LEXICON PHARMACEUTICALS, INC.
Form PRE 14A
February 15, 2019
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC. 20549

SCHEDULE 14A
(Rule 14A-101)

INFORMATION REQUIRED IN PROXY STATEMENT
SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934

Filed by the Registrant x
Filed by a Party other than the Registrant
Check the appropriate box:

x Preliminary Proxy Statement	o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
o Definitive Proxy Statement	
o Definitive Additional Materials	
o Soliciting Material Pursuant to Rule 14a-11(c)or Rule 14a-12	

LEXICON PHARMACEUTICALS, INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies: N/A
(2) Aggregate number of securities to which transaction applies: N/A
(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined): N/A
(4) Proposed maximum aggregate value of transaction: N/A
(5) Total fee paid: $0

o Fee paid previously with preliminary materials: N/A

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:
(2) Form, Schedule or Registration Statement No.:
(3) Filing Party:

(4) Date Filed

March ___, 2019

TO OUR STOCKHOLDERS:

I am pleased to invite you to attend the 2019 annual meeting of stockholders of Lexicon Pharmaceuticals, Inc. to be held on Thursday, April 25, 2019 at 8:00 a.m. CDT at the offices of the company, 8800 Technology Forest Place, The Woodlands, Texas.

Your vote is important, regardless of the number of shares that you hold. Whether or not you plan to attend the annual meeting, I hope you will vote as soon as possible, either electronically on the Internet, by telephone or by signing and returning the enclosed proxy card. Your proxy will not be used if you are present at the annual meeting and prefer to vote in person or if you revoke your proxy.

Thank you for your ongoing support of and continued interest in Lexicon Pharmaceuticals. We look forward to seeing you at the annual meeting.

Sincerely,

Lonnel Coats
President and Chief Executive Officer

LEXICON PHARMACEUTICALS, INC.
8800 Technology Forest Place
The Woodlands, Texas 77381
(281) 863-3000

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD APRIL 25, 2019

TO OUR STOCKHOLDERS:

The annual meeting of stockholders of Lexicon Pharmaceuticals, Inc. will be held on Thursday, April 25, 2019 at 8:00 a.m. CDT at the offices of the company, 8800 Technology Forest Place, The Woodlands, Texas, to:

- elect three Class I directors;
- ratify and approve an amendment to our 2017 Equity Incentive Plan increasing the total number of shares of our common stock that may be issued pursuant to stock awards granted under the plan from 15,000,000 to 20,000,000, all of which may be granted as incentive stock options;
- hold an advisory vote on the compensation paid to our named executive officers;
- ratify and approve the appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending December 31, 2019; and
- act on any other business that properly comes before the annual meeting.

You are entitled to vote at the annual meeting only if you are the record owner of shares of our common stock at the close of business on February 25, 2019.

It is important that your shares be represented at the annual meeting whether or not you plan to attend. Please cast your vote electronically on the Internet, by telephone or by signing and returning the enclosed proxy card as promptly as possible. If you are present at the annual meeting, and wish to do so, you may revoke the proxy and vote in person.

By order of the board of directors,

Brian T. Crum
Secretary
The Woodlands, Texas
March ___, 2019

LEXICON PHARMACEUTICALS, INC.
8800 Technology Forest Place
The Woodlands, Texas 77381
(281) 863-3000

PROXY STATEMENT
FOR
ANNUAL MEETING OF STOCKHOLDERS
To Be Held April 25, 2019
GENERAL INFORMATION
Purpose of this Proxy Statement
We have prepared this proxy statement to solicit proxies on behalf of our board of directors for use at our 2019 annual meeting of stockholders and any adjournment or postponement of such meeting.
Notice of Internet Availability of Proxy Materials
As permitted by rules adopted by the Securities and Exchange Commission, we are providing access to our proxy materials over the Internet. Accordingly, on or about March ___, 2019, we are mailing to our stockholders a notice containing instructions on how to access our proxy materials, including our proxy statement and annual report, and vote electronically over the Internet. The notice also provides instructions on how stockholders may request a paper copy of our proxy materials free of charge. Our proxy materials may be accessed by stockholders at any time after the date of mailing of the notice.
Date, Time and Place of Annual Meeting
The annual meeting will be held on Thursday, April 25, 2019 at 8:00 a.m. CDT at the offices of the company, 8800 Technology Forest Place, The Woodlands, Texas.
Matters to Be Considered at the Annual Meeting
At the annual meeting, our stockholders will be asked to consider and act upon the following matters:

- the election of three Class I directors;
- a proposal to ratify and approve an amendment to our 2017 Equity Incentive Plan increasing the total number of shares of our common stock that may be issued pursuant to stock awards granted under the plan from 15,000,000 to 20,000,000, all of which may be granted as incentive stock options;
- an advisory vote on the compensation paid to our named executive officers; and
- a proposal to ratify and approve the appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending December 31, 2019.

Our board of directors does not intend to bring any other matters before the annual meeting and has not been informed that any other matters are to be presented by others. Our bylaws contain several requirements that must be satisfied in order for any of our stockholders to bring a proposal before one of our annual meetings, including a requirement of delivering proper advance notice to us. Stockholders are advised to review our bylaws if they intend to present a proposal at any of our annual meetings.
Shares Entitled to Vote
You are entitled to vote at the annual meeting and at any postponement or adjournment thereof if you were the record owner of shares of our common stock as of the close of business on February 25, 2019, the record date for the annual meeting established by our board of directors. On the record date, __________ shares of our common stock were outstanding. If you were the record owner of shares of our common stock on the record date, you will be entitled to one vote for each share of stock that you own on each matter that is called to vote at the annual meeting or at any postponement or adjournment thereof.
Quorum
We must have a quorum to conduct any business at the annual meeting. This means that at least a majority of our outstanding shares eligible to vote at the annual meeting must be represented at the annual meeting, either in person or by proxy. Abstentions

are counted for purposes of determining whether a quorum is present. In addition, shares held by intermediaries that are voted for at least one matter at the annual meeting will be counted as being present for purposes of determining a quorum for all matters. This is true even if the beneficial owner's discretion has been withheld for voting on some or all other matters (commonly referred to as a "broker non-vote").

Vote Necessary to Approve Proposals

Our Class I directors will be elected by a plurality vote. As a result, the three persons receiving the greatest number of votes will be elected to serve as our Class I directors. Withholding authority to vote for a director nominee will not affect the outcome of the election of directors.

The ratification and approval of the amendment to our 2017 Equity Incentive Plan will require the affirmative vote of the majority of the votes cast with respect to such matter. Any abstention from voting or broker non-vote with respect to such matter will not count as a vote for or against the amendment and will not affect the outcome of the proposal.

The approval on an advisory basis of the compensation paid to our named executive officers will require the affirmative vote of the majority of the votes cast with respect to such matter. Any abstention from voting or broker non-vote with respect to such matter will not count as a vote for or against the compensation paid to our named executive officers and will not affect the outcome of the advisory vote.

The ratification and approval of the appointment of Ernst & Young LLP as our independent auditors for the year ending December 31, 2019 will require the affirmative vote of a majority of the votes cast with respect to such matter. Any abstention from voting or broker non-vote with respect to such matter will not count as a vote for or against the appointment of Ernst & Young LLP and will not affect the outcome of the proposal.

Any other business that may properly come before the annual meeting for a vote will require the affirmative vote of a majority of the votes cast with respect to such matter unless a greater vote is required by law or our charter or bylaws. Any abstention or broker non-vote with respect to any such matter will not count as a vote for or against the proposal and will not affect the outcome of the proposal.

How to Vote Your Shares

You may vote in person at the annual meeting or by proxy. To ensure that your shares are represented at the annual meeting, we recommend you vote by proxy even if you plan to attend the annual meeting in person. Even if you vote by proxy, if you wish, you can revoke your proxy and vote in person at the annual meeting. If you want to vote at the annual meeting but your shares are held by an intermediary, such as a broker or bank, you will need to obtain from the intermediary either proof of your ownership of such shares as of February 25, 2019 or a proxy from such intermediary authorizing you to vote your shares at the meeting.

You may receive more than one proxy depending on how you hold your shares. If you hold your shares through an intermediary, such as a broker or bank, you may receive materials from them asking you how you want your shares to be voted at the annual meeting.

How to Vote by Proxy

By Internet or Telephone. You may vote electronically on the Internet or by telephone by following the instructions contained on the notice of Internet availability of our proxy materials. If you hold your shares through an intermediary, such as a broker or bank, please follow the voting instructions contained on the voting card used by the intermediary.

By Mail. If you request a paper copy of our proxy materials, you may vote by mail by completing, dating and signing the proxy card provided and mailing it in the pre-addressed envelope enclosed with the paper copy of our proxy materials.

How Your Proxy Will Be Voted

Giving us your proxy means that you are authorizing us to vote your shares at the annual meeting and at any adjournment or postponement thereof in the manner you direct. You may vote for our nominees for election as Class I directors, or withhold your vote for any one or more of those nominees. You may vote for or against the ratification and approval of the amendment to our 2017 Equity Incentive Plan, the approval on an advisory basis of the compensation paid to our named executive officers and the ratification and approval of the appointment of Ernst & Young LLP as our independent auditors for the year ending December 31, 2019, or abstain from voting on those proposals.

2

If any of our nominees for election as Class I directors become unavailable for any reason before the election, we may reduce the number of directors serving on our board of directors, or our board of directors may designate substitute nominees, as necessary. We have no reason to believe that any of our nominees for election as Class I directors will be unavailable. If our board of directors designates any substitute nominees, the persons receiving your proxy will vote your shares for such substitute(s) if they are instructed to do so by our board of directors or, in the absence of any such instructions, in accordance with their own best judgment.

If you vote by proxy but do not specify how you want your shares voted, your shares will be voted in favor of our nominees for election as Class I directors, in favor of the ratification and approval of the amendment to our 2017 Equity Incentive Plan, in favor of the approval on an advisory basis of the compensation paid to our named executive officers, and in favor of the ratification and approval of the appointment of Ernst & Young LLP as our independent auditors for the year ending December 31, 2019.

If you vote by proxy and any additional business properly comes before the annual meeting, the persons receiving your proxy will vote your shares on those matters as instructed by our board of directors or, in the absence of any such instructions, in accordance with their own best judgment. As of the date of this proxy statement, we are not aware of any other matter to be raised at the annual meeting.

How to Revoke Your Proxy

You may revoke your proxy at any time before your shares are voted by providing our corporate secretary with either a new proxy with a later date or a written notice of your desire to revoke your proxy at the following address:

Lexicon Pharmaceuticals, Inc.
8800 Technology Forest Place
The Woodlands, Texas 77381
Attention: Corporate Secretary

You may also revoke your proxy at any time prior to your shares having been voted by attending the annual meeting in person and notifying the inspector of election of your desire to revoke your proxy. Your proxy will not automatically be revoked merely because you attend the annual meeting.

Inspector of Election

Broadridge Financial Solutions, Inc. will count votes and provide a representative who will serve as an inspector of election for the annual meeting.

List of Stockholders Entitled to Vote

A list of our stockholders entitled to vote at the annual meeting will be available for inspection at the annual meeting. The stockholder list will also be available for inspection for ten days prior to the annual meeting at our corporate offices located at 8800 Technology Forest Place, The Woodlands, Texas. Any inspection of this list at our offices will need to be conducted during ordinary business hours. If you wish to conduct an inspection of the stockholder list, we request that you please contact our corporate secretary before coming to our offices.

Solicitation of Proxies and Expenses

We are asking for your proxy on behalf of our board of directors. We will bear the entire cost of preparing, printing and soliciting proxies. We will send notices of Internet availability of proxy materials and, if requested, paper copies of our proxy materials to all of our stockholders of record as of the record date and to all intermediaries, such as brokers and banks, that held any of our shares on that date on behalf of others. These intermediaries will then forward the notices and, if requested, paper copies of our proxy materials to the beneficial owners of our shares, and we will reimburse them for their reasonable out-of-pocket expenses for forwarding such materials. Our directors, officers and employees may solicit proxies by mail, in person or by telephone or other electronic communication. Our directors, officers and employees will not receive additional compensation for their solicitation efforts, but they will be reimbursed for any out-of-pocket expenses they incur. No solicitation of proxies will be made by specially engaged employees or paid solicitors.

Householding

As permitted by rules adopted by the Securities and Exchange Commission, we are delivering a single notice of Internet availability of proxy materials, annual report and proxy statement, as applicable, to any household at which two or more stockholders reside if we believe the stockholders are members of the same family, unless otherwise instructed by one or more of the stockholders.

3

We will promptly deliver separate copies of these documents upon the written or oral request of any stockholder at a shared address to which a single copy of the documents were delivered.

If your household received a single set of any of these documents, but you would prefer to receive your own copy, or if you share an address with another stockholder and together both of you would like to receive only a single set of these documents, please follow these instructions:

- If your shares are registered in your own name, please contact our transfer agent, Computershare Inc., and inform them of your request by calling them at (877) 854-4583 or writing them at P.O. Box 30170, College Station, Texas 77842 or 211 Quality Circle, Suite 210, College Station, Texas 77845 for overnight correspondence.
- If an intermediary, such as a broker or bank, holds your shares, please contact Broadridge and inform them of your request by calling them at (800) 542-1061 or writing them at Householding Department, 51 Mercedes Way, Edgewood, New York 11717. Be sure to include your name, the name of your brokerage firm and your account number.

PROPOSAL NUMBER 1:
ELECTION OF DIRECTORS

Our board of directors, which currently has nine members, is divided or "classified" into three classes. Directors in each class are elected to hold office for a term ending on the date of the third annual meeting following the annual meeting at which they were elected. The current term of our Class I directors will expire at this annual meeting. The current terms of our Class II and Class III directors will expire at our 2020 and 2021 annual meetings of stockholders, respectively.

The board of directors has nominated and urges you to vote for the election of the individuals identified below, who have been nominated to serve as Class I directors until our 2022 annual meeting of stockholders or until their successors are duly elected and qualified. Each of these individuals is a member of our present board of directors. Your signed proxy will be voted for the nominees named below unless you specifically indicate on the proxy that you are withholding your vote.

Nominees for Class I Directors

The following individuals are nominated for election as Class I directors:

Name	Age	Position with the Company	Year First Became a Director
Raymond Debbane	64	Chairman of the Board of Directors (Class I)	2007
Robert J. Lefkowitz, M.D.	75	Director (Class I)	2001
Alan S. Nies, M.D.	81	Director (Class I)	2003

Raymond Debbane has been a director since August 2007 and became chairman of our board of directors in February 2012. Mr. Debbane is president and chief executive officer of The Invus Group, LLC, which he founded in New York in 1985 as the exclusive investment advisor of Benelux-based Artal Group S.A. Mr. Debbane serves as chairman of the board of directors of WW, Inc. and as chairman or director of a number of private companies in which Invus and Artal Group S.A. have invested. He previously served as a director of Blue Buffalo Pet Products, Inc. from 2007 until April 2018 when Blue Buffalo was acquired by General Mills, Inc. Before founding The Invus Group, Mr. Debbane was a manager in the Paris office of The Boston Consulting Group, Inc., where he did consulting work for a number of major European and international companies. Mr. Debbane holds an M.B.A. from Stanford University, an M.S. in food science and technology from the University of California at Davis, and a B.S in agricultural sciences and agricultural engineering from American University of Beirut.

Mr. Debbane provides us with the benefit of his extensive financial markets and investment expertise gained in more than 30 years of leading the identification, selection, negotiation and oversight of a wide range of investments in his role as president and chief executive officer of The Invus Group, as well as his background in strategic consulting across a broad range of industries developed while with The Boston Consulting Group. Mr. Debbane is a designee of Invus, L.P. and Invus C.V. pursuant to our stockholders' agreement with Invus described under the heading "Transactions with Related Persons - Arrangements with Invus."

Robert J. Lefkowitz, M.D. has been a director since February 2001. Dr. Lefkowitz is the James B. Duke Professor of Medicine, professor of biochemistry and a Howard Hughes Medical Institute investigator at Duke University Medical Center, where he has served on the faculty since 1973. Dr. Lefkowitz is a member of the National Academy of Sciences and has received more than 50 major awards for his research, including the 2012 Nobel Prize in Chemistry, the Shaw Prize, the Albany Medical Center Prize and the 2007 National Medal of Science. Dr. Lefkowitz received his B.A. from Columbia University and his M.D. from Columbia University College of Physicians and Surgeons.

Dr. Lefkowitz provides us with the benefit of his medical expertise and his extensive experience in biological and pharmaceutical research, particularly with respect to the identification of drug targets and preclinical evaluation of drug candidates, gained in more than 40 years as a member of the faculty at Duke University Medical Center.

Alan S. Nies, M.D. has been a director since November 2003. Dr. Nies served in a series of senior management positions during ten years at Merck & Co. Inc. until his retirement in 2002, including senior vice president, clinical sciences. Prior to joining Merck, Dr. Nies spent fifteen years as professor of medicine and pharmacology and head of the Division of Clinical Pharmacology at the University of Colorado Health Sciences Center. Dr. Nies holds a B.S. from Stanford University and an M.D. from Harvard Medical School.

Dr. Nies provides us with the benefit of his extensive clinical development experience, particularly with respect to the design, management and reporting of clinical trials, as well as his organizational and management skills developed while serving in his various leadership positions with Merck and the University of Colorado Health Sciences Center.

The Board of Directors recommends that stockholders vote "FOR" the foregoing nominees for election as Class I directors.

Current and Continuing Directors

The current directors of the Company are identified below:

Name	Age	Position with the Company
Raymond Debbane [3]	64	Chairman of the Board of Directors (Class I)
Philippe J. Amouyal [2]	60	Director (Class III)
Samuel L. Barker, Ph.D. [1] [2]	76	Director (Class II)
Lonnel Coats	54	President and Chief Executive Officer and Director (Class III)
Robert J. Lefkowitz, M.D. [3]	75	Director (Class I)
Alan S. Nies, M.D.	81	Director (Class I)
Frank P. Palantoni [1] [2]	61	Director (Class III)
Christopher J. Sobecki	60	Director (Class II)
Judith L. Swain, M.D. [1] [3]	70	Director (Class II)

(1) Member of the Audit Committee
(2) Member of the Compensation Committee
(3) Member of the Corporate Governance Committee

Information regarding the business experience of Mr. Debbane, Dr. Lefkowitz and Dr. Nies is set forth above under the heading "- Nominees for Class I Directors."

Philippe J. Amouyal has been a director since August 2007 and is a managing director of The Invus Group, LLC, a position he has held since 1999. Previously, Mr. Amouyal was a vice president and director of The Boston Consulting Group, Inc. in Boston, Massachusetts, where he coordinated the global technology and electronics practice through most of the 1990s. Mr. Amouyal is a director of WW, Inc., as well as a number of private companies in which Invus has invested. He previously served as a director of Blue Buffalo Pet Products, Inc. from 2007 until April 2018 when Blue Buffalo was acquired by General Mills, Inc. Mr. Amouyal holds an M.S. in engineering and a DEA in management from Ecole Centrale de Paris and was a research fellow at the Center for Policy Alternatives of the Massachusetts Institute of Technology.

Mr. Amouyal provides us with the benefit of his broad business and financial experience, as well as his expertise in compensation and performance management and the assessment and prioritization of research and development projects, gained in his active participation in the identification, selection, negotiation and oversight of investments by The Invus Group and his consulting experience with The Boston Consulting Group. Mr. Amouyal is a designee of Invus, L.P. and Invus C.V. pursuant to our stockholders' agreement with Invus described under the heading "Transactions with Related Persons - Arrangements with Invus."

Samuel L. Barker, Ph.D. has been a director since March 2000 and served as chairman of our board of directors from 2005 to 2012. Dr. Barker previously co-founded and served as president and chief executive officer of Clearview Projects, Inc., a provider of partnering and transaction services to biopharmaceutical companies. Dr. Barker served in a series of leadership positions at Bristol-Myers Squibb Company until his retirement in 1999. His positions at Bristol-Myers Squibb included service as executive vice president, Worldwide Franchise Management and Strategy; president, United States Pharmaceuticals; and president, Bristol-Myers Squibb Intercontinental Commercial Operations. Dr. Barker also previously held executive positions in research and development, manufacturing, finance, business development and sales and marketing at Squibb Pharmaceuticals. Dr. Barker currently serves as a director of Cyclacel Pharmaceuticals, Inc. Dr. Barker received his B.S. from Henderson State College, his M.S. from the University of Arkansas and his Ph.D. from Purdue University.

Dr. Barker provides us with the benefit of his extensive experience in a wide variety of disciplines within the pharmaceutical industry, including the development and commercialization of pharmaceutical products, the identification, evaluation and negotiation of collaborative agreements, and the management of pharmaceutical marketing and sales efforts, as well as his organizational and management skills developed while serving in his various leadership positions at Bristol-Myers Squibb and Clearview Projects.

Lonnel Coats has been our president and chief executive officer and a director since July 2014. Mr. Coats previously served in a series of executive leadership positions at Eisai Inc. and Eisai Corporation of North America, where he worked for 18 years before joining our company, most recently as chief executive officer from 2010 to 2014. Prior to joining Eisai, Mr. Coats spent eight years with Janssen Pharmaceuticals, Inc., a division of Johnson & Johnson, where he held a variety of management and sales positions. Mr. Coats serves as a director of Blueprint Medicines Corporation and holds a B.S. from Oakland University.

Mr. Coats provides us with the benefit of his extensive experience in a wide variety of disciplines within the pharmaceutical industry, including the development and commercialization of pharmaceutical products, the management of pharmaceutical marketing and sales efforts and the planning and execution of strategic initiatives, as well as his organizational and management skills developed while serving in his various leadership positions at Eisai.

Frank P. Palantoni has been a director since November 2004. Mr. Palantoni is chief executive officer of Laboratory M2, a clean technology company involved in animal health, crop protection and retail sectors. Mr. Palantoni was president of Palantoni & Partners LLC, an advisory firm for the consumer and health care industries, from 2013 to 2016. He previously served as president of the pet and animal health division of Central Garden & Pet Company, was a partner at P3 Capital Management LLC, an early stage consumer products equity fund, served as chief operating officer and chief executive officer of Prestige Brands Holding, Inc. and held a variety of senior management positions with Novartis AG, including president and chief executive officer, worldwide of the Gerber Products Company, and chief executive officer for North American operations of the Consumer Health Division. Prior to joining Novartis, he held a series of senior management positions with The Danone Group. He holds a B.S. from Tufts University and an M.B.A. from Columbia University.

Mr. Palantoni provides us with the benefit of his extensive business operations experience, as well as his expertise in compensation and performance management and his broad business and management skills developed while serving in his various leadership positions in the consumer health products industry.

Christopher J. Sobecki has been a director since August 2007 and is a managing director of The Invus Group, LLC, which he joined in 1989. Mr. Sobecki is currently a director of WW, Inc., as well as a number of private companies in which Invus has invested. He holds a B.S. in industrial engineering from Purdue University and an M.B.A. from Harvard University.

Mr. Sobecki provides us with the benefit of his diversified business and financial experience, including a particular expertise in risk assessment and business strategy development, and relationships in the financial community gained in his active participation in the identification, selection, negotiation and oversight of investments by The Invus Group and his service as a director of public and private companies. Mr. Sobecki is a designee of Invus, L.P. and Invus C.V. pursuant to our stockholders' agreement with Invus described under the heading "Transactions with Related Persons - Arrangements with Invus."

Judith L. Swain, M.D. has been a director since September 2007. Dr. Swain is a visiting professor of medicine at the National University of Singapore and chief medical officer of Physiowave, Inc. She previously served as founding director of the Singapore Institute for Clinical Sciences, dean for translational medicine at the University of California, San Diego, chair of the Department of Medicine at Stanford University, and on the medical faculties of the University of Pennsylvania and Duke University. She has previously served in a number of national and international leadership roles and as a director or member of the scientific advisory boards for a number of biomedical technology companies and is co-founder of Synecor, LLC. Dr. Swain received her B.S. from the University of California, Los Angeles and her M.D. from the University of California, San Diego.

Dr. Swain provides us with the benefit of her extensive medical and scientific research experience gained in her more than 30 years as a practicing physician and research scientist, as well as her organizational and management skills developed in her numerous leadership positions with a variety of prominent research and academic institutions.

PROPOSAL NUMBER 2:
RATIFICATION AND APPROVAL OF AMENDMENT TO 2017 EQUITY INCENTIVE PLAN

We use stock options, restricted stock units and other stock awards as a part of our overall compensation program in order to align the long-term interests of our employees with those of our stockholders. These awards are made principally under our 2017 Equity Incentive Plan, the purpose of which is to secure and retain the services of employees, directors and consultants, and to provide them with incentives to exert maximum efforts for our success by giving them the opportunity through the granting of stock options, restricted stock units and other stock awards to benefit from increases in the value of our common stock.

The 2017 Equity Incentive Plan currently provides that no more than 15,000,000 shares of our common stock may be issued pursuant to stock awards granted under the plan, all of which may be granted as incentive stock options. We are asking that stockholders ratify and approve an amendment to the 2017 Equity Incentive Plan increasing the total number of shares that may be issued pursuant to stock awards granted under the plan to 20,000,000 shares, all of which may be granted as incentive stock options, with the objective of maintaining the availability to our board of directors of this portion of our overall compensation program. The proposed amendment to the plan was approved by our board of directors, subject to stockholder approval, on February 7, 2019.

The terms of the 2017 Equity Incentive Plan are summarized below and the complete text of the plan is set forth in Appendix A to this proxy statement, in each case reflecting the amendment described above.

The Board of Directors recommends that stockholders vote "FOR" the ratification and approval of the amendment to our 2017 Equity Incentive Plan.

Administration of the Plan

The plan is administered by our board of directors, or a committee appointed by the board, which determines the recipients and types of awards to be granted, including the number of shares subject to the award and any relevant vesting schedules. The compensation committee of the board of directors presently administers the plan.

Awards under the Plan

The plan permits the following types of awards:

- incentive stock options;
- nonstatutory stock options;
- stock bonus awards;
- restricted stock awards;
- restricted stock unit awards;
- stock appreciation rights; and
- performance stock awards.

Awards granted under the plan are evidenced by agreements that specify the terms and conditions under which they are granted. All awards granted under the plan are subject to the terms and conditions contained in the applicable agreement and the plan.

Eligibility

Awards other than incentive stock options may be granted to employees, directors and consultants. Incentive stock options may be granted only to employees. As of February 25, 2019, approximately ____ persons were eligible to participate in the plan, including approximately ____ employees, eight non-employee directors and ____ consultants.

Shares Subject to the Plan

The total number of shares of common stock that may be issued pursuant to awards under the plan shall not exceed in the aggregate 20,000,000 shares, all of which may be granted as incentive stock options.

If any award expires, lapses, or is terminated or forfeited for any reason, the shares subject to that award will continue to be available for the grant of awards under the plan, provided that if shares are not delivered to the holder of an award because (1) the right to receive such shares is surrendered in a "net exercise" of a stock option or (2) such shares are withheld in satisfaction of the withholding of taxes incurred in connection with the exercise of a stock option or stock appreciation right or the issuance of shares under a stock bonus award, restricted stock award, restricted stock unit award or performance stock award, the surrendered or withheld shares will not be available for subsequent issuance under the plan. Common stock issued as or on the exercise of awards under the plan may be either authorized and unissued shares or reacquired shares.

As of February 25, 2019, there were outstanding under the plan (1) stock options to purchase a total of ___________ shares of our common stock, (2) no stock bonus awards, (3) no restricted stock awards, (4) restricted stock unit awards to receive a total of ___________ shares of our common stock, (5) no stock appreciation rights and (6) no performance stock awards. On a pro forma basis to reflect the increase in the number of shares reserved for issuance under the plan, ____________ shares remained available for issuance of new awards under the plan at that date. Since the founding of our company in 1995, a total of ____________ shares of our common stock have been issued under the plan and its predecessors upon the grant, exercise or vesting of awards granted under the plan.

Stock Options

The stock options granted under the plan are evidenced by agreements that specify the number of shares of our common stock which may be purchased at a certain specified price and contain other terms and conditions, such as vesting and termination provisions. All stock options granted under the plan are subject to the terms and conditions contained in the applicable stock option agreement and the plan.

Expiration and Termination

The term of each stock option is stated in the applicable stock option agreement. In no event, however, may a stock option be exercised more than ten years after the date the option is granted. In the case of an incentive stock option granted to a 10% stockholder, the maximum term is five years from the date the option is granted.

Option Exercise Price

The exercise price of stock options granted under the plan is determined by the plan administrator at the time the stock option is granted. Stock options must have an exercise price that is no less than 100% of the fair market value of our common stock on the date of grant.

The fair market value of a share of common stock on a particular date is equal to the previous day's closing sales price (or the closing bid price, if no sales were reported) of the common stock if the common stock is listed on any established stock exchange or traded on the Nasdaq Stock Market. If there is no regular public trading market for the common stock, the fair market value of the common stock is determined by the board of directors.

Consideration for Exercise of Options

The consideration to be paid for shares to be issued upon exercise of a stock option, including the method of payment, shall be determined by the administrator and may consist entirely of (1) cash or (2), at the discretion of the board of directors, (a) by delivery of other shares of our common stock, (b) according to a deferred payment or other similar arrangement, (c) by means of a "net exercise" of the option, or (d) in any other form of legal consideration acceptable to the board.

Stock Bonus Awards and Restricted Stock Awards

The terms and provisions of stock bonus awards and restricted stock awards shall be as set forth in the grant instrument. A stock bonus may be awarded in consideration for past services actually rendered to the company. Shares awarded under a stock bonus or restricted stock award may, but need not be subject to a repurchase or forfeiture right on behalf of the company in accordance with a vesting schedule in the event the participant's employment is terminated.

Restricted Stock Unit Awards and Stock Appreciation Rights

The terms and provisions of restricted stock unit awards and stock appreciation rights shall be as set forth in the grant instrument. The price of a common stock equivalent used as the basis from which appreciation is determined for purposes of a stock appreciation right shall be as the administrator shall determine, but not less than 100% of the fair market value on the date the stock appreciation right is granted. Restricted stock unit awards and the exercise value of a stock appreciation right may be paid in shares of common stock, cash, a combination of common stock and cash, or other consideration, as determined by the administrator and set forth in the grant instrument.

Performance Stock Awards

The terms and provisions of performance stock awards shall be as set forth in the grant instrument. Any type of award available under the plan may be designated as a performance stock award and subject to performance conditions based on business criteria or other measures of performance, with a performance period not to exceed ten years.

Other Provisions

Limits on Transfer of Awards

In general, plan participants may not sell, pledge, assign, transfer or otherwise dispose of any awards other than by will or the laws of descent or distribution and the plan participant alone may exercise his or her awards during his or her lifetime. Awards other than incentive stock options may be transferred only if permitted under the agreement that evidences the terms of the award.

Adjustments on Changes in Capital Structure or on Change of Control

If we effect a stock split, reverse stock split, stock dividend, redemption, combination, reclassification or other similar change affecting our capital stock, adjustments reflecting the change will be made in (1) the aggregate number of shares of common stock authorized for issuance under the plan; (2) the number of shares underlying each outstanding award; and (3) if applicable, the price per share of each award.

If a change in control transaction shall occur, the surviving or acquiring corporation shall assume all awards or provide a substitute similar award. If the surviving or acquiring corporation fails to so provide such assumption or substitution, then awards held by those participants whose employment has not been terminated will be accelerated in full and the awards will subsequently terminate if not exercised. Any other awards outstanding under the plan will terminate if not exercised (if applicable) prior to the event.

Amendment or Termination of the Plan

The board may at any time amend, alter, suspend or discontinue the plan, but no amendment, alteration, suspension or discontinuation which would impair a participant's rights under any previous grant may be made without the consent of the participant.

Term of the Plan

No awards may be granted under the plan after the day before the tenth (10^{th}) anniversary of the date the plan is adopted by our board of directors or approved by our stockholders, whichever is earlier.

United States Federal Income Tax Consequences

The following is a brief summary of certain of the federal income tax consequences of certain transactions under the plan based on current federal income tax laws. This summary is not intended to be exhaustive and does not describe state or local tax consequences. Additional or different federal tax consequences to the employee, director or consultant or to our company may result depending on considerations other than those described below.

Nonstatutory Stock Options

In general, optionholders will not recognize any taxable income at the time they are granted nonstatutory stock options. When an optionholder exercises a nonstatutory stock option, he or she will recognize ordinary income measured by the excess of the then fair market value of the shares over the exercise price and we will be entitled to a deduction for a corresponding amount. Different rules apply to options that have a "readily ascertainable fair market value," as that phrase is defined in regulations promulgated under Section 83 of the Internal Revenue Code of 1986.

When an optionholder sells or otherwise disposes of shares that were acquired by exercising nonstatutory stock options, any amount that the optionholder receives in excess of the sum of (1) the exercise price of the shares as of the date of exercise and (2) the amount includable in income with respect to such option, if any, such sum being the optionholder's "basis" in the shares, will, in general, be treated as a long term or short term capital gain, depending on the holding period of the shares. We are not entitled to any tax deduction in connection with an optionholder's sale or disposition of the shares. If an optionholder receives less than his or her basis in the shares, the loss will, in general, be treated as a long term or short term capital loss, depending on the holding period of the shares.

Incentive Stock Options

Optionholders will not be taxed on the grant or exercise of an incentive stock option that qualifies under Section 422 of the Internal Revenue Code, unless an alternative minimum tax liability is triggered. When an optionholder sells or otherwise makes a taxable disposition of shares that he or she acquired by exercising an incentive stock option, the optionholder will recognize a capital gain on the excess of the amount realized on disposition over the exercise price of the incentive stock option, provided that the optionholder has not disposed of the shares until at least two years after the date the option was granted and one year after the date the optionholder exercised the option. Failure to comply with these holding requirements will result in ordinary income treatment for the gain. Unless the optionholder disposes of shares received on exercise of the incentive stock option before meeting the applicable holding period requirements, we will not be entitled to a deduction with respect to the grant or exercise of the incentive stock option.

In the event an optionholder makes a "disposition" of the shares received on exercise of an incentive stock option before meeting the two year or one year holding period requirements, the gain on the disposition, to the extent of the lesser of (1) the excess of the fair market value of the shares on the date of exercise over the exercise price or (2) the excess of the amount realized on disposition over the exercise price, will be treated as ordinary income to the optionholder, and we will generally be entitled to a corresponding deduction. The balance of the gain, if any, realized on such a disposition will be treated as long term or short term capital gain, depending on the holding period of the shares. To the extent that an optionholder is entitled to capital gains treatment,

we will not be entitled to a corresponding deduction for such gain. If the amount realized at the time of the disposition is less than the exercise price, the optionholder will not be required to treat any amount as ordinary income, provided the disposition is of a type that would give rise to a recognizable loss. In such event, the loss will be treated as a long term or short term capital loss depending on the holding period of the shares.

Stock Bonus Awards

In general, if an individual receives a stock bonus award, he or she will be taxed on the fair market value of the shares on the date the shares are issued. We will be generally entitled to a deduction for a corresponding amount. When a stock bonus award is subject to forfeiture restrictions, an individual will not recognize any taxable income at the time he or she is granted the award, but upon the lapse of the restrictions applicable to such award, that person will recognize ordinary income equal to the fair market value of the shares on the date the restrictions on the award lapsed, and we will be entitled to a deduction for a corresponding amount. If, upon a taxable disposition of the shares, the stockholder receives more or less than his or her basis in the shares, the gain or loss will be a long term or short term capital gain or loss, depending on the holding period of the shares, measured from the date that the receipt of the shares was taxable to the stockholder.

Restricted Stock Awards

In general, an individual will not recognize any taxable income at the time he or she is granted an award of restricted stock, but upon the lapse of the restrictions applicable to such award, that person will recognize ordinary income equal to the fair market value of the shares on the date the restrictions on the award lapsed less the purchase price for such shares, and we will be entitled to a deduction for a corresponding amount. If the stockholder sells or otherwise disposes of such shares in a taxable disposition, the sale or disposition will be subject to the same treatment described above for a taxable disposition of shares acquired upon an exercise of a nonstatutory stock option.

Restricted Stock Unit Awards

In general, an individual will not recognize any taxable income at the time he or she is granted a restricted stock unit award. Upon settlement of a restricted stock unit award, the individual will recognize ordinary income equal to the fair market value of the cash or shares actually received by the individual. We will be generally entitled to a deduction for the corresponding amount.

Stock Appreciation Rights

In general, an individual will not recognize any taxable income at the time he or she is granted stock appreciation rights. Upon exercise of a stock appreciation right, the individual will recognize ordinary income equal to the fair market value of the cash or shares received by the individual upon exercise. We will be generally entitled to a deduction for the corresponding amount.

Performance Stock Awards

In general, the designation of any award as a performance stock award will not have any effect on the federal income tax consequences applicable to such award.

The foregoing summary does not constitute a definitive statement of the federal income tax effects of awards granted under the Plan.

New Plan Benefits Table

In February 2019, the compensation committee of our board of directors approved a mix of annual stock option and restricted stock unit awards under the plan to eligible executive officers and other employees, as described below under the heading “Executive and Director Compensation - Compensation Discussion and Analysis - Long-Term Stock-Based Incentive Awards.” The following table presents information regarding the number of annual stock options and the dollar value of annual restricted stock units awarded to the following individuals or groups of individuals in 2019:

- each of the individuals listed in “Executive and Director Compensation - Summary Compensation Table for 2018”;
- all current executive officers, as a group;
- all current directors who are not executive officers, as a group; and
- all non-executive officer employees, including all current officers who are not executive officers, as a group.

The compensation committee retains broad discretion over the granting and amount of awards under the plan. As a result, it is not possible to determine any additional benefits or amounts that will be received by any individual participant or group of participants in the future.

12,000 4,100 51,000

Net interest income (loss) after provision for loan losses	$	6,580	$	(3,609)	$	20,844	$	(26,474)
Noninterest income								
Net gain on sale of investments		479		-		1,741		-
Other		77		38		237		146
Total noninterest income	$	556	$	38	$	1,978	$	146
Noninterest expense								
Compensation and employee benefits		3,544		3,258		10,047		9,339
Occupancy and equipment		370		411		1,167		1,260
Professional fees		449		664		1,431		1,610
Data processing		181		191		573		533
(Gain) loss on sale of OREO property, net		(293)		(205)		(1,427)		218
OREO market value adjustments		515		2,016		1,432		5,184
OREO related expenses, net		540		962		2,376		2,372
FDIC/OTS assessments		578		910		1,900		2,005
Insurance and bond premiums		248		150		743		449
Marketing		43		49		154		170
Other general and administrative		338		94		1,111		1,237
Total noninterest expense	$	6,513	$	8,500	$	19,507	$	24,377
Income (loss) before provision for federal income taxes		623		(12,071)		3,315		(50,705)
Provision for federal income taxes		-		-		-		3,999
Net income (loss)	$	623	$	(12,071)	$	3,315	$	(54,704)
Basic income (loss) per share	$	0.04	$	(0.69)	$	0.19	$	(3.14)
Diluted income (loss) per share	$	0.04	$	(0.69)	$	0.19	$	(3.14)

See accompanying notes to consolidated financial statements.

4

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity and Comprehensive Income
(Dollars in thousands, except share data)
(Unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss), net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2010	18,805,168	$ 188	$ 187,371	$ (305)	$ 484	$ (13,260)	$ 174,478
Comprehensive income:							
Net income	-	-	-	3,315	-	-	3,315
Change in fair value of investments available for sale	-	-	-	-	(741)	-	(741)
Total comprehensive income							2,574
Compensation related to stock options and restricted stock awards	-	-	1,489	-	-	-	1,489
Allocation of 84,640 ESOP shares	-	-	(400)	-	-	846	446
Balances at September 30, 2011	18,805,168	$ 188	$ 188,460	$ 3,010	$ (257)	$ (12,414)	$ 178,987

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2011	2010
Cash flows from operating activities:		
Net income (loss)	$3,315	$(54,704)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	4,100	51,000
OREO market value adjustments	1,432	5,184
(Gain) loss on sale of OREO property, net	(1,427)	218
Depreciation of premises and equipment	792	829
Net amortization of premiums and discounts on investments	1,835	1,119
ESOP expense	446	461
Compensation expense related to stock options and restricted stock awards	1,489	1,441
Net realized gain on investments available for sale	(1,741)	-
Deferred federal income taxes	(1,061)	11,878
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	1,222	1,713
Accrued interest receivable	714	169
Accrued interest payable	14	(62)
Other liabilities	513	413
Investment transactions payable	10,000	-
Federal income taxes, net	5,916	3,779
Net cash provided by operating activities	$27,559	$23,438
Cash flows from investing activities:		
Proceeds from sales of investments	74,633	-
Capitalized improvements in OREO	(181)	(488)
Proceeds from sales of OREO properties	25,814	18,837
Principal repayments on investments	24,602	23,851
Purchases of investments	(74,679)	(84,408)
Net decrease in loans receivable	104,393	37,895
Purchases of premises and equipment	(55)	(1,321)
Net cash provided (used) by investing activities	$154,527	$(5,634)
Balance, carried forward	$182,086	$17,804

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2011	2010
Balance, brought forward	$ 182,086	$ 17,804
Cash flows from financing activities:		
Net increase (decrease) in deposits	(69,681)	13,325
Advances from the Federal Home Loan Bank	-	53,173
Repayments of advances from the Federal Home Loan Bank	-	(50,007)
Net increase in advance payments from borrowers for taxes and insurance	1,367	2,129
Repurchase and retirement of common stock	-	(106)
Dividends paid	-	(1,421)
Net cash provided (used) by financing activities	$ (68,314)	$ 17,093
Net increase in cash	113,772	34,897
Cash and cash equivalents:		
Beginning of period	98,427	104,970
End of period	$ 212,199	$ 139,867
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 14,448	$ 21,633
Noncash transactions:		
Loans, net of deferred loan fees and allowance for loan losses transferred to OREO	$ 20,737	$ 34,843

See accompanying notes to consolidated financial statements.

7

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

Note 1 – Description of Business

First Financial Northwest, Inc. ("First Financial Northwest" or the "Company"), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest ("First Savings Bank" or "the Bank") in connection with the conversion from a mutual holding company structure to a stock holding company structure. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information presented in the consolidated financial statements and related data, relates primarily to First Savings Bank. First Financial Northwest is a savings and loan holding company and is subject to regulation by the Federal Reserve Board ("FRB"), as successor on July 24, 2011 to the powers and responsibilities of the Office of Thrift Supervision ("OTS"). First Savings Bank is regulated by the Federal Deposit Insurance Corporation ("FDIC") and the Washington State Department of Financial Institutions ("DFI").

First Savings Bank is a community-based savings bank primarily serving King and to a lesser extent, Pierce, Snohomish and Kitsap counties, through our full-service banking office located in Renton, Washington. First Savings Bank's business consists of attracting deposits from the public and utilizing these deposits to originate one-to-four family, multifamily, commercial real estate, business, consumer and construction/land development loans.

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

Note 2 – Regulatory Items

On April 14, 2010, the OTS and members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement or Memorandum of Understanding ("MOU") which is now enforced by the FRB as the successor to the OTS. Under the terms of the MOU, the Company agreed, among other things, to provide notice to and obtain a written non-objection from the FRB prior to the Company (a) declaring a dividend or redeeming any capital stock and (b) incurring, issuing, renewing or repurchasing any new debt. Further, in connection with a prior examination of the Bank by the FDIC and DFI, we must obtain a written non-objection from the FDIC before engaging in any transaction that would materially change the balance sheet composition (including growth in total assets of five percent or more), significantly change funding sources (including brokered deposits) or declare or pay cash dividends. In addition, both the Company and the Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer or pay pursuant to or by entering into certain severance and other forms of compensation agreements.

The Bank entered into a Stipulation to the Issuance of a Consent Order ("Order") with the FDIC and the DFI which became effective on September 24, 2010. Under the terms of the Order, the Bank cannot declare dividends or repurchase stock without the prior written approval of the FDIC. Other material provisions of the Order require the Bank to:

- Maintain and preserve qualified management;
- Increase the Board of Directors' participation in the Bank's affairs;
- Obtain an independent study of management and the personnel structure of the Bank;
- Maintain specified Capital levels;
-

Eliminate loans classified as “Loss” at its regulatory examination, and reduce the loans classified as “Doubtful” and “Substandard” as a percent of capital;

- Revise its policy with respect to the allowance for loan losses;
- Not extend additional credit to borrowers whose loan had been classified as “Loss” and is uncollected;

8

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

- Revise its lending and collection policies and practices;
- Develop a plan to reduce the amount of commercial real estate loans;
- Enhance its written funds management and liquidity policy;
- Develop a three-year strategic plan;
- Not solicit brokered deposits and comply with certain deposit rate restrictions;
- Eliminate and correct all violations of laws; and
- Prepare and submit progress reports to the FDIC and DFI.

The Bank has implemented a comprehensive plan to achieve full compliance with the Order. The Order contains target dates to achieve the items listed above, including that the Bank’s Tier 1 capital ratio and total risk-based capital ratio be at least 10% and 12%, respectively. At September 30, 2011, the Bank’s Tier 1 capital ratio was 12.76% and its total risk-based capital ratio was 23.87%, which exceeded the requirements of the Order.

Adversely classified assets as a percent of Tier 1 capital plus the allowance for loan and lease losses (“ALLL”) was 128% at the beginning of 2010. The Order required this ratio to be below 65% by March 2011 for the adversely classified assets identified at that exam. We achieved this target as of September 30, 2010 and remained in compliance with this requirement at September 30, 2011.

The Order also required that the Bank develop a written plan to systematically reduce the amount of loans to borrowers in the commercial real estate loan category, including its construction/land development loans which are considered commercial real estate for purposes of this calculation. At September 30, 2010, the Bank’s commercial real estate loans, excluding owner-occupied properties, represented 314% of its total risk-based capital including construction/land development loans which equaled 84% of its total risk-based capital. As of September 30, 2011, the Bank’s concentration in commercial real estate loans was reduced to 238% of its risk-based capital and its construction/land development loan portfolio was reduced to 34% of total risk-based capital.

The Order also required the Bank to obtain an independent management study and adopt a plan to implement the recommendations from the study, satisfactory to its regulators. The Bank has obtained the independent management study and continues to work on implementing the study’s recommendations, including the addition of new Board members and the evaluation of senior management. We are in discussions with potential new Board members for the Bank and the Company who would further enhance the knowledge and expertise of our Boards of Directors. Senior management is also being evaluated in connection with the independent management study and efforts are being made to identify outside individuals who would augment the leadership of our organization and who possess the experience and qualifications to strengthen and establish the foundation for our future growth.

A copy of the Order is attached to the Form 8-K that we filed with the Securities and Exchange Commission (“SEC”) on September 27, 2010. The Order will remain in effect until modified or terminated by the FDIC and the DFI.

Note 3 – Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC. Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles (“GAAP”) for complete financial statements. These unaudited consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ended December 31, 2011. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the ALLL, the valuation of other real estate owned ("OREO") and the underlying collateral of loans in the process of foreclosure, deferred tax assets and the fair value of financial instruments.

Certain amounts in the unaudited consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation.

Note 4 – Recently Issued Accounting Pronouncements

In January 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. This ASU temporarily delays the effective date of the disclosures about troubled debt restructurings in Update 2010-20 for public entities. The delay is intended to allow the FASB time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. The guidance is effective for interim and annual periods ending after September 15, 2011. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-02, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring. The update provides additional guidance relating to when creditors should classify loan modifications as troubled debt restructurings. The ASU also ends the deferral issued in January 2011 of the disclosures about troubled debt restructurings required by ASU No. 2010-20. The provisions of ASU No. 2011-02 and the disclosure requirements of ASU No. 2010-20 are effective for the Company's interim reporting period ending September 30, 2011. The guidance applies retrospectively to restructurings occurring on or after January 1, 2011. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. The update amends existing guidance to remove from the assessment of effective control, the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and, as well, the collateral maintenance implementation guidance related to that criterion. ASU No. 2011-03 is effective for the Company's reporting period beginning on or after December 15, 2011. The guidance applies prospectively to transactions or modification of existing transactions that occur on or after the effective date and early adoption is not permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The update amends existing guidance regarding the highest and best use and valuation premise by clarifying these concepts are only applicable to measuring the fair value of nonfinancial assets. The Update also clarifies that the fair value measurement of financial assets and financial liabilities which have offsetting market risks or counterparty credit risks that are managed on a portfolio basis, when several criteria are met, can be measured at the net risk position. Additional disclosures about Level 3 fair value measurements are required including a quantitative disclosure of the unobservable inputs and assumptions used in the measurement, a description of the valuation process in place, and discussion of the sensitivity of fair value changes in unobservable inputs and interrelationships about those inputs as well as disclosure of the level of the fair value of items that are not measured at fair value in the financial statements but disclosure of fair value is required. The provisions of ASU No. 2011-04 are effective for the Company's reporting period beginning after December 15, 2011 and should be applied prospectively. The Company is currently evaluating the impact of this ASU and does not expect it to have a material impact on the Company's consolidated financial statements.

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

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The update amends current guidance to allow a company the option of presenting the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The provisions do not change the items that must be reported in other comprehensive income or when an item of other comprehensive must be reclassified to net income. The amendments do not change the option for a company to present components of other comprehensive income either net of related tax effects or before related tax effects, with one amount shown for the aggregate income tax expense (benefit) related to the total of other comprehensive income items. The amendments do not affect how earnings per share is calculated or presented. The provisions of ASU No. 2011-05 are effective for the Company's reporting periods beginning after December 15, 2011 and should be applied retrospectively. Early adoption is permitted and there are no required transition disclosures. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

Note 5 – Investments

Investment securities available for sale are summarized as follows:

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$ 56,562	$ 1,285	$ (8)	$ 57,839
Freddie Mac	21,974	632	-	22,606
Ginnie Mae	7,959	37	(19)	7,977
Municipal bonds	2,391	49	(306)	2,134
U.S. Government agencies	49,794	290	(367)	49,717
	$ 138,680	$ 2,293	$ (700)	$ 140,273

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$ 109,134	$ 1,291	$ (281)	$ 110,144
Freddie Mac	40,454	860	(165)	41,149
Ginnie Mae	9,542	-	(98)	9,444
Municipal bonds	2,395	-	(473)	1,922
U.S. Government agencies	1,805	139	-	1,944
	$ 163,330	$ 2,290	$ (1,017)	$ 164,603

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

The following table summarizes the aggregate fair value and gross unrealized loss by length of time those investments have been continuously in an unrealized loss position:

	September 30, 2011					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Mortgage-backed investments:	(In thousands)					
Fannie Mae	$1,515	$(8)	$-	$-	$1,515	$(8)
Ginnie Mae	4,374	(19)	-	-	4,374	(19)
Municipal bonds	-	-	1,403	(306)	1,403	(306)
U.S. Government agencies	35,060	(367)	-	-	35,060	(367)
	$40,949	$(394)	$1,403	$(306)	$42,352	$(700)

	December 31, 2010					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Mortgage-backed investments:	(In thousands)					
Fannie Mae	$39,801	$(281)	$-	$-	$39,801	$(281)
Freddie Mac	15,232	(165)	-	-	15,232	(165)
Ginnie Mae	5,193	(98)	-	-	5,193	(98)
Municipal bonds	-	-	1,885	(473)	1,885	(473)
	$60,226	$(544)	$1,885	$(473)	$62,111	$(1,017)

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. We consider many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be an other-than-temporary impairment ("OTTI") are written down to fair value. For equity securities, the write-down is recorded as a realized loss in noninterest income on our Consolidated Income Statements. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ("OCI"). Impairment losses related to all other factors are presented as separate categories within OCI. For the nine months ended September 30, 2011, we did not have any OTTI losses on investments.

The amortized cost and estimated fair value of investments available for sale at September 30, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments, are shown separately.

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

	September 30, 2011	
	Amortized Cost	Fair Value
	(In thousands)	
Due within one year	$ -	$ -
Due after one year through five years	30,494	30,239
Due after five years through ten years	10,827	10,862
Due after ten years	10,864	10,750
	52,185	51,851
Mortgage-backed investments	86,495	88,422
	$ 138,680	$ 140,273

We sold $43.1 million of investments during the three months ended September 30, 2011, resulting in gross gains of $487,000 and gross losses of $8,000. For the nine months ended September 30, 2011, we sold $72.9 million of investments resulting in gross gains of $1.7 million and gross losses of $8,000.

Note 6 - Loans Receivable

Loans receivable are summarized as follows:

	September 30, 2011		December 31, 2010	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
One-to-four family residential: (1)				
Permanent	$ 346,258	46.3%	$ 393,334	44.1%
Construction	-	-	5,356	0.6
	346,258	46.3	398,690	44.7
Multifamily:				
Permanent	113,759	15.2	140,762	15.8
Construction	3,526	0.5	4,114	0.5
	117,285	15.7	144,876	16.3
Commercial real estate:				
Permanent	221,817	29.6	237,708	26.6
Construction	12,500	1.7	28,362	3.2
Land	3,131	0.4	6,643	0.7
	237,448	31.7	272,713	30.5
Construction/land development:				
One-to-four family residential	10,034	1.3	26,848	3.0
Multifamily	882	0.1	1,283	0.1
Commercial	1,104	0.1	1,108	0.1
Land development	17,859	2.4	27,262	3.1
	29,879	3.9	56,501	6.3
Business	3,531	0.5	479	0.1
Consumer	13,898	1.9	19,127	2.1

Total loans		748,299	100.0%		892,386	100.0%
Less:						
Loans in process ("LIP")		2,591			10,975	
Deferred loan fees, net		1,848			2,421	
ALLL		16,634			22,534	
Loans receivable, net	$	727,226		$	856,456	

(1) Includes $151.3 million and $173.4 million of non-owner occupied loans at September 30, 2011 and December 31, 2010, respectively.

At September 30, 2011 and December 31, 2010, there were no loans classified as held for sale.

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

A summary of changes in the ALLL for the three and nine months ended September 30, 2011 and 2010 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
Balance at the beginning of the period	$ 16,989	$ 29,858	$ 22,534	$ 33,039
Provision for loan losses	1,300	12,000	4,100	51,000
Charge-offs	(1,686)	(14,121)	(10,337)	(56,506)
Recoveries	31	663	337	867
Balance at the end of the period	$ 16,634	$ 28,400	$ 16,634	$ 28,400

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

The following tables represent a summary of our ALLL and loan portfolio by loan type and impairment method:

	At or For the Three Months Ended September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:				(In thousands)			
Beginning balance	$5,499	$984	$7,279	$ 2,893	$14	$320	$16,989
Charge-offs	(371)	-	(590)	(633)	-	(92)	(1,686)
Recoveries	12	-	-	18	-	1	31
Provision	164	5	429	457	127	118	1,300
Ending balance	$5,304	$989	$7,118	$ 2,735	$141	$347	$16,634
General reserve	$4,739	$989	$7,074	$ 2,735	$141	$347	$16,025
Specific reserve	$565	$-	$44	$ -	$-	$-	$609
Loans (1):							
Total Loans	$346,222	$116,461	$236,775	$ 28,821	$3,531	$13,898	$745,708
General reserve (2)	$280,334	$113,311	$220,966	$ 16,930	$3,531	$13,784	$648,856
Specific reserve (3)	$65,888	$3,150	$15,809	$ 11,891	$-	$114	$96,852

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

	At or For the Nine Months Ended September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:				(In thousands)			
Beginning balance	$8,302	$1,893	$6,742	$ 5,151	$7	$439	$22,534
Charge-offs	(1,987)	(88)	(4,184)	(3,815)	-	(263)	(10,337)
Recoveries	31	-	-	304	-	2	337
Provision	(1,042)	(816)	4,560	1,095	134	169	4,100
Ending balance	$5,304	$989	$7,118	$ 2,735	$141	$347	$16,634
General reserve	$4,739	$989	$7,074	$ 2,735	$141	$347	$16,025
	$565	$-	$44	$ -	$-	$-	$609

Specific reserve							
Loans (1):							
Total Loans	$346,222	$116,461	$236,775	$ 28,821	$3,531	$13,898	$745,708
General reserve (2)	$280,334	$113,311	$220,966	$ 16,930	$3,531	$13,784	$648,856
Specific reserve (3)	$65,888	$3,150	$15,809	$ 11,891	$-	$114	$96,852

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

15

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

	At or For the Year Ended December 31, 2010						
ALLL:	One-to-Four Family Residential (In thousands)	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
Beginning balance	$11,130	$1,896	$6,422	$13,255	$6	$330	$33,039
Charge-offs	(24,594)	-	(8,012)	(32,080)	-	(790)	(65,476)
Recoveries	176	-	823	778	-	94	1,871
Provision	21,590	(3)	7,509	23,198	1	805	53,100
Ending balance	$8,302	$1,893	$6,742	$5,151	$7	$439	$22,534
General reserve	$7,137	$1,893	$5,499	$1,819	$7	$337	$16,692
Specific reserve	$1,165	$-	$1,243	$3,332	$-	$102	$5,842
Loans (1):							
Total Loans	$398,583	$143,513	$266,297	$53,412	$479	$19,127	$881,411
General reserve (2)	$330,651	$140,998	$248,578	$20,394	$479	$19,000	$760,100
Specific reserve (3)	$67,932	$2,515	$17,719	$33,018	$-	$127	$121,311

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

Nonperforming loans, net of undisbursed funds, were $30.8 million and $62.9 million at September 30, 2011 and December 31, 2010, respectively. Foregone interest on nonaccrual loans for the three and nine months ended September 30, 2011 was $527,000 and $2.1 million, respectively. Foregone interest for the same periods in 2010 was $1.5 million and $5.1 million, respectively.

Loans committed to be advanced in connection with impaired loans at September 30, 2011 and December 31, 2010 were $43,000 and $1.1 million, respectively.

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

The following tables represent a summary of loans individually evaluated for impairment by the type of loan:

	At or for the Three Months Ended September 30, 2011				
	Recorded Investment (1)	Unpaid Principal Balance (2)	Related Allowance (In thousands)	Average Recorded Investment	Interest Income Recognized
Loans with no related allowance:					
One-to-four family residential:					
Owner occupied	$ 7,438	$ 8,679	$ -	$ 7,618	$ 40
Non-owner occupied	43,290	46,422	-	44,759	552
Multifamily	3,150	3,238	-	3,154	42
Commercial real estate	12,068	16,763	-	13,311	112
Construction/land development	11,891	26,836	-	13,786	-
Consumer	114	117	-	114	1
Total	77,951	102,055	-	82,742	747
Loans with an allowance:					
One-to-four family residential:					
Owner occupied	5,120	5,219	190	5,207	57
Non-owner occupied	10,040	10,141	375	8,683	194
Commercial real estate	3,741	3,741	44	3,742	47
Total	18,901	19,101	609	17,632	298
Total impaired loans:					
One-to-four family residential:					
Owner occupied	12,558	13,898	190	12,825	97
Non-owner occupied	53,330	56,563	375	53,442	746
Multifamily	3,150	3,238	-	3,154	42
Commercial real estate	15,809	20,504	44	17,053	159
Construction/land development	11,891	26,836	-	13,786	-
Consumer	114	117	-	114	1
Total	$ 96,852	$ 121,156	$ 609	$ 100,374	$ 1,045

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

(2) Contractual loan principal balance.

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

	At or For the Nine Months Ended September 30, 2011				
	Recorded Investment (1)	Unpaid Principal Balance (2)	Related Allowance	Average Recorded Investment	Interest Income Recognized
			(In thousands)		
Loans with no related allowance:					
One-to-four family residential:					
Owner occupied	$ 7,438	$ 8,679	$ -	$ 7,747	$ 126
Non-owner occupied	43,290	46,422	-	44,858	1,683
Multifamily	3,150	3,238	-	2,833	126
Commercial real estate	12,068	16,763	-	11,744	329
Construction/land development	11,891	26,836	-	11,687	-
Consumer	114	117	-	123	2
Total	77,951	102,055	-	78,992	2,266
Loans with an allowance:					
One-to-four family residential:					
Owner occupied	5,120	5,219	190	5,216	193
Non-owner occupied	10,040	10,141	375	9,410	384
Multifamily	-	-	-	175	-
Commercial real estate	3,741	3,741	44	6,594	151
Construction/land development	-	-	-	9,332	-
Consumer	-	-	-	20	-
Total	18,901	19,101	609	30,747	728
Total impaired loans:					
One-to-four family residential:					
Owner occupied	12,558	13,898	190	12,963	319
Non-owner occupied	53,330	56,563	375	54,268	2,067
Multifamily	3,150	3,238	-	3,008	126
Commercial real estate	15,809	20,504	44	18,338	480
Construction/land development	11,891	26,836	-	21,019	-
Consumer	114	117	-	143	2
Total	$ 96,852	$ 121,156	$ 609	$ 109,739	$ 2,994

(1) Represents the loan balance less charge-offs.
(2)

Contractual loan principal balance.

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

	At or For the Year Ended December 31, 2010			
	Recorded Investment (1)(3)	Unpaid Principal Balance (2)(3)	Related Allowance	Interest Income Recognized (3)
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 5,663	$ 5,997	$ -	$ 178
Non-owner occupied	42,584	42,947	-	2,920
Multifamily	2,515	2,515	-	169
Commercial real estate	7,236	7,753	-	350
Construction/land development	6,565	8,607	-	8
Consumer	48	547	-	-
Total	64,611	68,366	-	3,625
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	7,333	8,570	276	95
Non-owner occupied	12,352	16,722	889	130
Commercial real estate	10,483	14,713	1,243	281
Construction/land development	26,453	46,026	3,332	-
Consumer	79	298	102	3
Total	56,700	86,329	5,842	509
Total impaired loans:				
One-to-four family residential:				
Owner occupied	12,996	14,567	276	273
Non-owner occupied	54,936	59,669	889	3,050
Multifamily	2,515	2,515	-	169
Commercial real estate	17,719	22,466	1,243	631
Construction/land development	33,018	54,633	3,332	8
Consumer	127	845	102	3
Total	$ 121,311	$ 154,695	$ 5,842	$ 4,134

(1) Represents the loan balance less charge-offs.
(2) Contractual loan principal balance.
(3) Certain amounts in the table have been reclassified to conform to the current presentation.

19

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

The following is a summary of information pertaining to impaired loans, nonperforming assets and troubled debt restructured loans ("TDRs"):

	September 30, 2011	December 31, 2010
	(In thousands)	
Impaired loans without a valuation allowance	$77,951	$64,611
Impaired loans with a valuation allowance	18,901	56,700
Total impaired loans	$96,852	$121,311
Valuation allowance related to impaired loans	$609	$5,842
Nonperforming assets (1):		
Nonaccrual loans	$23,644	$46,637
Nonaccrual troubled debt restructured loans	7,188	16,299
Total nonperforming loans	30,832	62,936
Other real estate owned	25,201	30,102
Total nonperforming assets	$56,033	$93,038
Performing troubled debt restructured loans	$66,020	$58,375
Nonaccrual troubled debt restructured loans	7,188	16,299
Total troubled debt restructured loans (2)	$73,208	$74,674

(1) There were no loans 90 days or more past due and still accruing interest at September 30, 2011 and December 31, 2010.
(2) Troubled debt restructured loans are also considered impaired loans and are included in "Total impaired loans."

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

A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the loan. In the process of identifying loans as impaired, management takes into consideration factors which include payment history and status, collateral value, financial condition of the borrower and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered by management on a case-by-case basis, after taking into consideration the circumstances surrounding the loan and the borrower, including payment history and the amounts of any payment shortfall, length and reason for delay and the likelihood of a return to stable performance. Impairment is measured on a loan-by-loan basis for all loans in the portfolio.

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

The following table is a summary of nonaccrual loans by loan type:

	September 30, 2011	December 31, 2010
	(In thousands)	
One-to-four family residential	$ 12,859	$ 22,688
Multifamily	638	-
Commercial real estate	5,400	7,306
Construction/land development	11,891	32,885
Consumer	44	57
Total nonaccrual loans	$ 30,832	$ 62,936

The following tables represent a summary of the aging of loans by type:

Loans Past Due as of September 30, 2011

	30-59 Days	60-89 Days	90 Days and Greater	Total	Current	Total Loans (1) (2)
	(In thousands)					
Real estate:						
One-to-four family residential:						
Owner occupied	$676	$674	$4,043	$5,393	$189,566	$194,959
Non-owner occupied	1,177	576	5,620	7,373	143,890	151,263
Multifamily	349	-	638	987	115,474	116,461
Commercial real estate	1,383	-	4,226	5,609	231,166	236,775
Construction/land development	1,104	-	11,891	12,995	15,826	28,821
Total real estate	4,689	1,250	26,418	32,357	695,922	728,279
Business	-	-	-	-	3,531	3,531
Consumer	644	-	-	644	13,254	13,898
Total	$5,333	$1,250	$26,418	$33,001	$712,707	$745,708

(1) There were no loans 90 days past due and still accruing interest at September 30, 2011.
(2) Net of undisbursed funds.

Loans Past Due as of December 31, 2010

30-59 Days	60-89 Days	90 Days and Greater	Total	Current	Total Loans (1) (2)
		(In thousands)			

Real estate:						
One-to-four family residential:						
Owner occupied	$2,178	$780	$5,863	$8,821	$216,392	$225,213
Non-owner occupied	800	1,996	11,801	14,597	158,773	173,370
Multifamily	-	-	-	-	143,513	143,513
Commercial real estate	2,141	836	6,948	9,925	256,372	266,297
Construction/land development	133	265	32,620	33,018	20,394	53,412
Total real estate	5,252	3,877	57,232	66,361	795,444	861,805
Business	-	-	-	-	479	479
Consumer	-	55	57	112	19,015	19,127
Total	$5,252	$3,932	$57,289	$66,473	$814,938	$881,411

(1) There were no loans 90 days past due and still accruing interest at December 31, 2010.

(2) Net of undisbursed funds.

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

Credit Quality Indicators. We utilize a nine-point risk rating system and assign a risk rating for all credit exposures. The risk rating system is designed to define the basic characteristics and identify risk elements of each credit extension. Credits risk rated 1 through 5 are considered to be "pass" credits. Pass credits can be assets where there is virtually no credit risk, such as cash secured loans with funds on deposit with the Bank. Pass credits also include credits that are on our watch list, where the borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower's financial capacity and threaten their ability to fulfill debt obligations in the future. Credits classified as special mention are risk rated 6 and possess weaknesses that deserve management's close attention. Special mention assets are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. Substandard credits are risk rated 7. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful are risk rated 8 and have all the weaknesses inherent in those credits classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions and values. Assets classified as loss are risk rated 9 and are considered uncollectible and cannot be justified as a viable asset for the Bank.

The following tables represent a summary of loans by type and risk category:

	September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (1)
				(In thousands)			
Risk Rating:							
Pass	$ 303,798	$ 110,392	$ 206,855	$ 16,506	$ 3,531	$ 13,632	$ 654,714
Special mention	24,308	5,431	13,980	424	-	222	44,365
Substandard	18,116	638	15,940	11,891	-	44	46,629
Doubtful	-	-	-	-	-	-	-
Total	$ 346,222	$ 116,461	$ 236,775	$ 28,821	$ 3,531	$ 13,898	$ 745,708

(1) Net of undisbursed funds.

	December 31, 2010						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (1)
				(In thousands)			
Risk Rating:							
Pass	$ 360,239	$ 141,224	$ 249,576	$ 17,589	$ 479	$ 18,792	$ 787,899
Special mention	10,261	1,936	5,805	-	-	189	18,191

Substandard	28,083	353	10,916	35,484	-	140	74,976
Doubtful	-	-	-	339	-	6	345
Total	$ 398,583	$ 143,513	$ 266,297	$ 53,412	$ 479	$ 19,127	$ 881,411

(1) Net of undisbursed funds.

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

The following tables summarize the loan portfolio by type and payment activity:

	September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (3)
				(In thousands)			
Performing (1)	$ 333,363	$ 115,823	$ 231,375	$ 16,930	$ 3,531	$ 13,854	$ 714,876
Nonperforming (2)	12,859	638	5,400	11,891	-	44	30,832
Total	$ 346,222	$ 116,461	$ 236,775	$ 28,821	$ 3,531	$ 13,898	$ 745,708

(1) There were $189.9 million of owner-occupied one-to-four family loans and $143.5 million of non-owner occupied one-to-four family loans classified
as performing.
(2) There were $5.1 million of owner-occupied one-to-four family loans and $7.8 million of non-owner occupied one-to-four family loans classified
as nonperforming.
(3) Net of undisbursed funds.

	December 31, 2010						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (3)
				(In thousands)			
Performing (1)	$375,895	$ 143,513	$ 258,991	$ 20,527	$479	$ 19,070	$ 818,475
Nonperforming (2)	22,688	-	7,306	32,885	-	57	62,936
Total	$ 398,583	$ 143,513	$ 266,297	$ 53,412	$479	$ 19,127	$ 881,411

(1) There were $217.3 million of owner-occupied one-to-four family loans and $158.6 million of non-owner occupied one-to-four family loans classified
as performing.
(2) There were $8.0 million of owner-occupied one-to-four family loans and $14.7 million of non-owner occupied one-to-four family loans classified
as nonperforming.
(3) Net of undisbursed funds.

The following table presents our TDRs recorded investment prior to the modification and after the modification:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
			(Dollars in thousands)			
TDRs that Occurred During the Period:						
One-to-four family residential:						
A/B Note restructure	-	$ -	$ -	6	$ 1,130	$ 635
Interest only payments with interest rate concession	1	1,019	1,017	12	4,459	4,451
Principal and interest with interest rate concession	14	2,471	2,464	23	6,190	6,069
Interest only payments with no interest rate concession	-	-	-	2	527	510
Total	15	$ 3,490	$ 3,481	43	$ 12,306	$ 11,665

At September 30, 2011, the Company had $36,000 in commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the ALLL.

The TDRs that occurred during the three and nine months ended September 30, 2011 were primarily a result of granting the borrower interest rate concessions for a period of time ranging from one to three years. The impaired portion of the loan with an interest rate concession for a specific period of time is calculated based on the present value of expected future cash flows discounted at the loan’s effective interest rate. The effective interest rate is the rate of return implicit on the original loan. This impaired amount reduces the ALLL and a valuation allowance

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

is established to reduce the loan balance. As loan payments are received in future periods, the ALLL entry is reversed and the valuation allowance is reduced utilizing the level yield method over the modification period. TDRs resulted in a charge to the ALLL of $148,000 and $396,000 for the three and nine months ended September 30, 2011, respectively.

The following is a summary of loans that were modified as TDRs within the previous 12 months and for which there was a payment default during the period.

		Types of Modifications	
	Number of Loans	Interest Only Payments	Interest Rate Concession
	(Dollars in thousands)		
TDRs that Subsequently Defaulted:			
One-to-four family residential	4	$391	$2,233

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment further reduces the ALLL.

Note 7 – Other Real Estate Owned

The following table is a summary of OREO:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
Beginning Balance	$ 25,979	$ 16,493	$ 30,102	$ 11,835
Loans transferred to OREO	4,787	17,177	20,737	34,843
Capitalized improvements	91	202	181	488
Dispositions of OREO	(5,141)	(2,016)	(24,387)	(19,055)
Market value adjustments	(515)	(8,929)	(1,432)	(5,184)
Ending Balance	$ 25,201	$ 22,927	$ 25,201	$ 22,927

OREO includes properties acquired by the Bank through foreclosure or deed in lieu of foreclosure. OREO at September 30, 2011 consisted of $9.2 million in one-to-four family residential homes, $7.3 million in construction/land development projects and $8.7 million in commercial real estate buildings.

Note 8 – Fair Value

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

We determined the fair values of our financial instruments based on the fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair values.

Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our estimates for market assumptions.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those

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

assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from an independent source. Unobservable inputs are assumptions based on our own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

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

- Level 1 – Quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable.
- Level 3 – Instruments whose significant value drivers are unobservable.

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

	Fair Value Measurements at September 30, 2011			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Available for sale investments:				
Mortgage-backed investments:				
Fannie Mae	$ 57,839	$ -	$ 57,839	$ -
Freddie Mac	22,606	-	22,606	-
Ginnie Mae	7,977	-	7,977	-
Municipal bonds	2,134	-	2,134	-
U.S. Government agencies	49,717	-	49,717	-
	$ 140,273	$ -	$ 140,273	$ -

	Fair Value Measurements at December 31, 2010			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Available for sale investments:				
Mortgage-backed investments:				
Fannie Mae	$ 110,144	$ -	$ 110,144	$ -

Freddie Mac		41,149		-		41,149		-
Ginnie Mae		9,444		-		9,444		-
Municipal bonds		1,922		-		1,922		-
U.S. Government agencies		1,944		-		1,944		-
	$	164,603	$	-	$	164,603	$	-

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

The tables below present the balances of assets and liabilities measured at fair value on a nonrecurring basis:

25

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

	Fair Value Measurements at September 30, 2011				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (In thousands)	Significant Unobservable Inputs (Level 3)	Total Losses
Impaired loans including undisbursed but committed funds of $43,000 (included in loans receivable, net)(1)	$ 96,286	$ -	$ -	$ 96,286	$ 60
OREO (2)	25,201	-	-	25,201	3
	$ 121,487	$ -	$ -	$ 121,487	$ 1,

(1) The loss represents the specific reserve against loans that were considered impaired at September 30, 2011
(2) The loss represents OREO market value adjustments for the quarter ended September 30, 2011

	Fair Value Measurements at December 31, 2010				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (In thousands)	Significant Unobservable Inputs (Level 3)	Total Losses
Impaired loans including undisbursed but committed funds of $1.1 million (included in loans receivable, net) (1)	$ 116,543	$ -	$ -	$ 116,543	$ 5,8
OREO (2)	30,102	-	-	30,102	5,0
	$ 146,645	$ -	$ -	$ 146,645	$ 11,4

(1) The loss represents the specific reserve against loans that were considered impaired at December 31, 2010.
(2) The loss represents OREO market value adjustments for the year ended December 31, 2010.

The fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. Inputs used in the collateral value method include appraised values, estimates of certain completion costs and closing and selling costs. Some of these inputs may not be observable in the marketplace.

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

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

The carrying amounts and estimated fair values of financial instruments were as follows:

	September 30, 2011		December 31, 2010	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(In thousands)			
Assets:				
Cash on hand and in banks	$ 5,159	$ 5,159	$ 7,466	$ 7,466
Interest-bearing deposits	207,040	207,040	90,961	90,961
Investments available for sale	140,273	140,273	164,603	164,603
Loans receivable, net	727,226	763,147	856,456	878,737
Federal Home Loan Bank stock	7,413	7,413	7,413	7,413
Accrued interest receivable	3,972	3,972	4,686	4,686
Liabilities:				
Deposits	212,257	212,257	231,527	231,527
Certificates of deposit	638,288	645,085	688,699	701,976
Advances from the Federal Home Loan Bank	93,066	95,522	93,066	95,972
Accrued interest payable	228	228	214	214

Fair value estimates, methods, and assumptions are set forth below for our financial instruments.

- Financial instruments with book value equal to fair value: The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value. These instruments include cash on hand and in banks, interest-bearing deposits, investments available for sale, Federal Home Loan Bank of Seattle ("FHLB") stock, accrued interest receivable and accrued interest payable. FHLB stock is not publicly-traded, however, it may be redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold, subject to the FHLB's discretion.

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

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

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

- Off balance sheet commitments: No fair value adjustment is necessary for commitments made to extend credit, which represents commitments for loan originations or for outstanding commitments to purchase loans. These commitments are at variable rates, are for loans with terms

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

of less than one year and have interest rates which approximate prevailing market rates, or are set at the time of loan closing.

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

Note 9 – Federal Home Loan Bank Stock

At September 30, 2011, we held $7.4 million of FHLB stock. FHLB stock is carried at par ($100 per share) and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par. As a result of ongoing turmoil in the capital and mortgage markets, the FHLB has a risk-based capital deficiency largely as a result of write-downs on its private label mortgage-backed securities portfolio.

Management evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on our assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB; and (4) the liquidity position of the FHLB.

On October 25, 2010, the FHLB agreed to the stipulation and issuance of a Consent Order by its primary regulator, the Federal Housing Finance Agency ("FHFA"). The Consent Order sets forth requirements for capital management, asset composition, and other operational and risk management improvements. The FHLB may not repurchase member stock or pay dividends, until they achieve and maintain financial thresholds established by the FHFA as part of the agency's supervisory process, subject to FHFA approval.

This restriction is not expected to have a material effect on our financial position, liquidity or results of operations. We have determined there is no OTTI on the FHLB stock investment as of September 30, 2011.

Note 10 - Stock-Based Compensation

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

Total compensation expense for the Plan was $540,000 and $464,000 for the three months ended September 30, 2011 and 2010, respectively, and the related income tax benefit was $189,000 and $162,000 for the nine months ended September 30, 2011 and 2010, respectively.

Total compensation expense for the Plan was $1.5 million and $1.4 million for the nine months ended September 30, 2011 and 2010, respectively, and the related income tax benefit was $521,000 and $504,000 for the nine months ended September 30, 2011 and 2010, respectively.

Stock Options

The Plan authorized the grant of stock options totaling 2,285,280 shares to our directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of our common stock at the date of grant. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date and a contractual life of ten years. Any unexercised stock options will expire ten years after the grant date or sooner in the event of the award recipient’s death, disability or termination of service

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

with the Company or the Bank. We have a policy of issuing new shares from authorized but unissued common stock upon the exercise of stock options. At September 30, 2011, remaining options for 911,756 shares of common stock were available for grant under the Plan.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. In previous periods, we elected to use a weighted-average of our peers' historical stock price information in conjunction with our own stock price history due to the limited amount of history available regarding our stock price. Now that sufficient historical stock price information is available regarding our stock, we will utilize in future periods the historical volatility of our stock price over a specified period of time for the expected volatility assumption. We base the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. We elected to use the "Share-Based Payments" method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at the midpoint. There were no options granted during the third quarter ended September 30, 2011.

The following is a summary of our stock option plan awards for the nine months ended September 30, 2011:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value	Weighted-Average Grant Date Fair Value
	(Dollars in thousands, except share data)				
Outstanding at January 1, 2011	1,383,524	$ 9.52	7.60	$ -	$ 1.91
Granted	-	-	-	-	-
Exercised	-	-	-	-	-
Forfeited or expired	(10,000)	9.78	-	-	-
Outstanding at September 30, 2011	1,373,524	9.52	6.85	80	1.91
Expected to vest assuming a 3% forfeiture rate over the vesting term	562,022	9.31	6.92	62	-
Exercisable at September 30, 2011	794,114	9.67	6.80	16	-

As of September 30, 2011, there was $929,000 of total unrecognized compensation cost related to non-vested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.9 years.

Restricted Stock Awards

The Plan authorized the grant of restricted stock awards amounting to 914,112 shares to our directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the date of grant. The restricted stock awards' fair value is equal to the value on the date of grant. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date. At September 30, 2011, remaining restricted awards for 167,078 shares were available to be issued. Shares that have been repurchased totaled 310,494 and are held in trust until they are issued in connection with the agreement.

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

The following is a summary of changes in non-vested restricted stock awards for the nine months ended September 30, 2011:

Non-vested Shares	Shares	Fair Value Per Share
Non-vested at January 1, 2011	456,140	$ 9.75
Granted	-	-
Vested	(145,646)	9.93
Forfeited	-	-
Non-vested at September 30, 2011	310,494	9.66
Expected to vest assuming a 3% forfeiture rate over the vesting term	301,178	

As of September 30, 2011, there was $2.8 million of total unrecognized compensation costs related to non-vested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 2.1 years. The total fair value of shares that vested during both of the quarters ended September 30, 2011 and 2010 was $1.4 million.

Note 11 – Federal Taxes on Income

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

Our primary deferred tax assets relate to our ALLL, our contribution to the First Financial Northwest Foundation and an impairment charge relating to a past investment in the AMF Ultra Short Mortgage Fund.

Under GAAP, a valuation allowance is required to be recognized if it is "more likely than not" that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. At September 30, 2011, we considered positive and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings. We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing these various factors, in 2010 we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential, resulting in no deferred tax asset at September 30, 2011.

30

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

Note 12 – Earnings/(Loss) Per Share

The following table presents a reconciliation of the components used to compute basic and diluted earnings (loss) per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in thousands, except share data)			
Net income (loss)	$ 623	$ (12,071)	$ 3,315	$ (54,704)
Basic weighted-average common shares outstanding	17,545,157	17,432,309	17,519,016	17,411,169
Plus common stock options considered outstanding for dilutive purposes (excludes antidilutive options)	-	-	-	-
Diluted weighted-average common shares outstanding	17,545,157	17,432,309	17,519,016	17,411,169
Basic income (loss) per share	$ 0.04	$ (0.69)	$ 0.19	$ (3.14)
Diluted income (loss) per share	$ 0.04	$ (0.69)	$ 0.19	$ (3.14)

For the three and nine months ended September 30, 2011 and 2010, there were no stock options included in calculating the dilutive earnings per share because they were antidilutive.

Note 13 – Segment Information

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

Note 14 – Subsequent Events

In October, 2011, we prepaid a $10.0 million fixed-rate advance due to mature in March 2012, at an interest rate of 2.82%. The prepayment penalty was $118,000. We prepaid this in advance in order to utilize some of our excess liquidity and to reduce our cost of funds.

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

Forward-looking statements:

Certain matters discussed in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believe," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or simila or future or conditional verbs such as "may," "will," "should," "would," and "could." Forward-looking statements inclu statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, and deterioration in the housing and commercial real estate markets, which may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the FRB and our bank subsidiary by the FDIC, the DFI or other regulatory authorities, including the possibility that any such regulatory authority may initiate additional enforcement actions against the Company or the Bank to take additional corrective action and refrain from unsafe and unsound practices which also may require us, among other things, to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including the requirements and restrictions that have been imposed upon the Company under the memoranda of understanding with the FRB and the consent order the Bank entered into with the FDIC and the DFI and the possibility that the Company and the Bank will be unable to fully comply with these enforcement actions which could result in the imposition of additional requirements or restrictions; our ability to pay dividends on our common stock; our ability to attract and retain deposits; further increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining the fair values of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the implementing regulations; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks

32

detailed in our reports filed with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2010 ("2010 Form 10-K"). Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

Regulatory Items

On April 14, 2010, the OTS and members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement or Memorandum of Understanding ("MOU") which is now enforced by the FRB as the successor to the OTS. Under the terms of the MOU, the Company agreed, among other things, to provide notice to and obtain a written non-objection from the FRB prior to the Company (a) declaring a dividend or redeeming any capital stock and (b) incurring, issuing, renewing or repurchasing any new debt. Further, in connection with a prior examination of the Bank by the FDIC and DFI, we must obtain a written non-objection from the FDIC before engaging in any transaction that would materially change the balance sheet composition (including growth in total assets of five percent or more), significantly change funding sources (including brokered deposits) or declare or pay cash dividends. In addition, both the Company and the Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer or pay pursuant to or by entering into certain severance and other forms of compensation agreements.

The Bank entered into a Stipulation to the Issuance of a Consent Order ("Order") with the FDIC and the DFI which became effective on September 24, 2010. Under the terms of the Order, the Bank cannot declare dividends or repurchase stock without the prior written approval of the FDIC. Other material provisions of the Order require the Bank to:

- Maintain and preserve qualified management;
- Increase the Board of Directors' participation in the Bank's affairs;
- Obtain an independent study of management and the personnel structure of the Bank;
- Maintain specified Capital levels;
- Eliminate loans classified as "Loss" at its regulatory examination, and reduce the loans classified as "Doubtful" and "Substandard" as a percent of capital;
- Revise its policy with respect to the allowance for loan losses;
- Not extend additional credit to borrowers whose loan had been classified as "Loss" and is uncollected;
- Revise its lending and collection policies and practices;
- Develop a plan to reduce the amount of commercial real estate loans;
- Enhance its written funds management and liquidity policy;
- Develop a three-year strategic plan;
- Not solicit brokered deposits and comply with certain deposit rate restrictions;
- Eliminate and correct all violations of laws; and
- Prepare and submit progress reports to the FDIC and DFI.

The Bank has implemented a comprehensive plan to achieve full compliance with the Order. The Order contains target dates to achieve the items listed above, including that the Bank's Tier 1 capital ratio and total risk-based capital ratio be at least 10% and 12%, respectively. At September 30, 2011, the Bank's Tier 1 capital ratio was 12.76% and its total risk-based capital ratio was 23.87%, which exceeded the requirements of the Order.

Adversely classified assets as a percent of Tier 1 capital plus the allowance for loan and lease losses ("ALLL") was 128% at the beginning of 2010. The Order required this ratio to be below 65% by March 2011 for the adversely classified assets identified at that exam. We achieved this target as of September 30, 2010 and remained in compliance with this requirement at September 30, 2011.

33

The Order also required that the Bank develop a written plan to systematically reduce the amount of loans to borrowers in the commercial real estate loan category, including its construction/land development loans which are considered commercial real estate for purposes of this calculation. At September 30, 2010, the Bank's commercial real estate loans, excluding owner-occupied properties, represented 314% of its total risk-based capital including construction/land development loans which equaled 84% of its total risk-based capital. As of September 30, 2011, the Bank's concentration in commercial real estate loans was reduced to 238% of its risk-based capital and its construction/land development loan portfolio was reduced to 34% of total risk-based capital.

The Order also required the Bank to obtain an independent management study and adopt a plan to implement the recommendations from the study, satisfactory to its regulators. The Bank has obtained the independent management study and continues to work on implementing the study's recommendations, including the addition of new Board members and the evaluation of senior management. We are in discussions with potential new Board members for the Bank and the Company who would further enhance the knowledge and expertise of our Boards of Directors. Senior management is also being evaluated in connection with the independent management study and efforts are being made to identify outside individuals who would augment the leadership of our organization and who possess the experience and qualifications to strengthen and establish the foundation for our future growth.

A copy of the Order is attached to the Form 8-K that we filed with the SEC on September 27, 2010. The Order will remain in effect until modified or terminated by the FDIC and the DFI.

Overview

First Savings Bank is a community-based savings bank primarily serving King and, to a lesser extent, Pierce, Snohomish and Kitsap counties, through our full-service banking office located in Renton, Washington. First Savings Bank's business consists of attracting deposits from the public and utilizing these funds to originate one-to-four family, multifamily, commercial real estate, business, consumer and construction/land development loans.

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

An offset to net interest income is the provision for loan losses which represents the quarterly charge to operations which is required to adequately provide for probable losses inherent in our loan portfolio.

Noninterest expense consists primarily of compensation and employee benefits, occupancy and equipment, data processing, marketing, postage and supplies, professional services, expenses associated with OREO and deposit insurance premiums. Compensation and employee benefits consist primarily of the salaries paid to our employees, payroll taxes, expenses for retirement benefits, the equity incentive plan and other employee benefits. Occupancy and equipment expenses consist primarily of real estate taxes, depreciation charges, maintenance and costs of utilities. OREO expenses consist of market value adjustments related to real estate that we own as well as maintenance costs, taxes, insurance and gains/losses resulting from the sale of these properties.

Net income for the third quarter ended September 30, 2011 was $623,000, or $0.04 per diluted share, as compared to a net loss of $12.1 million, or $0.69 per diluted share for the quarter ended September 30, 2010. The change in operating results in the third quarter of 2011 as compared to the third quarter of 2010 was primarily the result of a $10.7 million decrease in the provision for loan losses to $1.3 million, a $518,000 increase in noninterest income primarily the result of $479,000 in net gains on sales of investments with no comparable sales activity during the quarter ended September 30, 2010, and decreases of $2.0 million in noninterest expense primarily due to decreases in OREO related expenses and FDIC insurance premiums during the quarter.

For the nine months ended September 30, 2011, the Company had net income of $3.3 million, or $0.19 per diluted share as compared to a net loss of $54.7 million, or $3.14 per diluted share for the comparable period in 2010. The change in operating results for the nine months ended September 30, 2011 as compared to the same period last year was primarily the result of a $46.9 million decrease in the provision for loan losses, a $1.8 million increase in noninterest income primarily the result of $1.7 million in net gains on sales of investments with no comparable sales activity during the nine months ended September 30, 2010, a $4.9 million decrease in noninterest expense primarily due to a $5.4 million decrease in net OREO related expenses (including a $1.6 million increase in net gain on sales of OREO) and a $4.0 million decrease in the provision for federal income taxes as the Company utilized tax loss carry-forwards to offset net income. As a result, we did not recognize any tax expense in our Consolidated Income Statements during the current quarter and nine months ended September 30, 2011.

During the nine months ended September 30, 2011, our total loan portfolio decreased $144.1 million, or 16.1% from December 31, 2010, including a $26.6 million, or 47.1% decrease in construction/land development loans. In addition, our one-to-four family residential loans decreased $52.4 million, or 13.2%, multifamily loans decreased $27.6 million, or 19.0% and commercial real estate loans decreased $35.3 million, or 12.9%, all contributing to the overall decrease in our total loan portfolio.

The five largest borrowing relationships, as of September 30, 2011, in descending order were:

Borrower (1)	Aggregate Amount of Loans at September 30, 2011 (2) (Dollars in thousands)		Number of Loans
Real estate builder	$ 26,528		100
Real estate builder	20,194	(3)	101
Real estate investor	18,197		3
Real estate builder	17,331	(4)	84
Real estate investor	16,625		40
Total	$ 98,875		328

(1) The composition of borrowers represented in the table may change from one period to the next.
(2) Net of undisbursed funds.
(3) Of this amount, $18.8 million are considered impaired loans of which $ 13.3 million are performing and $5.5 million are nonperforming.
(4) Of this amount, $16.5 million are considered impaired loans of which $13.0 million are performing and $3.5 million are nonperforming.

The following table details the breakdown of the types of loans to our five largest borrowing relationships at September 30, 2011:

Borrower	One-to-Four Family Residential (Rental Properties)	Multifamily (Rental Properties)	Commercial (Rental Properties)	Construction/ Land Development (1)	Aggregate Balance of Loans (1)
			(In thousands)		
Real estate builder	$ 16,826	$ -	$ 104	$ 9,598	$ 26,528
Real estate builder (2)	15,249	-	244	4,701	20,194
Real estate investor	-	-	18,197	-	18,197
Real estate builder (3)	16,063	-	823	445	17,331
Real estate investor	10,641	5,037	947	-	16,625
Total	$ 58,779	$ 5,037	$ 20,315	$ 14,744	$ 98,875

(1) Net of undisbursed funds.
(2) Of the $18.8 million loans considered impaired, $13.9 million are one-to-four family residential loans, $4.7 million are construction/land development loans and $200,000 are commercial loans.
(3) Of the $16.5 million loans considered impaired, $15.2 million are one-to-four family residential loans, $500,000 are construction/land development loans and $800,000 are commercial loans.

Some of the builders listed in the above tables, as part of their previous business strategy, retained a certain percentage of their finished homes in their own inventory of permanent investment properties (i.e. one-to-four family rental properties). In the past, these properties were used to enhance the builders' liquidity through rental income and improve their long-term equity position through the appreciation in market value of the properties. Due to the continued, prolonged depressed housing market and the challenging local economy, this business strategy was not sustainable for these builders. As a result, we have incurred losses related to these builders and have significantly reduced our exposure to these builders by $26.3 million at September 30, 2011 as compared to September 30, 2010. We are continuing to work with these builders to further reduce our exposure through workout plans established in 2010. For the three builders included in the previous table, the total one-to-four family rental properties decreased $8.7 million, or 15.3% to $48.1 million at September 30, 2011 from $56.8 million at September 30, 2010.

The following table includes construction/land development loans, net of undisbursed funds, by the five counties that contain our largest loan concentrations at September 30, 2011.

County	Loan Balance (1)	Percent of Loan Balance	Nonperforming Loans	Nonperforming Loans as a Percent of Loan Balance (2)
	(Dollars in thousands)			
King	$ 9,210	32.0 %	$ 1,568	17.0 %
Pierce	5,345	18.5	1,758	32.9
Thurston	4,676	16.2	1,436	30.7
Whatcom (3)	3,635	12.6	3,635	100.0
Kitsap	2,681	9.3	2,612	97.4
All other counties	3,274	11.4	882	26.9
Total	$ 28,821	100.0 %	$ 11,891	41.3 %

(1) Net of undisbursed funds.
(2) Represents the percent of the loan balance by county that is nonperforming.
(3) Represents one loan.

Critical Accounting Policies

Critical accounting policies are those that involve significant judgments and assumptions by management and that have, or could have, a material impact on our income or the carrying value of our assets. The following are our critical accounting policies.

Allowance for Loan and Lease Losses. Management recognizes that loan losses may occur over the life of a loan and that the ALLL must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio. Our methodology for analyzing the ALLL consists of two components: general and specific allowances. The general allowance is determined by applying factors to our various groups of loans. Management considers factors such as charge-off history, current economic conditions in our market areas, borrowers' ability to repay, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, management's experience level, our loan review and grading systems, the value of underlying collateral and the level of problem loans in assessing the ALLL. The specific allowance component is created when management believes that the collectability of a specific loan has been impaired and a loss is probable. The specific reserves are computed using current appraisals, listed sales prices and other available information less costs to complete (if any) and costs to sell the property. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or as future events differ from predictions.

Our Board of Directors approves the provision for loan losses on a quarterly basis. The allowance is increased by the provision for loan losses, which is charged against current period earnings and decreased by the amount of actual loan charge-offs, net of recoveries.

We believe that the accounting estimate related to the ALLL is a critical accounting estimate because it is highly susceptible to change from period-to-period requiring management to make assumptions about probable losses inherent in the loan portfolio. The impact of a sudden large loss could deplete the allowance and potentially require increased provisions to replenish the allowance, which would negatively affect earnings. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution's ALLL and carrying amounts of OREO. Such agencies may require the financial institution to recognize additions to the allowance based on their judgment and information available to them at the time of their examination. For additional information see Item 1A-Risk Factors: "Our provision for loan losses has increased substantially and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could adversely affect our results of operations," in our 2010 Form 10-K.

Valuation of OREO and Foreclosed Assets. Real estate properties acquired through foreclosure or by deed-in-lieu of foreclosure are recorded at the lower of cost or fair value less estimated costs to sell. Fair value is generally determined by management based on a number of factors, including third-party appraisals of fair value in an orderly sale. Accordingly the valuation of OREO is subject to significant external and internal judgment. Any differences between management's assessment of fair value, less estimated costs to sell, and the carrying value of the loan at the date a particular property is transferred into OREO are charged to the ALLL. Management periodically reviews OREO values to determine whether the property continues to be carried at the lower of its recorded book value or fair value, net of estimated costs to sell. Any further decreases in the value of OREO are considered valuation adjustments and trigger a corresponding charge to noninterest expense in the Consolidated Income Statement. Expenses from the maintenance and operations and any gains or losses from the sales of OREO are included in noninterest expense.

Deferred Taxes. Deferred taxes arise from a variety of sources, the most significant being: a) expenses, such as our charitable contribution to the First Financial Northwest Foundation, that can be carried forward to be utilized against profits in future years; b) expenses recognized in our financial statements but disallowed in our tax return until the associated cash flow occurs; and c) write-downs in the value of assets for financial statement purposes that are not deductible for tax purposes until the asset is sold or deemed worthless.

We record a valuation allowance to reduce our deferred tax assets to the amount which can be recognized in line with the relevant accounting standards. The level of deferred tax asset recognition is influenced by management's assessment of our historic and future profitability profile. At each balance sheet date, existing assessments are reviewed and, if necessary, revised to reflect changed circumstances. In a situation where income is less than projected or recent losses have been incurred, the relevant accounting standards require convincing evidence that there will be sufficient future tax capacity.

Other-Than-Temporary Impairments In the Market Value of Investments. Declines in the fair value of any available for sale or held to maturity investment below their cost that is deemed to be other-than-temporary results in a reduction in the carrying amount of the investment to that of fair value. A charge to earnings and an establishment of a new cost basis for the investment is made. Unrealized investment losses are evaluated at least quarterly to determine whether such declines should be considered other-than-temporary and therefore be subject to immediate loss recognition. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the investment security is below the carrying value primarily due to changes in interest rates and where there has not been significant deterioration in the financial condition of the issuer. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other-than-temporary include ratings by recognized rating agencies; the extent and duration of an unrealized loss position; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Comparison of Financial Condition at September 30, 2011 and December 31, 2010

General. Total assets were $1.1 billion at September 30, 2011, a decrease of $53.3 million, or 4.5% from December 31, 2010. Increases in interest-bearing deposits of $116.1 million were offset by decreases in cash on hand and in banks of $2.3 million, net loans receivable of $129.2 million, investment securities of $24.3 million, OREO of $4.9 million and the federal income tax receivable of $5.9 million. Total liabilities were $961.4 million at September 30, 2011, a decrease of $57.8 million, or 5.7% from December 31, 2010. The decline in total liabilities was primarily the result of a decrease of $66.8 million in interest-bearing deposits and $2.9 million in noninterest-bearing deposits, partially offset by a $10.0 million increase in investment transactions payable. Stockholders' equity increased $4.5 million, primarily due to the net income of $3.3 million for the nine months ended September 30, 2011.

Assets. Total assets were $1.1 billion at September 30, 2011, a decrease of $53.3 million, or 4.5% from $1.2 billion at December 31, 2010. The following table details the changes in the composition of our assets.

	Balance at September 30, 2011	Increase / (Decrease) from December 31, 2010	Percentage Increase / (Decrease)
	(Dollars in thousands)		
Cash on hand and in banks	$ 5,159	$ (2,307)	(30.9)%
Interest-bearing deposits	207,040	116,079	127.6
Investments available for sale	140,273	(24,330)	(14.8)
Loans receivable, net	727,226	(129,230)	(15.1)
Premises and equipment, net	19,092	(737)	(3.7)
FHLB stock, at cost	7,413	-	-
Accrued interest receivable	3,972	(714)	(15.2)
Federal income tax receivable	-	(5,916)	(100.0)
OREO	25,201	(4,901)	(16.3)
Prepaid expenses and other assets	5,004	(1,222)	(19.6)
Total assets	$ 1,140,380	$ (53,278)	(4.5)%

Interest-bearing deposits increased $116.1 million to $207.0 million at September 30, 2011 from $91.0 million at December 31, 2010, as a result of $136.8 million in loan repayments, $74.6 million in proceeds from sales of investments and $25.8 million in OREO dispositions. Investments available for sale decreased $24.3 million, or 14.8% to $140.3 million at September 30, 2011 from $164.6 million at December 31, 2010. During the nine months ended September 30, 2011, we sold $72.9 million of investments, primarily fixed-rate, mortgage-backed securities issued by Freddie Mac and Fannie Mae, to recognize $1.7 million in net gains on these securities to support the Bank's profitability in this low interest rate environment. In addition, we received $24.6 million in principal repayments on our investment portfolio. We purchased $47.7 million of variable rate U.S. Government agency securities and $27.0 million of Freddie Mac and Fannie Mae mortgage-backed investments during the nine months ended September 30, 2011 to maintain our liquidity position, improve the Bank's interest rate risk profile and to position our securities portfolio to be more responsive to rising interest rates. Net loans receivable decreased $129.2 million, or 15.1% to $727.2 million at September 30, 2011 from $856.5 million at December 31, 2010. This decrease in net loans resulted from loan repayments of $136.8 million, charge-offs of $10.3 million and transfers of loans into OREO of $20.7 million during the nine months ended September 30, 2011. All of our loan categories decreased during the nine months ended September 30, 2011 except for business loans which increased $3.1 million. OREO decreased $4.9

million, or 16.3% to $25.2 million at September 30, 2011 from $30.1 million at December 31, 2010 as we continue to sell our inventory of foreclosed real estate.

Loan originations for the nine months ended September 30, 2011, totaled $22.2 million and included the following loan breakdown: $7.1 million in one-to-four family residential; $4.2 million in consumer; $2.5 million in commercial real estate; $1.4 million in construction/land development; $5.3 million in multifamily and $1.7 million in business loans.

Deposits. During the first nine months of 2011, deposits decreased $69.7 million to $850.5 million at September 30, 2011. The following table details the changes in our deposits:

	Balance at September 30, 2011 (Dollars in thousands)	Increase / (Decrease) from December 31, 2010	Percentage Increase / (Decrease)
Noninterest-bearing	$ 5,843	$ (2,857)	(32.8) %
NOW	12,427	(1,031)	(7.7)
Statement savings	17,601	2,214	14.4
Money market	176,386	(17,596)	(9.1)
Certificates of deposit	638,288	(50,411)	(7.3)
	$ 850,545	$ (69,681)	(7.6) %

All of our deposit categories decreased except for statement savings as compared to December 31, 2010. The decreases in certificates of deposit of $50.4 million, money market accounts of $17.6 million and noninterest-bearing deposit accounts of $2.9 million comprised the majority of the decrease. The decrease in certificates of deposit was primarily the result of our strategic plan to continue to reduce our cost of funds through our pricing decisions designed to allow higher rate certificates of deposit to run-off. We also chose not to renew our public funds at maturity as they are more expensive to maintain due to additional state collateralization requirements. The decline in public funds represented $27.6 million, or 54.8% of the total decrease in certificates of deposit for the nine months ended September 30, 2011. In addition, customers that were more rate sensitive chose other investment options which contributed to the decline in our deposit balances. We did not have any brokered deposits at September 30, 2011 or December 31, 2010. Public funds totaled $31.1 million at September 30, 2011.

Advances from the FHLB. Total FHLB advances were $93.1 million at September 30, 2011, unchanged from December 31, 2010. During October 2011, we prepaid a $10.0 million fixed-rate advance due to mature in March 2012, at an interest rate of 2.82%. The prepayment penalty was $118,000. The early repayment of this advance was executed in order to utilize some of our excess liquidity and to reduce our cost of funds.

Investment Transactions Payable. During the quarter ended September 30, 2011, we purchased a $10.0 million U.S. Government agency security which settled in October 2011. We were required to record the transaction on the trade date even though the cash payment for the purchase will not be transferred until October 2011.

Stockholders’ Equity. Total stockholders’ equity increased $4.5 million, or 2.6%, to $179.0 million at September 30, 2011 from $174.5 million at December 31, 2010. The increase was primarily the result of our net income for the nine months ended September 30, 2011 of $3.3 million.

Comparison of Operating Results for the Three and Nine Months Ended September 30, 2011 and 2010.

General. Net income was $623,000 for the third quarter of 2011, an increase of $12.7 million from the $12.1 million loss in the comparable quarter in the prior year. Net interest income was $7.9 million and noninterest income was $556,000 for the third quarter of 2011, partially offset by the provision for loan losses of $1.3 million and noninterest expense of $6.5 million. For the nine months ended September 30, 2011, net income was $3.3 million, an increase of $58.0 million from a net loss of $54.7 million for the same period in 2010. The change was primarily the result of decreases in the provision for loan losses of $46.9 million, noninterest expense of $4.9 million and provision for federal income taxes of $4.0 million for the nine months ended September 30, 2011 compared to the first nine months of 2010.

Net Interest Income. Our net interest income for the quarter ended September 30, 2011, decreased $511,000 to $7.9 million, as compared to $8.4 million for the same quarter in 2010. A decrease of $2.0 million in interest expense was offset by a $2.6 million reduction in interest income. Average interest-earning assets decreased $153.7 million to $1.1 billion for the three months ended September 30, 2011, from the same quarter in 2010. Average interest-bearing liabilities decreased $145.5 million to $950.9 million for the third quarter of 2011 compared to the third quarter of 2010. During the same period, our yield on interest-earning assets decreased 26 basis points while our cost of funds decreased 50 basis points. Our interest rate spread for the quarter ended September 30, 2011 increased 24 basis points to 2.67% from 2.43% during the same quarter in 2010. Our net interest margin for the third quarter of 2011 increased 20 basis points to 2.91% from 2.71% for the same quarter last year.

Our net interest income for the nine months ended September 30, 2011 increased $418,000 to $24.9 million, as compared to $24.5 million for the same period in 2010. A decrease of $7.1 million in interest expense was partially offset by a $6.7 million reduction in interest income. Average interest-earning assets decreased $144.0 million for the nine months ended September 30, 2011, from $1.2 billion for the same period in 2010. Average interest-bearing liabilities decreased $117.5 million to $975.1 million for the nine months ended September 30, 2011 from the same nine month period in 2010. The yield on interest-earning assets decreased 16 basis points to 4.78% while our cost of funds decreased 65 basis points increasing our interest rate spread for the first nine months of 2011 by 49 basis points to 2.80% from 2.31% for the same period last year. Our net interest margin for the first nine months of 2011 increased 39 basis points to 3.02% as compared to 2.63% for the same period last year.

The following table sets forth the effects of changes in rates and volumes on our net interest income:

	Three Months Ended September 30, 2011 Compared to September 30, 2010 Increase/(Decrease)			Nine Months Ended September 30, 2011 Compared to September 30, 2010 Increase/(Decrease)		
	Rate	Volume	Total	Rate	Volume	Total
	(In thousands)					
Interest-earning assets:						
Loans receivable, net	$ 782	$ (3,062)	$ (2,280)	$ 2,367	$ (9,167)	$ (6,800)
Investments available for sale	(207)	(121)	(328)	(814)	840	26
Interest-bearing deposits	(5)	52	47	-	83	83
Total net change in income on interest-earning assets	570	(3,131)	(2,561)	1,553	(8,244)	(6,691)
Interest-bearing liabilities:						
NOW	(7)	(1)	(8)	(25)	(1)	(26)
Statement savings	(32)	1	(31)	(97)	6	(91)
Money market	(262)	(54)	(316)	(1,010)	(137)	(1,147)
Certificates of deposit	(715)	(512)	(1,227)	(3,214)	(1,264)	(4,478)
Advances from the FHLB	(104)	(364)	(468)	(314)	(1,053)	(1,367)

Total net change in expense on interest-bearing liabilities	(1,120)	(930)	(2,050)	(4,660)	(2,449)	(7,109)
Change in net interest income	$ 1,690	$ (2,201)	$ (511)	$ 6,213	$ (5,795)	$ 418

Interest Income. Total interest income for the third quarter of 2011 decreased $2.6 million, or 17.1%, to $12.4 million from $15.0 million as compared to the third quarter of 2010. Total interest income for the nine months ended September 30, 2011 decreased $6.7 million, or 14.5% to $39.4 million from $46.1 million as compared to the nine months ended September 30, 2010.

40

The following table compares detailed average interest-earning asset balances, associated yields and resulting changes in interest income for the three months ended September 30, 2011 and 2010:

	Three Months Ended September 30, 2011 Average Balance	2011 Yield	2010 Average Balance	2010 Yield	Increase / (Decrease) in Interest and Dividend Income
	(Dollars in thousands)				
Loans receivable, net	$ 743,439	6.13%	$ 957,529	5.71%	$ (2,280)
Investments available for sale	133,001	2.78	147,304	3.41	(328)
Interest-bearing deposits	200,039	0.25	125,367	0.26	47
FHLB stock	7,413	-	7,413	-	-
Total interest-earning assets	$ 1,083,892	4.59%	$ 1,237,613	4.85%	$ (2,561)

Interest income from loans decreased $2.3 million during the third quarter of 2011 as compared to the same quarter in 2010. The decrease in loan interest income was primarily the result of a decrease in the average loan balance of $214.1 million resulting in a $3.1 million decrease in interest income for the quarter as compared to the third quarter of 2010. This decrease was partially offset by an increase in the average yield on the loan portfolio of 42 basis points, resulting in an increase of $782,000 in interest income. The decrease in the average loan portfolio was due to weaker loan demand, paydowns due to normal borrower activity, short sales, charge-offs and transfers of nonperforming loans to OREO. Interest income on investments available for sale decreased $328,000 to $926,000 for the quarter ended September 30, 2011, compared to $1.3 million for the comparable quarter in 2010. The decrease in interest income from investments available for sale was due to the decrease in the average balance of investments available for sale of $14.3 million, resulting in a decrease of $121,000 in interest income. In addition, the yield earned on investments declined to 2.78% during the third quarter of 2011 from 3.41% for the same quarter in 2010, resulting in a $207,000 decrease in interest income.

The following table compares detailed average interest-earning asset balances, associated yields and resulting changes in interest income for the nine months ended September 30, 2011 and 2010:

	Nine Months Ended September 30, 2011 Average Balance	2011 Yield	2010 Average Balance	2010 Yield	Increase / (Decrease) in Interest and Dividend Income
	(Dollars in thousands)				
Loans receivable, net	$ 784,956	6.07%	$ 999,414	5.67%	$ (6,800)
Investments available for sale	149,596	3.02	123,654	3.63	26
Interest-bearing deposits	158,077	0.25	113,533	0.25	83
FHLB stock	7,413	-	7,413	-	-
Total interest-earning assets	$ 1,100,042	4.78%	$ 1,244,014	4.94%	$ (6,691)

Interest income from loans decreased $6.8 million during the first nine months of 2011 compared to the same period in 2010. The decrease in interest income was due to a decrease in average loan balances of $214.5 million resulting in a decrease in interest income of $9.2 million, partially offset by an increase in the average yield of 40 basis points, or

$2.4 million. Interest income on investments available for sale remained relatively unchanged at $3.4 million for the nine months ended September 30, 2011 and 2010. The average balance of investments available for sale increased $25.9 million for the nine months ended September 30, 2011 from the same period in 2010 which resulted in an $840,000 increase in interest income. The yield on investments available for sale decreased 61 basis points resulting in an $814,000 decline in interest income.

Interest Expense. Total interest expense for the three months ended September 30, 2011 was $4.6 million, a decrease of $2.0 million compared to $6.6 million for the third quarter of 2010.

The following table details average balances, cost of funds and the resulting decrease in interest expense for the nine months ended September 30, 2011 and 2010:

	Three Months Ended September 30, 2011		Three Months Ended September 30, 2010		Increase / (Decrease) in Interest Expense
	Average Balance	Cost	Average Balance	Cost	
	(Dollars in thousands)				
NOW	$ 12,690	0.16%	$ 13,578	0.38%	$ (8)
Statement savings	16,827	0.26	16,523	1.02	(31)
Money market	175,814	0.43	196,945	1.03	(316)
Certificates of deposit	652,549	2.31	727,314	2.75	(1,227)
Advances from the FHLB	93,066	2.53	142,069	2.98	(468)
Total interest-bearing liabilities	$ 950,946	1.92%	$ 1,096,429	2.42%	$ (2,050)

Interest expense on our money market accounts decreased $316,000, primarily as a result of a decrease in the average cost of these funds of 60 basis points or $262,000 to 0.43% from 1.03% for the third quarter of 2011 compared to the same quarter in 2010. The average cost of our certificates of deposit decreased 44 basis points, or $715,000 as compared to the third quarter of 2010 due to maturing certificates repricing to lower rates. The decline in interest expense was also the result of a $74.8 million decrease in the average balance of certificates of deposit, resulting in a $512,000 reduction in interest expense. Interest expense related to our FHLB advances decreased $468,000 primarily as a result of the decrease in the average balance of our advances to $93.1 million as compared to $142.1 million at September 30, 2010, resulting in a $364,000 reduction in interest expense. In addition, our cost of funds for these advances decreased 45 basis points to 2.53% from 2.98% for the third quarter of 2011 compared to the same quarter in 2010, decreasing interest expense by $104,000.

The following table details average balances, cost of funds and the resulting decrease in interest expense for the nine months ended September 30, 2010 and 2011:

	Nine Months Ended September 30, 2011		Nine Months Ended September 30, 2010		Increase / (Decrease) in Interest Expense
	Average Balance	Cost	Average Balance	Cost	
	(Dollars in thousands)				
NOW	$ 12,818	0.18%	$ 13,175	0.44%	$ (26)
Statement savings	16,343	0.38	15,711	1.16	(91)
Money market	182,800	0.57	196,787	1.31	(1,147)
Certificates of deposit	670,116	2.36	726,313	3.00	(4,478)
Advances from the FHLB	93,066	2.50	140,631	2.95	(1,367)
Total interest-bearing liabilities	$ 975,143	1.98%	$ 1,092,617	2.63%	$ (7,109)

Our interest expense for the nine months ended September 30, 2011 decreased $7.1 million to $14.5 million from $21.6 million for the same period in 2010. The average cost of funds for the money market accounts decreased 74 basis points resulting in a $1.0 million reduction in interest expense for the first nine months of 2011 as compared to the same period in 2010. The average balance of our money market accounts decreased $14.0 million, resulting in a further decrease of $137,000 in interest expense as compared to the same period last year. The average cost of our certificates of deposit for the nine months ended September 30, 2011 decreased 64 basis points compared to the first nine months of 2010 resulting in a decline in interest expense of $3.2 million. This decline in interest expense was also affected by a decrease in the average balance of certificates of deposit of $56.2 million, which resulted in an additional $1.3 million decline in interest expense. Interest expense related to advances from the FHLB decreased $1.4 million for the nine months ended September 30, 2011 from the same period in 2010 primarily due to the $47.6 million decline in the average balance of advances. The average cost of funds for our advances decreased 45 basis points during this same period.

Provision for Loan Losses. We establish the ALLL for loan losses at a level we believe is necessary to absorb known and inherent losses that are both probable and reasonably estimable at the date of the financial statements. Our methodology in assessing the ALLL places greater emphasis on factors such as charge-off history, the economy, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, management experience levels, our loan review and grading system and the value of underlying collateral. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or as future events differ from predictions.

During the quarter ended September 30, 2011, management evaluated the adequacy of the ALLL and concluded that a provision of $1.3 million was required for the quarter, a decrease of $10.7 million compared to the same quarter in 2010. This decline was a result of the significant improvement in our nonperforming loans over the past year. Nonperforming loans decreased $62.6 million, or 67.0% to $30.8 million at September 30, 2011 from $93.4 million at September 30, 2010. We have been very proactive in identifying our problem loans and implementing workout strategies. The $1.3 million provision for loan losses represents a $300,000 decrease from the second quarter of 2011. This decrease was primarily the result of the reduction in the amount of charge-offs, a decrease in nonperforming loans of $7.1 million and the relatively unchanged amount of delinquent loans less than 90 days past due which totaled $6.6 million at September 30, 2011.

We believe that the ALLL as of September 30, 2011 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will be proven correct in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. Future changes to the allowance may become necessary based upon changing economic conditions, the level of loan balances or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of our ALLL is subject to review by the Bank's regulators as part of their routine examination process, which may result in the establishment of additional reserves or charge-offs, based upon their judgment of information available to them at the time of their examination.

For the nine months ended September 30, 2011, the provision for loan losses was $4.1 million compared to $51.0 million for the same period in 2010. The provision for loan losses and net charge-offs of $10.0 million during the nine months ended September 30, 2011 resulted in a decrease in the ALLL to $16.6 million from $22.5 million at December 31, 2010. The ALLL as a percent of nonperforming loans increased to 54.0% at September 30, 2011 compared to the following at the dates indicated:

June 30, 2011	March 31, 2011	December 31, 2010	September 30, 2010
44.8%	39.6%	35.8%	30.4%

43

The following table presents a breakdown of our nonperforming assets and as a percent of total assets at the dates indicated:

	September 30, 2011	December 31, 2010	September 30, 2010	Nine Month Increase / (Decrease)	One Year Increase / (Decrease)
			(Dollars in thousands)		
One-to-four family residential (1)	$12,859	$22,688	$37,420	$(9,829)	$(24,561)
Multifamily	638	-	-	638	638
Commercial real estate	5,400	7,306	8,170	(1,906)	(2,770)
Construction/land development	11,891	32,885	47,672	(20,994)	(35,781)
Consumer	44	57	181	(13)	(137)
Total nonperforming loans	30,832	62,936	93,443	(32,104)	(62,611)
OREO	25,201	30,102	22,927	(4,901)	2,274
Total nonperforming assets	$56,033	$93,038	$116,370	$(37,005)	$(60,337)
Nonperforming assets as a percent of total assets	4.9 %	7.8 %	9.1 %		

(1) The majority of these loans are related to investor rental properties.

Nonperforming loans include loans to borrowers who are experiencing deteriorating financial conditions and there is doubt as to the ultimate recoverability of the full principal and interest due the Bank in accordance with the terms of the loan agreement. Nonperforming loans decreased $32.1 million to $30.8 million at September 30, 2011, from $62.9 million at December 31, 2010. This decrease was the result of $16.5 million of loans becoming nonperforming during the nine months ended September 30, 2011 offset by $10.3 million in charge-offs, $17.6 million in short sales and $20.7 million of loans transferred to OREO.

The three largest nonperforming loans in the commercial real estate portfolio at September 30, 2011, consisted of a $943,000 loan secured by four individual rooming/dormitory style houses located in Snohomish County, a $692,000 loan secured by a gas station/convenience store located in Thurston County and a $570,000 loan secured by a warehouse/office building located in King County.

The three largest nonperforming, construction/land development loans included a $3.6 million loan secured by 34 acres intended for a 251-unit development located in Whatcom County. The project consists of 77 detached condominium lots (single-family residences) and vacant land for 174 attached units (multifamily). The second largest nonperforming construction/land development loan is a $1.3 million loan secured by 55 finished lots for residential development, of which, 15 lots have been sold, located in Thurston County. The third largest nonperforming, construction/land development loan is a $1.1 million loan secured by 43 finished lots for residential development, of which, 18 lots have been sold, located in Kitsap County.

Nonperforming assets decreased for the sixth consecutive quarter. At their peak, nonperforming assets reached $166.4 million at March 31, 2010 decreasing to $56.0 million at September 30, 2011, representing a $110.4 million, or 66.3% decrease.

The following table presents a breakdown of our TDRs:

	September 30, 2011	December 31, 2010	September 30, 2010	Nine Month $ Change	One Year $ Change
			(In thousands)		
Performing TDRs:					
One-to-four family residential	$53,029	$45,244	$34,227	$7,785	$18,802
Multifamily	2,512	2,515	2,523	(3)	(11)
Commercial real estate	10,409	10,413	6,071	(4)	4,338
Construction/land development	-	133	-	(133)	-
Consumer	70	70	70	-	-
Total performing TDRs	66,020	58,375	42,891	7,645	$23,129
Nonaccrual TDRs:					
One-to-four family residential	5,185	7,510	14,290	(2,325)	(9,105)
Commercial real estate	1,531	3,428	3,581	(1,897)	(2,050)
Construction/land development	472	5,361	10,516	(4,889)	(10,044)
Total nonaccrual TDRs	7,188	16,299	28,387	(9,111)	(21,199)
Total TDRs	$73,208	$74,674	$71,278	$(1,466)	$1,930

Our TDRs decreased $1.5 million, or 2.0% to $73.2 million at September 30, 2011 as compared to $74.7 million at December 31, 2010. During the first nine months of 2011, we added $10.8 million of new performing TDRs and transferred $8.6 million of nonperforming TDRs to OREO while $2.1 million of nonperforming TDRs were paid-off with the remaining activity relating to principal payments and charge-offs.

As we work with our borrowers to help them through this difficult economic cycle, we explore all options available to minimize our risk of loss. At times, the best option for our customers and the Bank is to modify the loan for a period of time, usually one year or less. These modifications have included lowering the interest rate on the loan for a period of time and/or extending the maturity date of the loan or allowing interest only payments for a period of time. These modifications are granted only when there is a reasonable and attainable workout plan that has been agreed to by the borrower and is in the Bank’s best interest. Of the $73.2 million in TDRs at September 30, 2011, $66.0 million were classified as performing and $7.2 million were not performing according to their restructured terms. Of the $66.0 million of performing TDRs, $33.9 million were related to an “A” note as a result of an “A/B” note workout strategy where the “A” note amount was the current loan balance charged down to result in an acceptable loan to value ratio and positive debt service coverage and the “B” note was charged-off at the time of the restructure.

The largest TDR relationship at September 30, 2011 was $13.8 million (which included both construction/land development loans as well as one-to-four family residential rental properties located in King, Kitsap, Pierce and Thurston Counties). At September 30, 2011, there were no undisbursed funds to that builder in connection with these TDRs.

The following table presents a breakdown of our OREO at September 30, 2011:

	King County	Pierce County	Kitsap County	All other counties	Total OREO	Percent of Total OREO
			(Dollars in thousands)			
One-to-four family residential	$2,874	$4,065	$1,515	$776	$9,230	36.6 %
Commercial real estate	2,643	4,375	1,201	450	8,669	34.4
Construction/land development	1,763	3,982	203	1,354	7,302	29.0
Total OREO	$7,280	$12,422	$2,919	$2,580	$25,201	100.0 %

The following table represents a breakdown of our OREO activity:

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(In thousands)			
Beginning Balance	$25,979	16,493	$30,102	11,835
Loans transferred to OREO	4,787	17,177	20,737	34,843
Capitalized improvements	91	202	181	488
Dispositions of OREO	(5,141)	(2,016)	(24,387)	(19,055)
Market value adjustments	(515)	(8,929)	(1,432)	(5,184)
Ending Balance	$25,201	$22,927	$25,201	$22,927

We sold $5.1 million of OREO during the third quarter of 2011 which was comprised of 24 properties and generated a net gain of $293,000. For the first nine months of 2011 we sold $24.4 million of OREO and generated a net gain of $1.4 million. The three largest OREO properties in terms of market value at September 30, 2011 were a residential development with 45 completed lots valued at $1.5 million, an office/retail building valued at $1.4 million, with both properties located in Pierce County, and an office/retail building valued at $1.3 million located in King County.

During the remainder of 2011, we will focus our efforts on converting nonperforming loans to OREO through foreclosure or deeds in lieu of foreclosure and selling the properties. These properties consist primarily of non-owner occupied and completed one-to-four family residential homes. By taking ownership of these properties, we can convert nonearning assets into earning assets on a more timely basis.

The following table summarizes selected financial data related to our ALLL:

	At or For the Nine Months Ended September 30, 2011		2010	
	(Dollars in thousands)			
Provision for loan losses	$	4,100	$	51,000
Charge-offs	$	10,337	$	56,506
Recoveries	$	337	$	867
ALLL	$	16,634	$	28,400
ALLL as a percent of total loans outstanding at the end of the period, net of undisbursed funds		2.23%		3.00%
ALLL as a percent of nonperforming loans at the end of the period, net of undisbursed funds		53.95%		30.39%
Total nonaccrual and 90 days or more past due loans, net of undisbursed funds	$	30,832	$	93,443
Nonaccrual and 90 days or more past due loans as a percent of total loans, net of undisbursed funds		4.13%		9.87%
Total loans receivable, net of undisbursed funds	$	745,708	$	946,649
Total loans originated, net of undisbursed funds	$	22,203	$	55,339

Noninterest Income. Noninterest income increased $518,000 to $556,000 for the three months ended September 30, 2011 from $38,000 in the comparable quarter in 2010. For the nine months ended September 30, 2011, noninterest income increased $1.8 million to $2.0 million from $146,000 for the same period in 2010.

The following tables provide a detailed analysis of the changes in the components of noninterest income:

	Three Months Ended September 30, 2011	Increase/ (Decrease) from September 30, 2010	Percentage Increase/ (Decrease)
	(Dollars in thousands)		
Service fees on deposit accounts	$ 17	$ (5)	(22.7) %
Loan service fees	59	30	103.5
Net gain on sale of investments	479	479	100.0
Amortization of servicing rights	(24)	13	35.1
Other	25	1	4.2
Total noninterest income	$ 556	$ 518	1,363.2 %

The increase in noninterest income was primarily due to a $479,000 net gain on the sale of $43.1 million of long-term, fixed-rate, mortgage-backed securities during the third quarter of 2011 with no comparable sales in the third quarter of 2010.

	Nine Months Ended September 30, 2011	Increase/ (Decrease) from September 30, 2010	Percentage Increase/ (Decrease)
	(Dollars in thousands)		
Service fees on deposit accounts	$ 65	$ (10)	(13.3) %
Loan service fees	153	35	29.7
Net gain on sale of investments	1,741	1,741	100.0
Amortization of servicing rights	(60)	49	45.0
Other	79	17	27.4
Total noninterest income	$ 1,978	$ 1,832	1,254.8 %

The increase in noninterest income for the nine months ended September 30, 2011 from the comparable period in 2010 was the result of $1.7 million in net gains on the sales of $72.9 million of investments with no comparable sales during the first nine months of 2010.

Noninterest Expense. Noninterest expense decreased $2.0 million during the quarter ended September 30, 2011 to $6.5 million as compared to $8.5 million for the same quarter in 2010. For the nine months ended September 30, 2011 noninterest expense decreased $4.9 million to $19.5 million from $24.4 million for the same nine month period in 2010.

The following tables provide the detail of the changes in noninterest expense:

	Three Months Ended September 30, 2011	Increase/ (Decrease) from September 30, 2010	Percentage Increase/ (Decrease)
	(Dollars in thousands)		
Compensation and benefits	$ 3,544	$ 286	8.8 %
Occupancy and equipment	370	(41)	(10.0)
Professional fees	449	(215)	(32.4)
Data processing	181	(10)	(5.2)
(Gain) loss on sale of OREO property, net	(293)	(88)	42.9
OREO market value adjustments	515	(1,501)	(74.5)
OREO related expenses, net	540	(422)	(43.9)
FDIC/OTS assessments	578	(332)	(36.5)
Insurance and bond premiums	248	98	65.3
Marketing	43	(6)	(12.2)
Other general and administrative	338	244	259.6
Total noninterest expense	$ 6,513	$ (1,987)	(23.4) %

The decrease in noninterest expense for the third quarter of 2011 as compared to the same period in 2010 was primarily a result of the $2.0 million decrease in OREO related expenses (net of gain on sales of OREO property) incurred during the third quarter of 2011 to $762,000 as compared to $2.8 million in the comparable period in 2010. This decrease was attributable to the stabilization of real estate market values in 2011 and the addition, during the second half of 2010, of experienced personnel knowledgeable in evaluating market trends. The combination of these two factors contributed to the increase in the net gain on sales of OREO properties during the quarter ended September 30, 2011 from the same period in 2010. Compensation and benefits expense increased $286,000 as compared to the same quarter last year due predominately to pension expense as a result of a lower than expected yield earned on the underlying investments in the plan and the vesting of new employees into the plan.

	Nine Months Ended September 30, 2011	Increase/ (Decrease) from September 30, 2010	Percentage Increase/ (Decrease)
		(Dollars in thousands)	
Compensation and benefits	$ 10,047	$ 708	7.6 %
Occupancy and equipment	1,167	(93)	(7.4)
Professional fees	1,431	(179)	(11.1)
Data processing	573	40	7.5
(Gain) loss on sale of OREO property, net	(1,427)	(1,645)	(754.6)
OREO market value adjustments	1,432	(3,752)	(72.4)
OREO related expenses, net	2,376	4	0.2
FDIC/OTS assessments	1,900	(105)	(5.2)
Insurance and bond premiums	743	294	65.5
Marketing	154	(16)	(9.4)
Other general and administrative	1,111	(126)	(10.2)
Total noninterest expense	$ 19,507	$ (4,870)	(20.0) %

The decrease in noninterest expense for the nine months ended September 30, 2011 from the comparable period in 2010 was primarily the result of the decrease in net OREO related expenses of $5.4 million to $2.4 million from $7.8 million. The decrease was partially offset by a $708,000 increase in compensation and benefits expenses. Both the decrease in OREO related expenses and the increase in compensation and benefits expenses resulted from the same events as previously described above for the third quarter of 2011.

Federal Income Tax Expense. We did not record any federal income tax expense for the third quarter or the nine months ended September 30, 2011, as we utilized our tax loss carryforward.

Liquidity

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

Our primary sources of funds are from customer deposits, loan repayments, maturing investment securities and advances from the FHLB. These funds, together with equity, are used to make loans, acquire investment securities and other assets and fund continuing operations. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and loan prepayments are greatly influenced by the level of interest rates, economic conditions and competition. At September 30, 2011, certificates of deposit scheduled to mature in one year or less totaled $363.3 million. Historically, we have been able to retain a significant amount of the deposits as they mature. We believe that our current liquidity position and our forecasted operating results are sufficient to fund all of our existing commitments.

While our primary source of funds is our deposits, when deposits are not available to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to advances from the FHLB, wholesale funding, federal funds purchased, dealer repurchase agreements and other short-term alternatives as permissible by regulation. At September 30, 2011, the Bank maintained credit facilities with the FHLB totaling $117.4 million with an outstanding balance of $93.1 million. Effective September 30, 2011, we also have a $10.0 million credit facility with another financial institution with no balance outstanding. For additional information see the Consolidated Statements of Cash Flows in Item 1 of this Form 10-Q.

Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit and lines of credit are not recorded as an asset or liability until the instrument is exercised. At September 30, 2011, we had no commitments to originate loans for sale.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of the collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the customer. The amount and type of collateral required varies, but may include real estate and income-producing commercial properties.

The following table summarizes our outstanding commitments to originate loans, to advance additional amounts pursuant to outstanding lines of credit and to disburse funds related to our construction loans at September 30, 2011.

	Amount of Commitment Expiration - Per Period				
	Total Amounts Committed	Through One Year	After One Through Three Years	After Three Through Five Years	After Five Years
	(In thousands)				
Commitments to originate loans	$1,192	$1,192	$-	$-	$-
Unused portion of lines of credit	8,579	810	2,803	216	4,750
Undisbursed portion of construction loans	2,591	1,821	270	500	-
Total commitments	$12,362	$3,823	$3,073	$716	$4,750

We are from time to time involved in various claims and legal actions arising in the ordinary course of business. There are currently no matters that in the opinion of management would have a material adverse effect on our financial position, results of operations or liquidity.

Among our contingent liabilities are exposures to limited recourse arrangements with respect to sales of whole loans and participation interests.

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

Capital

At September 30, 2011, stockholders' equity totaled $179.0 million, or 15.70% of total assets. Our book value per share of common stock was $9.52 as of September 30, 2011, as compared to $9.28 as of December 31, 2010. Consistent with our goal to operate a sound and profitable financial organization, we actively seek to maintain a "well-capitalized" institution in accordance with regulatory standards. As of September 30, 2011, the Bank exceeded all regulatory capital requirements. Regulatory capital ratios for the Bank only were as follows at September 30, 2011: Tier 1 leverage capital 12.76% (as compared to 10% required under the Order); Tier 1 risk-based capital 22.60%; and Total risk-based capital 23.87% (as compared to 12% required under the Order). The regulatory capital requirements to be considered well capitalized are 10%, 6% and 5%, respectively. The Bank met the financial ratios for "well-capitalized" status at September 30, 2011, however, the Bank is no longer regarded as "well-capitalized" for federal regulatory purposes as a result of the deficiencies cited in the Order. In addition, at September 30, 2011, First Financial Northwest, the parent company of the Bank, had $18.4 million of available cash to increase its investment in the Bank.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is defined as the sensitivity of income and capital to changes in interest rates and other relevant market rates or prices. Our profitability is largely dependent on our net interest income. Consequently, our primary exposure to market risk arises from the interest rate risk inherent in our lending, investment, deposit and borrowing activities. Interest rate risk is the risk to earnings and capital resulting from adverse movements in interest rates. We actively monitor and manage our exposure to interest rate risk.

A number of measures are utilized to monitor and manage interest rate risk, including net interest income and economic value of equity simulation models. We prepare these models on a quarterly basis for review by our Asset Liability Committee ("ALCO"), senior management and Board of Directors. The use of these models requires us to formulate and apply assumptions to various balance sheet items. Assumptions regarding interest rate risk are inherent in all financial institutions and may include, but are not limited to, prepayment speeds on loans and mortgage-backed securities, cash flows and maturities of financial instruments held for purposes other than trading, changes in market conditions, loan volumes and pricing, deposit sensitivities, consumer preferences and management's capital plans. We believe that the data and assumptions used for our models are reasonable representations of our portfolio and possible outcomes under the various interest rate scenarios. Nonetheless, these assumptions are inherently uncertain; therefore, the models cannot precisely estimate net interest income or predict the impact of higher or lower interest rates on net interest income. Actual results may differ significantly from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and specific strategies, among other factors.

Our primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on our net interest income and capital, while structuring the asset and liability components to maximize net interest margin, utilize capital effectively and provide adequate liquidity. We rely primarily on our asset/liability structure to control interest rate risk. We assume a high level of interest rate risk as a result of our business model which calls for us to originate and hold fixed-rate, single-family loans, which by their nature are longer-term than the short-term liabilities of customer deposits and borrowed funds.

Net Interest Income

Our primary source of income is net interest income, which is the difference between interest earned on loans and investments and the interest paid on deposits and borrowings. Like other financial institutions, we are subject to interest rate risk and expect periodic imbalances in the interest rate sensitivities of our assets and liabilities. Over any defined period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities or vice versa. We principally manage interest rate risk by managing the volume and mix of our interest-earning assets and interest-bearing liabilities.

Our income simulation model examines changes in net interest income in which interest rates are assumed to remain at their base level, gradually increase by 100, 200 and 300 basis points over a 12-month period, or decline assuming a gradual 100 basis point reduction in rates. Reductions of rates by 200 and 300 basis points were not reported due to the very low current rate environment and the unlikely nature of rates declining further. Based on information as of September 30, 2011, our model indicated that net interest income over the next 12 months would grow in the increasing rate scenarios of 100, 200 and 300 basis points as well as in the declining 100 basis points scenario.

Our net interest income increases in all three rising rate scenarios. Interest income increases due to our current level of liquidity, which is mainly interest-bearing deposits we hold in other banks and variable rate investment securities. As interest rates rise these investments reprice to reflect higher yields and higher interest income. Our loan portfolio is comprised predominately of fixed-rate products so changing interest rates have minimal affect on the change in interest income earned from our loan portfolio. Interest expense in the rising rate scenario decreases primarily due to higher costing certificates of deposits continuing to reprice to lower rates. If rates were to gradually increase 100 basis points over the next 12 months the weighted-average cost for renewed certificates of deposit would be approximately 1.35%. The current cost of these maturing certificates of deposit is 2.09%. We also receive a benefit from the sensitivity of our interest-bearing deposit liabilities, as the cost of these products does not increase at the same rate that prevailing interest rates increase.

In a declining interest rate environment of 100 basis points, net interest income increases as reductions in interest expense outweigh declines in interest income. In this rate environment our interest-bearing deposits in other banks reprice to lower yields from the current yield of 25 basis points and interest earned on our investment portfolio declines due to prepayments. Interest income from our loan portfolio does not change significantly because of its fixed-rate nature. Our interest expense declines as core deposits and maturing certificates of deposit reprice downwards. The weighted-average cost for renewed certificates of deposit declines to approximately 0.51%, a decrease of 158 basis points compared to the current cost of 2.09%.

During the third quarter of 2011, we completed several transactions to improve the Bank's interest rate risk profile. We sold $43.1 million of fixed-rate, mortgaged-backed securities, purchased $47.7 million of variable rate investment securities and added $22.6 million of interest-bearing deposits primarily from principal and interest payments from out investment and loan portfolios. Together these actions resulted in a significant increase in the level of interest sensitive assets on our balance sheet. Model results reflecting these shifts in interest sensitive assets are included in the table below:

September 30, 2011
Net Interest Income Change

	Basis Point Change in Rates	% Change
	+300	17.0%
	+200	14.7
	+100	12.2
	Base	8.4
	(100)	6.1
(1)	(200)	N/A
(1)	(300)	N/A

(1) The current federal funds rate is 0.25% making a 200 and 300 basis point drop impossible.

The changes indicated by the simulation model represent anticipated changes in net interest income over a 12 month period if rates were to gradually increase or decrease by the specified amount. The simulation assumes that the size of the balance sheet remains stable with no growth or contraction regardless of interest rate movements. Additionally, the tendency for loan and investment prepayments to accelerate in falling interest rate scenarios and slow when interest rates rise are incorporated in the model assumptions.

The rising and falling interest rate scenarios indicate that, if customer loan and deposit preferences do not change in response to further movements of the yield curve, a parallel 300, 200 or 100 basis points increase in rates and a 100 basis points decline in rates over a 12-month period will result in a positive change in our net interest income.

Economic Value of Equity (EVE) Simulation Model Results

The following table illustrates the change in the net portfolio value at September 30, 2011 that would occur in the event of an immediate change in interest rates equally across all maturities. The simulation model results are reported quarterly and are predicated upon a stable balance sheet, with no growth or change in asset or liability mix. Although the net portfolio value measurement provides an indication of our interest rate risk exposure at a particular point in time, such measurement is not intended to and does not provide, a precise forecast.

The EVE analysis goes beyond simulating net interest income for a specified period to estimating the present value of all financial instruments in our portfolio and analyzing how the economic value of the portfolio would be affected by various alternative interest rate scenarios. The portfolio's economic value is calculated by generating principal and interest cash flows for the entire life of all assets and liabilities and discounting these cash flows back to their present values. The assumed discount rate used for each projected cash flow is based on a current market rate, such as a FHLB or Treasury curve and from alternative instruments of comparable risk and duration.

September 30, 2011

Basis Point Change in Rates (Dollars in thousands)		Net Portfolio Value (2) Amount	$ Change	% Change	Net Portfolio as % of Portfolio Value of Assets NPV Ratio (3)	% Change (4)	Market Value of Assets (5)
+300		$ 147,737	$ (50,913)	(25.6) %	13.6 %	(4.4)%	$ 1,083,008
+200		165,242	(33,408)	(16.8)	14.9	(2.9)	1,111,255
+100		183,408	(15,242)	(7.7)	16.1	(1.3)	1,141,113
Base		198,650	-	-	17.0	-	1,169,160
(100)		207,767	9,117	4.6	17.5	0.8	1,187,404
(200)	(1)	N/A	N/A	N/A	N/A	N/A	N/A
(300)	(1)	N/A	N/A	N/A	N/A	N/A	N/A

(1) The current federal funds rate is 0.25%, making a 200 or 300 basis point decrease in rates impossible.
(2) The difference between the present value of discounted cash flows for assets and liabilities represents the net portfolio value or the market value of equity.
(3) Net portfolio value divided by the market value of assets.
(4) The increase or decrease in the net portfolio value divided by the market value of assets (base case).
(5) Calculated based on the present value of the discounted cash flows from assets.

In the simulated upward rate shift of the yield curve, the discount rates used to calculate the present value of assets and liabilities will increase, causing the present values of fixed-rate assets to decline and fixed-rate liabilities to increase. Our EVE simulation model results as of September 30, 2011 indicated that if rates increased 100, 200 or 300 basis points the market value of our assets would decrease. This decrease is largely because of the fixed-rate nature of our loan and investment portfolios. The fair value of our equity would also decrease under all three rising rate shift scenarios. The opposite occurs if rates were to decline. The discount rates used to calculate the present value of assets and liabilities will decrease, causing the present value of fixed-rate assets to increase and fixed-rate liabilities to decrease. If rates were to decrease by 100 basis points, the market value of our assets would increase and the fair value of equity would increase.

If interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth previously. Changes in U.S. Treasury rates in the designated amounts accompanied by changes in the shape of the Treasury yield curve could cause changes to the net portfolio value and net interest income other than those indicated previously.

At September 30, 2011, we had no derivative financial instruments or trading accounts for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. Interest rate risk continues to be one of our primary risks as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

Item 4. Controls and Procedures

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

(a) Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial and Accounting Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2011, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in Internal Controls: In the quarter ended September 30, 2011, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2010.

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

There were no repurchases of equity securities in the third quarter of 2011.

On February 18, 2009, the Board of Directors approved a second stock repurchase plan for the purchase of up to 2,056,752 shares, or approximately 10% of our outstanding shares of common stock. There are 294,400 shares remaining to be repurchased under this plan at September 30, 2011. Any future repurchases of stock would require regulatory approval as required by the Order and the MOU.

Under the terms of the MOU entered into with the OTS on April 14, 2010, the Company agreed, among other things, to provide notice to and obtain a written non-objection from the OTS prior to the Company declaring a dividend or redeeming any capital stock which is now enforced by the FRB as the successor to the OTS. Effective July 21, 2011 the FRB replaced the OTS as the Company's primary regulator.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. [Removed and Reserved]

Item 5. Other Information

Not applicable.

Item 6. Exhibits

3.1 Articles of Incorporation of First Financial Northwest (1)
3.2 Bylaws of First Financial Northwest (1)
4 Form of stock certificate of First Financial Northwest (1)
10.1 Form of Employment Agreement for President and Chief Executive Officer (1)
10.2 Form of Change in Control Severance Agreement for Executive Officers (1)
10.3 Form of First Savings Bank Employee Severance Compensation Plan (1)
10.4 Form of Supplemental Executive Retirement Agreement entered into by First Savings Bank with Victor Karpiak, Harry A. Blencoe
and Robert H. Gagnier (1)
10.5 Form of Financial Institutions Retirement Fund (1)
10.6 Form of 401(k) Retirement Plan (2)

10.7 2008 Equity Incentive Plan (3)
10.8 Forms of incentive and non-qualified stock option award agreements (4)
10.9 Form of restricted stock award agreement (4)
14 Code of Business Conduct and Ethics (5)
21 Subsidiaries of the Registrant
31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act

101 The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income; (4) Consolidated Statements of Cash Flows; and (5) Selected Notes to Consolidated Financial Statements.

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(1) Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-1 (333-143549).

(2) Filed as an exhibit to First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 and incorporated herein by reference.

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

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

(5) Registrant elects to satisfy Regulation S-K §229.406 (c) by posting its code of ethics on its website at www.fsbnw.com.

56

SIGNATURES

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

	First Financial Northwest, Inc.
Date: November 7, 2011	/s/Victor Karpiak Victor Karpiak Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)
Date: November 7, 2011	/s/Kari Stenslie Kari Stenslie Chief Financial Officer (Principal Financial and Accounting Officer)

EXHIBIT INDEX

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