for the same period in the prior year. The increase in NIM reflects new loan originations at higher interest rates and variable rate interest-earning assets repricing higher following recent increases in market interest rates. The benefit of the higher rates and increase in interest earning assets was partially offset by rising deposit and borrowing costs. Increases in average balances of higher costing CDs and borrowings placed additional pressure on NIM.

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Interest Income. Interest income for the nine months ended September 30, 2023, increased \$39.9 million to \$122.7 million, from \$82.9 million for the nine months ended September 30, 2022. The increase during the period was primarily attributable to a \$439.5 million increase in the average balance of total interest-earning assets and a 117-basis point increase in the average yield on total interest-earning assets.

The following table compares average interest-earning asset balances, associated yields, and resulting changes in interest income for the nine months ended September 30, 2023 and 2022:

(Dollars in thousands)

	Nine Months Ended September 30,			
	2023		2022	
	Average Balance Outstanding	Yield	Average Balance Outstanding	Yield
Loans receivable, net and loans held for sale (1)	\$ 2,362,885	6.46%	\$ 1,953,305	5.33%
Taxable AFS mortgage-backed securities (2)	87,357	1.78	87,687	2.24
Taxable AFS investment securities (2)	60,283	6.57	61,103	1.86
Tax-exempt AFS investment securities (2)	129,195	1.95	130,605	1.90
Taxable HTM investment securities	8,500	5.06	7,943	5.07
FHLB stock	5,190	5.41	5,716	4.96
Interest-bearing deposits at other financial institutions	67,163	4.23	34,705	1.16
Total interest-earning assets	<u>\$ 2,720,573</u>	<u>6.03%</u>	<u>\$ 2,281,064</u>	<u>4.86%</u>
				\$ 39,874

(1) The average loans receivable, net balances include nonaccrual loans.

(2) Shown at amortized cost.

Interest Expense. Interest expense increased \$22.0 million to \$29.9 million for the nine months ended September 30, 2023, from \$7.9 million for the same period in the prior year, primarily due to an increase of interest expense on deposits of \$19.3 million, primarily higher costing CDs, and on borrowings of \$2.7 million. The average cost of funds for total interest-bearing liabilities increased 145 basis points to 2.15% for the nine months ended September 30, 2023, from 0.70% for the nine months ended September 30, 2022. The increase in interest expense was predominantly due to the increase in market rate for deposits, a shift in deposits to higher costing CDs, and an increase in the average balance of borrowings. The average cost of total interest-bearing deposits increased 142 basis points to 1.94%, for the nine months ended September 30, 2023, compared to 0.52%, for the nine months ended September 30, 2022. The average cost of funds, including noninterest-bearing checking, increased 108 basis points to 1.58% for the nine months ended September 30, 2023, from 0.50% for the nine months ended September 30, 2022.

The following table details average balances of interest-bearing liabilities, associated rates and resulting changes in interest expense for the nine months ended September 30, 2023 and 2022:

(Dollars in thousands)

	Nine Months Ended September 30,			
	2023		2022	
	Average Balance Outstanding	Rate	Average Balance Outstanding	Rate
Savings and money market	\$ 640,461	0.85%	\$ 792,036	0.40%
Interest-bearing checking	171,192	0.87	186,856	0.25
Certificates of deposit	892,035	2.92	412,289	0.87
Borrowings	107,254	4.67	64,855	2.07
Subordinated note	49,484	3.93	49,417	3.94
Total interest-bearing liabilities	<u>\$ 1,860,426</u>	<u>2.15%</u>	<u>\$ 1,505,453</u>	<u>0.70%</u>
				\$ 22,004

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Provision for Credit Losses. For the nine months ended September 30, 2023, the provision for credit losses was \$3.4 million, consisting of a \$4.1 million provision for credit losses on loans partially offset by a \$745,000 reversal of the allowance for credit losses on unfunded loan commitments, compared to a \$4.6 million provision for credit losses for the nine months ended September 30, 2022, consisting of a \$4.5 million provision for credit losses on loans and a \$180,000 provision for credit losses on unfunded loan commitments. The provision for credit losses on loans reflects the increase in total loans receivable, increased net charge-offs, and increased reserves on individually evaluated nonaccrual loans. The reversal of the allowance for credit losses on unfunded loan commitments for the nine months ended September 30, 2023, was a result of a decrease in total unfunded commitments during current period.

During the nine months ended September 30, 2023, net loan charge-offs totaled \$1.6 million, compared to \$843,000 during the nine months ended September 30, 2022. The increase was primarily due to increases in net charge-offs of \$972,000 in indirect home improvement loans, \$164,000 in marine loans, \$10,000 in home equity loans, and \$2,000 in other loans, offset by a net decrease of \$400,000 in deposit overdrafts charge-offs. Management attributes the increase in net charge-offs primarily to volatile economic conditions. A further decline in national and local economic conditions, as a result the effects of inflation, a potential recession or slowed economic growth, among other economic factors, could result in a material increase in the ACL for loans and may adversely affect the Company's financial condition and result of operations.

Noninterest Income. Noninterest income increased \$622,000 to \$15.0 million for the nine months ended September 30, 2023, from \$14.4 million for the nine months ended September 30, 2022. The increase reflects a \$2.2 million increase in service charges and fee income, primarily as a result of a \$1.5 million increase in deposit fees, including interchange income, and a \$871,000 increase in servicing fee income from non-portfolio serviced loans, net of mortgage servicing rights amortization, and a \$391,000 increase in other noninterest income, partially offset by decreases of \$2.0 million in gain on sale of loans due primarily to a reduction in origination and sales volume of loans held for sale. Gross margin on home loan sales increased to 3.07% for the nine months ended September 30, 2023, from 2.85% for the nine months ended September 30, 2022.

Noninterest Expense. Noninterest expense increased \$14.0 million to \$71.3 million for the nine months ended September 30, 2023, from \$57.3 million for the nine months ended September 30, 2022. The increase was primarily a result of a \$5.8 million increase in salaries and benefits largely due to an increase in the number of FTEs as a result of the Branch Acquisition. Other increases included \$2.1 million in operations, \$2.0 million in amortization of core deposit intangible, \$1.6 million in acquisition costs, \$928,000 in FDIC insurance due to asset growth and an increase in assessment rates, \$845,000 in occupancy expense, \$729,000 in data processing, and \$420,000 in marketing and advertising, offset by a decrease of \$386,000 in professional and board fees.

The efficiency ratio weakened to 66.10% for the nine months ended September 30, 2023, compared to 64.14% for the nine months ended September 30, 2022, primarily representing the increase in noninterest expense due to the Branch Acquisition.

Provision for Income Taxes. For the nine months ended September 30, 2023, the Company recorded a provision for income taxes of \$6.9 million as compared to \$5.4 million for the nine months ended September 30, 2022. The increase in the income tax provision was primarily due to a \$5.8 million increase in pre-tax income during the nine months ended September 30, 2023, as compared to the same period last year. The effective corporate income tax rates for the nine months ended September 30, 2023 and 2022 were 20.8% and 19.7%, respectively. The increase in the effective corporate income tax rate was attributable to a decrease in nontaxable income between periods.

Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit runoff that may occur in the normal course of business. The Company relies on several different sources to meet potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, purchases of federal funds, sale of securities available-for-sale, cash flows from loan payments, sales of one-to-four-family loans held for sale, and maturing securities. While the maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund its operations. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At September 30, 2023, the Bank's total borrowing capacity was \$672.0 million with the FHLB of Des Moines, with unused borrowing capacity of \$667.7 million. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. At September 30, 2023, the Bank held approximately \$1.03 billion in loans that qualify as collateral for FHLB advances.

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In addition to the availability of liquidity from the FHLB of Des Moines, the Bank maintains a short-term borrowing line with the FRB with a limit of \$222.3 million and a combined credit limit of \$101.0 million in written federal funds lines of credit through correspondent banking relationships at September 30, 2023. The FRB borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for FRB line of credit. At September 30, 2023, the Bank held approximately \$629.3 million in loans that qualify as collateral for the FRB line of credit. Additionally, securities with a carrying value of \$73.7 million were pledged primarily to provide contingent liquidity through the Bank Term Funding Program at the Federal Reserve Bank at September 30, 2023, with a current limit of \$90.0 million and no unused borrowing capacity. Subject to market conditions, we expect to utilize these borrowing facilities from time to time in the future to fund loan originations and deposit withdrawals, to satisfy other financial commitments, repay maturing debt and to take advantage of investment opportunities to the extent feasible.

The Bank's Asset and Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or \$492.7 million at September 30, 2023. Total brokered deposits at September 30, 2023 were \$373.5 million. Management utilizes brokered deposits to mitigate interest rate risk and to enhance liquidity when appropriate.

Liquidity management is both a daily and long-term function of the Company's management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and federal funds. On a longer-term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and U.S. agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits, fund withdrawals, and to fund loan commitments. At September 30, 2023, outstanding loan commitments, including unused lines of credit totaled \$548.5 million. The Company purchased \$46.9 million in securities during the nine months ended September 30, 2023. Securities purchased during the nine months ended September 30, 2022 totaled \$24.0 million. Securities repayments, maturities and sales in those periods were \$13.5 million and \$17.8 million, respectively.

The Bank's liquidity is also affected by the volume of loans sold and loan principal payments. During the nine months ended September 30, 2023 and 2022, the Bank sold \$320.9 million and \$663.8 million in loans and loan participation interests, respectively.

The Bank's liquidity has been positively impacted by increases in deposit levels. Total deposits increased \$326.7 million during the nine months ended September 30, 2023 primarily driven by the Branch Purchase with assumed deposits remaining of \$301.2 million and growth in CDs. CDs scheduled to mature in three months or less at September 30, 2023, totaled \$338.8 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this strategy, management believes that a majority of maturing relationship deposits will remain with the Bank. Excess liquidity from the Branch Purchase was used to repay borrowings.

For the remainder of 2023, we project that fixed commitments will include \$483,000 of operating lease payments. No FHLB advances are scheduled to mature for the remainder of 2023. For information regarding our operating leases, see "Note 7 – Leases" of the Notes to Consolidated Financial Statements included in this report.

As a separate legal entity from the Bank, FS Bancorp, Inc. must provide for its own liquidity. In addition to its own operating expenses (many of which are paid to the Bank), FS Bancorp is responsible for paying for any stock repurchases, dividends declared to its stockholders, interest and principal on outstanding debt, and other general corporate expenses. Sources of capital and liquidity for FS Bancorp include distributions from the Bank and the issuance of debt or equity securities, although there are regulatory restrictions on the ability of the Bank to make distributions.

Dividends and other capital distributions from the Bank are subject to regulatory notice and certain restrictions. The unrestricted cash of FS Bancorp held at the Bank on an unconsolidated basis totaled \$8.7 million at September 30, 2023. The Company currently expects to continue the current practice of paying quarterly cash dividends on common stock subject to the Board of Directors' discretion to modify or terminate this practice at any time and for any reason without prior notice. Our current quarterly common stock dividend rate is \$0.25 per share, which we believe is a dividend rate per share which enables us to balance our multiple objectives of managing and investing in the Bank, and returning a substantial portion of our cash to our shareholders. Assuming continued payment during 2023 at this rate of \$0.25 per share, our total dividends paid each quarter would be approximately \$1.9 million based on the number of the current outstanding shares as of September 30, 2023.

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Under FS Bancorp's current stock repurchase program, approximately \$4.7 million remained available for future repurchases as of September 30, 2023. See "Unregistered Sales of Equity Securities, Use of Proceeds, and Issuer Purchases of Equity Securities" in Item 2, Part II of this Form 10-Q for additional information relating to stock repurchases.

At September 30, 2023, FS Bancorp, on an unconsolidated basis, had \$8.7 million in unrestricted cash to meet liquidity needs.

Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at September 30, 2023, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a well-capitalized status under the capital categories of the FDIC. Based on capital levels at September 30, 2023, the Bank was considered to be well capitalized. At September 30, 2023, the Bank exceeded all regulatory capital requirements with Tier 1 leverage-based capital, Tier 1 risk-based capital, total risk-based capital, and common equity Tier 1 capital ratios of 10.3%, 11.8%, 13.1%, and 11.8%, respectively.

As a bank holding company registered with the Federal Reserve, the Company is subject to the capital adequacy requirements of the Federal Reserve. Bank holding companies with less than \$3.0 billion in assets are generally not subject to compliance with the Federal Reserve's capital regulations, which are generally the same as the capital regulations applicable to the Bank. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to the holding company's subsidiary bank and the Federal Reserve expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. If FS Bancorp were subject to regulatory capital guidelines for bank holding companies with \$3.0 billion or more in assets at September 30, 2023, FS Bancorp would have exceeded all regulatory capital requirements. For informational purposes, the regulatory capital ratios calculated for FS Bancorp at September 30, 2023 were 8.9% for Tier 1 leverage-based capital, 10.2% for Tier 1 risk-based capital, 13.4% for total risk-based capital, and 10.2% for CET 1 capital ratio. For additional information regarding regulatory capital compliance, see the discussion included in "Note 14 – Regulatory Capital" to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in the market risk disclosures contained in FS Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2022.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

An evaluation of the disclosure controls and procedures as defined in Rule 13a-15(e) of the Exchange Act was carried out as of September 30, 2023 under the supervision and with the participation of the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") and several other members of the Company's senior management. In designing and evaluating the Company's disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily 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 also is 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.

The Company's CEO and CFO concluded that based on their evaluation at September 30, 2023, the Company's disclosure controls and procedures were effective in ensuring that information we are required to disclose in the reports we file or submit under the Exchange Act is (1) recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to FS Bancorp management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure, specified in the SEC's rules and forms.

(b) Changes in Internal Controls

There were no significant changes in the Company's internal control over financial reporting that occurred during the three months ended September 30, 2023, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting. The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute assurance that the objectives of the control procedure are met. 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. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls may be circumvented by the individual acts of some persons, by collusion of two or more people, or by override of the control. The design of any control procedure 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; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION**Item 1. Legal Proceedings**

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A. Risk Factors

There have been no material changes in the Risk Factors previously disclosed in FS Bancorp's Annual Report on Form 10-K for the fiscal year ended December 31, 2022.

Item 2. Unregistered Sales of Equity Securities, Use of Proceeds, and Issuer Purchases of Equity Securities

(a) Not applicable

(b) Not applicable

(c) The following table summarizes common stock repurchases during the three months ended September 30, 2023:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Repurchased as Part of Publicly Announced Plan or Program	Maximum Dollar Value of Shares that May Yet Be Repurchased Under the Plan or Program
July 1, 2023 - July 31, 2023	—	\$ —	—	\$ —
August 1, 2023 - August 31, 2023(1)	11,006	\$ 30.73	11,006	\$ 4,661,786
September 1, 2023 - September 30, 2023	—	—	—	—
Total for the quarter	11,006	\$ 30.73	11,006	\$ 4,661,786

(1) 11,006 shares were surrendered by participants included in the 2018 Equity Incentive Plan in satisfaction of payment for withholding taxes for vesting of restricted stock shares.

On August 15, 2023, the Company announced that its Board of Directors authorized the implementation of a stock repurchase program for the repurchase up to \$5.0 million of shares, or 2.5% of its outstanding shares of common stock as of that date, in the open market, in privately negotiated transactions or shares withheld upon the exercise of equity awards from time to time over a 12-month period until July 31, 2024, at such prices as may be determined by the Company's management, such program to commence no sooner than the third trading day after the public announcement of this repurchase program.

The repurchase program permits shares to be repurchased in open market or private transactions or pursuant to a trading plan adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission ("SEC").

Repurchases will be made at management's discretion at prices management considers to be attractive and in the best interests of both the Company and its shareholders, subject to the availability of stock, general market conditions, the trading price of the stock, alternative uses for capital, and the Company's financial performance. Open market purchases will be conducted in accordance with the limitations set forth in Rule 10b-18 of the SEC and other applicable legal requirements.

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Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

(a) None.

(b) None.

(c) Trading Plans. During the three months ended September 30, 2023, no director or officer (as defined in Rule 16a-1(f) under the Exchange Act) of the Company adopted or terminated a "Rule 10b5-1 trading arrangement" or "non-Rule 10b5-1 trading arrangement," as each term is defined in Item 408(a) of Regulation S-K.

Item 6. Exhibits

- 3.1 [Articles of Incorporation of FS Bancorp, Inc. \(1\)](#)
- 3.2 [Bylaws of FS Bancorp, Inc. \(2\)](#)
- 4.1 [Form of Common Stock Certificate of FS Bancorp, Inc. \(1\)](#)
- 4.2 [Indenture dated February 10, 2021, by and between FS Bancorp, Inc. and U.S. Bank National Association, as trustee \(3\)](#)
- 4.3 [Forms of 3.75 Fixed-to-Floating Rate Subordinated Notes due 2031 \(included as Exhibit A-1 and Exhibit A-2 to the Indenture filed as Exhibit 4.2 hereto \(3\)](#)
- 10.1 [Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams \(1\)](#)
- 10.2 [Form of Change of Control Agreement between 1st Security Bank of Washington and Matthew D. Mullet \(1\)](#)
- 10.3 [FS Bancorp, Inc. 2013 Equity Incentive Plan \(the "2013 Plan"\) \(4\)](#)
- 10.4 [Form of Incentive Stock Option Agreement under the 2013 Plan \(4\)](#)
- 10.5 [Form of Non-Qualified Stock Option Agreement under the 2013 Plan \(4\)](#)
- 10.6 [Form of Restricted Stock Agreement under the 2013 Plan \(4\)](#)
- 10.9 [Form of change of control agreement with Donn C. Costa, Dennis O'Leary, Erin Burr, Victoria Jarman, Kelli Nielsen, and May-Ling Sowell \(5\)](#)
- 10.10 [FS Bancorp, Inc. 2018 Equity Incentive Plan \(6\)](#)
- 10.11 [Form of Incentive Stock Option Award Agreement under the 2018 Equity Incentive Plan \(6\)](#)
- 10.12 [Form of Non-Qualified Stock Option Award Agreement under the 2018 Equity Incentive Plan \(6\)](#)
- 10.13 [Form of Restricted Stock Award Agreement under the 2018 Equity Incentive Plan \(6\)](#)
- 10.14 [FS Bancorp, Inc. Nonqualified 2022 Stock Purchase Plan \(7\)](#)
- 10.15 [Form of Enrollment/Change Form under the FS Bancorp, Inc. Nonqualified 2022 Stock Purchase Plan \(7\)](#)
- 31.1 [Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#)
- 31.2 [Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#)
- 32.1 [Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002](#)
- 32.2 [Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002](#)
- 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2023 formatted in Inline Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income (Loss); (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.
- 104 Cover Page Interactive Data File (formatted as inline XBRL and contained in Exhibit 101)
- (1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-177125) filed on October 3, 2011, and incorporated by reference.
- (2) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on July 10, 2013 (File No. 001-355589).
- (3) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on February 11, 2021 (File No. 001-35589).
- (4) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-192990) filed on December 20, 2013 and incorporated by reference.
- (5) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on February 1, 2016 (File No. 001-35589).
- (6) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-22513) filed on May 23, 2018.
- (7) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-265729) filed on June 21, 2022.

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.

FS BANCORP, INC.

Date: November 8, 2023

By: /s/Joseph C. Adams
Joseph C. Adams,
Chief Executive Officer
(*Principal Executive Officer*)

Date: November 8, 2023

By: /s/Matthew D. Mullet
Matthew D. Mullet
Secretary, Treasurer and
Chief Financial Officer
(*Principal Financial and Accounting Officer*)

Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Joseph C. Adams, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of FS Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2023

/s/Joseph C. Adams
Joseph C. Adams
Chief Executive Officer

Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Matthew D. Mullet, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of FS Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2023

/s/Matthew D. Mullet

Matthew D. Mullet
Chief Financial Officer

Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Quarterly Report on Form 10-Q of FS Bancorp, Inc. (the "Company") for the quarter ended September 30, 2023 (the "Report"), I, Joseph C. Adams, in my capacity as Chief Executive Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods presented in the financial statements included in the Report.

Date: November 8, 2023

/s/Joseph C. Adams
Joseph C. Adams
Chief Executive Officer

Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Quarterly Report on Form 10-Q of FS Bancorp, Inc. (the "Company") for the quarter ended September 30, 2023 (the "Report"), I, Matthew D. Mullet, in my capacity as Chief Financial Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods presented in the financial statements included in the Report.

Date: November 8, 2023

/s/Matthew D. Mullet

Matthew D. Mullet
Chief Financial Officer
