FS Bancorp, Inc.
Form 10-Q
May 12, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2014 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: 333-177125
FS BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington	45-4585178
(State or other jurisdiction of incorporation or organization)	(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)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]

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

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

Large accelerated filer [ ]	Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [X]

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of May 9, 2014, there were 3,240,125 outstanding shares of the registrant's common stock.

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

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Item 1. Financial Statements
FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data) (Unaudited)

	March 31, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$1,972	$1,425
Interest-bearing deposits at other financial institutions	31,336	39,660
Securities available-for-sale, at fair value	72,092	56,239
Federal Home Loan Bank stock, at cost	1,686	1,702
Loans held for sale, at fair value	11,592	11,185
Loans receivable, net	288,526	281,081
Accrued interest receivable	1,430	1,261
Premises and equipment, net	13,764	13,818
Other real estate owned ("OREO")	535	2,075
Deferred tax asset	181	816
Bank owned life insurance ("BOLI")	6,414	6,369
Other assets	3,668	3,556
TOTAL ASSETS	$433,196	$419,187
LIABILITIES		
Deposits		
Noninterest-bearing accounts	$47,367	$45,783
Interest-bearing accounts	302,969	291,093
Total deposits	350,336	336,876
Borrowings	16,345	16,664
Other liabilities	3,047	3,334
Total liabilities	369,728	356,874
COMMITMENTS AND CONTINGENCIES (NOTE 9)		
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; 3,240,125 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	32	32
Additional paid-in capital	30,106	30,097
Retained earnings	35,938	35,215
Accumulated other comprehensive loss	(541)	(898)
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(2,067)	(2,133)
Total stockholders' equity	63,468	62,313
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$433,196	$419,187

See accompanying notes to these consolidated financial statements.

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

	Three Months Ended March 31,	
	2014	2013
INTEREST INCOME		
Loans receivable	$5,181	$4,938
Interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions	330	237
Total interest and dividend income	5,511	5,175
INTEREST EXPENSE		
Deposits	550	472
Borrowings	58	38
Total interest expense	608	510
NET INTEREST INCOME	4,903	4,665
PROVISION FOR LOAN LOSSES	450	600
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,453	4,065
NONINTEREST INCOME		
Service charges and fee income	398	453
Gain on sale of loans	1,508	1,552
Gain on sale of investment securities	—	168
Other noninterest income	134	90
Total noninterest income	2,040	2,263
NONINTEREST EXPENSE		
Salaries and benefits	3,122	2,477
Operations	546	758
Occupancy	398	317
Data processing	287	266
OREO fair value impairments, net of (gain) loss on sales	32	78
OREO expenses	21	22
Loan costs	305	300
Professional and board fees	304	230
FDIC insurance	63	57
Marketing and advertising	107	85
Recovery of loss on servicing rights	—	(122)
Total noninterest expense	5,185	4,468
INCOME BEFORE PROVISION FOR INCOME TAX	1,308	1,860
PROVISION FOR INCOME TAX	433	625
NET INCOME	$875	$1,235
Basic earnings per share	$0.29	$0.41
Diluted earnings per share	$0.29	$0.41

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) (Unaudited)

	Three Months Ended March 31,	
	2014	2013
Net Income	$ 875	$ 1,235
Other comprehensive gain (loss), net of tax:		
Unrealized gain (loss) on securities available-for-sale:		
Unrealized holding gain (loss) arising during period	542	(265)
Income tax (provision) benefit related to unrealized gains	(185)	90
Reclassification adjustment for realized gains included in net income	—	(168)
Income tax benefit related to reclassification for realized gains	—	57
Other comprehensive gain (loss), net of tax	357	(286)
COMPREHENSIVE INCOME	$ 1,232	$ 949

See accompanying notes to these consolidated financial statements.

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

	Common Stock		Additional		Accumulated Other	Unearned	
	Shares	Amount	Paid-in Capital	Retained Earnings	Comprehensive Income (Loss)	ESOP Shares	Total Equity
BALANCE, January 1, 2013	3,240,125	$32	$29,894	$31,746	$597	$(2,372)	$59,897
Net income	—	—	—	1,235	—	—	1,235
Other comprehensive loss, net of tax	—	—	—	—	(286)	—	(286)
ESOP shares allocated	—	—	29	—	—	66	95
BALANCE, March 31, 2013	3,240,125	$32	$29,923	$32,981	$311	$(2,306)	$60,941
BALANCE, January 1, 2014	3,240,125	$32	$30,097	$35,215	$(898)	$(2,133)	$62,313
Net income	—	—	—	875	—	—	875
Dividends paid ($0.05 per share)	—	—	—	(152)	—	—	(152)
Other comprehensive gain, net of tax	—	—	—	—	357	—	357
ESOP cash distribution			(35)		—	—	(35)
ESOP shares allocated	—	—	44	—	—	66	110
BALANCE, March 31, 2014	3,240,125	$32	$30,106	$35,938	$(541)	$(2,067)	$63,468

See accompanying notes to these consolidated financial statements.

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

	Three Months Ended March 31,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$875	$1,235
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	450	600
Depreciation, amortization and accretion	548	496
ESOP expense	110	95
Provision for deferred income taxes	635	525
Increase in cash surrender value of BOLI	(45)	—
Gain on sale of loans held for sale	(983)	(1,552)
Gain on sale of portfolio loans	(525)	—
Origination of loans held for sale	(33,813)	(52,508)
Proceeds from sale of loans held for sale	34,144	42,474
Gain on sale of investment securities	—	(168)
Gain on sale of OREO	(8)	—
Recovery of loss on servicing rights	—	(122)
Impairment loss on other real estate owned	40	78
Changes in operating assets and liabilities		
Accrued interest receivable	(169)	(105)
Other assets	(307)	(168)
Other liabilities	(269)	(77)
Net cash from (used by) operating activities	683	(9,197)
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	—	4,068
Maturities, prepayments, and calls	2,375	844
Purchases	(18,034)	(5,095)
Loan originations and principal collections, net	(20,646)	(2,301)
Proceeds from sale of portfolio loans	12,849	—
Proceeds from sale of OREO	1,953	93
Purchase of premises and equipment	(196)	(570)
Net cash used by investing activities	(21,699)	(2,961)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	13,460	4,832
Proceeds from borrowings	—	31,819
Repayments of borrowings	(319)	(25,000)
Dividends paid	(152)	—
Net cash from financing activities	12,989	11,651
NET DECREASE IN CASH AND CASH EQUIVALENTS	(8,027)	(507)
CASH AND CASH EQUIVALENTS, beginning of period	38,459	6,787
CASH AND CASH EQUIVALENTS, end of period	$30,432	$6,280
SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for:		

Interest	$608	$508
Income taxes	$140	$100
SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES		
Change in unrealized gain (loss) on investment securities	$542	$(433)
Property taken in settlement of loans	$445	$—

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 proposed holding company for 1st Security Bank of Washington (the “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 stock owned savings bank with seven branches in suburban communities in the greater Puget Sound area. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals.

Financial Statement Presentation – The accompanying unaudited consolidated interim financial statements do not contain all necessary disclosures required by Generally Accepted Accounting Principles in the United States of America (“U.S. GAAP”) for complete financial statements and, therefore, should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission ("SEC") on March 29, 2014. These unaudited financial statements include all normal and recurring adjustments that management believes are necessary in order to conform to U.S. GAAP and have been reflected as required by Article 10 of Regulation S-X as promulgated by the SEC. The results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014 or any other future period. Amounts presented in the financial statements and footnote tables are rounded and presented in thousands of dollars. In the narrative footnote discussion amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above $1.0 million. Amounts below $1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2014 presentation with no change to net income or stockholders' equity previously reported.

Conversion and Change in Corporate Form – On July 9, 2012, in accordance with a Plan of Conversion (the "Plan") adopted by its Board of Directors and as approved by its depositors and borrower members, the Bank (i) converted from a mutual savings bank to a stock savings bank, and (ii) became the wholly-owned subsidiary of FS Bancorp, Inc., a bank holding company registered with the Board of Governors of the Federal Reserve System ("FRB"). In connection with the conversion, FS Bancorp, Inc. issued an aggregate of 3,240,125 shares of common stock at an offering price of $10.00 per share for gross proceeds of $32.4 million. From the proceeds, FS Bancorp, Inc. made a capital contribution of $15.5 million to the Bank. The Bank intends to use this additional capital for future lending and investment activities and for general and other corporate purposes subject to regulatory limitations. The cost of conversion and the issuance of capital stock was approximately $2.5 million, which was deducted from the proceeds of the offering.

Pursuant to the Plan, the Company's Board of Directors adopted an ESOP plan which purchased 8% of the common stock in the open market or 259,210 shares. As provided for in the Plan, the Bank also established a liquidation account in the amount of retained earnings as of December 31, 2011. The liquidation account will be maintained for the benefits of eligible savings account holders as of June 30, 2007 and supplemental eligible account holders as of March 31, 2012 who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company’s assets, liabilities, and equity unchanged as a result.

Use of Estimates – 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 change in the near term are allowances for loan losses, fair value of measurements, and the estimated realizability related to the deferred tax asset.

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

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Subsequent Events – The Company has evaluated events and transactions subsequent to March 31, 2014 for potential recognition or disclosure.

Cash and Cash Equivalents – Cash and cash equivalents include cash and due from banks, and interest-bearing balances due from other banks and the Federal Reserve Bank of San Francisco. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. As of March 31, 2014 and December 31, 2013, the Company had cash deposits at other financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") insured limits. However, as the Company places these deposits with major financial institutions and monitors the financial condition of these institutions, management believes the risk of loss to be minimal.

Deposits in Other Financial Institutions – The Company held interest-bearing deposits at other financial institutions with a cost basis of $31.3 million and $39.7 million as of March 31, 2014 and December 31, 2013, respectively. Certificates of deposits in the amount of $2.9 million and $2.6 million with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of March 31, 2014 and December 31, 2013, respectively.

RECENT ACCOUNTING PRONOUNCEMENTS

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014 - 04, Receivables - Trouble Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This ASU is intended to clarify when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate recognized. This ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either: (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. This ASU is effective for fiscal years, and interim reporting periods within those annual periods beginning after December 15, 2014. The adoption of this ASU is not expected to have a material impact on the Company’s consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, “Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. This ASU is effective for annual periods beginning on or after December 15, 2014. Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. The adoption of this ASU is not expected to have a material impact on the Company’s consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SECURITIES AVAILABLE-FOR-SALE

The following table presents the amortized costs, unrealized gains, unrealized losses and approximate fair values of securities available-for-sale at March 31, 2014 and December 31, 2013:

	March 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
SECURITIES AVAILABLE-FOR-SALE				
Federal agency securities	$16,747	$14	$(429)	$16,332
Municipal bonds	14,497	183	(208)	14,472
Corporate securities	4,998	2	(52)	4,948
Mortgage-backed securities	36,670	80	(410)	36,340
Total securities available-for-sale	$72,912	$279	$(1,099)	$72,092

	December 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
SECURITIES AVAILABLE-FOR-SALE				
Federal agency securities	$12,297	$21	$(651)	$11,667
Municipal bonds	13,347	111	(278)	13,180
Corporate securities	4,005	2	(69)	3,938
Mortgage-backed securities	27,952	66	(564)	27,454
Total securities available-for-sale	$57,601	$200	$(1,562)	$56,239

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - SECURITIES AVAILABLE-FOR-SALE (Continued)

Investment securities that were in an unrealized loss position as of March 31, 2014 and December 31, 2013 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. In the opinion of management, these securities are considered only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

	March 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
Federal agency securities	$6,469	$(19)	$5,585	$(410)	$12,054	$(429)
Municipal bonds	5,975	(112)	1,723	(96)	7,698	(208)
Corporate securities	2,453	(42)	490	(10)	2,943	(52)
Mortgage-backed securities	23,573	(410)	—	—	23,573	(410)
Total securities available-for-sale	$38,470	$(583)	$7,798	$(516)	$46,268	$(1,099)

	December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
Federal agency securities	$4,772	$(244)	$3,591	$(407)	$8,363	$(651)
Municipal bonds	5,915	(206)	1,210	(72)	7,125	(278)
Corporate securities	2,443	(59)	490	(10)	2,933	(69)
Mortgage-backed securities	23,696	(564)	—	—	23,696	(564)
Total securities available-for-sale	$36,826	$(1,073)	$5,291	$(489)	$42,117	$(1,562)

There were 32 investments with unrealized losses of less than one year as of March 31, 2014, and 10 investments with unrealized losses of more than one year. There were 31 investments with unrealized losses of less than one year as of December 31, 2013, and seven investments with unrealized losses of more than one year. The unrealized losses associated with these investments are believed to be caused by changing market conditions that are considered to be temporary and the Company has the intent and ability to hold these securities until recovery, and is not likely to be required to sell these securities. No other-than-temporary impairment write-downs were recorded for the three months ended March 31, 2014 or the year ended December 31, 2013.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - SECURITIES AVAILABLE-FOR-SALE (Continued)

The contractual maturities of securities available-for-sale at March 31, 2014 were as follows:

	March 31, 2014	
	Amortized Cost	Fair Value
No contractual maturity	$—	$—
Due in one year or less	2,261	2,265
Due after one year through five years	9,280	9,297
Due after five years through ten years	21,955	21,450
Due after ten years	39,416	39,080
Total	$72,912	$72,092

The proceeds and resulting gains, computed using specific identification, from sales of securities available-for-sale for the three months ended March 31, 2014 and 2013 were as follows:

	Three Months Ended March 31, 2014		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	$—	$—	$—

	Three Months Ended March 31, 2013		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	$4,068	$168	$—

FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio at March 31, 2014 and December 31, 2013 was as follows:

	March 31, 2014	December 31, 2013
REAL ESTATE LOANS		
Commercial	$33,469	$32,970
Construction and development	39,394	41,633
Home equity	15,178	15,172
One-to-four-family	24,750	20,809
Multi-family	6,509	4,682
Total real estate loans	119,300	115,266
CONSUMER LOANS		
Indirect home improvement	91,558	91,167
Solar	9,745	16,838
Marine	12,719	11,203
Automobile	1,063	1,230
Recreational	523	553
Home improvement	442	463
Other	1,211	1,252
Total consumer loans	117,261	122,706
COMMERCIAL BUSINESS LOANS	57,740	49,244
Total loans	294,301	287,216
Allowance for loan losses	(5,243)	(5,092)
Deferred costs, fees, and discounts, net	(532)	(1,043)
Total loans receivable, net	$288,526	$281,081

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 manner in which 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 Puget Sound market area.

Construction and Development Lending. Loans originated by the Company for the construction of and secured by commercial real estate and one-to-four-family residences and tracts of land for development, primarily located in our Puget Sound market area.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences, primarily located in our Puget Sound market area.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

One-to-Four-Family Real Estate Lending. Loans originated by the Company secured by first mortgages on one-to-four-family residences, primarily located in our Puget Sound market area.

Multi-family Lending. Apartment lending (more than four units) to current banking customers and community reinvestment loans for housing for low to moderate income individuals primarily located in our Puget Sound market area.

Consumer Lending

Indirect Home Improvement. Fixture secured loans are originated by the Company for home improvement 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, solar panels, and other home fixture installations in Washington, Oregon and California.

Marine, Automobile and Recreational. Loans originated by the Company secured by boats, automobiles and RVs to borrowers primarily located in our Puget Sound market area.

Other Consumer and Home Improvement Loans. Loans originated by the Company, including direct home improvement loans, loans on deposits and other consumer loans to borrowers located in our Puget Sound market area.

Commercial Business Loans

Commercial Business Lending. Commercial business loans originated by the Company to local small and mid-sized businesses located in our Puget Sound market area are secured by accounts receivable, inventory or personal property, plant and equipment. Commercial business loans are made on the basis of the borrower’s ability to make repayment from the cash flow of the borrower’s business.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table details activity in the allowance for loan losses by loan categories:

	At or For the Three Months Ended March 31, 2014				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,963	$1,512	$800	$817	$5,092
Provision for loan losses	(372)	48	311	463	450
Charge-offs	(144)	(251)	(75)	—	(470)
Recoveries	18	153	—	—	171
Net charge-offs	(126)	(98)	(75)	—	(299)
Ending balance	$1,465	$1,462	$1,036	$1,280	$5,243
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$5	$—	$5
Loans collectively evaluated for impairment	1,465	1,462	1,031	1,280	5,238
Ending balance	$1,465	$1,462	$1,036	$1,280	$5,243
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$—	$—	$50	$—	$50
Loans collectively evaluated for impairment	119,300	117,261	57,690	—	294,251
Ending balance	$119,300	$117,261	$57,740	$—	$294,301

	At or For the Three Months Ended March 31, 2013				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,690	$2,158	$815	$35	$4,698
Provision for loan losses	654	(151)	(138)	235	600
Charge-offs	(115)	(399)	—	—	(514)
Recoveries	35	223	2	—	260
Net charge-offs	(80)	(176)	2	—	(254)
Ending balance	$2,264	$1,831	$679	$270	$5,044
Period end amount allocated to:					
Loans individually evaluated for impairment	$116	$—	$6	$—	$122
Loans collectively evaluated for impairment	2,148	1,831	673	270	4,922
Ending balance	$2,264	$1,831	$679	$270	$5,044
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$3,590	$—	$227	$—	$3,817
Loans collectively evaluated for impairment	103,105	113,952	60,834	—	277,891
Ending balance	$106,695	$113,952	$61,061	$—	$281,708

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Information pertaining to aging analysis of past due loans are summarized as follows:

	March 31, 2014						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ —	$33,469	$33,469
Construction and development	—	—	—	—	—	39,394	39,394
Home equity	193	43	—	236	138	14,804	15,178
One-to-four-family	—	—	—	—	99	24,651	24,750
Multi-family	—	—	—	—	—	6,509	6,509
Total real estate loans	193	43	—	236	237	118,827	119,300
CONSUMER							
Indirect home improvement	408	309	—	717	193	90,648	91,558
Solar	—	29	—	29	—	9,716	9,745
Marine	12	19	—	31	—	12,688	12,719
Automobile	—	1	—	1	—	1,062	1,063
Recreational	51	—	—	51	—	472	523
Home improvement	—	7	—	7	—	435	442
Other	5	—	—	5	3	1,203	1,211
Total consumer loans	476	365	—	841	196	116,224	117,261
COMMERCIAL BUSINESS LOANS	—	—	—	—	—	57,740	57,740
Total	$669	$408	$—	$1,077	$ 433	$292,791	$294,301

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FS BANCORP, INC. AND SUBSIDIARY
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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	December 31, 2013						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	—	$ 567	$32,403	32,970
Construction and development	—	—	—	—	—	41,633	41,633
Home equity	63	146	—	209	172	14,791	15,172
One-to-four-family	—	—	—	—	104	20,705	20,809
Multi-family	—	—	—	—	—	4,682	4,682
Total real estate loans	63	146	—	209	843	114,214	115,266
CONSUMER							
Indirect home improvement	533	218	—	751	258	90,158	91,167
Solar	—	—	—	—	—	16,838	16,838
Marine	33	—	—	33	—	11,170	11,203
Automobile	34	13	—	47	—	1,183	1,230
Recreational	39	—	—	39	—	514	553
Home improvement	7	—	—	7	—	456	463
Other	15	6	—	21	—	1,231	1,252
Total consumer loans	661	237	—	898	258	121,550	122,706
COMMERCIAL BUSINESS LOANS	54	—	—	54	—	49,190	49,244
Total	$778	$383	$—	$1,161	$ 1,101	$284,954	$287,216

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FS BANCORP, INC. AND SUBSIDIARY
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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided:

	At or For the Three Months Ended March 31, 2014						
	Unpaid Principal Balance	Write-downs	Recorded Investment	Specific Reserve	Adjusted Recorded Investment	YTD Average Recorded Investment	YTD Interest Income Recognized
WITH NO RELATED ALLOWANCE RECORDED							
Commercial	$—	$—	$—	$—	$—	$—	$—
Construction and development	—	—	—	—	—	—	—
Home equity	3	—	3	—	3	4	—
One-to-four-family	641	(7)	634	—	634	637	9
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	644	(7)	637	—	637	641	9
WITH AN ALLOWANCE RECORDED							
Commercial	—	—	—	—	—	—	—
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—

Commercial business loans	52	(2	)	50	(5	) 45	45	50	1
Subtotal loans	52	(2	)	50	(5	)	45	50	1
Total	$696	$(9	)	$687	$(5	)	$682	$691	$10

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	At or For the Year Ended December 31, 2013						
	Unpaid Principal Balance	Write-downs	Recorded Investment	Specific Reserve	Adjusted Recorded Investment	YTD Average Recorded Investment	YTD Interest Income Recognized
WITH NO RELATED ALLOWANCE RECORDED							
Commercial	$—	$—	$—	$—	$—	$—	$—
Construction and development	—	—	—	—	—	—	—
Home equity	39	—	39	—	39	39	59
One-to-four-family	1,212	(169)	1,043	—	1,043	1,041	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	1,251	(169)	1,082	—	1,082	1,080	59
WITH AN ALLOWANCE RECORDED							
Commercial	731	(164)	567	(85)	482	622	15
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—

Commercial business loans	56	(2)	54	(6)	48	59	—
Subtotal loans	787	(166)	621	(91)	530	681	15
Total	$2,038	$(335)	$1,703	$(91)	$1,612	$1,761	$74

The average recorded investment in impaired loans was $691,000 and $3.8 million for the three months ended March 31, 2014 and 2013, respectively. For the three months ended March 31, 2014 and 2013, the Company recognized interest income on impaired loans of $10,000 and $26,000, respectively.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

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 market.

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 allowance for loan loss 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)” 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.

Consumer, Home Equity and One-to-Four-Family Real Estate Loans

Homogeneous loans are risk rated based upon the FDIC'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, recreational, automobile, direct home improvement and other, 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 graded "4" internally. Loans that are past due more than 90 days are classified “Substandard” and risk graded "8" internally. At 120 days past due, homogeneous loans are charged off based on the value of the collateral less cost to sell.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables summarize risk rated loan balances by category:

	March 31, 2014						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
REAL ESTATE LOANS							
Commercial	$32,025	$551	$893	$—	$ —	$—	$33,469
Construction and development	39,394	—	—	—	—	—	39,394
Home equity	15,040	—	—	138	—	—	15,178
One-to-four-family	24,116	—	—	634	—	—	24,750
Multi-family	6,509	—	—	—	—	—	6,509
Total real estate loans	117,084	551	893	772	—	—	119,300
CONSUMER							
Indirect home improvement	91,362	—	—	196	—	—	91,558
Solar	9,745	—	—	—	—	—	9,745
Marine	12,719	—	—	—	—	—	12,719
Automobile	1,063	—	—	—	—	—	1,063
Recreational	523	—	—	—	—	—	523
Home improvement	442	—	—	—	—	—	442
Other	1,211	—	—	—	—	—	1,211
Total consumer loans	117,065	—	—	196	—	—	117,261
COMMERCIAL BUSINESS LOANS	46,076	10,393	1,221	50	—	—	57,740
Total	$280,225	$10,944	$2,114	$1,018	$ —	$—	$294,301

	December 31, 2013						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
REAL ESTATE LOANS							
Commercial	$31,500	$903	$—	$567	$ —	$—	$32,970
Construction and development	41,633	—	—	—	—	—	41,633
Home equity	15,000	—	—	172	—	—	15,172
One-to-four-family	19,766	—	—	1,043	—	—	20,809
Multi-family	4,682	—	—	—	—	—	4,682
Total real estate loans	112,581	903	—	1,782	—	—	115,266
CONSUMER							
Indirect home improvement	90,909	—	—	258	—	—	91,167
Solar	16,838	—	—	—	—	—	16,838
Marine	11,203	—	—	—	—	—	11,203
Automobile	1,230	—	—	—	—	—	1,230
Recreational	553	—	—	—	—	—	553
Home improvement	463	—	—	—	—	—	463

Other	1,252	—	—	—	—	—	1,252
Total consumer loans	122,448	—	—	258	—	—	122,706
COMMERCIAL BUSINESS LOANS	38,492	10,698	—	54	—	—	49,244
Total	$273,521	$11,601	$—	$2,094	$ —	$—	$287,216

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Troubled Debt Restructured Loans

Troubled debt restructured (“TDR”) loans are loans for which the Company, for economic or legal reasons related to the borrower’s financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The loan terms which have been modified or restructured due to a borrower’s financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status. The Company had four troubled debt restructured ("TDR") loans still on accrual and included in impaired loans at March 31, 2014, and at December 31, 2013, respectively. In addition, at March 31, 2014 and December 31, 2013, the Company had no TDR loans on non-accrual. The Company had no commitments to lend additional funds on these restructured loans.

A summary of TDR loans at the dates indicated is as follows:

	March 31, 2014	December 31, 2013
Troubled debt restructured loans still on accrual	$807	$815
Troubled debt restructured loans on non-accrual	—	—
Total troubled debt restructured loans	$807	$815

The following table present loans that became TDRs during the following periods:

	At or For the Three Months Ended March 31,							
	2014				2013			
	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance
Commercial Business	—	$—	$—	$ —	1	$35	$—	$ —
Total	—	$—	$—	$ —	1	$35	$—	$ —

There were no TDRs recorded in the twelve months prior to March 31, 2014 and 2013, that subsequently defaulted in the three months ended March 31, 2014 and 2013, respectively.

The recorded investments in the tables above are period end balances that are inclusive of all partial pay-downs and charge-offs since the modification date. Loans modified in a TDR that were fully paid down, charged off, or foreclosed upon by the period end are not included.

TDRs in the tables above were the result of interest rate modifications and extended payment terms. The Company has not forgiven any principal on the above loans.

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NOTE 4 – SERVICING RIGHTS

Loans serviced for others are not included on the consolidated balance sheets. The unpaid principal balances of mortgage, commercial and consumer loans serviced for others were $253.4 million and $243.0 million at March 31, 2014 and December 31, 2013, respectively. The fair market value of the servicing rights' asset at March 31, 2014 and December 31, 2013 was unchanged at $3.0 million. Fair value adjustments to mortgage, commercial and consumer servicing rights were mainly due to market based assumptions associated with loan prepayment speeds and changes in interest rates.

The following table summarizes servicing rights activity for the three months ended March 31, 2014 and 2013:

	At or For the Three Months Ended March 31,	
	2014	2013
Beginning balance	$2,093	$1,064
Additions	176	296
Mortgage, commercial and consumer servicing rights amortized	(135)	(78)
Recovery of impairment on servicing rights	—	122
Ending balance	$2,134	$1,404

The Company recorded $160,000 and $92,000 of contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage, commercial and consumer loans for the three months ended March 31, 2014 and 2013, respectively, which is reported in noninterest income.

NOTE 5 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters 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. 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. The Company recognizes all derivative instruments as either other assets or other liabilities on the consolidated balance sheet and measures those instruments at fair value.

The following tables summarize the Company's derivative instruments as of the dates indicated:

	March 31, 2014		
		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	$19,158	$360	$—
Mandatory and best effort forward commitments with investors	5,669	24	—
Forward TBA mortgage-backed securities	23,750	21	—
TBA mortgage-backed securities forward sales paired off with investors	6,750	—	34

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 - DERIVATIVES (Continued)

	December 31, 2013		
		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	$8,467	$166	$—
Mandatory and best effort forward commitments with investors	4,527	45	—
Forward TBA mortgage-backed securities	13,750	106	—
TBA mortgage-backed securities forward sales paired off with investors	4,000	44	—

The income on derivatives from fair value changes recognized in other noninterest income on the consolidated statements of income, included in gain on sale of loans was $677,000 and $778,000 for the three months ended March 31, 2014 and 2013, respectively.

NOTE 6 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the three months ended March 31, 2014 and 2013:

	At or For the Three Months Ended March 31,	
	2014	2013
Beginning balance	$2,075	$2,127
Additions	445	—
Fair value write-downs	(40)	(78)
Disposition of assets	(1,945)	(93)
Ending balance	$535	$1,956

At March 31, 2014, OREO consisted of three properties located in Washington, with balances ranging from $36,000 to $445,000. For the three months ended March 31, 2014 and 2013, the Company recorded an $8,000 net gain, and no gain or loss on disposals of OREO, respectively. Holding costs associated with OREO were $21,000 and $22,000, for the three months ended March 31, 2014 and 2013, respectively.

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NOTE 7 – DEPOSITS

Deposits are summarized as follows as of March 31, 2014 and December 31, 2013:

	March 31, 2014	December 31, 2013
Noninterest-bearing checking	$47,367	$45,783
Interest-bearing checking	28,119	26,725
Savings	16,682	15,345
Money market	126,081	119,162
Certificates of deposits of less than $100,000[1]	45,611	46,237
Certificates of deposits of $100,000 through $250,000	53,380	52,264
Certificates of deposits of more than $250,000	33,096	31,360
Total	$350,336	$336,876

(1) Includes $16.9 million of brokered deposits as of March 31, 2014 and December 31, 2013.

Scheduled maturities of time deposits for future periods ending were as follows:

	As of March 31, 2014
2014	$44,095
2015	41,481
2016	36,720
2017	5,584
2018	3,896
Thereafter	311
Total	$132,087

The Bank pledged two securities held at the Federal Home Loan Bank ("FHLB") of Seattle with a fair value of $1.2 million to secure Washington State public deposits of $250,000 with a collateral requirement of $58,000, at March 31, 2014.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB, based on a percentage of deposits. The amounts of such balances at March 31, 2014 and December 31, 2013 were $1.7 million and $1.6 million, respectively and were in compliance with FRB regulations.

Interest expense by deposit category for the three months ended March 31, 2014 and 2013 was as follows:

	For Three Months Ended March 31,	
	2014	2013
Interest-bearing checking	$8	$9
Savings and money market	118	134
Certificates of deposit	424	329
Total	$550	$472

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 – INCOME TAXES

The Company recorded a provision for income taxes of $433,000 and $625,000 during the three months ended March 31, 2014 and March 31, 2013, respectively.
At March 31, 2014, the Company had net operating loss carryforwards of approximately $980,000, which begin to expire in 2029. The Company files a consolidated U.S. Federal income tax return, which is subject to examinations by tax authorities for years 2010 and later. At March 31, 2014, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at March 31, 2014, the Company had recognized no interest and penalties.

NOTE 9 – 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 balance sheet.

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.

A summary of the Company’s commitments at March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014	December 31, 2013
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Construction and development	$35,981	$25,164
One-to-four-family	31,970	18,277
Home equity	12,943	12,452
Commercial/Multi-family	515	518
Total real estate loans	81,409	56,411
CONSUMER LOANS		
Indirect home improvement	—	—
Other	6,072	6,162
Total consumer loans	6,072	6,162
COMMERCIAL BUSINESS LOANS	48,194	52,344
Total commitments to extend credit	$135,675	$114,917

Commitments to extend credit are agreements to lend to a customer as long as 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 total commitment amounts do 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 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 commercial, multi-family, and residential real estate.

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NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

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 are uncollateralized and 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 has established reserves for estimated losses from unfunded commitments of $80,000 and $58,000 as of March 31, 2014 and December 31, 2013, respectively. One-to-four-family commitments listed above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company has entered into a severance agreement (the "Agreement") with its Chief Executive Officer. The Agreement, subject to certain requirements, generally includes a lump sum payment to the Chief Executive Officer 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 Agreement.

The Company has entered into change of control agreements (the "Agreements") with its Chief Financial Officer and the Chief Operating Officer. The Agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the Agreements the executive generally will be entitled to a change of control payment from the Company if they are involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the 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 Agreements.

Because 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.

In the ordinary course of business, the Company sells loans without recourse that 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 payment defaults, breach of representation or warranty, and 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 $234,000 and $217,000 reserve to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at March 31, 2014 and December 31, 2013, respectively.

In December 2013, the Company sold a portion of the consumer loan portfolio with an unpaid principal balance of approximately $9.3 million and recognized a gain of $166,000. Under the terms of this sale, the Company has recourse for loans that default before June 14, 2014 and has recorded a reserve of $35,000 for potential defaults.

NOTE 10 – SIGNIFICANT CONCENTRATION OF CREDIT RISK

Most of the Company's business activity is primarily with customers located in the greater Puget Sound area. The Company originates real estate and consumer loans and has concentrations in these areas. Generally loans are secured by deposit accounts, personal property, or real estate. 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.

NOTE 11 – REGULATORY CAPITAL

FS Bancorp, Inc. and its subsidiary bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 – REGULATORY CAPITAL (Continued)

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 Company must meet specific capital adequacy guidelines that involve quantitative measures of the Company’s assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company’s capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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 and total capital (as defined) to risk-weighted assets (as defined).

As of March 31, 2014 and December 31, 2013, the Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank’s category.

The Bank’s actual capital amounts and ratios at March 31, 2014 and December 31, 2013 are also presented in the table.

	Actual			For Capital Adequacy Purposes			To be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of March 31, 2014									
Total risk-based capital (to risk-weighted assets)	$56,167	16.37	%	$27,450	8.00	%	$34,312	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	$51,865	15.12	%	$13,725	4.00	%	$20,587	6.00	%
Tier 1 leverage capital (to average assets)	$51,865	12.24	%	$16,951	4.00	%	$21,188	5.00	%
As of December 31, 2013									
Total risk-based capital (to risk-weighted assets)	$55,141	16.64	%	$26,512	8.00	%	$33,140	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	$50,985	15.38	%	$13,256	4.00	%	$19,884	6.00	%
Tier 1 leverage capital (to average assets)	$50,985	12.61	%	$16,177	4.00	%	$20,221	5.00	%

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 – REGULATORY CAPITAL (Continued)

Regulatory capital levels reported above differ from the Company's total equity, computed in accordance with U.S. GAAP.

	Company March 31, 2014	December 31, 2013	Bank March 31, 2014	December 31, 2013
Equity	$63,468	$62,313	$51,539	$50,297
Unrealized loss (gain) on securities available-for-sale	541	898	541	898
Disallowed deferred tax assets	—	—	—	—
Disallowed servicing assets	(215)	(210)	(215)	(210)
Total Tier 1 capital	63,794	63,001	51,865	50,985
Allowance for loan and lease losses for regulatory capital purposes	4,302	4,156	4,302	4,156
Total risk-based capital	$68,096	$67,157	$56,167	$55,141

For a bank holding company with less than $500 million in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If the Company were subject to regulatory guidelines for bank holding companies with $500 million or more in assets, at March 31, 2014, the Company would have exceeded all regulatory capital requirements. The regulatory capital ratios calculated for the Company as of March 31, 2014 were 15.1% for Tier 1 leverage-based capital, 18.6% for Tier 1 risk-based capital and 19.9% for total risk-based capital.

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with U.S. GAAP. Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. 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.

Determination of Fair Market Values:

Securities - Securities available-for-sale are recorded at fair value 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. All models and processes used take into account market convention (Level 1 and 2).

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Derivative Instruments - 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 valued using similar contracts in the market and changes in the market interest rates (Level 3).

Impaired Loans – Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management's assumptions (Level 3).

Other Real Estate Owned – Fair value adjustments to OREO are recorded at the lower of carrying amount of the loan or fair value less selling costs. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. 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).

Servicing Rights - The fair value of mortgage, commercial and consumer servicing rights are 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 measured at fair value on a recurring basis:

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
March 31, 2014				
Federal agency securities	$—	$16,332	$—	$16,332
Municipal bonds	—	14,472	—	14,472
Corporate securities	2,004	2,944	—	4,948
Mortgage-backed securities	—	36,340	—	36,340
Total	$2,004	$70,088	$—	$72,092

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
December 31, 2013				
Federal agency securities	$—	$11,667	$—	$11,667
Municipal bonds	—	13,180	—	13,180
Corporate securities	997	2,941	—	3,938
Mortgage-backed securities	—	27,454	—	27,454
Total	$997	$55,242	$—	$56,239

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following tables present the fair value of interest rate lock commitments with customers, forward sale commitments with investors and paired off commitments with investors measured at their fair value on a recurring basis at March 31, 2014 and December 31, 2013.

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$—	$360	$360
December 31, 2013	$—	$—	$166	$166

	Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$21	$24	$45
December 31, 2013	$—	$106	$45	$151

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$(34)	$—	$(34)
December 31, 2013	$—	$44	$—	$44

The following table presents the impaired loans measured at fair value on a nonrecurring basis:

	Impaired Loans			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$—	$687	$687
December 31, 2013	$—	$—	$1,703	$1,703

The following table presents OREO measured at fair value on a nonrecurring basis:

	OREO			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$—	$535	$535
December 31, 2013	$—	$—	$2,075	$2,075

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents servicing rights measured at carrying value on a nonrecurring basis:

	Servicing Rights			
	Level 1	Level 2	Level 3	Total
March 31, 2014	$—	$—	$2,134	$2,134
December 31, 2013	$—	$—	$2,093	$2,093

Quantitative Information about Level 3 Fair Value Measurements – The fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at March 31, 2014 is shown in the following table.

Level 3 Fair Value Instrument	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average Rate
RECURRING				
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	92.5%
Forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	92.5%
NONRECURRING				
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 10%	0.7%
OREO	Fair value of collateral	Discount applied to the obtained appraisal	41.5% - 84.9%	76.8%
Servicing rights	Discounted cash flow	Weighted average prepayment speed	8.5% - 11.5%	8.5%

Fair Values of Financial Instruments – The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these financial statements:

Cash, and Due from Banks and Interest-Bearing Deposits at Other Financial Institutions – The carrying amounts of cash and short-term instruments approximate their fair value (Level 1).

Loans Held for Sale - The fair value of loans held for sale reflects the value of commitments with investors (Level 2).

Federal Home Loan Bank Stock – The par value of FHLB stock approximates its fair value (Level 2).

Accrued Interest – The carrying amounts of accrued interest approximate their fair value (Level 2).

Loans Receivable, Net – For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow

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NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

analyses, using interest rates currently being offered for loans with similar terms to borrowers or similar credit quality (Level 3).

Deposits – The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation on interest rates currently offered on similar certificates (Level 2).

Borrowings – The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

Off-Balance Sheet Instruments – The fair value of commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the customers. The majority of the Company's off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value. The fair value of loan lock commitments with customers and investors reflect an estimate of value based upon the interest rate lock date, the expected pull through percentage for the commitment, and the interest rate at year end (Level 3).

The estimated fair values of the Company's financial instruments were as follows:

	March 31, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Level 1 inputs:				
Cash, due from banks, and interest-bearing deposits at other financial institutions	$33,308	$33,308	$41,085	$41,085
Securities available-for-sale	2,004	2,004	997	997
Level 2 inputs:				
Securities available-for-sale	70,088	70,088	55,242	55,242
Loans held for sale	11,592			