

HERITAGE FINANCIAL CORP /WA/  
Form 10-K  
March 11, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934  
For the fiscal year ended December 31, 2013  
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 (I.R.S. Employer  
incorporation or organization) 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)  
Securities registered pursuant to Section 12(b) of the Act:  
Title of each class  
Common Stock  
Securities registered pursuant to Section 12(g) of the Act:  
None

Name of each exchange on which registered  
NASDAQ Stock Market LLC

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was \$208,300,000 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2013.

The registrant had 16,216,367 shares of common stock outstanding as of February 25, 2014.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive Proxy Statement for the 2014 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

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PART 1

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the "Company" or "Heritage") is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a state chartered savings bank to a state chartered commercial bank and changed its legal name from Heritage Savings Bank to Heritage Bank (the "Bank"). Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a nationally chartered commercial bank to a state chartered commercial bank. In June 2006, the Company completed the acquisition of Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A., at which time Washington State Bank, N.A. was merged into Heritage Bank.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the Federal Deposit Insurance Corporation (the "FDIC"), pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered commercial bank headquartered in Longview, Washington (the "Cowlitz Acquisition"). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. The acquisition also included the Trust Services Division of Cowlitz Bank. In 2013, the Company consolidated three of these branches into existing Heritage Bank branches. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington (the "Pierce Commercial Acquisition"). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010. On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank ("NCB"), a full service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State (the "NCB Acquisition"). The acquisition of NCB was completed on January 9, 2013, at which time NCB was merged with and into Heritage Bank. The Lakewood branch was subsequently consolidated with an existing Heritage Bank branch in 2013. On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley" or "Valley Community Bancshares") and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the "Valley Acquisition") and its eight branches. The Valley Acquisition was completed on July 15, 2013. Subsequently, four of these branches were consolidated into existing branches and closed as of December 31, 2013. On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013. Central Valley Bank now operates as a division of Heritage Bank.

On October 23, 2013, the Company, along with the Bank, and Washington Banking Company ("Washington Banking") and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"), jointly announced the signing of a merger agreement pursuant to which Heritage and Washington Banking will enter into a strategic merger with Washington Banking merging into Heritage. Immediately following the merger, Whidbey will merge into the Bank. Washington Banking branches will adopt the Heritage Bank name in all markets, with the exception of six branches in Whidbey Island markets which will continue to operate using the Whidbey Island Bank name. The corporate headquarters of the combined company will be in Olympia, Washington. The merger is anticipated to be completed in the second quarter of 2014. For additional information on this proposed merger, see Note 22 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary Heritage Bank. The deposits of the Bank are insured by the FDIC. Heritage Bank is headquartered in Olympia, Washington and conducts business in its thirty-five branch offices located in Washington and the greater

Portland, Oregon area.

Our business consists primarily of lending and deposit relationships with small businesses and their owners in our market areas, and attracting deposits from the general public. We also make real estate construction and land development loans, one-to-four family residential loans, and consumer loans. Historically the Bank would originate for sale purposes first mortgage loans on residential properties but this operation ceased in the second quarter of 2013. The Company was a participant in the U.S. Department of the Treasury's ("Treasury") Troubled Asset Relief Program ("TARP") Capital Purchase Plan, pursuant to which the Company sold (i) 24,000 shares of the Company's

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Fixed Rate Cumulative Perpetual Preferred Stock, Series A (“Series A Preferred Stock”) and (ii) a warrant (the “Warrant”) to purchase 276,074 shares of the Company’s common stock at \$13.04 per share for an aggregate purchase price of \$24.0 million in cash. Effective December 22, 2010, the Company redeemed all of the Series A Preferred Stock held by the Treasury. Effective August 17, 2011, the Company repurchased the Warrant and has no other obligations under TARP. For additional information, see Note 17 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and its thirty-five branch offices located along the I-5 corridor throughout Washington and the greater Portland, Oregon area. We additionally have offices located in eastern Washington primarily in the Yakima county.

Lending Activities

General. Lending activities are conducted through Heritage Bank. Our focus is on commercial business lending. We also originate consumer loans, real estate construction and land development loans and one-to-four family residential loans. Commercial and industrial loans, including owner occupied commercial real estate loans, totaled \$494.4 million, or 50.6% of total originated loans, as of December 31, 2013, and \$465.7 million, or 53.3% of total originated loans, as of December 31, 2012 and non-owner occupied commercial real estate totaled \$354.5 million, or 36.3%, as of December 31, 2013 and \$265.8 million, or 30.4% of total originated loans, as of December 31, 2012. One-to-four family residential loans totaled \$39.2 million, or 4.0% of total originated loans, at December 31, 2013, and \$38.8 million, or 4.4% of total originated loans, at December 31, 2012. Real estate construction and land development loans totaled \$63.8 million, or 6.5% of total originated loans, at December 31, 2013, and \$77.3 million, or 8.8% of total originated loans, at December 31, 2012.

Our loans are originated under policies that are reviewed and approved annually by our board of directors. In addition, we have established internal lending guidelines that are updated as needed. These policies and guidelines address underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely perform internal loan reviews of our loan portfolio to check for credit quality, proper documentation and compliance with laws and regulations.

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The following table provides information about our originated loan portfolio by type of loan for the dates indicated. These balances are prior to deduction for the allowance for loan losses.

	December 31, 2013		2012		2011		2010		2009	
	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)
(Dollars in thousands)										
Originated loans:										
Commercial business:										
Commercial and industrial(1)	\$494,362	50.6 %	\$465,734	53.3 %	\$440,471	52.5 %	\$392,301	52.8 %	\$408,622	52.8 %
Non-owner occupied commercial real estate(1)	354,451	36.3	265,835	30.4	251,049	30.0	221,739	29.9	194,613	25.2
Total commercial business	848,813	86.9	731,569	83.7	691,520	82.5	614,040	82.7	603,235	78.0
One-to-four family residential(2)	39,235	4.0	38,848	4.4	37,960	4.5	47,505	6.5	53,623	7.0
Real estate construction and land development:										
One-to-four family residential	18,593	1.9	25,175	2.9	22,369	2.7	29,377	4.0	46,060	6.0
Five or more family residential and commercial properties	45,184	4.6	52,075	5.9	54,954	6.6	28,588	3.8	49,665	6.4
Total real estate construction and land development(3)	63,777	6.5	77,250	8.8	77,323	9.3	57,965	7.8	95,725	12.4
Consumer	28,130	2.9	28,914	3.3	32,981	3.9	23,832	3.2	21,261	2.8
Gross originated loans	979,955	100.3	876,581	100.2	839,784	100.2	743,342	100.2	773,844	100.2
Less: deferred loan fees	(2,670 )	(0.3 )	(2,096 )	(0.2 )	(1,860 )	(0.2 )	(1,323 )	(0.2 )	(1,597 )	(0.2 )
Total originated loans	\$977,285	100.0%	\$874,485	100.0%	\$837,924	100.0%	\$742,019	100.0%	\$772,247	100.0%

(1) Commercial and industrial loans include owner-occupied commercial real estate



- (2) Excludes loans held for sale of \$0, \$1.7 million, \$1.8 million, \$764,000 and \$825,000 as of December 31, 2013, 2012, 2011, 2010 and 2009, respectively.
- (3) Balances are net of undisbursed loan proceeds
- (4) Percent of total originated loan balance

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The following table provides information about our purchased covered loan portfolio by type of loan for the years ended December 31, 2013, 2012, 2011 and 2010. There were no purchased covered loans for the year ended December 31, 2009. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31, 2013		2012		2011		2010		
	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	
	(Dollars in thousands)								
Purchased covered loans:									
Commercial business:									
Commercial and industrial(1)	\$39,056	61.3	% \$60,577	68.6	% \$76,674	70.1	% \$92,265	71.7	%
Non-owner occupied commercial real estate(1)	14,625	22.9	13,028	14.7	15,753	14.4	17,576	13.6	
Total commercial business	53,681	84.2	73,605	83.3	92,427	84.5	109,841	85.3	
One-to-four family residential Real estate construction and land development:	4,777	7.5	5,027	5.7	5,197	4.8	6,224	4.8	
One-to-four family residential	1,556	2.4	4,433	5.0	5,786	5.3	5,876	4.6	
Total real estate construction and land development(2)	1,556	2.4	4,433	5.0	5,786	5.3	5,876	4.6	
Consumer	3,740	5.9	5,265	6.0	5,947	5.4	6,774	5.3	
Gross purchased covered loans	\$63,754	100.0	% \$88,330	100.0	% \$109,357	100.0	% \$128,715	100.0	%

(1)Commercial and industrial loans include owner-occupied commercial real estate

(2)Balances are net of undisbursed loan proceeds

(3)Percent of total purchased covered loans

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The following table provides information about our purchased non-covered loan portfolio by type of loan for the years ended December 31, 2013, 2012, 2011 and 2010. There were no purchased non-covered loans for the year ended December 31, 2009. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31, 2013		2012		2011		2010		
	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	
(Dollars in thousands)									
Purchased non-covered loans:									
Commercial business:									
Commercial and industrial(1)	\$123,487	64.7	% \$37,974	59.2	% \$52,659	59.8	% \$77,815	59.4	%
Non-owner occupied commercial real estate(1)	45,528	23.9	11,019	17.2	12,833	14.5	18,435	14.0	
Total commercial business	169,015	88.6	48,993	76.4	65,492	74.3	96,250	73.4	
One-to-four family residential	3,847	2.0	3,040	4.7	2,743	3.1	4,986	3.8	
Real estate construction and land development:									
One-to-four family residential	1,131	0.6	513	0.8	1,381	1.6	3,816	2.9	
Five or more family residential and commercial properties	3,471	1.8	864	1.4	1,078	1.2	1,244	1.0	
Total real estate construction and land development(2)	4,602	2.4	1,377	2.2	2,459	2.8	5,060	3.9	
Consumer	13,417	7.0	10,713	16.7	17,420	19.8	24,753	18.9	
Gross purchased non-covered loans	\$190,881	100.0	% \$64,123	100.0	% \$88,114	100.0	% \$131,049	100.0	%

(1)Commercial and industrial loans include owner-occupied commercial real estate

(2)Balances are net of undisbursed loan proceeds

(3)Percent of total purchased non-covered loans

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The following table presents at December 31, 2013 (i) the aggregate contractual maturities of loans in the named categories of our originated loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

	Maturing			Total
	Within 1 year (In thousands)	Over 1-5 years	After 5 years	
Commercial business	\$141,527	\$206,660	\$500,626	\$848,813
Real estate construction and land development	53,661	5,468	4,648	63,777
Total	\$195,188	\$212,128	\$505,274	\$912,590
Fixed rate loans, due after 1 year		\$123,266	\$160,110	\$283,376
Variable or adjustable rate loans, due after 1 year		88,862	345,164	434,026
Total		\$212,128	\$505,274	\$717,402

**Commercial Business Lending**

We offer different types of commercial business loans, including lines of credit, term equipment financing and term owner-occupied commercial real estate loans. We also originate loans that are guaranteed by the Small Business Administration (“SBA”), for which Heritage Bank is a “preferred lender.” Before extending credit to a business we analyze the borrower’s management ability, financial history, including cash flow of the borrower and all guarantors, and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower’s global cash flow and performing necessary financial due diligence.

At December 31, 2013 we had \$848.8 million, or 86.9%, of our total originated loans receivable in commercial business loans with an average loan size of approximately \$303,000, excluding zero outstanding balance loans. We originate commercial real estate loans within our primary market areas with a preference for loans secured by owner-occupied properties. Our underwriting standards require that commercial real estate loans not exceed 75% of the lower of appraised value at origination or cost of the underlying collateral. Cash flow coverage to debt servicing requirements is generally a minimum of 1.15 times for five or more family residential loans and 1.25 times for commercial real estate loans. Cash flow coverage is calculated using an “underwriting” interest rate that is higher than the note rate.

Commercial real estate loans typically involve a greater degree of risk than one-to-four family residential loans. Payments on loans secured by commercial real estate properties are dependent on successful operation and management of the properties and repayment of these loans may be affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by determining the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from the owners of the collateral after a thorough review of personal financial statements. In addition, we review our commercial real estate loan portfolio annually for performance of individual loans, and stress-test loans for potential changes in interest rates, occupancy, and collateral values.

See “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Repayment of our commercial business loans consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.” See also “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Our non-owner commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers.”

**One-to-Four Family Residential Loans**

The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that one-to-four family residential 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 typically range from 15 to 30 years. Until the second quarter of 2013, we sold a significant portion of

our one-to-four family residential loans in the secondary market.

See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Asset/Liability Management.”

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We originate one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks present in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands.

We further endeavor to limit our construction lending risk through adherence to strict underwriting guidelines and procedures. Speculative construction loans are short term in nature and priced with a variable rate of interest. We require builders to have tangible equity in each construction project and have prompt and thorough documentation of all draw requests, and we inspect the project prior to paying any draw requests.

See “Item 1A. Risk Factors—Our loan portfolio is concentrated in loans with a higher risk of loss—Our real estate construction and land development loans are based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate.”

**Origination and Sales of One-to-Four Family Residential Loans**

Historically, as part of the asset/liability management strategy, we sold a significant portion of our one-to-four family residential loans into the secondary market. We discontinued this strategy in the second quarter of 2013, which also set forth a reduction in mortgage department staffing. Currently, all mortgage loan originations are retained in the Bank's portfolio.

When we sold mortgage loans, we typically sold the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced a minimal \$49,000 and \$84,000 in mortgage loans for others as of December 31, 2012 and 2011, respectively. We did not service any mortgage loans for others as of December 31, 2013.

The following table presents summary information concerning our origination and sale of our one-to-four family residential loans and the gains from the sale of loans.

	Years Ended December 31,				
	2013	2012	2011	2010	2009
	(In thousands)				
One-to-four family residential loans:					
Originated(1)	\$18,867	\$35,730	\$23,865	\$18,605	\$34,183
Sold	8,460	21,187	15,888	16,187	25,338
Gains on sales of loans, net(2)	142	295	285	226	288

(1) Includes loans originated for our loan portfolio or for sale in the secondary market.

(2) Excludes gains on sales of SBA loans.

**Commitments and Contingent Liabilities**

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our Consolidated Financial Statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments.

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The following table presents outstanding commitments to extend credit, including letters of credit, at the dates indicated:

	December 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	\$ 169,079	\$ 126,162
Owner-occupied commercial real estate	2,812	2,151
Non-owner occupied commercial real estate	2,405	7,006
Total commercial business	174,296	135,319
One-to-four family residential	45	—
Real estate construction and land development:		
One-to-four family residential	12,236	4,662
Five or more family residential and commercial properties	20,720	26,301
Total real estate construction and land development	32,956	30,963
Consumer	27,480	34,525
Total outstanding commitments	\$234,777	\$200,807

#### Delinquencies and Nonperforming Assets

**Delinquency Procedures.** We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the due date.

If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property. We may negotiate and accept a repayment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is sold at a public sale and we bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan relative to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower's ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us is classified as other real estate owned until it is sold. When property is acquired, it is recorded at the estimated fair value (less costs to sell) at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property's net realizable value. If the estimated realizable value of the other real estate owned property declines after the acquisition date, the adjustment to the value is charged to other real estate owned expense, net.

Delinquencies in the commercial business loan portfolio are handled by the assigned loan officer. Generally, notices are sent and personal contact is made with the borrower when the loan is 15 days past due. Loan officers are responsible for collecting loans they originate or which are assigned to them. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program or take other actions as circumstances warrant.

**Classification of Loans.** Federal regulations require that the Bank periodically evaluates the risks inherent in its loan portfolio. In addition, the Division of Banks of the Washington State Department of Financial Institutions ("Division") and the FDIC have the authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful, and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful loans have the weaknesses of Substandard loans, with additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high probability of some loss in loans classified