HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 05, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington	91-1857900
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA	98501
(Address of principal executive offices)	(Zip Code)

(360) 943-1500
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer¨ Accelerated filer x
Non-accelerated filer ¨ Smaller reporting company¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date:
As of August 1, 2016 there were 29,971,286 shares of the registrant's common stock, no par value per share, outstanding.

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FORWARD LOOKING STATEMENTS:

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q ("Form 10-Q") contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from the Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares, Inc. and the Washington Banking Company transactions described in this Form 10-Q, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be effected by 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 no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; 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; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; 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 Board of Governors of the Federal Reserve System and of our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, initiate an enforcement action against the Company or our bank subsidiary which could require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements on us, any of which could affect our ability to continue our growth through mergers, acquisitions or similar transactions and adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our Condensed Consolidated Statements of Financial Condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; 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 expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; 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; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission including our Annual Report on Form 10-K for the year ended December 31, 2015.
The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually

known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for future periods to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's operating results and stock price performance.

As used throughout this report, the terms "we", "our", "us", or the "Company" refer to Heritage Financial Corporation and its consolidated subsidiaries, unless the context otherwise requires.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)

	June 30, 2016	December 31, 2015
	(Dollars in thousands)	
ASSETS		
Cash on hand and in banks	$69,216	$63,816
Interest earning deposits	29,729	62,824
Cash and cash equivalents	98,945	126,640
Other interest earning deposits	5,461	6,719
Investment securities available for sale, at fair value	815,920	811,869
Loans held for sale	7,130	7,682
Loans receivable, net	2,524,601	2,402,042
Allowance for loan losses	(28,426)	(29,746)
Total loans receivable, net	2,496,175	2,372,296
Other real estate owned	1,560	2,019
Premises and equipment, net	60,759	61,891
Federal Home Loan Bank stock, at cost	5,700	4,148
Bank owned life insurance	61,571	60,876
Accrued interest receivable	10,535	10,469
Prepaid expenses and other assets	66,000	58,365
Other intangible assets, net	8,091	8,789
Goodwill	119,029	119,029
Total assets	$3,756,876	$3,650,792
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$3,158,906	$3,108,287
Federal Home Loan Bank advances	33,000	—
Junior subordinated debentures	19,571	19,424
Securities sold under agreement to repurchase	16,715	23,214
Accrued expenses and other liabilities	38,626	29,897
Total liabilities	3,266,818	3,180,822
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at June 30, 2016 and December 31, 2015	—	—
Common stock, no par value, 50,000,000 shares authorized; 29,992,236 and 29,975,439 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	358,663	359,451
Retained earnings	119,052	107,960
Accumulated other comprehensive income, net	12,343	2,559
Total stockholders’ equity	490,058	469,970
Total liabilities and stockholders’ equity	$3,756,876	$3,650,792

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share amounts)			
INTEREST INCOME				
Interest and fees on loans	$30,503	$30,554	$60,680	$61,035
Taxable interest on investment securities	2,838	2,328	5,634	5,012
Nontaxable interest on investment securities	1,193	1,048	2,364	2,081
Interest and dividends on other interest earning assets	58	60	149	111
Total interest income	34,592	33,990	68,827	68,239
INTEREST EXPENSE				
Deposits	1,242	1,309	2,496	2,626
Junior subordinated debentures	216	193	426	432
Other borrowings	49	18	60	37
Total interest expense	1,507	1,520	2,982	3,095
Net interest income	33,085	32,470	65,845	65,144
Provision for loan losses	1,120	1,189	2,259	2,397
Net interest income after provision for loan losses	31,965	31,281	63,586	62,747
NONINTEREST INCOME				
Service charges and other fees	3,476	3,687	6,832	6,982
Gain on sale of investment securities, net	201	425	761	969
Gain on sale of loans, net	1,242	1,282	1,971	2,417
Gain on sale of Merchant Visa portfolio	—	—	—	1,650
Other income	1,657	1,487	4,002	3,208
Total noninterest income	6,576	6,881	13,566	15,226
NONINTEREST EXPENSE				
Compensation and employee benefits	14,898	13,842	30,019	28,067
Occupancy and equipment	4,111	3,850	7,947	7,541
Data processing	1,829	1,925	3,621	3,552
Marketing	781	1,063	1,509	1,696
Professional services	833	904	1,678	1,708
State and local taxes	604	569	1,211	1,189
Federal deposit insurance premium	528	523	1,020	1,038
Other real estate owned, net	61	200	472	859
Amortization of intangible assets	363	527	698	1,054
Other expense	2,469	2,676	4,671	5,413
Total noninterest expense	26,477	26,079	52,846	52,117
Income before income taxes	12,064	12,083	24,306	25,856
Income tax expense	3,169	3,358	6,320	7,352
Net income	$8,895	$8,725	$17,986	$18,504
Basic earnings per common share	$0.30	$0.29	$0.60	$0.61
Diluted earnings per common share	$0.30	$0.29	$0.60	$0.61
Dividends declared per common share	$0.12	$0.11	$0.23	$0.21

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Net income	$8,895	$8,725	$17,986	$18,504
Change in fair value of investment securities available for sale, net of tax of $2,267, $(2,062), $5,553 and $(358), respectively	4,203	(3,809)	10,278	(657)
Reclassification adjustment for net gain from sale of investment securities available for sale included in income, net of tax of $(71), $(192), $(267) and $(382), respectively	(130)	(358)	(494)	(712)
Accretion of other-than-temporary impairment on investment securities, net of tax of $0, $1, $0 and $4, respectively	—	100	—	108
Reclassification of remaining unaccreted other-than-temporary impairment upon sale of investment securities held to maturity included in income, net of tax $0, $44, $0 and $44, respectively	—	81	—	81
Other comprehensive income (loss)	4,073	(3,986)	9,784	(1,180)
Comprehensive income	$12,968	$4,739	$27,770	$17,324

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income, net	Total stock-holders' equity
	(In thousands, except per share amounts)				
Balance at December 31, 2014	30,260	$364,741	$86,387	$ 3,378	$454,506
Restricted and unrestricted stock awards issued, net of forfeitures	116	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	43	541	—	—	541
Restricted stock compensation expense	—	716	—	—	716
Net excess tax benefits from vesting of restricted stock	—	90	—	—	90
Common stock repurchased	(464)	(7,723)	—	—	(7,723)
Net income	—	—	18,504	—	18,504
Other comprehensive income, net of tax	—	—	—	(1,180)	(1,180)
Cash dividends declared on common stock ($0.21 per share)	—	—	(6,326)	—	(6,326)
Balance at June 30, 2015	29,955	$358,365	$98,565	$ 2,198	$459,128
Balance at December 31, 2015	29,975	$359,451	$107,960	$ 2,559	$469,970
Restricted and unrestricted stock awards issued, net of forfeitures	115	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	26	390	—	—	390
Restricted stock compensation expense	—	872	—	—	872
Net excess tax benefits from vesting of restricted stock	—	76	—	—	76
Common stock repurchased	(124)	(2,126)	—	—	(2,126)
Net income	—	—	17,986	—	17,986
Other comprehensive income, net of tax	—	—	—	9,784	9,784
Cash dividends declared on common stock ($0.23 per share)	—	—	(6,894)	—	(6,894)
Balance at June 30, 2016	29,992	$358,663	$119,052	$ 12,343	$490,058

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2016	2015
	(In thousands)	
Cash flows from operating activities:		
Net income	$17,986	$18,504
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,483	6,670
Changes in net deferred loan costs, net of amortization	(455)	(1,001)
Provision for loan losses	2,259	2,397
Net change in accrued interest receivable, FDIC indemnification asset, prepaid expenses and other assets, accrued expenses and other liabilities	(3,071)	(6,022)
Restricted stock compensation expense	872	716
Net excess tax benefit from exercise of stock options and vesting of restricted stock	(97)	(90)
Amortization of intangible assets	698	1,054
Gain on sale of investment securities, net	(761)	(969)
Origination of loans held for sale	(57,975)	(66,257)
Gain on sale of loans, net	(1,971)	(2,417)
Gain on sale of Merchant Visa portfolio	—	(1,650)
Proceeds from sale of loans	60,498	67,317
Earnings on bank owned life insurance	(695)	(403)
Valuation adjustment on other real estate owned	383	415
(Gain) loss on sale of other real estate owned, net	(42)	97
Loss on sale or write-off of furniture, equipment and leasehold improvements	244	—
Net cash provided by operating activities	24,356	18,361
Cash flows from investing activities:		
Loans originated, net of principal payments	(126,335)	(98,885)
Maturities of other interest earning deposits	1,248	4,986
Maturities, calls and payments of investment securities available for sale	60,803	56,700
Maturities, calls and payments of investment securities held to maturity	—	1,235
Purchase of investment securities available for sale	(128,046)	(81,755)
Purchase of premises and equipment	(1,088)	(979)
Proceeds from sales of other real estate owned	770	1,639
Proceeds from sales of investment securities available for sale	75,837	63,460
Proceeds from sales of investment securities held to maturity	—	972
Proceeds from redemption of FHLB stock	10,460	8,160
Purchases of FHLB stock	(12,012)	(120)
Purchase of bank owned life insurance	—	(25,000)
Investment in low-income housing tax credit partnership	(2,254)	(244)
Net cash used in investing activities	(120,617)	(69,831)

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	Six Months Ended June 30,	
	2016	2015
	(In thousands)	
Cash flows from financing activities:		
Net increase in deposits	50,619	40,156
FHLB advances	294,500	—
Repayments of FHLB advances	(261,500)	—
Common stock cash dividends paid	(6,894)	(6,326)
Net decrease in securities sold under agreement to repurchase	(6,499)	(11,592)
Proceeds from exercise of stock options	369	541
Net excess tax benefit from exercise of stock options and vesting of restricted stock	97	90
Repurchase of common stock	(2,126)	(7,723)
Net cash provided by financing activities	68,566	15,146
Net decrease in cash and cash equivalents	(27,695)	(36,324)
Cash and cash equivalents at beginning of period	126,640	121,636
Cash and cash equivalents at end of period	$98,945	$85,312
Supplemental disclosures of cash flow information:		
Cash paid for interest	$3,008	$2,923
Cash paid for income taxes	6,000	9,805
Supplemental non-cash disclosures of cash flow information:		
Transfers of loans receivable to other real estate owned	$652	$1,813
Investment in low income housing tax credit partnership and related funding commitment	10,224	—
Purchases of investment securities available for sale not settled	1,164	—

See accompanying Notes to Condensed Consolidated Financial Statements.

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Description of Business, Basis of Presentation, Significant Accounting Policies and Recently Issued Accounting Pronouncements

(a) Description of Business

Heritage Financial Corporation ("Heritage" or the “Company”) is a bank holding company that was incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly-owned subsidiary, Heritage Bank (the “Bank”). The Bank is a Washington-chartered commercial bank and its deposits are insured by the FDIC under the Deposit Insurance Fund. The Bank is headquartered in Olympia, Washington and conducts business from its 63 branch offices located throughout Washington State and the greater Portland, Oregon area. The Bank’s business consists primarily of commercial lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Bank also makes real estate construction and land development loans and consumer loans and originates first mortgage loans on residential properties primarily located in its market area.

The Company has expanded its footprint through mergers and acquisitions. The largest of these transactions was the strategic merger with Washington Banking Company (“Washington Banking”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"). Effective May 1, 2014, Washington Banking merged with and into Heritage and Whidbey merged with and into Heritage Bank and this transaction is referred to herein as the "Washington Banking Merger". In connection with the Washington Banking Merger, Heritage also acquired as a subsidiary the Washington Banking Master Trust, a Delaware statutory business trust. Pursuant to the merger agreement, Heritage assumed the performance and observance of the covenants to be performed by Washington Banking under an indenture relating to $25.0 million in trust preferred securities issued in 2007 and the due and punctual payment of the principal of and premium and interest on such trust preferred securities. For additional information, see Note (8) Junior Subordinated Debentures.

(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the accounting principles generally accepted in the United States (“GAAP”) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. It is recommended that these unaudited Condensed Consolidated Financial Statements and accompanying Notes be read with the audited Consolidated Financial Statements and the accompanying Notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 (“2015 Annual Form 10-K”). In management's opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. In preparing the unaudited Condensed Consolidated Financial Statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the facts and circumstances at the time. Actual results, however, could differ from those estimates.

Certain prior period amounts have been reclassified to conform to the current period’s presentation. Specifically, the Company reclassified $56.6 million of loans receivable previously classified as owner-occupied commercial real estate at December 31, 2015 to non-owner occupied commercial real estate for all comparative tables in Note (3) Loans Receivable. The related allowance for loan losses and provision for loan losses for all historical periods in Note (4) Allowance for Loan Losses were also reclassified. None of these loans were considered impaired at June 30, 2016 or December 31, 2015. The reclassification was due to a review of certain loan products, including hotels, assisted-living housing and self-storage units, for which the Bank determined the risk characteristics were more akin

to non-owner occupied loans. Reclassifications had no effect on prior periods' net income or stockholders’ equity.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of the Company's Condensed Consolidated Financial Statements are disclosed in the 2015 Annual Form 10-K. There have not been any material changes in the Company's significant accounting policies from those contained in the 2015 Annual Form 10-K.

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(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU" or "Update") 2014-09, Revenue from Contracts with Customers, was issued in May 2014. Under this Update, FASB created a new Topic 606 which is in response to a joint initiative of FASB and the International Accounting Standards Board to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and international financial reporting standards that would:

- Remove inconsistencies and weaknesses in revenue requirements.
- Provide a more robust framework for addressing revenue issues.
- Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- Provide more useful information to users of financial statements through improved disclosure requirements.
- Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The original effective date for this Update was deferred in FASB ASU 2015-14 below. The Company is currently evaluating the impact that the Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2015-14, Revenue from Contracts with Customers, was issued in August 2015 and defers the effective date of the above-mentioned FASB ASU 2014-09 for certain entities. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in Update 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is now permitted, but only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is a public business entity and will not early adopt the guidance in Update 2014-09 as permitted in this Update. The Company is currently evaluating the impact that Update 2014-09 will have on its Condensed Consolidated Financial Statements upon adoption.

FASB ASU 2015-16, Business Combinations (Topic 805), was issued in September 2015. Topic 805 requires that an acquirer retrospectively adjust provisional amounts recognized in a business combination, during the measurement period. To simplify the accounting for adjustments made to provisional amounts, the Update requires that the acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amount is determined. The acquirer is required to also record, in the same period’s financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. In addition, an entity is required to present separately on the income statement or disclose in the notes to the financial statements the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The Update did not have an impact on the Company's Condensed Consolidated Financial Statements as of June 30, 2016.

FASB ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10), was issued in January 2016, to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This Update contains several provisions, including but not limited to 1) requiring equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate fair value ; and 4) requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. The Update is effective for public entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact that the Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-02, Leases (Topic 842), was issued in February 2016, to increase transparency and comparability of leases among organizations and to disclose key information about leasing arrangements. The Update sets out the principles for the recognition, measurement, presentation and disclosure of leases for both lessees and lessors. The Update requires lessees to apply a dual approach, classifying leases as either a finance or operating lease. This

classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term greater than 12 months regardless of their classification. All cash payments will be classified within operating activities in the statement of cash flows. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective

approach. The Update is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact that the Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-08, Revenue from Contracts with Customers: Principal versus Agent Considerations, was issued in March 2016 and it clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to principal versus agent considerations. The Update addresses identifying the unit of account and nature of the goods or services as well as applying the control principle and interactions with the control principle. The amendments to the Update do not change the core principle of the guidance. The effective date and transition requirements for this Update are the same as FASB ASU 2014-09. The Company is currently evaluating the impact that the Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-09, Stock Compensation (Topic 718), issued in March 2016, is intended to simplify several aspects of the accounting for share-based payment award transactions. For public business entities, the guidance is effective for annual periods after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. Certain amendments will be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Other amendments will be applied retroactively (such as presentation of employee taxes paid on the statement of cash flows) or prospectively (such as recognition of excess tax benefits on the income statement). The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, was issued in April 2016 which clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to identifying performance obligations and licensing. The effective date and transition requirements for this Update are the same as FASB ASU 2014-09. The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-scope Improvements and Practical Expedients, was issued in May 2016. The amendments in this Update do not change the core principle of the guidance in Topic 606. Rather, the amendments in this Update affect only the narrow aspects of Topic 606. The effective date and transition requirements for this Update are the same as FASB ASU 2014-09. The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2016-13, Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, was issued in June 2016. Commonly referred to as the current expected credit loss model("CECL"), this Update requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net carrying value at the amount expected to be collected on the financial asset. The measurement of expected credit losses is based on relevant information about past events including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. The amendment affects loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial asset not excluded from the scope that have the contractual right to receive cash. The Update replaces the incurred loss impairment methodology, which generally only considered past events and current conditions, with a methodology that reflects the expected credit losses and required consideration of a broader range of reasonable and supportable information to estimate all expected credit losses. The Update additionally addresses purchased assets and introduces the purchased financial asset with a more-than-insignificant amount of credit deterioration since origination ("PCD"). The accounting for these PCD assets is similar to the existing accounting guidance of FASB Accounting Standards Codification ("ASC") 310-30 for

purchased credit impaired ("PCI") assets, except the subsequent improvements in estimated cash flows will be immediately recognized into income, similar to the immediate recognition of subsequent deteriorations in cash flows. Current guidance only allows for the prospective recognition of these cash flow improvements. Because the terminology has been changed to a "more-than-insignificant" amount of credit deterioration, the presumption is that more assets might qualify for this accounting under the Update than those under current guidance. For public business entities, the Update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Entities may early adopt beginning in the years after December 15, 2018. An entity will apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. A prospective transition approach is required for debt securities. An entity with that has previously applied the guidance of ASC 310-30 will prospectively apply the guidance in this Update for PCD assets.

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A prospective transition approach should be used for PCD assets where upon adoption, the amortized cost basis should be adjusted to reflect the addition of the allowance for credit losses. The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements.

(2) Investment Securities

The Company's investment policy is designed primarily to provide and maintain liquidity, generate a favorable return on assets without incurring undue interest rate and credit risk, and complement the Bank's lending activities. Securities are classified as either available for sale or held to maturity when acquired. During the year ended December 31, 2015, the Company transferred all of its investment securities previously classified as held to maturity to available for sale. As a result of the transfer and subsequent sales, the Company believes its held to maturity classification process has been compromised and careful evaluation and analysis will be required going forward in determining when circumstances are suitable for management to assert with a sufficient degree of credibility that it has the intent and ability to hold investments to maturity.

(a) Securities by Type and Maturity

The amortized cost, gross unrealized gains, gross unrealized losses and fair values of investment securities available for sale at the dates indicated were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
June 30, 2016				
U.S. Treasury and U.S. Government-sponsored agencies	$10,567	$ 42	$ (2)	$10,607
Municipal securities	227,064	9,723	(51)	236,736
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	535,529	9,708	(268)	544,969
Collateralized loan obligations	14,508	—	(110)	14,398
Corporate obligations	9,189	10	(61)	9,138
Mutual funds and other equities	45	27	—	72
Total	$796,902	$ 19,510	$ (492)	$815,920
December 31, 2015				
U.S. Treasury and U.S. Government-sponsored agencies	$35,618	$ 145	$ (186)	$35,577
Municipal securities	216,352	4,826	(185)	220,993
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	531,403	2,092	(2,460)	531,035
Collateralized loan obligations	15,251	—	(154)	15,097
Corporate obligations	9,252	—	(139)	9,113
Mutual funds and other equities	45	9	—	54
Total	$807,921	$ 7,072	$ (3,124)	$811,869

There were no securities classified as trading or held to maturity at June 30, 2016 or December 31, 2015.

The amortized cost and fair value of investment securities available for sale at June 30, 2016, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

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	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	$4,846	$4,868
Due after one year through three years	37,037	37,528
Due after three years through five years	57,565	58,761
Due after five years through ten years	246,989	253,375
Due after ten years	450,420	461,316
Investment securities with no stated maturities	45	72
Total	$796,902	$815,920

(b) Unrealized Losses and Other-Than-Temporary Impairments

The following table shows the gross unrealized losses and fair value of the Company's investment securities available for sale that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that the individual securities have been in continuous unrealized loss positions as of June 30, 2016 and December 31, 2015 were as follows:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
June 30, 2016						
U.S. Treasury and U.S. Government-sponsored agencies	$2,998	$(2)	$—	$—	$2,998	$(2)
Municipal securities	7,274	(51)	—	—	7,274	(51)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	20,026	(82)	27,014	(186)	47,040	(268)
Collateralized loan obligations	11,409	(93)	2,989	(17)	14,398	(110)
Corporate obligations	1,987	(12)	3,978	(49)	5,965	(61)
Total	$43,694	$(240)	$33,981	$(252)	$77,675	$(492)
December 31, 2015						
U.S. Treasury and U.S. Government-sponsored agencies	$30,381	$(186)	$—	$—	$30,381	$(186)
Municipal securities	21,929	(174)	2,068	(11)	23,997	(185)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	253,062	(1,987)	43,938	(473)	297,000	(2,460)
Collateralized loan obligations	15,097	(154)	—	—	15,097	(154)
Corporate obligations	8,134	(110)	979	(29)	9,113	(139)
Total	$328,603	$(2,611)	$46,985	$(513)	$375,588	$(3,124)

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The Company has evaluated these investment securities available for sale as of June 30, 2016 and December 31, 2015 and has determined that the decline in their value is temporary. The unrealized losses are primarily due to increases in market interest rates. The fair value of these securities is expected to recover as the securities approach their maturity date. None of the underlying bonds of the municipal securities had credit ratings that were below investment grade levels at June 30, 2016 or December 31, 2015. The Company has the ability and intent to hold the investments until recovery of the securities' amortized cost which may be the maturity date of the securities.

All of the other-than-temporary impairment experienced by the Company has been related to its portfolio of private-residential collateralized mortgage obligations. As there were no private-residential collateralized mortgage obligations at June 30, 2016 and December 31, 2015, the Company did not perform an other-than-temporary impairment analysis for the three and six months ended June 30, 2016 on these securities. For the three and six months ended June 30, 2015, there were no investment securities held to maturity determined to be other-than-temporarily impaired and the Company recorded no unrealized losses for the three and six months ended June 30, 2015 in earnings or other comprehensive income. To analyze the unrealized losses, the Company estimated expected future cash flows of the investments by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordinated interests owned by third parties, to the security. The expected future cash flows of the underlying collateral were determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security were then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount. The Company did not use any impairment assumptions as of June 30, 2015 as the unrealized losses were insignificant.

(c) Pledged Securities

The following table summarizes the amortized cost and fair value of investment securities available for sale that are pledged as collateral for the following obligations at June 30, 2016 and December 31, 2015:

	June 30, 2016		December 31, 2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	$234,096	$240,869	$212,325	$215,284
Federal Reserve Bank of San Francisco and Federal Home Loan Bank to secure borrowing arrangements	—	—	506	506
Repurchase agreements	27,759	28,190	28,500	28,503
Other securities pledged	3,602	3,658	2,125	2,160
Total	$265,457	$272,717	$243,456	$246,453

(3) Loans Receivable

The Company originates loans in the ordinary course of business and has also acquired loans through FDIC-assisted and open bank transactions. Loans acquired in a business combination may be further classified as “purchased” loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as “purchased credit impaired” ("PCI") loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs, and are referred to as "non-PCI" loans.

Disclosures related to the Company's recorded investment in loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs because they are insignificant.

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(a) Loan Origination/Risk Management
The Company categorizes loans in one of the four segments of the total loan portfolio: commercial business, one-to-four family residential, real estate construction and land development and consumer. Within these segments are classes of loans for which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts internal loan reviews and validates the credit risk assessment on a periodic basis and presents the results of these reviews to management. The loan review process complements and reinforces the risk identification and assessment decisions made by loan officers and credit personnel, as well as the Company’s policies and procedures.
A discussion of the risk characteristics of each loan portfolio segment is as follows:
Commercial Business:
There are three significant classes of loans in the commercial portfolio segment: commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.
Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.
Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes of loans in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy. Owner-occupied commercial real estate loans are generally of lower credit risk than non-owner occupied commercial real estate loans as the borrowers' businesses are likely dependent on the properties.
One-to-Four Family Residential:
The majority of the Company’s one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company’s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. Historically, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. From the second quarter of 2013 until May 1, 2014, the Company only originated single-family loans for its loan portfolio. As a result of the Washington Banking Merger, since May 1, 2014 the Company is originating and selling a majority of its single-family mortgages.
Real Estate Construction and Land Development:
The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest.

Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project's completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company's estimates with regard to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often

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involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company's estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being dependent upon successful completion of the construction project, interest rate changes, government regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:

The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process for these loans ensures a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are significantly influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of consumer loans are for relatively small amounts disbursed among many individual borrowers which reduces the credit risk for this type of loan. To further reduce the risk, trend reports are reviewed by management on a regular basis.

As a result of the Washington Banking Merger, the Company is originating indirect consumer loans. These loans are for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in the Company's market areas. The Company has limited its purchase of indirect loans primarily to dealerships that are established and well known in their market areas and to applicants that are not classified as sub-prime.

Loans receivable at June 30, 2016 and December 31, 2015 consisted of the following portfolio segments and classes:

	June 30, 2016	December 31, 2015
	(In thousands)	
Commercial business:		
Commercial and industrial	$624,200	$596,726
Owner-occupied commercial real estate	575,660	572,609
Non-owner occupied commercial real estate	775,646	753,986
Total commercial business	1,975,506	1,923,321
One-to-four family residential	77,274	72,548
Real estate construction and land development:		
One-to-four family residential	49,519	51,752
Five or more family residential and commercial properties	99,423	55,325
Total real estate construction and land development	148,942	107,077
Consumer	321,495	298,167
Gross loans receivable	2,523,217	2,401,113
Net deferred loan costs	1,384	929
Loans receivable, net	2,524,601	2,402,042
Allowance for loan losses	(28,426)	(29,746)
Total loans receivable, net	$2,496,175	$2,372,296

(b) Concentrations of Credit

Most of the Company's lending activity occurs within Washington State, and to a lesser extent Oregon. The Company's primary market areas are concentrated along the I-5 corridor from Whatcom County to Clark County in Washington State and Multnomah County in Oregon, as well as other contiguous markets. The majority of the Company's loan portfolio consists of, in order of balances at June 30, 2016, non-owner occupied commercial real estate, owner-occupied commercial real estate and commercial and industrial. As of June 30, 2016 and December 31, 2015,

there were no concentrations of loans related to any single industry in excess of 10% of the Company’s total loans.

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(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 10. A description of the general characteristics of the risk grades is as follows:

- Grades 1 to 5: These grades are considered "pass grade" and include loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the "pass" category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.
- Grade 6: This grade includes "Watch" loans and is considered a "pass grade". The grade is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.
- Grade 7: This grade includes "Other Assets Especially Mentioned" ("OAEM") loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.
- Grade 8: This grade includes "Substandard" loans in accordance with regulatory guidelines, which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company's accrual policy.
- Grade 9: This grade includes "Doubtful" loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance or have been partially charged-off for the amount considered uncollectible.
- Grade 10: This grade includes "Loss" loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. "Loss" is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Numerical loan grades for loans are established at the origination of the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. The Bank follows the FDIC's Uniform Retail Credit Classification and Account Management Policy for subsequent classification in the event of payment delinquencies or default. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some estimated inherent losses, but to a lesser extent than the other loan grades. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the

Company is almost certain of the losses, and the outstanding principal balances are generally charged-off to the realizable value.

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The following tables present the balance of the loans receivable by credit quality indicator as of June 30, 2016 and December 31, 2015.

	June 30, 2016				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$585,387	$9,289	$ 29,410	$ 114	$624,200
Owner-occupied commercial real estate	548,827	5,279	21,298	256	575,660
Non-owner occupied commercial real estate	729,204	16,590	29,852	—	775,646
Total commercial business	1,863,418	31,158	80,560	370	1,975,506
One-to-four family residential	76,204	—	1,070	—	77,274
Real estate construction and land development:					
One-to-four family residential	42,107	1,260	6,152	—	49,519
Five or more family residential and commercial properties	95,537	—	3,886	—	99,423
Total real estate construction and land development	137,644	1,260	10,038	—	148,942
Consumer	316,041	—	5,454	—	321,495
Gross loans receivable	$2,393,307	$32,418	$ 97,122	$ 370	$2,523,217

	December 31, 2015				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$563,002	$8,093	$ 25,333	$ 298	$596,726
Owner-occupied commercial real estate	544,429	11,662	16,260	258	572,609
Non-owner occupied commercial real estate	699,759	23,447	30,780	—	753,986
Total commercial business	1,807,190	43,202	72,373	556	1,923,321
One-to-four family residential	71,457	—	1,091	—	72,548
Real estate construction and land development:					
One-to-four family residential	44,069	896	6,787	—	51,752
Five or more family residential and commercial properties	50,678	—	4,647	—	55,325
Total real estate construction and land development	94,747	896	11,434	—	107,077
Consumer	291,892	—	6,275	—	298,167
Gross loans receivable	$2,265,286	$44,098	$ 91,173	$ 556	$2,401,113

Potential problem loans are loans classified as OAEM or worse that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem loans may include PCI loans as these loans continue to accrete loan discounts established at acquisition based on the guidance of FASB ASC 310-30. Potential problem loans as of June 30, 2016 and December 31, 2015 were $101.2 million and $110.4 million, respectively. The balance of potential problem loans guaranteed by a governmental agency, which guarantee reduces the Company's credit exposure, was $675,000 and $1.2 million as of June 30, 2016 and December 31, 2015, respectively.

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(d) Nonaccrual Loans

Nonaccrual loans, segregated by segments and classes of loans, were as follows as of June 30, 2016 and December 31, 2015:

	June 30, 2016	December 31, 2015
	(In thousands)	
Commercial business:		
Commercial and industrial	$5,531	$ 5,095
Owner-occupied commercial real estate	3,998	2,027
Non-owner occupied commercial real estate	1,350	—
Total commercial business	10,879	7,122
One-to-four family residential	36	38
Real estate construction and land development:		
One-to-four family residential	2,029	2,414
Five or more family residential and commercial properties	—	—
Total real estate construction and land development	2,029	2,414
Consumer	919	94
Nonaccrual loans	$13,863	$ 9,668

The Company had $2.2 million and $1.1 million of nonaccrual loans guaranteed by governmental agencies at June 30, 2016 and December 31, 2015, respectively.

PCI loans are not included in the nonaccrual loan table above because these loans are accounted for under FASB ASC 310-30, which provides that accretable yield is calculated based on a loan's expected cash flow even if the loan is not performing under its contractual terms.

(e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements.

The balances of past due loans, segregated by segments and classes of loans, as of June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016				
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$2,404	$ 1,513	$ 3,917	$620,283	$624,200
Owner-occupied commercial real estate	1,581	2,390	3,971	571,689	575,660
Non-owner occupied commercial real estate	1,350	—	1,350	774,296	775,646
Total commercial business	5,335	3,903	9,238	1,966,268	1,975,506
One-to-four family residential	—	—	—	77,274	77,274
Real estate construction and land development:					
One-to-four family residential	14	1,965	1,979	47,540	49,519
Five or more family residential and commercial properties	679	—	679	98,744	99,423
Total real estate construction and land development	693	1,965	2,658	146,284	148,942
Consumer	1,799	850	2,649	318,846	321,495
Gross loans receivable	$7,827	$ 6,718	$ 14,545	$2,508,672	$2,523,217

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	December 31, 2015				
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$2,900	$ 2,679	$ 5,579	$591,147	$596,726
Owner-occupied commercial real estate	2,240	2,609	4,849	567,760	572,609
Non-owner occupied commercial real estate	2,177	184	2,361	751,625	753,986
Total commercial business	7,317	5,472	12,789	1,910,532	1,923,321
One-to-four family residential	490	—	490	72,058	72,548
Real estate construction and land development:					
One-to-four family residential	—	2,392	2,392	49,360	51,752
Five or more family residential and commercial properties	118	42	160	55,165	55,325
Total real estate construction and land development	118	2,434	2,552	104,525	107,077
Consumer	3,029	202	3,231	294,936	298,167
Gross loans receivable	$10,954	$ 8,108	$ 19,062	$2,382,051	$2,401,113

There were no loans 90 days or more past due that were still accruing interest as of June 30, 2016 or December 31, 2015, excluding PCI loans.

(f) Impaired loans

Impaired loans include nonaccrual loans and performing troubled debt restructured ("TDR") loans. The balances of impaired loans as of June 30, 2016 and December 31, 2015 are set forth in the following tables.

	June 30, 2016				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$2,166	$ 8,220	$ 10,386	$ 13,330	$ 1,026
Owner-occupied commercial real estate	2,243	2,949	5,192	5,491	424
Non-owner occupied commercial real estate	4,990	6,511	11,501	11,543	859
Total commercial business	9,399	17,680	27,079	30,364	2,309
One-to-four family residential	—	267	267	269	81
Real estate construction and land development:					
One-to-four family residential	2,335	879	3,214	3,886	17
Five or more family residential and commercial properties	—	1,633	1,633	1,633	179
Total real estate construction and land development	2,335	2,512	4,847	5,519	196
Consumer	791	211	1,002	1,046	54
Total	$12,525	$ 20,670	$ 33,195	$ 37,198	$ 2,640

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	December 31, 2015				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$872	$ 8,769	$ 9,641	$ 11,368	$ 1,173
Owner-occupied commercial real estate	—	4,295	4,295	4,342	809
Non-owner occupied commercial real estate	3,696	6,834	10,530	10,539	943
Total commercial business	4,568	19,898	24,466	26,249	2,925
One-to-four family residential	—	275	275	276	85
Real estate construction and land development:					
One-to-four family residential	1,403	2,065	3,468	4,089	66
Five or more family residential and commercial properties	—	1,960	1,960	1,960	203
Total real estate construction and land development	1,403	4,025	5,428	6,049	269
Consumer	48	145	193	200	29
Total	$6,019	$ 24,343	$ 30,362	$ 32,774	$ 3,308

The Company had governmental guarantees of $3.0 million and $1.5 million related to the impaired loan balances at June 30, 2016 and December 31, 2015, respectively.
The average recorded investment of impaired loans for the three and six months ended June 30, 2016 and 2015 are set forth in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Commercial business:				
Commercial and industrial	$10,192	$9,524	$9,933	$12,203
Owner-occupied commercial real estate	5,209	4,186	4,904	3,981
Non-owner occupied commercial real estate	11,665	8,727	11,287	8,446
Total commercial business	27,066	22,437	26,124	24,630
One-to-four family residential	269	242	271	375
Real estate construction and land development:				
One-to-four family residential	3,310	3,669	3,438	4,683
Five or more family residential and commercial properties	1,816	2,020	1,864	2,056
Total real estate construction and land development	5,126	5,689	5,302	6,739
Consumer	977	143	716	488
Total	$33,438	$28,511	$32,413	$32,232

For the three and six months ended June 30, 2016 and 2015, no interest income was recognized subsequent to a loan's classification as nonaccrual. For the three months ended June 30, 2016 and 2015, the Bank recorded $167,000 and $250,000, respectively, of interest income related to performing TDR loans. For the six months ended June 30, 2016 and 2015, the Bank recorded $345,000 and $449,000, respectively, of interest income related to performing TDR loans.

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(g) Troubled Debt Restructured Loans

A TDR loan is a restructuring in which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDRs are considered impaired and are separately measured for impairment under FASB ASC 310-10-35, whether on accrual ("performing") or nonaccrual ("nonperforming") status. The Company has more stringent definitions of concessions and impairment measures for PCI loans which are not in a pool as these loans have known credit deterioration and are generally accreting income at a lower discounted rate as compared to the contractual note rate based on the guidance of FASB ASC 310-30.

The majority of the Bank's TDR loans are a result of granting extensions of maturity on troubled credits which have already been adversely classified. The Bank grants such extensions to reassess the borrower's financial status and to develop a plan for repayment. The second most prevalent concessions are certain modifications with extensions that also include interest rate reductions. Certain TDRs were additionally re-amortized over a longer period of time. These modifications would all be considered a concession for a borrower that could not obtain similar financing terms from another source other than from the Bank.

The financial effects of each modification will vary based on the specific restructure. For the majority of the Bank's TDRs, the loans were interest-only with a balloon payment at maturity. If the interest rate is not adjusted and the modified terms are consistent with other similar credits being offered, the Bank may not experience any loss associated with the restructure. If, however, the restructure involves forbearance agreements or interest rate modifications, the Bank may not collect all the principal and interest based on the original contractual terms. The Bank estimates the necessary allowance for loan losses on TDRs using the same guidance as used for other impaired loans.

The recorded investment balance and related allowance for loan losses of performing and nonaccrual TDR loans as of June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016		December 31, 2015	
	Performing TDRs	Nonaccrual TDRs	Performing TDRs	Nonaccrual TDRs
	(In thousands)			
TDR loans	$19,331	$ 6,618	$20,695	$ 6,301
Allowance for loan losses on TDR loans	1,844	568	2,069	679

The unfunded commitment to borrowers related to TDRs was $428,000 and $551,000 at June 30, 2016 and December 31, 2015, respectively.

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Loans that were modified as TDRs during the three and six months ended June 30, 2016 and 2015 are set forth in the following tables:

	Three Months Ended June 30,			
	2016		2015	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	5	$ 325	13	$ 2,243
Owner-occupied commercial real estate	—	—	3	873
Non-owner occupied commercial real estate	—	—	4	13,695
Total commercial business	5	325	20	16,811
Real estate construction and land development:				
One-to-four family residential	—	—	2	1,038
Five or more family residential and commercial properties	1	1,633	1	418
Total real estate construction and land development	1	1,633	3	1,456
Consumer	2	28	—	—
Total TDR loans	8	$ 1,986	23	$ 18,267

	Six Months Ended June 30,			
	2016		2015	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	13	$ 1,225	19	$ 3,288
Owner-occupied commercial real estate	—	—	4	1,181
Non-owner occupied commercial real estate	1	834	4	13,695
Total commercial business	14	2,059	27	18,164
Real estate construction and land development:				
One-to-four family residential	5	2,349	4	2,543
Five or more family residential and commercial properties	1	1,633	1	418
Total real estate construction and land development	6	3,982	5	2,961
Consumer	5	67	2	142
Total TDR loans	25	$ 6,108	34	$ 21,267

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three and six months ended June 30, 2016 and 2015.

(2) Includes subsequent payments after modifications and reflects the balance as of period end. As the Bank did not forgive any principal or interest balance as part of the loan modification, the Bank's recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification (post-modification).

Of the eight loans modified during the three months ended June 30, 2016, three loans with a total outstanding principal balance of $61,000 had no prior modifications. Of the 25 loans modified during the six months ended June

30, 2016, ten loans with a total outstanding principal balance of $571,000 had no prior modifications. Of the 23 loans modified during the three months ended June 30, 2015, nine loans with a total outstanding principal balance of $4.0 million had no prior modifications. Of the 34 loans modified during the six months ended June 30, 2015, 14 loans with

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a total outstanding principal balance of $5.0 million had no prior modifications. The remaining loans included in the tables above for the three and six months ended June 30, 2016 and 2015 were previously reported as TDRs. The Bank typically grants shorter extension periods to continually monitor these troubled credits despite that the extended date may not be when cash flows from these troubled credits are expected. The Company does not consider these modifications a subsequent default of a TDR as new loan terms, specifically new maturity dates, were granted. The potential losses related to these loans would have been considered in the period the loan was first reported as a TDR and adjusted, as necessary, in the current period based on more recent information. The related specific valuation allowance at June 30, 2016 for loans that were modified as TDRs during the six months ended June 30, 2016 was $378,000.

There were no loans that were modified during the previous twelve months that subsequently defaulted during the three and six months ended June 30, 2016. There were two commercial and industrial loans totaling $1.9 million at June 30, 2015 that were modified during the previous twelve months that subsequently defaulted during the three and six months ended June 30, 2015. Of the two loans that were modified as TDRs and subsequently defaulted, one with outstanding principal balance of $1.8 million defaulted because the borrower did not pay the loan balance at its maturity date during the period. The other TDR subsequently defaulted as the borrower was 90 days delinquent on his scheduled payment.

(h) Purchased Credit Impaired Loans

The Company acquired loans and designated them as PCI loans, which are accounted for under FASB ASC 310-30, in the Washington Banking Merger on May 1, 2014 and in previously completed acquisitions, including the FDIC-assisted acquisitions of Cowlitz Bank ("Cowlitz") and Pierce Commercial Bank ("Pierce") on July 30, 2010 and November 8, 2010, respectively, and the acquisitions of Northwest Commercial Bank ("NCB") on January 9, 2013 and Valley Community Bancshares, Inc. ("Valley") on July 15, 2013.

The following table reflects the outstanding principal balance and recorded investment at June 30, 2016 and December 31, 2015 of the PCI loans:

	June 30, 2016		December 31, 2015	
	Outstanding Principal	Recorded Investment	Outstanding Principal	Recorded Investment
	(In thousands)			
Commercial business:				
Commercial and industrial	$16,108	$ 11,919	$20,110	$ 16,986
Owner-occupied commercial real estate	20,621	18,423	24,730	22,313
Non-owner occupied commercial real estate	28,560	26,593	30,685	27,774
Total commercial business	65,289	56,935	75,525	67,073
One-to-four family residential	5,210	4,958	5,707	5,392
Real estate construction and land development:				
One-to-four family residential	5,499	3,286	6,904	4,121
Five or more family residential and commercial properties	2,971	2,857	3,071	3,207
Total real estate construction and land development	8,470	6,143	9,975	7,328
Consumer	5,680	6,558	6,720	7,126
Gross PCI loans	$84,649	$ 74,594	$97,927	$ 86,919

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On the acquisition dates, the amount by which the undiscounted expected cash flows of the PCI loans exceeded the estimated fair value of the loan is the “accretable yield.” The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the PCI loans.

The following table summarizes the accretable yield on the PCI loans for the three and six months ended June 30, 2016 and 2015.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In thousands)			
Balance at the beginning of the period	$16,276	$22,325	$17,592	$21,092
Accretion	(1,305)	(1,828)	(2,722)	(3,738)
Disposal and other	(821)	(1,766)	(2,430)	(2,404)
Change in accretable yield	1,209	—	2,919	3,781
Balance at the end of the period	$15,359	$18,731	$15,359	$18,731

(4) Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to provide for probable incurred credit losses in the loan portfolio. The methodology for calculating the allowance for loan losses is completed on loans originated by the Bank and on loans purchased in mergers and acquisitions. The FDIC shared-loss agreements for loans purchased in mergers and acquisitions were terminated on August 4, 2015. Prior to their termination, when a credit deterioration occurred subsequent to the acquisition on loan that was covered by the FDIC shared-loss agreements, a provision for loan losses was charged to earnings for the full amount of the impairment, without regard to the coverage of the FDIC shared-loss agreements.

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The following tables details the activity in the allowance for loan losses disaggregated by segment and class for the three and six months ended June 30, 2016:

	Balance at Beginning of Period	Charge-offs	Recoveries	Provision for Loan Losses	Balance at End of Period
	(In thousands)				
Three Months Ended June 30, 2016					
Commercial business:					
Commercial and industrial	$9,830	$ (1,392)	$ 85	$ 1,447	$9,970
Owner-occupied commercial real estate	4,092	(398)	—	(116)	3,578
Non-owner occupied commercial real estate	7,557	(350)	—	(283)	6,924
Total commercial business	21,479	(2,140)	85	1,048	20,472
One-to-four family residential	1,087	—	1	(138)	950
Real estate construction and land development:					
One-to-four family residential	804	—	—	(50)	754
Five or more family residential and commercial properties	1,067	(1)	—	211	1,277
Total real estate construction and land development	1,871	(1)	—	161	2,031
Consumer	4,756	(467)	161	366	4,816
Unallocated	474	—	—	(317)	157
Total	$29,667	$ (2,608)	$ 247	$ 1,120	$28,426
Six Months Ended June 30, 2016					
Commercial business:					
Commercial and industrial	$9,972	$ (2,570)	$ 359	$ 2,209	$9,970
Owner-occupied commercial real estate	4,370	(450)	—	(342)	3,578
Non-owner occupied commercial real estate	7,722	(350)	—	(448)	6,924
Total commercial business	22,064	(3,370)	359	1,419	20,472
One-to-four family residential	1,157	—	2	(209)	950
Real estate construction and land development:					
One-to-four family residential	1,058	(100)	83	(287)	754
Five or more family residential and commercial properties	813	(54)	—	518	1,277
Total real estate construction and land development	1,871	(154)	83	231	2,031
Consumer	4,309	(798)	299	1,006	4,816
Unallocated	345	—	—	(188)	157
Total	$29,746	$ (4,322)	$ 743	$ 2,259	$28,426

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The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company's impairment method as of June 30, 2016.

	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	PCI Loans	Total Allowance for Loan Losses
	(In thousands)			
Commercial business:				
Commercial and industrial	$1,026	$ 7,175	$1,769	$ 9,970
Owner-occupied commercial real estate	424	1,757	1,397	3,578
Non-owner occupied commercial real estate	859	4,232	1,833	6,924
Total commercial business	2,309			