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Waterstone Financial, Inc.
Form 10-Q
October 30, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-Q

T Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2018

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 001-36271

WATERSTONE FINANCIAL, INC.
(Exact name of registrant as specified in its charter)

Maryland 90-1026709
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

11200 W. Plank Court Wauwatosa, Wisconsin 53226
(Address of principal executive offices) (Zip Code)

(414) 761-1000
(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 T No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes T 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", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer T Non-accelerated filer Smaller reporting company
Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No T

The number of shares outstanding of the issuer's common stock, \$0.01 par value per share, was 28,829,339 at October 29, 2018.

WATERSTONE FINANCIAL, INC.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	(Unaudited)	
	September 30, 2018	December 31, 2017
	(Dollars In Thousands, except share and per share data)	
Assets		
Cash	\$32,966	\$22,306
Federal funds sold	18,352	17,034
Interest-earning deposits in other financial institutions and other short term investments	7,538	9,267
Cash and cash equivalents	58,856	48,607
Securities available for sale (at fair value)	179,076	199,707
Loans held for sale (at fair value)	192,674	149,896
Loans receivable	1,357,656	1,291,814
Less: Allowance for loan losses	13,226	14,077
Loans receivable, net	1,344,430	1,277,737
Office properties and equipment, net	22,417	22,941
Federal Home Loan Bank stock (at cost)	19,575	16,875
Cash surrender value of life insurance	67,198	65,996
Real estate owned, net	2,170	4,558
Prepaid expenses and other assets	33,007	20,084
Total assets	\$1,919,403	\$1,806,401
Liabilities and Shareholders' Equity		
Liabilities:		
Demand deposits	\$130,969	\$129,597
Money market and savings deposits	159,742	148,804
Time deposits	713,739	688,979
Total deposits	1,004,450	967,380
Borrowings	451,132	386,285
Advance payments by borrowers for taxes	30,460	4,876
Other liabilities	28,717	35,756
Total liabilities	1,514,759	1,394,297
Shareholders' equity:		
Preferred stock (par value \$.01 per share)		
Authorized - 50,000,000 shares in 2018 and in 2017, no shares issued	-	-
Common stock (par value \$.01 per share)		
Authorized - 100,000,000 shares in 2018 and in 2017		
Issued - 29,049,939 in 2018 and 29,501,346 in 2017		
Outstanding - 29,049,939 in 2018 and 29,501,346 in 2017	291	295
Additional paid-in capital	329,743	326,655
Retained earnings	184,697	183,358
Unearned ESOP shares	(18,101)	(18,991)
Accumulated other comprehensive loss, net of taxes	(3,808)	(477)
Cost of shares repurchased (6,583,837 shares at September 30, 2018 and 6,030,900 shares at December 31, 2017)	(88,178)	(78,736)

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Total shareholders' equity	404,644	412,104
Total liabilities and shareholders' equity	\$1,919,403	\$1,806,401

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In Thousands, except per share amounts)			
Interest income:				
Loans	\$17,340	\$15,855	\$49,498	\$45,078
Mortgage-related securities	643	647	1,925	2,021
Debt securities, federal funds sold and short-term investments	1,063	951	2,949	2,680
Total interest income	19,046	17,453	54,372	49,779
Interest expense:				
Deposits	3,063	1,981	8,087	5,614
Borrowings	2,133	2,439	5,574	6,756
Total interest expense	5,196	4,420	13,661	12,370
Net interest income	13,850	13,033	40,711	37,409
Provision for loan losses	40	20	(1,060)	(1,166)
Net interest income after provision for loan losses	13,810	13,013	41,771	38,575
Noninterest income:				
Service charges on loans and deposits	442	300	1,332	1,148
Increase in cash surrender value of life insurance	695	688	1,496	1,476
Loss on sale of securities	-	-	-	(107)
Mortgage banking income	32,653	31,863	88,930	92,774
Other	272	203	805	941
Total noninterest income	34,062	33,054	92,563	96,232
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	27,453	26,153	74,670	73,732
Occupancy, office furniture, and equipment	2,751	2,533	7,995	7,587
Advertising	1,224	821	3,084	2,414
Data processing	809	623	2,057	1,854
Communications	412	394	1,229	1,170
Professional fees	583	629	1,930	1,953
Real estate owned	(128)	(20)	63	258
FDIC insurance premiums	131	129	361	366
Other	3,191	3,054	9,921	10,227
Total noninterest expenses	36,426	34,316	101,310	99,561
Income before income taxes	11,446	11,751	33,024	35,246
Income tax expense	2,743	4,362	7,948	12,397
Net income	\$8,703	\$7,389	\$25,076	\$22,849
Income per share:				
Basic	\$0.32	\$0.27	\$0.91	\$0.83
Diluted	\$0.31	\$0.26	\$0.90	\$0.82
Weighted average shares outstanding:				
Basic	27,451	27,532	27,488	27,449
Diluted	27,680	27,953	27,765	27,927

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

	Common Shares	Stock Amount	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Cost of Shares Repurchased	Total Shareholders' Equity
(Dollars In Thousands, except per share amounts)								
Balances at December 31, 2016	29,430	\$ 294	\$ 322,934	\$ 184,565	\$(20,178)	\$ (378)	\$(76,547)	\$ 410,690
Comprehensive income:								
Net income	-	-	-	22,849	-	-	-	22,849
Other comprehensive income	-	-	-	-	-	706	-	706
Total comprehensive income								23,555
ESOP shares committed to be released to Plan participants	-	-	572	-	890	-	-	1,462
Cash dividend, \$0.86 per share	-	-	-	(23,836)	-	-	-	(23,836)
Stock compensation activity, net of tax	176	2	820	-	-	-	-	822
Stock compensation expense	-	-	1,427	-	-	-	-	1,427
Purchase of common stock returned to authorized but unissued	(123)	(1)	-	-	-	-	(2,189)	(2,190)
Balances at September 30, 2017	29,483	\$ 295	\$ 325,753	\$ 183,578	\$(19,288)	\$ 328	\$(78,736)	\$ 411,930
Balances at December 31, 2017	29,501	\$ 295	\$ 326,655	\$ 183,358	\$(18,991)	\$ (477)	\$(78,736)	\$ 412,104
Comprehensive income:								
Net income	-	-	-	25,076	-	-	-	25,076
Other comprehensive loss	-	-	-	-	-	(3,331)	-	(3,331)
Total comprehensive income								21,745
Reclassification for net deferred tax liability revaluation	-	-	-	(5)	-	-	-	(5)

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ESOP shares committed to be released to Plan participants	-	-	472	-	890	-	-	1,362
Cash dividend, \$0.86 per share	-	-	-	(23,732)	-	-	-	(23,732)
Stock based compensation activity	102	1	1,289	-	-	-	-	1,290
Stock compensation expense	-	-	1,327	-	-	-	-	1,327
Purchase of common stock returned to authorized but unissued	(553)	(5)	-	-	-	-	(9,442)	(9,447)
Balances at September 30, 2018	29,050	\$ 291	\$ 329,743	\$ 184,697	\$ (18,101)	\$ (3,808)	\$ (88,178)	\$ 404,644

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine months ended September 30, 2018 2017 (In Thousands)	
Operating activities:		
Net income	\$25,076	\$22,849
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Provision for loan losses	(1,060)	(1,166)
Provision for depreciation	1,704	1,549
Stock based compensation	1,327	1,427
Net amortization of premium/discount on debt and mortgage related securities	373	524
Amortization of unearned ESOP shares	1,362	1,462
Amortization and impairment of mortgage servicing rights	146	71
Gain on sale of loans held for sale	(85,366)	(94,219)
Loans originated for sale	(1,927,627)	(1,881,351)
Proceeds on sales of loans originated for sale	1,970,215	2,025,682
Increase in accrued interest receivable	(457)	(294)
Increase in cash surrender value of life insurance	(1,496)	(1,476)
Increase in accrued interest on deposits and borrowings	268	2
Increase in other liabilities	3,108	336
Increase in prepaid tax expense	(266)	(2,088)
Loss on sale of securities	-	107
Net gain related to real estate owned	(211)	(11)
Gain on sale of mortgage servicing rights	-	(308)
Other	(10,840)	440
Net cash (used in) provided by operating activities	(23,744)	73,536
Investing activities:		
Net increase in loans receivable	(66,178)	(85,685)
Net change in FHLB stock	(2,700)	(5,175)
Purchases of:		
Debt securities	-	(6,140)
Mortgage related securities	(13,179)	(6,940)
Premises and equipment, net	(1,257)	(939)
Bank owned life insurance	(180)	(2,680)
Mortgage banking branch	(163)	-
Proceeds from:		
Principal repayments on mortgage-related securities	22,216	25,177
Maturities of debt securities	8,590	13,941
Sales of debt securities	-	448
Sales of real estate owned	3,128	3,104
Bank owned life insurance	474	-
Net cash used in investing activities	(49,249)	(64,889)
Financing activities:		
Net increase in deposits	37,070	7,362

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Net change in short term borrowings	(25,153)	(7,652)
Repayment of long term debt	(165,000)	(69,000)
Proceeds from long term debt	255,000	125,000
Net change in advance payments by borrowers for taxes	13,268	6,021
Cash dividends on common stock	(23,786)	(23,636)
Purchase of common stock returned to authorized but unissued	(9,447)	(2,190)
Proceeds from stock option exercises	1,290	822
Net cash provided by financing activities	83,242	36,727
Increase in cash and cash equivalents	10,249	45,374
Cash and cash equivalents at beginning of period	48,607	47,217
Cash and cash equivalents at end of period	\$58,856	\$92,591

Supplemental information:

Cash paid or credited during the period for:

Income tax payments	\$7,763	\$14,141
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Interest payments	13,393	12,368
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Noncash activities:

Loans receivable transferred to real estate owned	545	1,609
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Dividends declared but not paid in other liabilities	3,458	3,877
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See Accompanying Notes to Unaudited Consolidated Financial Statements.

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Note 1 — Basis of Presentation

The unaudited interim consolidated financial statements include the accounts of Waterstone Financial, Inc. (the "Company") and the Company's subsidiaries.

WaterStone Bank SSB (the "Bank") is a community bank that has served the banking needs of its customers since 1921. WaterStone Bank also has an active mortgage banking subsidiary, Waterstone Mortgage Corporation.

WaterStone Bank conducts its community banking business from 11 banking offices located in Milwaukee, Washington and Waukesha Counties, Wisconsin, as well as a loan production office in Minneapolis, Minnesota. WaterStone Bank's principal lending activity is originating one- to four-family, multi-family residential real estate, and commercial real estate loans for retention in its portfolio. WaterStone Bank also offers home equity loans and lines of credit, construction and land loans, and commercial business loans, and consumer loans. WaterStone Bank funds its loan production primarily with retail deposits and Federal Home Loan Bank advances. Our deposit offerings include: certificates of deposit, money market savings accounts, transaction deposit accounts, non-interest bearing demand accounts and individual retirement accounts. Our investment securities portfolio is comprised principally of mortgage-backed securities, government-sponsored enterprise bonds and municipal obligations.

WaterStone Bank's mortgage banking operations are conducted through its wholly-owned subsidiary, Waterstone Mortgage Corporation. Waterstone Mortgage Corporation originates single-family residential real estate loans for sale into the secondary market. Waterstone Mortgage Corporation utilizes lines of credit provided by WaterStone Bank as a primary source of funds, and also utilizes a line of credit with another financial institution as needed.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information, Rule 10-01 of Regulation S-X and the instructions to Form 10-Q. The financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the financial position, results of operations, changes in shareholders' equity, and cash flows of the Company for the periods presented.

The accompanying unaudited consolidated financial statements and related notes should be read in conjunction with the Company's December 31, 2017 Annual Report on Form 10-K. Operating results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018 or for any other period.

The preparation of the unaudited consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include the allowance for loan losses, deferred income taxes and real estate owned. Actual results could differ from those estimates.

Certain prior period amounts have been reclassified to conform to current period presentation. These reclassifications did not result in any changes to previously reported net income or shareholders' equity.

Impact of Recent Accounting Pronouncements

Accounting Standards Codification ("ASC") Topic 606 "Revenue from Contracts with Customers." Authoritative accounting guidance under ASC Topic 606, "Revenue from Contracts with Customers" amended prior guidance to

require an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services and to provide clarification on identifying performance obligations and licensing implementation guidance. The Company's revenue is comprised of interest and non-interest revenue. The guidance does not apply to revenue associated with financial instruments, including loans and securities. The Company completed its overall assessment of revenue streams and related contracts affected by the guidance, including asset management fees, deposit related fees, and other non-interest related fees. The Company adopted ASC 606 as of January 1, 2018 with no impact on total shareholders' equity or net income.

Revenue Recognition

The Company recognizes revenue as it is earned and noted no impact to its revenue recognition policies as a result of the adoption of ASC 606. The following is a discussion of revenues within the scope of the new revenue guidance:

Debit and credit card interchange fee income - Card processing fees consist of interchange fees from consumer debit and credit card networks and other card related services. Interchange fees are based on purchase volumes and other factors and are recognized as transactions occur.

Service charges on deposit accounts - Revenue from service charges on deposit accounts is earned through deposit-related services; as well as overdraft, non-sufficient funds, account management and other deposit-related fees. Revenue is recognized for these services either over time, corresponding with deposit accounts' monthly cycle, or at a point in time for transactional related services and fees.

Service charges on loan accounts - Revenue from loan accounts consists primarily of fees earned on prepayment penalties. Revenue is recognized for these services at a point in time for transactional related services and fees.

ASC Topic 825 "Financial Instruments." Authoritative accounting guidance under ASC Topic 825, "Financial Instruments" amended prior guidance to require equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. An entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of the same issuer. The guidance simplifies the impairment assessment of equity investments without readily determinable fair values, requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from changes in the instrument-specific credit risk when the entity has selected the fair value option for financial instruments and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset. The Company adopted ASC 825 as of January 1, 2018 with no material impact on the Company's statements of operations or financial condition.

ASC Topic 842 "Leases." Authoritative accounting guidance under ASC Topic 842, "Leases" amended prior guidance to require lessees to recognize the assets and liabilities arising from all leases on the balance sheet. The authoritative guidance defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. In addition, the qualifications for a sale and leaseback transaction have been amended. The new authoritative guidance also requires qualitative and quantitative disclosures by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. 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 authoritative guidance will be effective for reporting periods after January 1, 2019. The Company is evaluating the guidance and its impact on the Company's statements of operations and financial condition.

ASC Topic 326 "Financial Instruments - Credit Losses." Authoritative accounting guidance under ASC Topic 326, "Financial Instruments - Credit Losses" amended the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information for credit loss estimates. 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 collectability of the reported amount. The authoritative guidance also requires a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected (net of the allowance for credit losses). In addition, the credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses rather than a write-down. The authoritative guidance will be effective for reporting periods after January 1, 2020. The Company is evaluating the guidance and its impact on the Company's statements of operations and financial condition.

ASC Topic 310 "Receivables - Nonrefundable Fees and Other Costs." Authoritative accounting guidance under ASC Topic 310, "Receivables - Nonrefundable Fees and Other Costs" amends prior guidance by shortening the amortization period for certain callable debt securities held at a premium requiring the premium to be amortized to the earliest call date. The new authoritative guidance will be effective for reporting periods after January 1, 2019 with early adoption permitted. The Company is evaluating the guidance and its impact on the Company's statements of operations and financial condition.

ASC Topic 220 "Income Statement - Reporting Comprehensive Income." Authoritative accounting guidance under ASC Topic 220, "Income Statement - Reporting Comprehensive Income" allows Companies to make a one-time reclassification from accumulated other comprehensive income (loss) to retained earnings for the effects of remeasuring deferred income taxes originally recorded in other comprehensive income as a result of the change in the federal income tax rate by the Tax Cuts and Jobs Act. The Company adopted this guidance as of January 1, 2018 with no impact on total shareholders' equity or net income.

Note 2— Securities Available for Sale

The amortized cost and fair values of the Company's investment in securities available for sale follow:

	September 30, 2018			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In Thousands)			
Mortgage-backed securities	\$45,384	\$ 94	\$ (1,112)	) \$44,366
Collateralized mortgage obligations:				
Government sponsored enterprise issued	66,072	-	(2,248)	) 63,824
Mortgage-related securities	111,456	94	(3,360)	) 108,190
Government sponsored enterprise bonds	500	-	(1)	) 499
Municipal securities	56,415	526	(291)	) 56,650
Other debt securities	15,003	-	(1,511)	) 13,492
Debt securities	71,918	526	(1,803)	) 70,641
Certificates of deposit	245	-	-	) 245
	\$183,619	\$ 620	\$ (5,163)	) \$179,076
	December 31, 2017			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In Thousands)			
Mortgage-backed securities	\$57,351	\$ 324	\$ (240)	) \$57,435
Collateralized mortgage obligations:				
Government sponsored enterprise issued	61,313	3	(816)	) 60,500
Mortgage-related securities	118,664	327	(1,056)	) 117,935
Government sponsored enterprise bonds	2,500	-	(3)	) 2,497
Municipal securities	62,516	1,334	(81)	) 63,769
Other debt securities	15,005	12	(492)	) 14,525
Debt securities	80,021	1,346	(576)	) 80,791
Certificates of deposit	980	1	-	) 981
	\$199,665	\$ 1,674	\$ (1,632)	) \$199,707

The Company's mortgage-backed securities and collateralized mortgage obligations issued by government sponsored enterprises are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. At September 30, 2018, \$1.9 million of the Company's mortgage related securities were pledged as collateral to secure mortgage banking related activities. At December 31, 2017, \$2.5 million of the Company's mortgage related securities were pledged as collateral to secure mortgage banking related activities.

The amortized cost and fair values of investment securities by contractual maturity at September 30, 2018 are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Amortized Fair

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	Cost	Value
	(In Thousands)	
Debt and other securities		
Due within one year	\$2,750	\$2,746
Due after one year through five years	26,710	26,503
Due after five years through ten years	31,038	31,405
Due after ten years	11,665	10,232
Mortgage-related securities	111,456	108,190
	\$183,619	\$179,076

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Gross unrealized losses on securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position were as follows:

	September 30, 2018					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
	(In Thousands)					
Mortgage-backed securities	\$24,121	\$ (530)	\$17,479	\$ (582)	\$41,600	\$ (1,112)
Collateralized mortgage obligations:						
Government sponsored enterprise issued	30,376	(779)	31,427	(1,469)	61,803	(2,248)
Government sponsored enterprise bonds	-	-	499	(1)	499	(1)
Municipal securities	27,459	(253)	2,117	(38)	29,576	(291)
Other debt securities	4,980	(23)	8,512	(1,488)	13,492	(1,511)
	\$86,936	\$ (1,585)	\$60,034	\$ (3,578)	\$146,970	\$ (5,163)

	December 31, 2017					
	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
	(In Thousands)					
Mortgage-backed securities	\$35,136	\$ (143)	\$4,464	\$ (97)	\$39,600	\$ (240)
Collateralized mortgage obligations:						
Government sponsored enterprise issued	37,949	(348)	21,651	(468)	59,600	(816)
Government sponsored enterprise bonds	2,497	(3)	-	-	2,497	(3)
Municipal securities	17,096	(80)	100	(1)	17,196	(81)
Other debt securities	-	-	9,508	(492)	9,508	(492)
	\$92,678	\$ (574)	\$35,723	\$ (1,058)	\$128,401	\$ (1,632)

The Company reviews the investment securities portfolio on a quarterly basis to monitor its exposure to other-than-temporary impairment. In evaluating whether a security's decline in market value is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition of the issuer and the underlying obligors, quality of credit enhancements, volatility of the fair value of the security, the expected recovery period of the security and ratings agency evaluations. In addition, the Company may also evaluate payment structure, whether there are defaulted payments or expected defaults, prepayment speeds and the value of any underlying collateral.

The following table presents the change in other-than-temporary credit related impairment charges on securities available for sale for which a portion of the other-than-temporary impairments related to other factors was recognized in other comprehensive loss.

	(In Thousands)
Credit-related impairments on securities as of December 31, 2016	\$ 94
Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized	-
Credit-related impairments on securities as of December 31, 2017	94
Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized	-

Credit-related impairments on securities as of September 30, 2018

\$ 94

As of September 30, 2018, the Company held one municipal security that had previously been deemed to be other-than-temporarily impaired. The security was issued by a tax incremental district in a municipality located in Wisconsin. During the year ended December 31, 2012, the Company received audited financial statements with respect to the municipal issuer that called into question the ability of the underlying taxing district that issued the security to operate as a going concern. During the year ended December 31, 2012, the Company's analysis of this security resulted in \$77,000 in credit losses charged to earnings with respect to this municipal security. An additional \$17,000 credit loss was charged to earnings during the year ended December 31, 2014 with respect to this security as a sale occurred at a discounted price. As of September 30, 2018, this security had an amortized cost of \$116,000 and total life-to-date impairment of \$94,000.

As of September 30, 2018, the Company had 22 mortgage-backed securities, 26 government sponsored enterprise issued securities, six municipal bond securities, and one corporate debt security which had been in an unrealized loss position for twelve months or longer and represents a loss of 5.6% of the aggregate amortized cost. These securities were determined not to be other-than-temporarily impaired as of September 30, 2018. The Company has determined that the decline in fair value of these securities is primarily attributable to an increase in market interest rates compared to the stated rates on these securities and is not attributable to credit deterioration. As the Company does not intend to sell nor is it more likely than not that it will be required to sell these securities before recovery of the amortized cost basis, these securities are not considered other-than-temporarily impaired.

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The unrealized losses for the other debt security with an unrealized loss greater than 12 months is due to the current slope of the yield curve. The security currently earns a fixed interest rate but transitions in the future to a floating rate that is indexed to the 10 year Treasury interest rate. The Company does not intend to sell nor does it believe that it will be required to sell the security before recovery of their amortized cost basis.

Deterioration of general economic market conditions could result in the recognition of future other than temporary impairment losses within the investment portfolio and such amounts could be material to our consolidated financial statements.

During the nine months ended September 30, 2018, there were no sales of securities. During the nine months ended September 30, 2017, proceeds from the sale of securities totaled \$448,000 and resulted in losses totaling \$107,000. The \$107,000 included in loss on sale of available for sale securities in the consolidated statements of income during the nine months ended September 30, 2017 was reclassified, net of tax, from accumulated other comprehensive income.

Note 3 - Loans Receivable

Loans receivable at September 30, 2018 and December 31, 2017 are summarized as follows:

	September 30, 2018	December 31, 2017
	(In Thousands)	
Mortgage loans:		
Residential real estate:		
One- to four-family	\$485,449	\$439,597
Multi-family	586,563	578,440
Home equity	20,417	21,124
Construction and land	8,947	19,859
Commercial real estate	222,742	195,842
Consumer	400	255
Commercial loans	33,138	36,697
	\$1,357,656	\$1,291,814

The Company provides several types of loans to its customers, including residential, construction, commercial and consumer loans. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to one borrower or to multiple borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. While the Company's credit risks are geographically concentrated in the Milwaukee metropolitan area, there are no concentrations with individual or groups of related borrowers.

Qualifying loans receivable totaling \$1.01 billion and \$971.3 million at September 30, 2018 and December 31, 2017, respectively, are pledged as collateral against \$435.0 million and \$375.0 million in outstanding Federal Home Loan Bank of Chicago ("FHLBC") advances under a blanket security agreement at September 30, 2018 and December 31, 2017.

Certain of the Company's executive officers, directors, employees, and their related interests have loans with the Bank. As of September 30, 2018 and December 31, 2017, loans aggregating approximately \$3.2 million and \$4.5 million, respectively, were outstanding to such parties. None of these loans were considered impaired as of September 30, 2018 or December 31, 2017.

As of September 30, 2018 and December 31, 2017, there were no loans 90 or more days past due and still accruing interest.

An analysis of past due loans receivable as of September 30, 2018 and December 31, 2017 follows:

	As of September 30, 2018					
	1-59 Days Past Due ⁽¹⁾	60-89 Days Past Due ⁽²⁾	90 Days or Greater	Total Past Due	Current ⁽³⁾	Total Loans
	(In Thousands)					
Mortgage loans:						
Residential real estate:						
One- to four-family	\$3,792	\$ 27	\$ 3,720	\$7,539	\$477,910	\$485,449
Multi-family	355	-	593	948	585,615	586,563
Home equity	263	-	111	374	20,043	20,417
Construction and land	-	-	-	-	8,947	8,947

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Commercial real estate	-	-	172	172	222,570	222,742
Consumer	34	-	-	34	366	400
Commercial loans	-	-	26	26	33,112	33,138
Total	\$4,444	\$ 27	\$ 4,622	\$ 9,093	\$ 1,348,563	\$ 1,357,656

As of December 31, 2017

	1-59 Days Past Due ⁽¹⁾	60-89 Days Past Due ⁽²⁾	90 Days or Greater	Total Past Due	Current ⁽³⁾	Total Loans
(In Thousands)						
Mortgage loans:						
Residential real estate:						
One- to four-family	\$ 1,494	\$ 146	\$ 3,516	\$ 5,156	\$ 434,441	\$ 439,597
Multi-family	-	128	192	320	578,120	578,440
Home equity	68	-	56	124	21,000	21,124
Construction and land	-	-	-	-	19,859	19,859
Commercial real estate	-	-	184	184	195,658	195,842
Consumer	-	-	-	-	255	255
Commercial loans	-	42	26	68	36,629	36,697
Total	\$ 1,562	\$ 316	\$ 3,974	\$ 5,852	\$ 1,285,962	\$ 1,291,814

⁽¹⁾ Includes \$442,000 and \$241,000 at September 30, 2018 and December 31, 2017, respectively, which are on non-accrual status.

⁽²⁾ Includes \$- and \$15,000 at September 30, 2018 and December 31, 2017, respectively, which are on non-accrual status.

⁽³⁾ Includes \$1.5 million and \$1.8 million at September 30, 2018 and December 31, 2017, respectively, which are on non-accrual status.

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A summary of the activity for the nine months ended September 30, 2018 and 2017 in the allowance for loan losses follows:

	One- to Four- Family (In Thousands)	Multi-Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total	
Nine months ended September 30, 2018									
Balance at beginning of period	\$5,794	\$ 4,431	\$ 356	\$ 949	\$ 1,881	\$ 10	\$ 656	\$14,077	
Provision (credit) for loan losses	205	(491)	(57)	(702)	133	4	(152)	(1,060)	
Charge-offs	(68)	(13)	(1)	-	-	-	-	(82)	
Recoveries	150	82	18	40	1	-	-	291	
Balance at end of period	\$6,081	\$ 4,009	\$ 316	\$ 287	\$ 2,015	\$ 14	\$ 504	\$13,226	
Nine months ended September 30, 2017									
Balance at beginning of period		\$7,164	\$4,809	\$364	\$1,016	\$1,951	\$12	\$713	\$16,029
Provision (credit) for loan losses		(249)	(396)	8	(283)	(170)	(2)	(74)	(1,166)
Charge-offs		(1,092)	(92)	-	(14)	(6)	-	-	(1,204)
Recoveries		200	102	21	80	1	-	-	404
Balance at end of period		\$6,023	\$4,423	\$393	\$799	\$1,776	\$10	\$639	\$14,063

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of September 30, 2018 follows:

	One- to Four- Family (In Thousands)	Multi- Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
Allowance related to loans individually evaluated for impairment								
	\$51	\$-	\$32	\$ -	\$21	\$ -	\$ -	\$104
Allowance related to loans collectively evaluated for impairment								
	6,030	4,009	284	287	1,994	14	504	13,122
Balance at end of period	\$6,081	\$4,009	\$316	\$ 287	\$2,015	\$ 14	\$ 504	\$13,226
Loans individually evaluated for impairment								
	\$7,903	\$981	\$217	\$ -	\$457	\$ -	\$ 26	\$9,584
Loans collectively evaluated for impairment								
	477,546	585,582	20,200	8,947	222,285	400	33,112	1,348,072
Total gross loans	\$485,449	\$586,563	\$20,417	\$ 8,947	\$222,742	\$ 400	\$ 33,138	\$1,357,656

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A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of December 31, 2017 follows:

	One- to Four-Family (In Thousands)	Multi- Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
Allowance related to loans individually evaluated for impairment	\$77	\$-	\$44	\$ -	\$ 34	\$ -	\$ -	\$ 155
Allowance related to loans collectively evaluated for impairment	5,717	4,431	312	949	1,847	10	656	13,922
Balance at end of period	\$5,794	\$4,431	\$356	\$ 949	\$ 1,881	\$ 10	\$ 656	\$ 14,077
Loans individually evaluated for impairment	\$7,418	\$1,007	\$185	\$ -	\$ 540	\$ -	\$ 26	\$9,176
Loans collectively evaluated for impairment	432,179	577,433	20,939	19,859	195,302	255	36,671	1,282,638
Total gross loans	\$439,597	\$578,440	\$21,124	\$ 19,859	\$ 195,842	\$ 255	\$ 36,697	\$ 1,291,814

The following table presents information relating to the Company's internal risk ratings of its loans receivable as of September 30, 2018 and December 31, 2017:

	One to Four- Family (In Thousands)	Multi-Family	Home Equity	Construction and Land	Commercial Real Estate	Consumer	Commercial	Total
At September 30, 2018								
Substandard	\$8,061	\$ 981	\$249	\$ -	\$ 732	\$ -	\$ 936	\$10,959
Watch	6,053	326	421	-	109	-	923	7,832
Pass	471,335	585,256	19,747	8,947	221,901	400	31,279	1,338,865
	\$485,449	\$ 586,563	\$20,417	\$ 8,947	\$ 222,742	\$ 400	\$ 33,138	\$ 1,357,656
At December 31, 2017								
Substandard	\$7,581	\$ 1,135	\$138	\$ -	\$ 1,124	\$ -	\$ 1,585	\$11,563
Watch	4,939	330	401	-	295	-	741	6,706
Pass	427,077	576,975	20,585	19,859	194,423	255	34,371	1,273,545
	\$439,597	\$ 578,440	\$21,124	\$ 19,859	\$ 195,842	\$ 255	\$ 36,697	\$ 1,291,814

Factors that are important to managing overall credit quality include sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an allowance for loan losses, and sound non-accrual and charge-off policies. Our underwriting policies require an officers' loan committee review and approval of all loans in excess of \$500,000. A member of the credit department, independent of the loan originator, performs a loan review for all loans. Our ability

to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we maintain a loan review system under which our credit management personnel review non-owner occupied one- to four-family, multi-family, construction and land, commercial real estate and commercial loans that individually, or as part of an overall borrower relationship exceed \$1.0 million in potential exposure. Loans meeting these criteria are reviewed on an annual basis, or more frequently, if the loan renewal is less than one year. With respect to this review process, management has determined that pass loans include loans that exhibit acceptable financial statements, cash flow and leverage. Watch loans have potential weaknesses that deserve management's attention, and if left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit. Substandard loans are considered inadequately protected by the current net worth and paying capacity of the obligor or the collateral pledged. These loans generally have a well-defined weakness that may jeopardize liquidation of the debt and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Finally, a loan is considered to be impaired when it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management has determined that all non-accrual loans and loans modified under troubled debt restructurings meet the definition of an impaired loan.

The Company's procedures dictate that an updated valuation must be obtained with respect to underlying collateral at the time a loan is deemed impaired. Updated valuations may also be obtained upon transfer from loans receivable to real estate owned based upon the age of the prior appraisal, changes in market conditions or known changes to the physical condition of the property.

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Estimated fair values are reduced to account for sales commissions, broker fees, unpaid property taxes and additional selling expenses to arrive at an estimated net realizable value. The adjustment factor is based upon the Company's actual experience with respect to sales of real estate owned over the prior two years. In situations in which we are placing reliance on an appraisal that is more than one year old, an additional adjustment factor is applied to account for downward market pressure since the date of appraisal. The additional adjustment factor is based upon relevant sales data available for our general operating market as well as company-specific historical net realizable values as compared to the most recent appraisal prior to disposition.

With respect to multi-family income-producing real estate, appraisals are reviewed and estimated collateral values are adjusted by updating significant appraisal assumptions to reflect current real estate market conditions. Significant assumptions reviewed and updated include the capitalization rate, rental income and operating expenses. These adjusted assumptions are based upon recent appraisals received on similar properties as well as on actual experience related to real estate owned and currently under Company management.

The following tables present data on impaired loans at September 30, 2018 and December 31, 2017.

	As of or for the Nine Months Ended September 30, 2018					
	Recorded Investment	Unpaid Principal	Reserve	Cumulative Charge-Offs	Average Recorded Investment	Interest Paid
	(In Thousands)					
Total Impaired with Reserve						
One- to four-family	\$467	\$467	\$ 51	\$ -	\$ 468	\$ 24
Multi-family	-	-	-	-	-	-
Home equity	76	76	32	-	79	4
Construction and land	-	-	-	-	-	-
Commercial real estate	21	430	21	409	28	-
Consumer	-	-	-	-	-	-
Commercial	-	-	-	-	-	-
	564	973	104	409	575	28
Total Impaired with no Reserve						
One- to four-family	7,436	8,386	-	950	7,577	311
Multi-family	981	1,817	-	836	874	51
Home equity	141	141	-	-	145	4
Construction and land	-	-	-	-	-	-
Commercial real estate	436	436	-	-	438	11
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	9,020	10,806	-	1,786	9,060	377
Total Impaired						
One- to four-family	7,903	8,853	51	950	8,045	335
Multi-family	981	1,817	-	836	874	51
Home equity	217	217	32	-	224	8
Construction and land	-	-	-	-	-	-
Commercial real estate	457	866	21	409	466	11
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	\$9,584	\$11,779	\$ 104	\$ 2,195	\$ 9,635	\$ 405

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As of or for the Year Ended December 31, 2017

	Recorded Investment (In Thousands)	Unpaid Principal	Reserve	Cumulative Charge-Offs	Average Recorded Investment	Interest Paid
Total Impaired with Reserve						
One- to four-family	\$903	\$903	\$ 77	\$ -	\$ 913	\$ 52
Multi-family	-	-	-	-	-	-
Home equity	79	79	44	-	83	6
Construction and land	-	-	-	-	-	-
Commercial real estate	34	443	34	409	43	-
Consumer	-	-	-	-	-	-
Commercial	-	-	-	-	-	-
	1,016	1,425	155	409	1,039	58
Total Impaired with no Reserve						
One- to four-family	6,515	7,604	-	1,089	6,796	359
Multi-family	1,007	1,864	-	857	1,005	94
Home equity	106	106	-	-	111	5
Construction and land	-	-	-	-	-	-
Commercial real estate	506	506	-	-	513	19
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	8,160	10,106	-	1,946	8,451	477
Total Impaired						
One- to four-family	7,418	8,507	77	1,089	7,709	411
Multi-family	1,007	1,864	-	857	1,005	94
Home equity	185	185	44	-	194	11
Construction and land	-	-	-	-	-	-
Commercial real estate	540	949	34	409	556	19
Consumer	-	-	-	-	-	-
Commercial	26	26	-	-	26	-
	\$9,176	\$11,531	\$ 155	\$ 2,355	\$ 9,490	\$ 535

The difference between a loan's recorded investment and the unpaid principal balance represents a partial charge-off resulting from a confirmed loss when the value of the collateral securing the loan is below the loan balance and management's assessment that the full collection of the loan balance is not likely.

When a loan is considered impaired, interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

The determination as to whether an allowance is required with respect to impaired loans is based upon an analysis of the value of the underlying collateral and/or the borrower's intent and ability to make all principal and interest payments in accordance with contractual terms. The evaluation process is subject to the use of significant estimates and actual results could differ from estimates. This analysis is primarily based upon third party appraisals and/or a discounted cash flow analysis. In those cases in which no allowance has been provided for an impaired loan, the Company has determined that the estimated value of the underlying collateral exceeds the remaining outstanding balance of the loan. Of the total \$9.0 million of impaired loans as of September 30, 2018 for which no allowance has

been provided, \$1.8 million in net charge-offs have been recorded to reduce the unpaid principal balance to an amount that is commensurate with the loans' net realizable value, using the estimated fair value of the underlying collateral. To the extent that further deterioration in property values continues, the Company may have to reevaluate the sufficiency of the collateral servicing these impaired loans resulting in additional provisions to the allowance for loans losses or charge-offs.

At September 30, 2018, total impaired loans included \$4.3 million of troubled debt restructurings. Troubled debt restructurings involve granting concessions to a borrower experiencing financial difficulty by modifying the terms of the loan in an effort to avoid foreclosure. The vast majority of debt restructurings include a modification of terms to allow for an interest only payment and/or reduction in interest rate. The restructured terms are typically in place for six to twelve months. At December 31, 2017, total impaired loans included \$5.1 million of troubled debt restructurings.

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The following presents data on troubled debt restructurings:

	As of September 30, 2018					
	Accruing		Non-accruing		Total	
	Amount	Number	Amount	Number	Amount	Number
	(Dollars in Thousands)					
One- to four-family	\$2,740	2	\$ 890	5	\$3,630	7
Multi-family	-	-	388	2	388	2
Commercial real estate	285	1	21	1	306	2
	\$3,025	3	\$ 1,299	8	\$4,324	11

	As of December 31, 2017					
	Accruing		Non-accruing		Total	
	Amount	Number	Amount	Number	Amount	Number
	(Dollars in Thousands)					
One- to four-family	\$2,740	2	\$ 1,156	7	\$3,896	9
Multi-family	-	-	815	3	815	3
Home equity	47	1	-	-	47	1
Commercial real estate	290	1	34	1	324	2
	\$3,077	4	\$2,005	11	\$5,082	15

At September 30, 2018, \$4.3 million in loans had been modified in troubled debt restructurings and \$1.3 million of these loans were included in the non-accrual loan total. The remaining \$3.0 million, while meeting the internal requirements for modification in a troubled debt restructuring, were current with respect to payments under their original loan terms at the time of the restructuring and, therefore, continued to be included with accruing loans. Provided these loans perform in accordance with the modified terms, they will continue to be accounted for on an accrual basis.

All loans that have been modified in a troubled debt restructuring are considered to be impaired. As such, an analysis has been performed with respect to all of these loans to determine the need for a valuation reserve. When a loan is expected to perform in accordance with the restructured terms and ultimately return to and perform under contract terms, a valuation allowance is established for an amount equal to the excess of the present value of the expected future cash flows under the original contract terms as compared with the modified terms, including an estimated default rate. When there is doubt as to the borrower's ability to perform under the restructured terms or ultimately return to and perform under market terms, a valuation allowance is established equal to the impairment when the carrying amount exceeds fair value of the underlying collateral. As a result of the impairment analysis, a \$21,000 valuation allowance has been established as of September 30, 2018 with respect to the \$4.3 million in troubled debt restructurings. As of December 31, 2017, a \$34,000 valuation allowance had been established with respect to the \$5.1 million in troubled debt restructurings.

After a troubled debt restructuring reverts to market terms, a minimum of six consecutive contractual payments must be received prior to consideration for a return to accrual status. If an updated credit department review indicates no other evidence of elevated credit risk, the loan is returned to accrual status at that time.

The following presents troubled debt restructurings by concession type:

	As of September 30, 2018		
	Performing in accordance with	In Default	Total

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	modified terms		In Default		Total	
	Amount	Number	Amount	Number	Amount	Number
	(Dollars in Thousands)					
Interest reduction and principal forbearance	\$3,404	6	\$579	2	\$3,983	8
Interest reduction	341	3	-	-	341	3
	\$3,745	9	\$579	2	\$4,324	11

As of December 31, 2017

	Performing in accordance with modified terms		In Default		Total	
	Amount	Number	Amount	Number	Amount	Number
	(Dollars in Thousands)					
Interest reduction and principal forbearance	\$4,022	9	\$660	2	\$4,682	11
Principal forbearance	47	1	-	-	47	1
Interest reduction	353	3	-	-	353	3
	\$4,422	13	\$660	2	\$5,082	15

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There were no loans modified as troubled debt restructurings during the three or nine months ended September 30, 2018 and September 30, 2017.

There were no troubled debt restructurings within the past twelve months for which there was a default during the three months or nine ended September 30, 2018 and September 30, 2017.

The following table presents data on non-accrual loans as of September 30, 2018 and December 31, 2017:

	September 30, 2018		December 31, 2017	
	(Dollars in Thousands)			
Non-accrual loans:				
Residential				
One- to four-family	\$5,162		\$ 4,677	
Multi-family	981		1,007	
Home equity	203		107	
Construction and land	-		-	
Commercial real estate	172		251	
Commercial	26		26	
Consumer	-		-	
Total non-accrual loans	\$6,544		\$ 6,068	
Total non-accrual loans to total loans receivable	0.48	%	0.47	%
Total non-accrual loans to total assets	0.34	%	0.34	%

Note 4— Real Estate Owned

Real estate owned is summarized as follows:

	September 30, 2018		December 31, 2017
	(In Thousands)		
One- to four-family	\$ 181		\$ 1,330
Multi-family	-		-
Construction and land	3,327		4,582
Commercial real estate	300		300
Total real estate owned	3,808		6,212
Valuation allowance at end of period	(1,638)		(1,654)
Total real estate owned, net	\$2,170		\$ 4,558

The following table presents the activity in the Company's real estate owned:

	Nine months ended September 30, 2018		2017
	(In Thousands)		
Real estate owned at beginning of the period	\$4,558		6,118
Transferred from loans receivable	545		1,609
Sales (net of gains / losses)	(2,632)		(2,654)
Write downs	(301)		(504)
Other	-		(1)
Real estate owned at the end of the period	\$2,170		4,568

Residential one- to four-family mortgage loans that were in the process of foreclosure were \$2.5 million and \$2.3 million at September 30, 2018 and December 31, 2017, respectively.

Note 5— Mortgage Servicing Rights

The following table presents the activity in the Company's mortgage servicing rights:

	Nine months ended September 30, 2018		2017
	(In Thousands)		
Mortgage servicing rights at beginning of the period	\$888		\$2,260
Additions	357		793
Amortization	(146)		(71)
Sales	-		(2,264)
Mortgage servicing rights at end of the period	1,099		718
Valuation allowance at end of period	-		-
Mortgage servicing rights at end of the period, net	\$1,099		\$718

During the nine months ended September 30, 2018, \$1.93 billion in residential loans were originated for sale on a consolidated basis. During the same period, sales of loans held for sale totaled \$1.97 billion, generating mortgage banking income of \$88.9 million. The unpaid principal balance of loans serviced for others was \$158.3 million and \$126.3 million at September 30, 2018 and December 31, 2017, respectively. These loans are not reflected in the consolidated statements of financial condition.

During the nine months ended September 30, 2018, the Company did not sell any mortgage servicing rights. During the nine months ended September 30, 2017, the Company sold mortgage servicing rights related to \$295.1 million in loans receivable with a book value of \$2.3 million for \$2.6 million resulting in a gain on sale of \$308,000.

The following table shows the estimated future amortization expense for mortgage servicing rights for the periods indicated:

Estimate for the period ending December 31:	(In Thousands)
2018	\$ 49
2019	138
2020	128
2021	119
2022	109
Thereafter	556
Total	\$ 1,099

Note 6— Deposits

At September 30, 2018 and December 31, 2017, time deposits with balances greater than \$250,000 amounted to \$58.0 million and \$45.9 million, respectively.

A summary of the contractual maturities of time deposits at September 30, 2018 is as follows:

	(In Thousands)
Within one year	\$ 509,294
More than one to two years	193,084
More than two to three years	7,794
More than three to four years	1,992
More than four through five years	1,575
	\$ 713,739

Note 7— Borrowings

Borrowings consist of the following:

	September 30, 2018		December 31, 2017	
	Balance	Weighted Average Rate	Balance	Weighted Average Rate
	(Dollars in Thousands)			
Short term:				
Repurchase agreement	\$ 16,132	5.51 %	\$ 11,285	4.32 %
Federal Home Loan Bank, Chicago advances	5,000	2.24 %	35,000	1.28 %
Long term:				
Federal Home Loan Bank, Chicago advances maturing:				
2018	-	-	65,000	2.97 %
2021	-	-	100,000	0.78 %
2027	175,000	1.38 %	175,000	1.38 %
2028	255,000	2.37 %	-	-
	\$ 451,132	2.10 %	\$ 386,285	1.57 %

The short-term repurchase agreement represents the outstanding portion of a total \$35.0 million commitment with one unrelated bank. The short-term repurchase agreement is utilized by Waterstone Mortgage Corporation to finance loans originated for sale. This agreement is secured by the underlying loans being financed. Related interest rates are based upon the note rate associated with the loans being financed. The short-term repurchase agreement had a \$16.1 million balance at September 30, 2018 and an \$11.3 million balance at December 31, 2017.

The \$5.0 million short-term advance has a fixed rate of 2.24% and a maturity date of October 1, 2018.

The \$175.0 million in advances due in 2027 consists of one \$50.0 million advance with a fixed rate of 1.24% with a FHLB single call option in May 2019, one \$50.0 million advance with a fixed rate of 1.23% with a FHLB single call option in June 2019, one \$25.0 million advance with a fixed rate of 1.23% with a FHLB single call option in August 2019, and one \$50.0 million advance with a fixed rate of 1.73% with a FHLB single call option in December 2019.

The \$255.0 million in advances due in 2028 consists of one \$25.0 million advance with a fixed rate of 2.16% with a FHLB single call option in March 2020, two advances totaling \$55.0 million with a fixed rate of 2.27% and with a FHLB single call option in March 2021, one advance of \$25.0 million with a fixed rate of 2.40% and with a FHLB single call option in May 2020, two advances totaling \$50.0 million with fixed rates of 2.34% and 2.48% and with a FHLB single call option in May 2021, one advance of \$50.0 million with a fixed rate of 2.34% and with a FHLB quarterly call option beginning in June 2020, and one advance of \$50.0 million with a fixed rate of 2.57% and with a FHLB quarterly call option beginning in September 2020.

The Company selects loans that meet underwriting criteria established by the FHLBC as collateral for outstanding advances. The Company's borrowings from the FHLBC are limited to 77% of the carrying value of unencumbered one- to four-family mortgage loans, 75% of the carrying value of multi-family loans and 64% of the carrying value of home equity loans. In addition, these advances were collateralized by FHLBC stock of \$19.6 million at September 30, 2018 and \$16.9 million at December 31, 2017. In the event of prepayment, the Company is obligated to pay all remaining contractual interest on the advance.

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Note 8 – Regulatory Capital

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

The Federal Reserve Board and the Federal Deposit Insurance Corporation ("FDIC") issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier I capital ratio, increase the minimum Tier 1 capital ratio requirements and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The Company and the Bank have made the election to retain the existing treatment for accumulated other comprehensive income. The final rules took effect for the Company and the Bank on January 1, 2015, subject to a transition period for certain parts of the rules.

As a result of the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act, the Federal Reserve Board is required to amend its small bank holding company and savings and loan holding company policy statement to provide that holding companies with consolidated assets of less than \$3 billion that are (i) not engaged in significant nonbanking activities, (ii) do not conduct significant off-balance sheet activities, and (3) do not have a material amount of SEC-registered debt or equity securities, other than trust preferred securities, that contribute to an organization's complexity, will no longer be subject to regulatory capital requirements, effective no later than November 2018.

In addition, as a result of the legislation, the federal banking agencies are required to develop a "Community Bank Leverage Ratio" (the ratio of a bank's tangible equity capital to average total consolidated assets) for financial institutions with assets of less than \$10 billion. A "qualifying community bank" that exceeds this ratio will be deemed to be in compliance with all other capital and leverage requirements, including the capital requirements to be considered "well capitalized" under Prompt Corrective Action statutes. The federal banking agencies may consider a financial institution's risk profile when evaluating whether it qualifies as a community bank for purposes of the capital ratio requirement. The federal banking agencies must set the minimum capital for the new Community Bank Leverage Ratio at not less than 8% and not more than 10%. A financial institution can elect to be subject to this new definition.

The table below includes the regulatory capital ratio requirements that became effective on January 1, 2015. Beginning in 2016, an additional capital conservation buffer was added to the minimum requirements for capital adequacy purposes, subject to a three year phase-in period. The capital conservation buffer will be fully phased-in on January 1, 2019 at 2.5%. A banking organization with a conservation buffer of less than 2.5% (or the required phase-in amount in years prior to 2019) will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At September 30, 2018, the ratios for the Company and the Bank are sufficient to meet the fully phased-in conservation buffer.

The actual and required capital amounts and ratios for the Bank as of September 30, 2018 and December 31, 2017 are presented in the table below:

September 30, 2018			
Actual	For Capital	Minimum Capital	To Be Well

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	Adequacy Purposes		Adequacy with Capital Buffer		Capitalized Under Prompt Corrective Action Provisions			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
(Dollars In Thousands)								
Total Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	\$421,058	28.82 %	\$116,891	8.00 %	\$144,287	9.875 %	\$N/A	N/A
WaterStone Bank	394,128	27.01 %	116,757	8.00 %	144,949	9.875 %	145,946	10.00 %
Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	407,832	27.91 %	87,668	6.00 %	115,064	7.875 %	N/A	N/A
WaterStone Bank	380,902	26.10 %	87,568	6.00 %	116,757	7.875 %	116,757	8.00 %
Common Equity Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone Financial, Inc.								
	407,832	27.91 %	65,751	4.50 %	93,147	6.375 %	N/A	N/A
WaterStone Bank	380,902	26.10 %	65,676	4.50 %	93,041	6.375 %	94,865	6.50 %
Tier 1 Capital (to average assets)								
Consolidated Waterstone Financial, Inc.								
	407,832	21.33 %	76,495	4.00 %	N/A	N/A	N/A	N/A
WaterStone Bank	380,902	19.92 %	76,495	4.00 %	N/A	N/A	95,618	5.00 %
State of Wisconsin (to total assets)								
WaterStone Bank	380,902	19.89 %	114,919	6.00 %	N/A	N/A	N/A	N/A

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December 31, 2017

	Actual		For Capital Adequacy Purposes		Minimum Capital Adequacy with Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars In Thousands)							
Total Capital (to risk-weighted assets)								
Consolidated Waterstone								
Financial, Inc.	\$426,057	30.75 %	\$110,829	8.00 %	\$128,146	9.25 %	\$N/A	N/A
WaterStone Bank	400,792	28.93 %	110,812	8.00 %	128,127	9.25 %	138,515	10.00 %
Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone								
Financial, Inc.	411,980	29.74 %	83,122	6.00 %	100,439	7.25 %	N/A	N/A
WaterStone Bank	386,715	27.92 %	83,109	6.00 %	100,424	7.25 %	110,812	8.00 %
Common Equity Tier 1 Capital (to risk-weighted assets)								
Consolidated Waterstone								
Financial, Inc.	411,980	29.74 %	62,341	4.50 %	79,658	5.75 %	N/A	N/A
WaterStone Bank	386,715	27.92 %	62,332	4.50 %	79,646	5.75 %	90,035	6.50 %
Tier 1 Capital (to average assets)								
Consolidated Waterstone								
Financial, Inc.	411,980	22.43 %	73,481	4.00 %	N/A	N/A	N/A	N/A
WaterStone Bank	386,715	21.10 %	73,304	4.00 %	N/A	N/A	91,630	5.00 %
State of Wisconsin (to total assets)								
WaterStone Bank	386,715	21.44 %	108,243	6.00 %	N/A	N/A	N/A	N/A

Note 9 – Income Taxes

Income tax expense decreased \$4.4 million, or 35.9%, to \$7.9 million for the nine months ended September 30, 2018 compared to \$12.4 million during the nine months ended September 30, 2017. Income tax expense was recognized on the statement of income during the nine months ended September 30, 2018 at an effective rate of 24.1% of pretax income compared to 35.2% during the nine months ended September 30, 2017. The decrease in the effective rate primarily resulted from the federal tax rate decrease from 35% to 21% as a result of The Tax Cuts and Jobs Act that was enacted into law on December 22, 2017. During the nine months ended September 30, 2018, the Company recognized a benefit of approximately \$197,000 related to stock awards exercised compared to a benefit of \$827,000 recognized during the nine months ended September 30, 2017.

Note 10 – Offsetting of Assets and Liabilities

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. In addition, the Company enters into agreements under which it sells loans held for sale subject to an obligation to repurchase the same loans. Under these arrangements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of assets. The obligation to repurchase the assets is reflected as a liability in the Company's consolidated statements of condition, while the securities and loans held for sale underlying the repurchase agreements remain in the respective investment securities and loans held for sale asset accounts. In other words, there is no offsetting or netting of the investment securities or loans held for sale assets with the repurchase agreement liabilities. The Company's repurchase agreement is subject to master netting agreements, which sets forth the rights and obligations for repurchase and offset. Under the master netting agreement, the Company is entitled to set off the collateral placed with a single counterparty against obligations owed to that counterparty.

The following table presents the liabilities subject to an enforceable master netting agreement as of September 30, 2018 and December 31, 2017.

	Gross Recognize Liabilities (In Thousands)	Gross Amounts Offset	Net Amounts Presented	Gross Amounts Not Offset	Net Amount
September 30, 2018					
Repurchase Agreements					
Short-term	\$16,132	\$ -	\$ 16,132	\$ 16,132	\$ -
	\$16,132	\$ -	\$ 16,132	\$ 16,132	\$ -
December 31, 2017					
Repurchase Agreements					
Short-term	\$11,285	\$ -	\$ 11,285	\$ 11,285	\$ -
	\$11,285	\$ -	\$ 11,285	\$ 11,285	\$ -

Note 11– Commitments, Off-Balance Sheet Arrangements, and Contingent Liabilities

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated statements of financial condition. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

	September 30, 2018	December 31, 2017
	(In Thousands)	
Financial instruments whose contract amounts represent potential credit risk:		
Commitments to extend credit under amortizing loans (1)	\$29,213	\$ 31,543
Commitments to extend credit under home equity lines of credit (2)	14,850	14,972
Unused portion of construction loans (3)	49,850	17,097
Unused portion of business lines of credit	17,740	16,878
Standby letters of credit	839	259

(1) Commitments for loans are extended to customers for up to 90 days after which they expire. Excludes commitments to originate loans held for sale, which are discussed in the following footnote.

(2) Unused portions of home equity loans are available to the borrower for up to 10 years.

(3) Unused portions of construction loans are available to the borrower for up to one year.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements of the Company. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral obtained generally consists of mortgages on the underlying real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds mortgages on the underlying real estate as collateral supporting those commitments for which collateral is deemed necessary.

The Company has determined that there are no probable losses related to commitments to extend credit or the standby letters of credit as of September 30, 2018 and December 31, 2017.

In the normal course of business, the Company, or its subsidiaries, are involved in various legal proceedings. In the opinion of management, any liability resulting from pending proceedings would not be expected to have a material adverse effect on the Company's consolidated financial statements.

Herrington et al. v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit that was filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their employment agreements. On July 5, 2017, the arbitrator issued a Final Award finding Waterstone Mortgage Corporation liable for unpaid

minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. On December 8, 2017, the District Court confirmed the award in large part, and entered a judgment against Waterstone in the amount of \$7,267,919 in damages to Claimants, \$3,298,851 in attorney fees and costs, and a \$20,000 incentive fee to Plaintiff Herrington, plus post-judgment interest. On February 12, 2018, the District Court awarded post-arbitration fees and costs of approximately \$98,000. The judgment was appealed by Waterstone to the Seventh Circuit Court of Appeals, where oral argument was held on May 29, 2018. On October 22, 2018, the Seventh Circuit issued a ruling vacating the District Court's order enforcing the arbitration award. If the District Court determines the agreement only allows for individual arbitration, the award would be vacated and the case sent to individual arbitration for a new proceeding. If the District Court determines the arbitration agreement nevertheless allows for collective arbitration, the District Court could confirm the prior award.

If the judgment is upheld in full, the Company has estimated that the award, which includes attorney's fees, costs, and interest, could be as high as \$11 million. However, Waterstone has meaningful appellate rights and intends to vigorously defend its interests in this matter, including arguing for complete reversal on appeal. Although the Company believes there is a strong basis to vacate the award, there remains a reasonable possibility that the Court's judgment will be affirmed in whole or in part, with the possible range of loss from \$0 to \$11 million. We do not believe that the loss is probable at this time, as that term is used in assessing loss contingencies. Accordingly, in accordance with the authoritative guidance in the evaluation of contingencies, the Company has not recorded an accrual related to this matter.

Werner v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a putative collection action lawsuit that was filed on August 4, 2017 in the United States District Court for the Western District of Wisconsin, Werner et al. v. Waterstone Mortgage Corporation. Plaintiffs allege that Waterstone Mortgage Corporation violated the Fair Labor Standards Act (FLSA) by failing to pay loan officers minimum and overtime wages. On October 26, 2017, Plaintiffs moved for conditional certification and to provide notice to the putative class. On February 9, 2018, the Court denied Plaintiffs' motion for conditional certification and notice. The Company intends to continue to vigorously defend its interests in this matter and pursue all possible defenses against the claims. Given the early stage of the litigation, the Company is not yet able to make a determination as to the likelihood of an unfavorable outcome in this matter, or is it able to estimate the range of any possible loss.

Note 12 – Derivative Financial Instruments

In connection with its mortgage banking activities, the Company enters into derivative financial instruments as part of its strategy to manage its exposure to changes in interest rates. Mortgage banking derivatives include interest rate lock commitments provided to customers to fund mortgage loans to be sold in the secondary market and forward commitments for the future delivery of such loans to third party investors. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of future changes in interest rates on its commitments to fund the loans as well as on its portfolio of mortgage loans held for sale. The Company's mortgage banking derivatives have not been designated as hedge relationships. These instruments are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements of ASC 815. Changes in the fair value of derivatives not designated in hedging relationships are recorded as a component of mortgage banking income in the Company's consolidated statements of operations. The Company does not use derivatives for speculative purposes.

Forward commitments to sell mortgage loans represent commitments obtained by the Company from a secondary market agency to purchase mortgages from the Company at specified interest rates and within specified periods of time. Commitments to sell loans are made to mitigate interest rate risk on interest rate lock commitments to originate loans and loans held for sale. At September 30, 2018, the Company had forward commitments to sell mortgage loans with an aggregate notional amount of approximately \$399.2 million and interest rate lock commitments with an aggregate notional amount of approximately \$252.7 million. The fair value of the forward commitments to sell mortgage loans at September 30, 2018 included a gain of \$1.6 million that is reported as a component of other assets on the Company's consolidated statement of financial condition. The fair value of the interest rate locks at September 30, 2018 included a gain of \$1.8 million that is reported as a component of other assets on the Company's consolidated statements of financial condition.

In determining the fair value of its derivative loan commitments, the Company considers the value that would be generated by the loan arising from exercise of the loan commitment when sold in the secondary mortgage market. That value includes the price that the loan is expected to be sold for in the secondary mortgage market. The fair value of these commitments is recorded on the consolidated statements of financial condition with the changes in fair value recorded as a component of mortgage banking income.

The significant unobservable input used in the fair value measurement of the Company's mortgage banking derivatives, including interest rate lock commitments, is the loan pull through rate. This represents the percentage of loans currently in a lock position which the Company estimates will ultimately close. Generally, the fair value of an interest rate lock commitment will be positively (negatively) impacted when the prevailing interest rate is lower (higher) than the interest rate lock commitment. Generally, an increase in the pull through rate will result in the fair value of the interest rate lock increasing when in a gain position, or decreasing when in a loss position. The pull through rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. The pull through rate is computed using historical data and the ratio is periodically reviewed by the Company.

Residential mortgage loans sold to others are predominantly conventional residential first lien mortgages. The Company's agreements to sell residential mortgage loans in the normal course of business usually require certain representations and warranties on the underlying loans sold related to credit information, loan documentation and collateral, which if subsequently are untrue or breached, could require the Company to repurchase certain loans affected. The Company has only been required to make insignificant repurchases as a result of breaches of these representations and warranties. The Company's agreements to sell residential mortgage loans also contain limited recourse provisions. The recourse provisions are limited in that the recourse provision ends after certain payment criteria have been met. With respect to these loans, repurchase could be required if defined delinquency issues arose during the limited recourse period. Given that the underlying loans delivered to buyers are predominantly

conventional first lien mortgages and that historical experience shows negligible losses and insignificant repurchase activity, management believes that losses and repurchases under the limited recourse provisions will continue to be insignificant.

Note 13 – Earnings Per Share

Earnings per share are computed using the two-class method. Basic earnings per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the applicable period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares.

Presented below are the calculations for basic and diluted earnings per share:

	Three months ended September 30, 2018		Nine months ended September 30, 2017	
	2018	2017	2018	2017
	(In Thousands, except per share amounts)			
Net income	\$8,703	\$7,389	\$25,076	\$22,849
Weighted average shares outstanding	27,451	27,532	27,488	27,449
Effect of dilutive potential common shares	229	421	277	478
Diluted weighted average shares outstanding	27,680	27,953	27,765	27,927
Basic earnings per share	\$0.32	\$0.27	\$0.91	\$0.83
Diluted earnings per share	0.31	0.26	0.90	0.82

Note 14 – Fair Value Measurements

ASC Topic 820, "Fair Value Measurements and Disclosures" defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This accounting standard applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements. The standard also emphasizes that fair value (i.e., the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date), among other things, is based on exit price versus entry price, should include assumptions about risk such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. When considering the assumptions that market participants would use in pricing the asset or liability, this accounting standard establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The fair value hierarchy prioritizes inputs used to measure fair value into three broad levels.

Level 1 inputs - In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2 inputs - Fair values determined by Level 2 inputs use inputs other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets where there are few transactions and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Level 3 inputs are unobservable inputs for the asset or liability and include situations where there is little, if any, market activity for the asset or liability.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The following table presents information about our assets recorded in our consolidated statement of financial condition at their fair value on a recurring basis as of September 30, 2018 and December 31, 2017, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

	September 30, 2018	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Available for sale securities				
Mortgage-backed securities	\$44,366	\$-	\$44,366	\$-
Collateralized mortgage obligations				
Government sponsored enterprise issued	63,824	-	63,824	-
Government sponsored enterprise bonds	499	-	499	-
Municipal securities	56,650	-	56,650	-

The following summarizes the valuation techniques for assets recorded in our consolidated statements of financial condition at their fair value on a recurring basis:

Available for sale securities – The Company's investment securities classified as available for sale include: mortgage-backed securities, collateralized mortgage obligations, government sponsored enterprise bonds, municipal securities and other debt securities. The fair value of mortgage-backed securities, collateralized mortgage obligations and government sponsored enterprise bonds are determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities, prepayment models and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. The fair value of municipal and other debt securities is determined by a third party valuation source using observable market data utilizing a multi-dimensional relational pricing model. Standard inputs to this model include observable market data such as benchmark yields, reported trades, broker quotes, rating updates and issuer spreads. These model measurements are classified as Level 2 in the fair value hierarchy. The change in fair value is recorded through an adjustment to the statement of comprehensive income.

Loans held for sale – The Company carries loans held for sale at fair value under the fair value option model. Fair value is generally determined by estimating a gross premium or discount, which is derived from pricing currently observable in the secondary market, principally from observable prices for forward sale commitments. Loans held-for-sale are considered to be Level 2 in the fair value hierarchy of valuation techniques. The change in fair value is recorded through an adjustment to the statement of income.

Mortgage banking derivatives - Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company utilizes a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment and then multiplying by quoted investor prices. The Company also utilizes a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. While there are Level 2 and 3 inputs used in the valuation models, the Company has determined that one or more of the inputs significant in the valuation of both of the mortgage banking derivatives fall within Level 3 of the fair value hierarchy. The change in fair value is recorded through an adjustment to the statement of income.

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2018 and 2017.

	Mortgage banking derivatives, net (In Thousands)
Balance at December 31, 2016	\$ 3,334
Mortgage derivative loss, net	(1,330)
Balance at December 31, 2017	\$ 2,004
Mortgage derivative gain, net	1,462
Balance at September 30, 2018	\$ 3,466

There were no transfers in or out of Level 1, 2 or 3 measurements during the periods.

Assets Recorded at Fair Value on a Non-recurring Basis

The following tables present information about our assets recorded in our consolidated statement of financial condition at their fair value on a non-recurring basis as of September 30, 2018 and December 31, 2017, and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value.

	Fair Value Measurements Using			
	September			
	30,	Level	Level	Level
	2018	1	2	3
	(In Thousands)			
Impaired loans, net (1)	\$460	\$-	\$-	\$460
Real estate owned	2,170	-	-	2,170

	Fair Value Measurements Using			
	December			
	31,	Level	Level	Level
	2017	1	2	3
	(In Thousands)			
Impaired loans, net (1)	\$861	\$-	\$-	\$861
Real estate owned	4,558	-	-	4,558

(1) Represents collateral-dependent impaired loans, net, which are included in loans.

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A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Fair value information about financial instruments follows, whether or not recognized in the consolidated statements of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company's financial instruments consist of the following:

	September 30, 2018					December 31, 2017				
	Carrying amount (In Thousands)	Fair Value Total	Level 1	Level 2	Level 3	Carrying amount	Fair Value Total	Level 1	Level 2	Level 3
Financial Assets										
and cash										
Equivalents	\$58,856	\$58,856	\$51,581	\$7,275	\$-	\$48,607	\$48,607	\$39,607	\$9,000	\$-
Securities										
Available-for-sale	179,076	179,076	-	179,076	-	199,707	199,707	-	199,707	-
Assets held for	192,674	192,674	-	192,674	-	149,896	149,896	-	149,896	-
Accounts receivable	1,357,656	1,278,679	-	-	1,278,679	1,291,814	1,291,142	-	-	1,291,142
Bank stock	19,575	19,575	-	19,575	-	16,875	16,875	-	16,875	-
Quoted interest										
Available	5,381	5,381	5,381	-	-	4,924	4,924	4,924	-	-
Engage										
Trading rights	1,099	1,575	-	-	1,575	888	1,125	-	-	1,125
Engage										
Trading										
Intangible assets	3,466	3,466	-	-	3,466	2,004	2,004	-	-	2,004
Financial										
Liabilities										
Deposits	1,004,450	1,003,886	290,711	713,175	-	967,380	967,558	278,401	689,157	-
Liabilities										
Arrows for	30,460	30,460	30,460	-	-	4,876	4,876	4,876	-	-
Drawings	451,132	445,500	-	445,500	-	386,285	384,348	-	384,348	-
Quoted interest										
Available	1,154	1,154	1,154	-	-	886	886	886	-	-
Engage										
Trading										
Intangible										
Liabilities	-	-	-	-	-	-	-	-	-	-

The following methods and assumptions were used by the Company in determining its fair value disclosures for financial instruments.

Cash and Cash Equivalents

The carrying amount reported in the consolidated statements of financial condition for cash and cash equivalents is a reasonable estimate of fair value.

Securities

The fair value of securities is generally determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. Prepayment models are used for mortgage related securities with prepayment features.

Loans Held for Sale

Fair value is estimated using the prices of the Company's existing commitments to sell such loans and/or the quoted market price for commitments to sell similar loans.

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Loans Receivable

The fair value estimation process for the loan portfolio uses an exit price concept and reflects discounts the Company believes are consistent with discounts in the market place. Fair values are estimated for portfolios of loans with similar characteristics. Loans are segregated by type such as one- to four-family, multi-family, home equity, construction and land, commercial real estate, commercial, and other consumer. The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for similar maturities. The fair value analysis also includes other assumptions to estimate fair value, intended to approximate those a market participant would use in an orderly transaction, with adjustments for discount rates, interest rates, liquidity, and credit spreads, as appropriate.

FHLB Stock

For FHLB stock, the carrying amount is the amount at which shares can be redeemed with the FHLB and is a reasonable estimate of fair value.

Deposits and Advance Payments by Borrowers for Taxes

The fair values for interest-bearing and noninterest-bearing negotiable order of withdrawal accounts, savings accounts, and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates of similar remaining maturities to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit. The advance payments by borrowers for taxes are equal to their carrying amounts at the reporting date.

Borrowings

Fair values for borrowings are estimated using a discounted cash flow calculation that applies current interest rates to estimated future cash flows of the borrowings.

Accrued Interest Payable and Accrued Interest Receivable

For accrued interest payable and accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would be generally established at market rates at the time of the draw. Fair values for the Company's commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the counterparty's credit standing, and discounted cash flow analyses. The fair value of the Company's commitments to extend credit was not material at September 30, 2018 and December 31, 2017.

Mortgage Banking Derivative Assets and Liabilities

Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company relies on a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment, and then multiplying by quoted investor prices. The Company also relies on a

valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. On the Company's Consolidated Statements of Condition, instruments that have a positive fair value are included in prepaid expenses and other assets, and those instruments that have a negative fair value are included in other liabilities.

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Note 15 – Segment Reporting

Selected financial and descriptive information is required to be provided about reportable operating segments, considering a "management approach" concept as the basis for identifying reportable segments. The management approach is based on the way that management organizes the segments within the enterprise for making operating decisions, allocating resources, and assessing performance. Consequently, the segments are evident from the structure of the enterprise's internal organization, focusing on financial information that an enterprise's chief operating decision-makers use to make decisions about the enterprise's operating matters.

The Company has determined that it has two reportable segments: community banking and mortgage banking. The Company's operating segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Company and therefore, the financial results of the Company's business segments are not necessarily comparable with similar information for other financial institutions.

Community Banking

The community banking segment provides consumer and business banking products and services to customers primarily within Southeastern Wisconsin along with a loan production office in Minneapolis, Minnesota. Within this segment, the following products and services are provided: (1) lending solutions such as residential mortgages, home equity loans and lines of credit, personal and installment loans, real estate financing, business loans, and business lines of credit; (2) deposit and transactional solutions such as checking, credit, debit and pre-paid cards, online banking and bill pay, and money transfer services; (3) investable funds solutions such as savings, money market deposit accounts, IRA accounts, certificates of deposit, and (4) fixed and variable annuities, insurance as well as trust and investment management accounts.

Consumer products include loan and deposit products: mortgage, home equity loans and lines, personal term loans, demand deposit accounts, interest bearing transaction accounts and time deposits. Consumer products also include personal investment services. Business banking products include secured and unsecured lines and term loans for working capital, inventory and general corporate use, commercial real estate construction loans, demand deposit accounts, interest bearing transaction accounts and time deposits.

Mortgage Banking

The mortgage banking segment provides residential mortgage loans for the primary purpose of sale on the secondary market. Mortgage banking products and services are provided by offices in 24 states with the ability to lend in 47 states.

As of or for the three months ended September 30, 2018

	Community Banking (In Thousands)	Mortgage Banking	Holding Company and Other	Consolidated
Net interest income (loss)	\$ 14,121	\$(286)	\$ 15	\$ 13,850
Provision for loan losses	-	40	-	40
Net interest income (loss) after provision for loan losses	14,121	(326)	15	13,810
Noninterest income	1,312	33,165	(415)	34,062

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Noninterest expenses:

Compensation, payroll taxes, and other employee benefits	4,435	23,164	(146)	27,453
Occupancy, office furniture and equipment	826	1,925	-	2,751
FDIC insurance premiums	131	-	-	131
Real estate owned	(128)	-	-	(128)
Other	1,536	4,947	(264)	6,219
Total noninterest expenses	6,800	30,036	(410)	36,426
Income before income taxes	8,633	2,803	10	11,446
Income tax expense	2,003	737	3	2,743
Net income	\$6,630	\$2,066	\$7	\$8,703
Total assets	\$1,901,441	\$230,769	\$(212,807)	\$1,919,403

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	As of or for the three months ended September 30, 2017			
	Community Banking	Mortgage Banking	Holding Company and Other	Consolidated
	(In Thousands)			
Net interest income (loss)	\$13,120	\$(102)	) \$15	\$13,033
Provision for loan losses	-	20	-	20
Net interest income (loss) after provision for loan losses	13,120	(122)	) 15	13,013
Noninterest income	1,161	32,318	(425)	) 33,054
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	4,483	21,792	(122)	) 26,153
Occupancy, office furniture and equipment	733	1,800	-	2,533
FDIC insurance premiums	129	-	-	129
Real estate owned	(20)	) -	-	(20)
Other	1,499	4,290	(268)	) 5,521
Total noninterest expenses	6,824	27,882	(390)	) 34,316
Income (loss) before income taxes	7,457	4,314	(20)	) 11,751
Income tax expense (benefit)	2,597	1,767	(2)	) 4,362
Net income (loss)	\$4,860	\$2,547	\$(18)	) \$7,389
Total assets	\$1,859,494	\$203,826	\$(209,192)	\$1,854,128

	As of or for the nine months ended September 30, 2018			
	Community Banking	Mortgage Banking	Holding Company and Other	Consolidated
	(In Thousands)			
Net interest income	\$41,172	\$(518)	) \$57	\$40,711
Provision for loan losses	(1,150)	90	-	(1,060)
Net interest income (loss) after provision for loan losses	42,322	(608)	) 57	41,771
Noninterest income	3,388	90,443	(1,268)	) 92,563
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	13,624	61,483	(437)	) 74,670
Occupancy, office furniture and equipment	2,465	5,530	-	7,995
FDIC insurance premiums	361	-	-	361
Real estate owned	63	-	-	63
Other	4,557	14,457	(793)	) 18,221
Total noninterest expenses	21,070	81,470	(1,230)	) 101,310
Income before income taxes	24,640	8,365	19	33,024
Income tax expense	5,641	2,305	2	7,948

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Net income	\$18,999	\$6,060	\$17	\$25,076
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As of or for the nine months ended September 30, 2017

	Community Banking	Mortgage and Banking	Holding Company Other	Consolidated
	(In Thousands)			
Net interest income	\$37,233	\$23	\$ 153	\$ 37,409
Provision for loan losses	(1,300)	134	-	(1,166)
Net interest income after provision for loan losses	38,533	(111)	153	38,575
Noninterest income	2,968	94,446	(1,182)	96,232
Noninterest expenses:				
Compensation, payroll taxes, and other employee benefits	12,964	61,134	(366)	73,732
Occupancy, office furniture and equipment	2,356	5,231	-	7,587
FDIC insurance premiums	366	-	-	366
Real estate owned	258	-	-	258
Other	4,382	13,934	(698)	17,618
Total noninterest expenses	20,326	80,299	(1,064)	99,561
Income before income taxes	21,175	14,036	35	35,246
Income tax expense	6,658	5,716	23	12,397
Net income (loss)	\$14,517	\$8,320	\$ 12	\$ 22,849

Note 16. - Business Combination

Academy Mortgage Corporation Branch

On June 29, 2018, Waterstone Mortgage Corporation, a subsidiary of WaterStone Bank SSB, completed an acquisition of a branch of Academy Mortgage Corporation, a mortgage banking company. Waterstone Mortgage Corporation paid Academy approximately \$600,000 in cash for the transaction.

Waterstone Mortgage Corporation's acquisition of the branch was accounted for as a business combination. Under the transaction, fixed assets and a customer list were acquired and the branch leases were assumed. Under this method of accounting, assets acquired are recorded at their estimated fair values. Total consideration paid less the fair value of assets acquired was recorded as goodwill. The Company recorded an insignificant amount of goodwill as a result of this acquisition. The determination of estimated fair values required management to make certain estimates that are subjective in nature and may require adjustments upon the availability of new information regarding facts and circumstances which existed at the date of acquisition (i.e., appraisals) for up to a year following the acquisition. The Company continues to review information relating to events or circumstances existing at the acquisition date. Management's continuing review could result in adjustments to the acquisition date valuation amounts presented herein but does not anticipate that these adjustments will be material.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

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

Forward-Looking Information

This Quarterly Report on Form 10-Q may contain various forward-looking statements, which can be identified by the use of words such as "estimate," "project," "believe," "intend," "anticipate," "plan," "seek," "expect" and similar expressions and verbs in the future tense. These forward-looking statements include, but are not limited to:

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

These forward-looking statements are based on current beliefs and expectations of our management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins and yields, our mortgage banking revenues, the fair value of financial instruments or the origination levels in our lending business, or increase the level of defaults, losses or prepayments on loans we have made and make whether held in portfolio or sold in the secondary markets;
- adverse changes in the securities or secondary mortgage markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- changes in monetary or fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board;
- our ability to manage market risk, credit risk and operational risk in the current economic conditions;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities;
- decreased demand for our products and services;
- changes in tax policies or assessment policies;
- the inability of third-party providers to perform their obligations to us;
- changes in consumer demand, spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission or the Public Company Accounting Oversight Board;
- our ability to retain key employees;

cyber attacks, computer viruses and other technological risks that may breach the security of our websites or other systems to obtain unauthorized access to confidential information and destroy data or disable our systems; technological changes that may be more difficult or expensive than expected; the ability of third-party providers to perform their obligations to us; the ability of the U.S. Government to manage federal debt limits; significant increases in our loan losses; and changes in the financial condition, results of operations or future prospects of issuers of securities that we own.

See also the factors referred to in reports filed by the Company with the Securities and Exchange Commission (particularly those under the caption "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017).

Overview

The following discussion and analysis is presented to assist the reader in understanding and evaluating the Company's financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Quarterly Report on Form 10-Q and should be read in conjunction therewith. The detailed discussion in the sections below focuses on the results of operations for the three and nine months ended September 30, 2018 and 2017 and the financial condition as of September 30, 2018 compared to the financial condition as of December 31, 2017.

As described in the notes to the unaudited consolidated financial statements, we have two reportable segments: community banking and mortgage banking. The community banking segment provides consumer and business banking products and services to customers primarily within Southeastern Wisconsin along with a loan production office in Minneapolis, Minnesota. Consumer products include loan products, deposit products, and personal investment services. Business banking products include loans for working capital, inventory and general corporate use, commercial real estate construction loans, and deposit accounts. The mortgage banking segment, which is conducted by offices in 24 states through Waterstone Mortgage Corporation, consists of originating residential mortgage loans primarily for sale in the secondary market.

Our community banking segment generates the significant majority of our consolidated net interest income and requires the significant majority of our provision for loan losses. Our mortgage banking segment generates the significant majority of our noninterest income and a majority of our noninterest expenses. We have provided below a discussion of the material results of operations for each segment on a separate basis for the three and nine months ended September 30, 2018 and 2017, which focuses on noninterest income and noninterest expenses. We have also provided a discussion of the consolidated operations of the Company, which includes the consolidated operations of the Bank and Waterstone Mortgage Corporation, for the same periods.

Comparison of Community Banking Segment Results of Operations for the Three Months Ended September 30, 2018 and 2017

Net income for the three months ended September 30, 2018 totaled \$6.6 million compared to net income of \$4.9 million for the three months ended September 30, 2017. Net interest income increased \$1.0 million to \$14.1 million for the three months ended September 30, 2018 compared to \$13.1 million for the three months ended September 30, 2017. Net interest income increased due to an increase in average loan balances, an increase in loan rates, and a reduction in our overall cost of borrowings. The long-term borrowings that matured during 2017 and the first nine months ended September 30, 2018 were replaced with a lower cost mix of funding, including long and short-term borrowings and deposits raised through our retail network. There was no provision for loan losses for either the three months ended September 30, 2018 or the three months ended September 30, 2017.

Total noninterest income increased \$151,000 due primarily to increases in loan fees, cash surrender value of life insurance, and other income. The loan fees increased primary due to increased loan prepayments. Cash surrender value of life insurance increased as the earnings rate improved slightly year over year. Other income increased primarily due to an increase in rental and wealth management income.

Compensation, payroll taxes, and other employee benefits expense decreased \$48,000 to \$4.4 million due primarily to a decrease in stock based compensation expenses partially offset by increases in salaries expense. Occupancy, office furniture, and equipment increased \$93,000 due primarily to increased computer and maintenance expense. Real estate owned expense decreased as there was an increase in gain on sale of real estate owned and a decrease in writedowns. Other noninterest expense increased resulting from an increase in professional fees and advertising costs.

Comparison of Mortgage Banking Segment Results of Operations for the Three Months Ended September 30, 2018 and 2017

Net income totaled \$2.1 million for the three months ended September 30, 2018 compared to \$2.5 million for the three months ended September 30, 2017. We originated \$761.2 million in mortgage loans held for sale during the three months ended September 30, 2018, which was an increase of \$76.7 million, or 11.2%, from the \$684.5 million originated during the three months ended September 30, 2017. The increase in loan production volume was driven by a 14.3% increase in mortgage purchase products offset by a 15.5% decrease in refinance products. Total mortgage banking noninterest income increased \$847,000, or 2.6%, to \$33.2 million during the three months ended September 30, 2018 compared to \$32.3 million during the three months ended September 30, 2017. The increase in mortgage banking noninterest income related to an increase in volume. Offsetting the increase in volume, margins decreased approximately 10% for the three months ended September 30, 2018 compared to September 30, 2017. The margin compression reflects industry dynamics, as price-based competition has escalated to maintain market share in the face of lower demand.

Our overall margin can be affected by the mix of both loan type (conventional loans versus governmental) and loan purpose (purchase versus refinance). Conventional loans include loans that conform to Fannie Mae and Freddie Mac standards, whereas governmental loans are those loans guaranteed by the federal government, such as a Federal Housing Authority or U.S. Department of Agriculture loan. Loans originated for the purchase of a residential property, which generally yield a higher margin than loans originated for refinancing existing loans, comprised 92.1% of total originations during the three months ended September 30, 2018, compared to 89.6% of total originations during the three months ended September 30, 2017. The mix of loan type trended towards more conventional loans and less governmental loans; with conventional loans and governmental loans comprising 70.4% and 29.6% of all loan originations, respectively, during the three months ended September 30, 2018, compared 64.5% and 35.5% of all loan originations, respectively, during the three months ended September 30, 2017.

Total compensation, payroll taxes and other employee benefits increased \$1.4 million, or 6.3%, to \$23.2 million for the three months ended September 30, 2018 compared to \$21.8 million for the three months ended September 30, 2017. The increase in compensation expense was primarily a result of the increase in salaries as the New Mexico branches were added at the end of the second quarter. In addition to the salaries increased, commission expense increased as volumes grew with the New Mexico expansion. Occupancy, office furniture, and equipment expense increased as the New Mexico branches were added. Other noninterest expense increased primarily due to increased origination expenses, advertising expenses, data processing expenses, and communication expenses offset by slightly lower legal fees.

Consolidated Waterstone Financial, Inc. Results of Operations

	Three months ended September 30, 2018 2017 (Dollars in Thousands, except per share amounts)	
Net income	\$8,703	7,389
Earnings per share - basic	0.32	0.27
Earnings per share - diluted	0.31	0.26
Annualized return on average assets	1.80 %	1.56 %
Annualized return on average equity	8.48 %	7.12 %

Net Interest Income

Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans are included in the computation of the average balances of loans receivable and held for sale. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense. Yields on interest-earning assets are computed on a fully tax-equivalent yield, where applicable.

	Three months ended September 30, 2018			2017				
	Average Balance	Interest	Yield/Cost	Average Balance	Interest	Yield/Cost		
(Dollars in Thousands)								
Assets								
Interest-earning assets:								
Loans receivable and held for sale (1)	\$1,507,632	\$17,340	4.56	%	\$1,419,477	\$15,855	4.43	%
Mortgage related securities (2)	106,047	643	2.41	%	119,902	647	2.14	%
Debt securities, federal funds sold and short-term investments (2)(3)	176,733	1,141	2.56	%	215,597	1,118	2.06	%
Total interest-earning assets	1,790,412	19,124	4.24	%	1,754,976	17,620	3.98	%
Noninterest-earning assets	122,575				121,982			
Total assets	\$1,912,987				\$1,876,958			
Liabilities and equity								
Interest-bearing liabilities:								
Demand accounts	\$37,936	10	0.10	%	\$35,211	7	0.08	%
Money market and savings accounts	185,864	163	0.35	%	175,666	104	0.23	%
Time deposits	707,970	2,890	1.62	%	676,881	1,870	1.10	%
Total interest-bearing deposits	931,770	3,063	1.30	%	887,758	1,981	0.89	%
Borrowings	444,570	2,133	1.90	%	461,549	2,439	2.10	%
Total interest-bearing liabilities	1,376,340	5,196	1.50	%	1,349,307	4,420	1.30	%
Noninterest-bearing liabilities								
Noninterest-bearing deposits	100,804				91,710			
Other noninterest-bearing liabilities	28,632				24,265			
Total noninterest-bearing liabilities	129,436				115,975			
Total liabilities	1,505,776				1,465,282			
Equity	407,211				411,676			
Total liabilities and equity	\$1,912,987				\$1,876,958			
Net interest income / Net interest rate spread (4)								
		13,928	2.74	%		13,200	2.68	%
Less: taxable equivalent adjustment		78	0.02	%		167	0.03	%
Net interest income / Net interest rate spread, as reported		\$13,850	2.72	%		\$13,033	2.65	%
Net interest-earning assets (5)	\$414,072				\$405,669			
Net interest margin (6)			3.07	%			2.95	%
Tax equivalent effect			0.02	%			0.03	%
			3.09	%			2.98	%

Net interest margin on a fully tax
equivalent basis (6)

Average interest-earning assets to average
interest-bearing liabilities

130.09 %

130.06 %

(1) Interest income includes net deferred loan fee amortization income of \$163,000 and \$178,000 for the three months ended September 30, 2018 and 2017, respectively.

(2) Average balance of mortgage related and debt securities are based on amortized historical cost.

(3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 21% for the three months ended September 30, 2018 and 35% for the three months ended September 30, 2017. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 2.39% and 1.75% for the three months ended September 30, 2018 and 2017, respectively.

(4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.

(5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.

(6) Net interest margin represents net interest income divided by average total interest-earning assets.

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Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

	Three months ended September 30, 2018 versus 2017 Increase (Decrease) due to		
	Volume	Rate	Net
	(In Thousands)		
Interest income:			
Loans receivable and held for sale (1)(2)	\$1,067	\$418	\$1,485
Mortgage related securities (3)	(79)	75	(4)
Debt securities, federal funds sold and short-term investments (3)(4)	(220)	243	23
Total interest-earning assets	768	736	1,504
Interest expense:			
Demand accounts	1	2	3
Money market and savings accounts	6	53	59
Time deposits	90	930	1,020
Total interest-earning deposits	97	985	1,082
Borrowings	(85)	(221)	(306)
Total interest-bearing liabilities	12	764	776
Net change in net interest income	\$756	\$(28)	\$728

(1) Interest income includes net deferred loan fee amortization income of \$163,000 and \$178,000 for the three months ended September 30, 2018 and 2017, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 21% for the three months ended September 30, 2018 and 35% for the three months ended September 30, 2017.

Net interest income increased \$817,000, or 6.3%, to \$13.9 million during the three months ended September 30, 2018 compared to \$13.0 million during the three months ended September 30, 2017.

Interest income on loans increased \$1.5 million due primarily to an increase of \$88.2 million, or 6.2%, in average loans along with a 13 basis point increase in average yield on loans. The increase in average loan balance was driven by a \$91.3 million, or 7.3%, increase in the average balance of loans held in portfolio partially offset by a decrease of \$3.2 million, or 1.9%, in the average balance of loans held for sale.

Interest income from mortgage-related securities decreased \$4,000 year over year as the average balance decreased \$13.9 million as securities have paid down and less purchases have occurred to replace those securities, as excess funds were used to support loan growth. The yield increased 27 basis points.

Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased \$112,000 due to a 64 basis point increase in the average yield. The increase in average yield was driven by four rate increases in the Federal Funds rate since September 2017 along with the increase in the dividend paid by the FHLB on its stock. The average balance decreased \$38.9 million to \$176.7 million. Municipal securities that matured throughout the past 12 months were not replaced due to market conditions. Those funds were primarily used to fund loan growth while the remainder was held in a cash account.

Interest expense on time deposits increased \$1.0 million, or 54.5%, primarily due to a 52 basis point increase of average cost of time deposits, as maturing time deposits have repriced or have been replaced at a slightly higher rate in the current competitive market. In addition to the increase in cost of time deposits, the average balance of time deposits increased \$31.1 million compared to the prior year period.

Interest expense on money market and savings accounts increased \$59,000 due primarily to a 12 basis point increase in average cost of savings and money market accounts along with an increase in average balance of \$10.2 million.

Interest expense on borrowings decreased \$306,000, or 12.5%, due to a decrease in the average cost of borrowings that resulted from the maturity and replacement of fixed rate borrowings since the beginning of the prior year. The average cost of borrowings totaled 1.90% during the quarter ended September 30, 2018, compared to 2.10% during the quarter ended September 30, 2017. In addition to the decrease in rate, average borrowing volume decreased.

Provision for Loan Losses

Our provision for loan losses was \$40,000 for the three months ended September 30, 2018, compared to \$20,000 for the three months ended September 30, 2017. The provision for loan losses was due to an increase in loans held at our mortgage banking segment.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Losses" section.

Noninterest Income

	Three months ended September 30,				
	2018	2017	\$ Change	% Change	
	(Dollars in Thousands)				
Service charges on loans and deposits	\$442	\$300	\$ 142	47.3	%
Increase in cash surrender value of life insurance	695	688	7	1.0	%
Loss on sale of securities	-	-	-	N/	M
Mortgage banking income	32,653	31,863	790	2.5	%
Other	272	203	69	34.0	%
Total noninterest income	\$34,062	\$33,054	\$ 1,008	3.0	%

N/M - Not meaningful

Total noninterest income increased \$1.0 million, or 3.0%, to \$34.1 million during the three months ended September 30, 2018 compared to \$33.1 million during the three months ended September 30, 2017. The increase resulted primarily from a increase in mortgage banking income and an increase in service charges on loans and deposits along with a slight increase in each of the other noninterest income categories.

The increase in mortgage banking income was primarily the result of an increase in volumes. Total loan origination volume on a consolidated basis increased \$74.8 million, or 11.3%, to \$736.9 million during the three months ended September 30, 2018 compared to \$662.1 million during the three months ended September 30, 2017. Gross margin on loans sold decreased approximately 10% at the mortgage banking segment. See "Comparison of Mortgage Banking Segment Operations for the Three Months Ended September 30, 2018 and 2017" above for additional discussion of the increase in mortgage banking income.

Service charges on loans and deposits increased primarily due to an increase in loan prepayment fees.

The increase in cash surrender value of life insurance was due to an increase in earnings on a higher balance.

The \$69,000 increase in other noninterest income was due primarily to an increase in mortgage servicing fee income along with an increase in wealth management revenue and rent income.

Noninterest Expenses

		Three months ended September 30,	
		\$	%
2018	2017	Change	Change

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(Dollars in Thousands)

Compensation, payroll taxes, and other employee benefits	\$27,453	\$26,153	\$ 1,300	5.0	%
Occupancy, office furniture and equipment	2,751	2,533	218	8.6	%
Advertising	1,224	821	403	49.1	%
Data processing	809	623	186	29.9	%
Communications	412	394	18	4.6	%
Professional fees	583	629	(46)	(7.3)	%
Real estate owned	(128)	(20)	(108)	540.0	%
FDIC insurance premiums	131	129	2	1.6	%
Other	3,191	3,054	137	4.5	%
Total noninterest expenses	\$36,426	\$34,316	\$ 2,110	6.1	%

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Total noninterest expenses increased \$2.1 million, or 6.1%, to \$36.4 million during the three months ended September 30, 2018 compared to \$34.3 million during the three months ended September 30, 2017.

Compensation, payroll taxes and other employee benefits expense at our mortgage banking segment increased \$1.4 million, or 6.3%, to \$23.2 million during the three months ended September 30, 2018. The increase in compensation expense was primarily a result of the increase in salaries as the New Mexico branches were added at the end of the second quarter. In addition to the salaries increase, commission expense increased as volumes increased with the New Mexico expansion.

Compensation, payroll taxes and other employee benefits expense at the community banking segment decreased \$48,000, or 1.1%, to \$4.4 million during the three months ended September 30, 2018. The decrease was due primarily to a decrease in stock based compensation expenses offset by increases in salaries expense.

Occupancy, office furniture and equipment expense at the mortgage banking segment increased \$125,000 to \$1.9 million during the three months ended September 30, 2018, resulting from additional rent and equipment needed with the additional New Mexico branches that were added at the end of the second quarter.

Occupancy, office furniture and equipment expense at the community banking segment increased \$93,000 to \$826,000 during the three months ended September 30, 2018. The increase was due primarily to increased computer and maintenance expense.

Advertising expense increased \$403,000, or 49.1%, to \$1.2 million during the three months ended September 30, 2018. This was primarily due to marketing increases at the mortgage banking segment in an effort to increase volumes at the branches.

Data processing expense increased \$186,000, or 29.9%, to \$809,000 during the three months ended September 30, 2018. This was primarily due to increases at the mortgage banking segment with the addition of the New Mexico branches.

Professional fees decreased \$46,000, or 7.3%, to \$583,000 during the three months ended September 30, 2018. This was primarily due to a decrease in legal expenses at the mortgage banking segment.

Net real estate owned expense decreased \$108,000, resulting in \$128,000 of income during the three months ended September 30, 2018, compared to \$20,000 of income during the three months ended September 30, 2017. Property management expense (other than gains/losses) decreased \$12,000 during the three months ended September 30, 2018 compared to the three months ended September 30, 2017. Net gains on sales of real estate owned increased \$54,000 to \$207,000 for the three months ended September 30, 2018 compared to \$153,000 for the three months ended September 30, 2017. Real estate owned writedowns decreased \$40,000 as there were no writedowns for the three months ended September 30, 2018 compared to \$40,000 for the three months ended September 30, 2017.

Other noninterest expense increased \$137,000 to \$3.2 million during the three months ended September 30, 2018. This increase was primarily at the mortgage banking segment and resulted from increased loan origination costs with the increase in volumes along with other overhead expenses with the additional New Mexico branches. In addition, other noninterest expenses decreased at the community banking segment due primarily to decreases in loan expenses.

Income Taxes

Income tax expense decreased \$1.6 million, or 37.1%, to \$2.7 million during the three months ended September 30, 2018, compared to \$4.4 million during the three months ended September 30, 2017. Income tax expense was recognized during the three months ended September 30, 2018 at an effective rate of 24.0% compared to an effective rate of 37.1% during the three months ended September 30, 2017. The decrease in the effective rate primarily resulted from the federal tax rate decrease from 35% to 21% as a result of The Tax Cuts and Jobs Act that was enacted into law on December 22, 2017. During the three months ended September 30, 2018, the Company recognized a benefit of approximately \$60,000 related to stock awards exercised compared to a benefit of \$21,000 recognized during the three months ended September 30, 2017.

Comparison of Community Banking Segment for the Nine Months Ended September 30, 2018 and 2017

Net income increased \$4.5 million for the nine months ended September 30, 2018 for a total of \$19.0 million compared to net income of \$14.5 million for the nine months ended September 30, 2017. Net interest income increased \$3.9 million to \$41.2 million for the nine months ended September 30, 2018 compared to \$37.2 million for the nine months ended September 30, 2017. Net interest income increased due to an increase in average loan balances, an increase in loan rates, and a reduction in our overall cost of borrowings. The long-term borrowings that matured during 2017 and the nine months ended September 30, 2018 were replaced with a lower cost mix of funding, including long and short-term borrowings and deposits raised through our retail network. Offsetting those decreases, the cost of deposits increased as interest expense on certificates of deposit increased as maturities repriced in the past year.

Provision for loan losses was a negative provision of \$1.2 million for the nine months ended September 30, 2018 compared to a negative provision of \$1.3 million for the nine months ended September 30, 2017.

Noninterest income increased \$420,000 primarily due to increases in loan fees and a decrease in loss on sale of available for sale securities along with slight increases to cash surrender value of life insurance and other income. The loan fees increased primary due to increased prepayment penalties. The decrease in loss on sale of available for sale securities resulted from a sale of a municipal bond for a loss of \$107,000 in 2017 with no sales in 2018. Cash surrender value of life insurance increased as a \$2.5 million policy was purchased in 2017. Other income increased primarily due to an increase in rental and wealth management income.

Compensation, payroll taxes, and other employee benefits expense increased \$660,000 due primarily to an increase in health insurance and salaries expense offset by lower stock based compensation expenses. Occupancy, office furniture, and equipment increased due primarily to increased snow removal and maintenance expense. Real estate owned expense decreased as there was a decrease in writedowns offset by a slight decrease in gain on sale of real estate owned and an increase in management expense. Other noninterest expense increased resulting from an increase in loan origination expenses.

Comparison of Mortgage Banking Segment Operations for the Nine Months Ended September 30, 2018 and 2017

Net income decreased \$2.3 million to \$6.1 million for the nine months ended September 30, 2018, compared to net income of \$8.3 million for the nine months ended September 30, 2017. Mortgage banking segment noninterest income decreased \$4.0 million, or 4.2%, to \$90.4 million for the nine months ended September 30, 2018 compared to \$94.4 million for the nine months ended September 30, 2017. The decrease in revenue was attributable to a decrease in margin of approximately 10%. Offsetting the decrease in margin, volume origination increased 2.7% to \$2.00 billion during the nine months ended September 30, 2018 compared to \$1.95 billion during the nine months ended September 30, 2017.

Loans originated by the mortgage banking segment for the purpose of sale in the secondary market increased \$52.3 million, or 2.7%, to \$2.00 billion during the nine months ended September 30, 2018, compared to \$1.95 billion for the nine months ended September 30, 2017. The increase in originations was driven by a 3.8% increase in the origination of loans made for the purpose of residential purchases offset by a 6.5% decrease in the origination of mortgage refinance products. Our origination efforts continue to be focused on loans made for the purpose of residential purchases, as opposed to mortgage refinance. The percentage of origination volume related to purchase activity increased slightly to 90.5% from 89.5% of total originations for the nine months ended September 30, 2018 and 2017, respectively. The mix of loan type trended towards more conventional loans and less governmental loans; with conventional loans and governmental loans comprising 69.2% and 30.8% of all loan originations, respectively, during the nine months ended September 30, 2018, compared to 63.9% and 36.1% of all originations, respectively, during the nine months ended September 30, 2017.

During the nine months ended September 30, 2018, no mortgage servicing rights were sold. During the nine months ended September 30, 2017, mortgage servicing rights related to \$295.1 million in loans receivable with a book value of \$2.3 million were sold at a gain of \$308,000.

Total compensation, payroll taxes and other employee benefits increased \$349,000, or 0.6%, to \$61.5 million for the nine months ended September 30, 2018 compared to \$61.1 million for the nine months ended September 30, 2017. The increase in compensation expense was primarily a result of the salary and health insurance increases with the additional branch network with the New Mexico branch acquisition. Offsetting those increases, commission expense and branch manager pay decreased. Occupancy, office furniture, and equipment expense increased as the number of branches increased with the addition of the New Mexico branches. Other noninterest expense increased primarily due to higher advertising expenses, data processing expenses, legal expense, and branch loss expenses.

Consolidated Waterstone Financial, Inc. Results of Operations

	Nine months ended September 30, 2018 2017 (Dollars in Thousands, except per share amounts)			
Net income	\$25,076		\$22,849	
Earnings per share - basic	0.91		0.83	
Earnings per share - diluted	0.90		0.82	
Annualized return on average assets	1.80	%	1.70	%
Annualized return on average equity	8.25	%	7.42	%

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Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans are included in the computation of the average balances of loans receivable and held for sale. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense. Yields on interest-earning assets are computed on a fully tax-equivalent yield, where applicable.

	Nine months ended September 30,						
	2018			2017			
	Average	Interest	Yield/Cost	Average	Interest	Yield/Cost	
	Balance			Balance			
	(Dollars in Thousands)						
Assets							
Interest-earning assets:							
Loans receivable and held for sale (1)	\$1,452,795	\$49,498	4.56	% \$1,357,884	\$45,078	4.44	%
Mortgage related securities (2)	109,843	1,925	2.34	% 126,856	2,021	2.13	%
Debt securities, federal funds sold and short-term investments (2)(3)	178,379	3,186	2.39	% 198,947	3,210	2.16	%
Total interest-earning assets	1,741,017	54,609	4.19	% 1,683,687	50,309	3.99	%
Noninterest-earning assets	118,424			117,316			
Total assets	\$1,859,441			\$1,801,003			
Liabilities and equity							
Interest-bearing liabilities:							
Demand accounts	\$37,539	24	0.09	% \$36,419	20	0.07	%
Money market and savings accounts	168,678	379	0.30	% 171,659	315	0.25	%
Time deposits	704,495	7,684	1.46	% 667,168	5,279	1.06	%
Total interest-bearing deposits	910,712	8,087	1.19	% 875,246	5,614	0.86	%
Borrowings	423,156	5,574	1.76	% 401,931	6,756	2.25	%
Total interest-bearing liabilities	1,333,868	13,661	1.37	% 1,277,177	12,370	1.29	%
Noninterest-bearing liabilities							
Noninterest-bearing deposits	96,273			88,454			
Other noninterest-bearing liabilities	22,762			23,408			
Total noninterest-bearing liabilities	119,035			111,862			
Total liabilities	1,452,903			1,389,039			
Equity	406,538			411,964			
Total liabilities and equity	\$1,859,441			\$1,801,003			
Net interest income / Net interest rate spread (4)							
		40,948	2.82	%	37,939	2.70	%
Less: taxable equivalent adjustment		237	0.01	%	530	0.04	%
Net interest income / Net interest rate spread, as reported		\$40,711	2.81	%	\$37,409	2.66	%
Net interest-earning assets (5)	\$407,149			\$406,510			
Net interest margin (6)			3.13	%		2.97	%
Tax equivalent effect			0.01	%		0.04	%
Net interest margin on a fully tax equivalent basis (6)			3.14	%		3.01	%
			130.52	%		131.83	%

Average interest-earning assets to average
interest-bearing liabilities

- (1) Interest income includes net deferred loan fee amortization income of \$547,000 and \$563,000 for the nine months ended September 30, 2018 and 2017, respectively.
- (2) Average balance of mortgage related and debt securities are based on amortized historical cost.
- (3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 21% for the nine months ended September 30, 2018 and 35% for the nine months ended September 30, 2017. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 2.21% and 1.80% for the nine months ended September 30, 2018 and 2017, respectively.
- (4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.
- (5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (6) Net interest margin represents net interest income divided by average total interest-earning assets.

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Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

	Nine months ended September 30, 2018 versus 2017 Increase (Decrease) due to Volume Rate Net (In Thousands)		
Interest income:			
Loans receivable and held for sale (1)(2)	\$3,221	\$1,199	\$4,420
Mortgage related securities (3)	(286)	190	(96)
Debt securities, federal funds sold and short-term investments (3) (4)	(350)	326	(24)
Total interest-earning assets	2,585	1,715	4,300
Interest expense:			
Demand accounts	1	3	4
Money market and savings accounts	(7)	71	64
Time deposits	311	2,094	2,405
Total interest-earning deposits	305	2,168	2,473
Borrowings	378	(1,560)	(1,182)
Total interest-bearing liabilities	683	608	1,291
Net change in net interest income	\$1,902	\$1,107	\$3,009

(1) Interest income includes net deferred loan fee amortization income of \$547,000 and \$563,000 for the nine months ended September 30, 2018 and 2017, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 21% for the nine months ended September 30, 2018 and 35% for the nine months ended September 30, 2017.

Net interest income increased \$3.3 million, or 8.8%, to \$40.7 million during the nine months ended September 30, 2018 compared to \$37.4 million during the nine months ended September 30, 2017.

Interest income on loans increased \$4.4 million due to an increase in average balance of \$94.9 million and by a 12 basis point increase in average yield on loans. The increase in average loan balance was driven by a \$108.6 million, or 8.9%, increase in the average balance of loans held in portfolio offset by a decrease in the average balance of loans held for sale of \$13.7 million, or 9.6%.

Interest income from mortgage related securities decreased \$96,000 year over year as securities have paid down and less purchases have occurred to replace those securities due to current market conditions.

Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased \$269,000 due to a 41 basis point increase in the average yield. The increase in average yield was driven by an increase in the Federal Funds rate since March 2017 along with the increase in the dividend paid by the FHLB on its stock. The average balance decreased \$20.6 million to \$178.4 million. Municipal securities that matured throughout the past 12 months were not replaced due to market conditions. Those funds were primarily used to fund loan growth at the community banking segment.

Interest expense on time deposits increased \$2.4 million primarily due to a 40 basis point increase in the average cost of time deposits, as maturing time deposits have repriced, or have been replaced at a higher rate in the current competitive market. Along with the increase in rate, the average balance of time deposits increased \$37.3 million compared to the prior year period.

Interest expense on money market and savings accounts increased \$64,000 due primarily to a five basis point increase in rate offset slightly by a decrease of \$3.0 million in average balance.

Interest expense on borrowings decreased \$1.2 million due to a decrease in the average cost of borrowings that resulted from the maturity and replacement of fixed rate borrowings. The average cost of borrowings totaled 1.76% during the nine months ended September 30, 2018, compared to 2.25% during the nine months ended September 30, 2017. Partially offsetting the decrease in rate, average volume increased to fund loan growth at the community banking segment.

Provision for Loan Losses

Our provision for loan losses amounted to a negative provision of \$1.1 million during the nine months ended September 30, 2018, from a negative provision of \$1.2 million during the nine months ended September 30, 2017. The negative provision reflects recoveries received during the year and a continued improvement in the overall risk profile of the loan portfolio.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Losses" section.

Noninterest Income

	Nine months ended September 30,			
	2018	2017	\$ Change	% Change
	(Dollars in Thousands)			
Service charges on loans and deposits	\$1,332	1,148	184	16.0 %
Increase in cash surrender value of life insurance	1,496	1,476	20	1.4 %
Loss on sale of securities	-	(107)	107	(100.0)%
Mortgage banking income	88,930	92,774	(3,844)	(4.1)%
Other	805	941	(136)	(14.5)%
Total noninterest income	\$92,563	96,232	(3,669)	(3.8)%

Total noninterest income decreased \$3.7 million, or 3.8%, to \$92.6 million during the nine months ended September 30, 2018 compared to \$96.2 million during the nine months ended September 30, 2017. The decrease resulted primarily from a decrease in mortgage banking income along with a decrease in other noninterest income.

The \$3.8 million decrease in mortgage banking income was primarily the result of a decrease in gross margin on loans sold at the mortgage banking segment of approximately 10%. Offsetting the decrease in margin, total loan origination volume on a consolidated basis increased \$46.3 million, or 2.5%, to \$1.93 billion during the nine months ended September 30, 2018 compared to \$1.88 billion during the nine months ended September 30, 2017. See "Comparison of Mortgage Banking Segment Operations for the Nine Months Ended September 30, 2018 and 2017" above, for additional discussion of the decrease in mortgage banking income.

The increase in service charges on loans and deposits was related to an increase in loan prepayment and other loan fees.

The increase in cash surrender value of life insurance was primarily due to the purchase of a \$2.5 million policy in June 2017.

The \$107,000 loss on sale of securities was due to a sale of a municipal bond in June 2017. There have been no sales of securities in 2018.

The \$136,000 decrease in other noninterest income was primarily due to a gain on mortgage servicing rights as there was a bulk sale of mortgage servicing rights for \$308,000 during the nine months ended September 30, 2017. There were no sales of mortgage servicing rights during the nine months ended September 30, 2018. Offsetting the decrease from the gain on sale of mortgage servicing rights, other noninterest income increased due to increases from servicing fee income on loans sold, rental income, and wealth management revenue.

Noninterest Expenses

	Nine months ended September 30,				
	2018	2017	\$ Change	% Change	
	(Dollars in Thousands)				
Compensation, payroll taxes, and other employee benefits	\$74,670	\$73,732	\$ 938	1.3	%
Occupancy, office furniture and equipment	7,995	7,587	408	5.4	%
Advertising	3,084	2,414	670	27.8	%
Data processing	2,057	1,854	203	10.9	%
Communications	1,229	1,170	59	5.0	%
Professional fees	1,930	1,953	(23)	(1.2)	%
Real estate owned	63	258	(195)	(75.6)	%
FDIC insurance premiums	361	366	(5)	(1.4)	%
Other	9,921	10,227	(306)	(3.0)	%
Total noninterest expenses	\$101,310	\$99,561	\$ 1,749	1.8	%

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Total noninterest expenses increased \$1.7 million, or 1.8%, to \$101.3 million during the nine months ended September 30, 2018 compared to \$99.6 million during the nine months ended September 30, 2017.

Compensation, payroll taxes and other employee benefit expense at our mortgage banking segment increased \$349,000, or 0.6%, to \$61.5 million for the nine months ended September 30, 2018. The increase in compensation expense was primarily a result of the salary and health insurance increases with the additional branch network with the New Mexico branch acquisition. Offsetting those increases, commission expense and branch manager pay decreased.

Compensation, payroll taxes and other employee benefits expense at the community banking segment increased \$660,000, or 5.1%, to \$13.6 million during the nine months ended September 30, 2018. The increase was primarily due to health insurance and salaries expense offset by lower stock based compensation expenses.

Occupancy, office furniture and equipment expense at the mortgage banking segment increased \$299,000 to \$5.5 million during the nine months ended September 30, 2018, resulting from additional rent and depreciation expense in the current year period compared to prior year period due to the addition of the New Mexico branches at the end of the second quarter.

Occupancy, office furniture and equipment expense at the community banking segment increased \$109,000 to \$2.5 million during the nine months ended September 30, 2018. The increase was primarily related to increased snow removal and maintenance expense.

Advertising expense increased as a result of increased advertising efforts to generate more volume at the mortgage banking segment branches.

Data processing expense increased \$203,000, or 10.9%, to \$2.1 million during the nine months ended September 30, 2018. This was primarily due to increases at the mortgage banking segment with the addition of the New Mexico branches.

Professional fees expense decreased slightly as a result of a decrease in consulting and accounting expense at the mortgage banking segment offset by an increase in legal fees at the mortgage banking segment.

Net real estate owned expense decreased \$195,000, to \$63,000 during the nine months ended September 30, 2018 compared to \$258,000 for the nine months ended September 30, 2017. Real estate owned writedowns decreased \$204,000 to \$300,000 for the nine months ended September 30, 2018 compared to \$504,000 for the nine months ended September 30, 2017. Net gains on sales of real estate owned decreased \$4,000 to \$511,000 for the nine months ended September 30, 2018 compared to \$515,000 for the nine months ended September 30, 2017. Property management expense (other than gains/losses) increased \$5,000 to \$274,000 during the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017.

Other noninterest expense decreased \$306,000 primarily due to decreased expense at the mortgage banking segment. The mortgage banking segment resulted from decreased branch from certain branch expenses and lower provision for losses on loans sold at the mortgage banking segment. Offsetting the decrease from the mortgage company, other noninterest expenses increased at the community banking segment due primarily to increases in loan origination expenses.

Income Taxes

Income tax expense decreased \$4.4 million, or 35.9%, to \$7.9 million during the nine months ended September 30, 2018, compared to \$12.4 million during the nine months ended September 30, 2017. Income tax expense was recognized during the nine months ended September 30, 2018 at an effective rate of 24.1% compared to 35.2% for the nine months ended September 30, 2017. The decrease in the effective rate primarily resulted from the federal tax rate decrease from 35% to 21% as a result of The Tax Cuts and Jobs Act that was enacted into law on December 22, 2017. During the nine months ended September 30, 2018, the Company recognized a benefit of approximately \$197,000 related to stock awards exercised compared to a benefit of \$827,000 recognized during the nine months ended September 30, 2017.

Comparison of Financial Condition at September 30, 2018 and December 31, 2017

Total Assets – Total assets increased by \$113.0 million, or 6.3%, to \$1.92 billion at September 30, 2018 from \$1.81 billion at December 31, 2017. The increase in total assets primarily reflects an increase in cash and cash equivalents, loans held for sale, and loans receivable, partially offset by a decrease in securities available for sale. Funding needed for loan originations was provided by deposits, additional long-term FHLB debt, and advanced payments by borrowers for taxes in 2018.

Cash and Cash Equivalents – Cash and cash equivalents increased \$10.2 million, or 21.1%, to \$58.9 million at September 30, 2018, compared to \$48.6 million at December 31, 2017. The increase in cash and cash equivalents primarily reflects the increase in deposits, advanced payments by borrowers for taxes, and long-term FHLB borrowings offset by increases in loans held for sale and loans receivable.

Securities Available for Sale – Securities available for sale decreased \$20.6 million during the nine months ended September 30, 2018. The decrease was due to paydowns in mortgage related securities and maturities of debt securities exceeding security purchases for the year.

Loans Held for Sale - Loans held for sale increased \$42.8 million to \$192.7 million during the nine months ended September 30, 2018 due to the increase of mortgage originations with the addition of the New Mexico branches along with the timing of loans sold to investors.

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Loans Receivable - Loans receivable held for investment increased \$65.8 million to \$1.36 billion at September 30, 2018 from \$1.29 billion at December 31, 2017. The increase in total loans receivable was primarily attributable to increases in the one- to four-family, multi-family, commercial real estate, and consumer categories. Partially offsetting those increases, the home equity, construction and land, and commercial loan categories decreased.

The following table shows loan origination, loan purchases, principal repayment activity, transfers to real estate owned, charge-offs and sales during the periods indicated.

	As of or for the Nine months ended September 30,		As of or for the Year Ended December 31, 2017
	2018	2017	
	(In Thousands)		
Total gross loans receivable and held for sale at beginning of period	\$1,441,710	\$1,403,132	\$1,403,132
Real estate loans originated for investment:			
Residential			
One- to four-family	99,871	87,473	117,747
Multi-family	88,686	90,422	108,380
Home equity	4,032	655	5,430
Construction and land	26,139	4,539	2,270
Commercial real estate	50,241	38,904	61,684
Total real estate loans originated for investment	268,969	221,993	295,511
Consumer loans originated for investment	142	-	80
Commercial business loans originated for investment	5,072	12,846	19,610
Total loans originated for investment	274,183	234,839	315,201
Principal repayments	(207,714)	(148,750)	(197,623)
Transfers to real estate owned	(545)	(1,609)	(2,171)
Loan principal charged-off	(82)	(1,204)	(1,477)
Net activity in loans held for investment	65,842	83,276	113,930
Loans originated for sale	1,927,627	1,881,351	2,458,370
Loans sold	(1,884,849)	(1,931,462)	(2,533,722)
Net activity in loans held for sale	42,778	(50,111)	(75,352)
Total gross loans receivable and held for sale at end of period	\$1,550,330	\$1,436,297	\$1,441,710

Allowance for Loan Losses - The allowance for loan losses decreased \$851,000 from December 31, 2017. The decrease resulted from the negative provision due to improvement of key loan quality metrics decreasing the allowance related to the loans collectively and specifically reviewed. The overall decrease was primarily related to the multi-family, construction and land, and commercial categories. See Note 3 for further discussion on the allowance for loan losses.

Federal Home Loan Bank stock – Total FHLB stock increased \$2.7 million from December 31, 2017. During the nine months ended September 30, 2018, \$11.0 million of stock was purchased when entering into new short-term and long-term FHLB borrowings. A total of \$8.3 million of stock was sold as short-term FHLB borrowings matured and our ownership requirement decreased accordingly.

Real Estate Owned – Total real estate owned decreased \$2.4 million from December 31, 2017. During the nine months ended September 30, 2018, \$545,000 was transferred from loans receivable to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled \$2.6 million and writedowns were \$301,000 in an effort to sell various aged properties.

Deposits – Total deposits increased \$37.1 million to \$1.00 billion at September 30, 2018 from December 31, 2017. The increase was driven by an increase of \$24.8 million in time deposits, \$10.9 million in money market and savings deposits, and \$1.4 million in demand deposits.

Borrowings – Total borrowings increased \$64.8 million to \$451.1 million at September 30, 2018. The community banking segment borrowed a total of \$60.0 million additional long term and short term FHLB advances to fund loan and loans held for sale growth. External short term borrowings at the mortgage banking segment increased a total of \$4.8 million at September 30, 2018 from December 31, 2017 to fund loans held for sale.

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Advance Payments by Borrowers for Taxes - Advance payments by borrowers for taxes increased \$25.6 million. The increase was the result of payments received from borrowers for their real estate taxes and is seasonally normal, as balances increase during the course of the calendar year until real estate tax obligations are paid in the fourth quarter.

Other Liabilities - Other liabilities decreased \$7.0 million during the nine months ended September 30, 2018 compared to December 31, 2017. The decrease was primarily related to a seasonal decrease in outstanding checks related to advance payments by borrowers for taxes. The Company receives payments from borrowers for their real estate taxes during the course of the calendar year until real estate tax obligations are paid in the fourth quarter. At the time at which the disbursements are made, the outstanding checks are classified as other liabilities. These amounts remain classified as other liabilities until settled. Offsetting the decreases from those checks, accrued expenses and accounts payable increased due to timing of payments.

Shareholders' Equity - Shareholders' equity decreased by \$7.5 million to \$404.6 million at September 30, 2018 from December 31, 2017. Shareholders' equity decreased primarily due to the declaration of regular dividends and a special dividend, the repurchase of stock, and the decrease in the fair value of the security portfolio. Partially offsetting the decreases were increases to net income, additional paid in capital as stock options were exercised, and unearned ESOP shares as they continue to vest.

ASSET QUALITY

NONPERFORMING ASSETS

	At September 30, 2018	At December 31, 2017	
	(Dollars in Thousands)		
Non-accrual loans:			
Residential			
One- to four-family	\$5,162	\$ 4,677	
Multi-family	981	1,007	
Home equity	203	107	
Construction and land	-	-	
Commercial real estate	172	251	
Commercial	26	26	
Consumer	-	-	
Total non-accrual loans	6,544	6,068	
Real estate owned			
One- to four-family	181	1,330	
Multi-family	-	-	
Construction and land	3,327	4,582	
Commercial real estate	300	300	
Total real estate owned	3,808	6,212	
Valuation allowance at end of period	(1,638)	(1,654))
Total real estate owned, net	2,170	4,558	
Total nonperforming assets	\$8,714	\$ 10,626	
Total non-accrual loans to total loans, net	0.48	%	0.47 %

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Total non-accrual loans to total assets	0.34	%	0.34	%
Total nonperforming assets to total assets	0.45	%	0.59	%

All loans that are 90 days or more past due with respect to principal and interest are recognized as non-accrual. Troubled debt restructurings that are non-accrual either due to being past due greater than 90 days or which have not yet performed under the modified terms for a reasonable period of time, are included in the table above. In addition, loans that are past due less than 90 days are evaluated to determine the likelihood of collectability given other credit risk factors such as early stage delinquency, the nature of the collateral or the results of a borrower review. When the collection of all contractual principal and interest is determined to be unlikely, the loan is moved to non-accrual status and an updated appraisal of the underlying collateral is ordered. This process generally takes place when a loan is contractually past due between 60 and 90 days. Upon determining the updated estimated value of the collateral, a loan loss provision is recorded to establish a specific reserve to the extent that the outstanding principal balance exceeds the updated estimated net realizable value of the collateral. When a loan is determined to be uncollectible, typically coinciding with the initiation of foreclosure action, the specific reserve is reviewed for adequacy, adjusted if necessary, and charged-off.

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The following table sets forth activity in our non-accrual loans for the periods indicated.

	At or for the Nine Months Ended September 30, 2018 2017 (In Thousands)	
Balance at beginning of period	\$6,068	9,857
Additions	2,838	2,553
Transfers to real estate owned	(545)	(1,609)
Charge-offs	(6)	(649)
Returned to accrual status	(111)	(2,168)
Principal paydowns and other	(1,700)	(975)
Balance at end of period	\$6,544	7,009

Total non-accrual loans increased by \$476,000, or 7.8%, to \$6.5 million as of September 30, 2018 compared to \$6.1 million as of December 31, 2017. The ratio of non-accrual loans to total loans receivable was 0.48% at September 30, 2018 compared to 0.47% at December 31, 2017. During the nine months ended September 30, 2018, \$2.8 million in loans were placed on non-accrual status. Offsetting this activity, \$545,000 in non-accrual loans were transferred to real estate owned, \$6,000 in loan principal was charged off, \$111,000 returned to accrual status, and approximately \$1.7 million in principal payments were received during the nine months ended September 30, 2018.

Of the \$6.5 million in total non-accrual loans as of September 30, 2018, \$6.1 million in loans have been specifically reviewed to assess whether a specific valuation allowance is necessary. A specific valuation allowance is established for an amount equal to the impairment when the carrying value of the loan exceeds the present value of expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral with an adjustment made for costs to dispose of the asset. Based upon these specific reviews, a total of \$1.5 million in cumulative partial net charge-offs have been recorded over the life of these loans as of September 30, 2018. Partially charged-off loans measured for impairment based upon net realizable collateral value are maintained in a "non-performing" status and are disclosed as impaired loans. In addition, specific reserves totaling \$90,000 have been recorded as of September 30, 2018. The remaining \$515,000 of non-accrual loans were reviewed on an aggregate basis and \$103,000 in general valuation allowance was deemed necessary related to those loans as of September 30, 2018. The \$103,000 in valuation allowance is based upon a migration analysis performed with respect to similar non-accrual loans in prior periods.

The outstanding principal balance of our five largest non-accrual loans as of September 30, 2018 totaled \$1.9 million, which represents 28.6% of total non-accrual loans as of that date. These five loans are carried net of cumulative life-to-date net charge-offs of \$10,000. No specific valuation allowance was deemed necessary based on net realizable collateral value with respect to these five loans as of September 30, 2018.

For the nine months ended September 30, 2018, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was \$375,000. We received \$292,000 of interest payments on such loans during the nine months ended September 30, 2018. Interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

There were no accruing loans past due 90 days or more at September 30, 2018 or December 31, 2017.

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TROUBLED DEBT RESTRUCTURINGS

The following table summarizes information with respect to the accrual status of our troubled debt restructurings:

	As of September 30, 2018		
	Accruing	Non-accruing	Total
	(In Thousands)		
One- to four-family	\$2,740	\$ 890	3,630
Multi-family	-	388	388
Commercial real estate	285	21	306
	\$3,025	\$ 1,299	4,324
	As of December 31, 2017		
	Accruing	Non-accruing	Total
One- to four-family	\$2,740	\$ 1,156	3,896
Multi-family	-	815	815
Home equity	47	-	47
Commercial real estate	290	34	324
	\$3,077	\$ 2,005	5,082

All troubled debt restructurings are considered to be impaired, are risk rated as either substandard or watch and are included in the internal risk rating tables disclosed in the notes to the financial statements. Specific reserves have been established to the extent that collateral-based impairment analyses indicate that a collateral shortfall exists.

We do not participate in government-sponsored troubled debt restructuring programs. Our troubled debt restructurings are short-term modifications. Typical initial restructured terms include six to twelve months of principal forbearance, a reduction in interest rate or both. Restructured terms do not include a reduction of the outstanding principal balance unless mandated by a bankruptcy court. Troubled debt restructuring terms may be renewed or further modified at the end of the initial term for an additional period if performance has been acceptable and the short-term borrower difficulty persists.

If a restructured loan is current in all respects and a minimum of six consecutive restructured payments have been received, it can be considered for return to accrual status. After a restructured loan that is current in all respects reverts to contractual/market terms, if a credit department review indicates no evidence of elevated market risk, the loan is removed from the troubled debt restructuring classification.

LOAN DELINQUENCY

The following table summarizes loan delinquency in total dollars and as a percentage of the total loan portfolio:

At	At
September	December
30,	31,
2018	2017
(Dollars in	
Thousands)	

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Loans past due less than 90 days	\$4,471	\$ 1,878
Loans past due 90 days or more	4,622	3,974
Total loans past due	\$9,093	\$ 5,852
Total loans past due to total loans receivable	0.67 %	0.45 %

Past due loans increased by \$3.2 million, or 55.4%, to \$9.1 million at September 30, 2018 from \$5.9 million at December 31, 2017. Loans past due less than 90 days increased by \$2.6 million, or 138.1% due primarily to an increase in the one- to four-family category. Loans past due 90 days or more increased by \$648,000, or 16.3%, during the nine months ended September 30, 2018.

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REAL ESTATE OWNED

Total real estate owned decreased by \$2.4 million, or 52.4%, to \$2.2 million at September 30, 2018, compared to \$4.6 million at December 31, 2017. During the nine months ended September 30, 2018, \$545,000 was transferred from loans to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled \$2.6 million. A total of \$301,000 in write downs occurred during the nine months ended September 30, 2018. New appraisals received on real estate owned and collateral dependent impaired loans are based upon an "as is value" assumption. During the period of time in which we are awaiting receipt of an updated appraisal, loans evaluated for impairment based upon collateral value are measured by the following:

- Applying an updated adjustment factor (as described previously) to an existing appraisal;
- Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;
- Comparing the estimated current value of the collateral to that of updated sales values experienced on similar collateral;
- Comparing the estimated current value of the collateral to that of updated values seen on current appraisals of similar collateral; and
- Comparing the estimated current value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

Virtually all habitable real estate owned (both residential and commercial properties) is managed with the intent of attracting a lessee to generate revenue. Foreclosed properties are recorded at the lower of carrying value or fair value, less costs to sell, with charge-offs, if any, charged to the allowance for loan losses upon transfer to real estate owned. The fair value is primarily based upon updated appraisals in addition to an analysis of current real estate market conditions.

ALLOWANCE FOR LOAN LOSSES

	At or for the Nine Months Ended September 30, 2018 2017 (Dollars in Thousands)	
Balance at beginning of period	\$14,077	\$16,029
Provision for loan losses	(1,060)	(1,166)
Charge-offs:		
Mortgage		
One- to four-family	68	1,092
Multi-family	13	92
Home equity	1	-
Commercial real estate	-	6
Construction and land	-	14
Consumer	-	-
Commercial	-	-

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Total charge-offs	82	1,204
Recoveries:		
Mortgage		
One- to four-family	150	200
Multi-family	82	102
Home equity	18	21
Commercial real estate	1	1
Construction and land	40	80
Consumer	-	-
Commercial	-	-
Total recoveries	291	404
Net (recoveries) charge-offs	(209)	800
Allowance at end of period	\$13,226	\$14,063

Ratios:

Allowance for loan losses to non-accrual loans at end of period	202.11 %	200.64 %
Allowance for loan losses to loans receivable at end of period	0.97 %	1.12 %
Net (recoveries) charge-offs to average loans outstanding (annualized)	(0.02)%	0.09 %
Provision for loan losses to net recoveries (charge-offs)	507.18 %	(145.75)%
Net (recoveries) charge-offs to beginning of the period allowance (annualized)	(1.99)%	6.67 %

The allowance for loan losses decreased \$851,000 to \$13.2 million at September 30, 2018, compared to \$14.1 million at December 31, 2017. The decrease in allowance for loan losses reflects the negative provision. The negative provision recorded during the current year reflects a continued improvement in the overall risk profile of the loan portfolio.

Net recoveries totaled \$209,000, or 0.02% of average loans annualized, for the nine months ended September 30, 2018, compared to net charge-offs of \$800,000, or 0.09% of average loans annualized, for the nine months ended September 30, 2017. Of the \$82,000 in charge-offs during the nine months ended September 30, 2018, most of the activity related to loans secured by one- to four-family residential loans.

Our underwriting policies and procedures emphasize that credit decisions must rely on both the credit quality of the borrower and the estimated value of the underlying collateral. Credit quality is assured only when the estimated value of the collateral is objectively determined and is not subject to significant fluctuation.

The allowance for loan losses has been determined in accordance with GAAP. We are responsible for the timely and periodic determination of the amount of the allowance required. Any future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and the underlying collateral, trends in non-performing loans, current economic conditions and other relevant factors. To the best of management's knowledge, all probable losses have been provided for in the allowance for loan losses.

The establishment of the amount of the loan loss allowance inherently involves judgments by management as to the appropriateness of the allowance, which ultimately may or may not be correct. Higher than anticipated rates of loan default would likely result in a need to increase provisions in future years.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet our liquidity needs. We adjust our liquidity levels to fund loan commitments, repay our borrowings, fund deposit outflows and pay real estate taxes on mortgage loans. We also adjust liquidity as appropriate to meet asset and liability management objectives. The level of our liquidity position at any point in time is dependent upon the judgment of the senior management as supported by the Asset/Liability Committee. Liquidity is monitored on a daily, weekly and monthly basis using a variety of measurement tools and indicators.

Our primary sources of liquidity are deposits, amortization and repayment of loans, sales of loans held for sale, maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan repayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competitors. We set the interest rates on our deposits to maintain a desired level of total deposits. In addition, we invest excess funds in short-term, interest-earning assets, which provide liquidity to meet lending requirements. Additional sources of liquidity used for the purpose of managing long- and short-term cash flows include advances from the FHLB.

During the nine months ended September 30, 2018 primary uses of cash and cash equivalents included: \$1.93 billion in funding loans held for sale, \$66.2 million increase in loans receivable, \$23.8 million for cash dividends paid, \$25.2 million for repayment of short-term borrowings, \$13.2 million for purchases of mortgage related securities, and \$9.4 million in purchases of our common stock.

During the nine months ended September 30, 2018, primary sources of cash and cash equivalents included: \$1.97 billion in proceeds from the sale of loans held for sale, \$90.0 million in additional proceeds from long-term FHLB debt, \$22.2 million in principal repayments on mortgage related securities, \$25.1 million in net income, \$8.6 million from maturities of debt securities, \$37.1 million increase in deposits and \$13.3 million from advanced payments by

borrowers for taxes.

During the nine months ended September 30, 2017 primary uses of cash and cash equivalents included: \$1.88 billion in funding loans held for sale, \$85.7 million increase in loans receivable, \$69.0 decrease in repurchase agreements, \$23.6 million for cash dividends paid, \$7.7 million decrease from fewer short-term borrowings, \$6.9 million in purchases of mortgage related securities, \$6.1 million in purchases of debt securities, and \$5.2 million in purchases of FHLB stock.

During the nine months ended September 30, 2017, primary sources of cash and cash equivalents included: \$2.03 billion in proceeds from the sale of loans held for sale, \$125.0 million in proceeds from long-term FHLB debt, \$25.2 million in principal repayments on mortgage related securities, \$22.8 million in net income, \$13.9 million from maturities of debt securities, \$7.4 million increase in deposits, \$6.0 million increase in advance payments by borrowers for taxes, and \$3.1 million from real estate owned sales.

A portion of our liquidity consists of cash and cash equivalents, which are a product of our operating, investing and financing activities. At September 30, 2018 and 2017, respectively, \$58.9 million and \$92.6 million of our assets were invested in cash and cash equivalents. At September 30, 2018, cash and cash equivalents were comprised of the following: \$33.0 million in cash held at the Federal Reserve Bank and other depository institutions and \$25.9 million in federal funds sold and short-term investments. Our primary sources of cash are principal repayments on loans, proceeds from the calls and maturities of debt and mortgage-related securities, increases in deposit accounts and advances from the FHLB.

Liquidity management is both a daily and longer-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLB which provide an additional source of funds. At September 30, 2018, we had \$430.0 million in long term advances from the FHLB with contractual maturity dates in 2021, 2027, and 2028. The 2021 advance maturities have quarterly call options beginning in June 2018 and September 2018. The 2027 advance maturities have single call options in May 2019, June 2019, August 2019, and December 2019. The 2028 advance maturities have single call options in March 2020, March 2021, May 2020, and May 2021, along with two advances that have quarterly call options beginning in June 2020 and September 2020. As an additional source of funds, the mortgage banking segment has a repurchase agreement. At September 30, 2018, we had \$16.1 million outstanding under the repurchase agreement with a total outstanding commitment of \$35.0 million.

At September 30, 2018, we had outstanding commitments to originate loans receivable of \$29.2 million. In addition, at September 30, 2018, we had unfunded commitments under construction loans of \$49.9 million, unfunded commitments under business lines of credit of \$17.7 million and unfunded commitments under home equity lines of credit and standby letters of credit of \$15.7 million. At September 30, 2018, certificates of deposit scheduled to mature in one year or less totaled \$509.3 million. Based on prior experience, management believes that, subject to the Bank's funding needs, a significant portion of such deposits will remain with us, although there can be no assurance that this will be the case. In the event a significant portion of our deposits is not retained by us, we will have to utilize other funding sources, such as FHLB advances, in order to maintain our level of assets. However, we cannot assure that such borrowings would be available on attractive terms, or at all, if and when needed. Alternatively, we could reduce our level of liquid assets, such as our cash and cash equivalents and securities available-for-sale in order to meet funding needs. In addition, the cost of such deposits may be significantly higher if market interest rates are higher or there is an increased amount of competition for deposits in our market area at the time of renewal.

Waterstone Financial, Inc. is a separate legal entity from WaterStone Bank and must provide for its own liquidity to pay dividends to its shareholders, repurchase shares of its common stock, and for other corporate purposes. The primary source of liquidity for Waterstone Financial, Inc. is dividend payments from WaterStone Bank. The ability of WaterStone Bank to pay dividends is subject to regulatory restrictions. At September 30, 2018, Waterstone Financial, Inc. (on an unconsolidated basis) had liquid assets totaling \$27.3 million.

Capital

Shareholders' equity decreased by \$7.5 million to \$404.6 million at September 30, 2018 from December 31, 2017. Shareholders' equity decreased primarily due to the declaration of regular dividends and a special dividend, the repurchase of stock, and the decrease in the fair value of the security portfolio. Partially offsetting the decreases were increases to net income, additional paid in capital as stock options were exercised, and unearned ESOP shares as they continue to vest.

The Company's Board of Directors authorized a stock repurchase program in the first quarter of 2015. The Company authorized two stock repurchase programs in the second quarter of 2015. These first three programs have been either fulfilled or cancelled and replaced. The Company's Board of Directors authorized the current fourth stock repurchase program in the third quarter of 2015. The timing of the repurchases will depend on certain factors, including but not limited to, market conditions and prices, available funds and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, negotiated private transactions and pursuant to a trading plan that will be adopted in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934. Repurchased shares are held by the Company as authorized but unissued shares.

As of September 30, 2018, the Company had repurchased 6,386,553 shares at an average price of \$13.31 under previously approved stock repurchase plans. As of September 30, 2018, the Company is authorized to purchase up to 389,300 additional shares under the current approved stock repurchase program.

WaterStone Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories. At September 30, 2018, WaterStone Bank exceeded all regulatory capital requirements and is considered "well capitalized" under regulatory guidelines. See "Notes to Consolidated Financial Statements - Note 8 Regulatory Capital."

Contractual Obligations, Commitments, Contingent Liabilities, and Off-balance Sheet Arrangements

The following tables present information indicating various contractual obligations and commitments of the Company as of September 30, 2018 and the respective maturity dates.

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	Total	One Year	More than One Year	More than Three Years	Over Five Years
	(In Thousands)	or Less	Through Three Years	Through Five Years	Years
Demand deposits (3)	\$130,969	\$130,969	\$-	\$-	\$-
Money market and savings deposits (3)	159,742	159,742	-	-	-
Time deposit (3)	713,739	509,294	200,878	3,567	-
Federal Home Loan Bank advances (1)	16,132	16,132	-	-	-
Repurchase agreements (3)	435,000	5,000	-	-	430,000
Operating leases (2)	8,898	2,964	3,418	1,588	928
	\$1,464,480	\$824,101	\$204,296	\$5,155	\$430,928

(1) Secured under a blanket security agreement on qualifying assets, principally, mortgage loans. Excludes interest which will accrue on the advances.

(2) Represents non-cancelable operating leases for offices and equipment.

(3) Excludes interest.

Herrington et al. v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit that was filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their employment agreements. On July 5, 2017, the arbitrator issued a Final Award finding Waterstone Mortgage Corporation liable for unpaid minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. On December 8, 2017, the District Court confirmed the award in large part, and entered a judgment against Waterstone in the amount of \$7,267,919 in damages to Claimants, \$3,298,851 in attorney fees and costs, and a \$20,000 incentive fee to Plaintiff Herrington, plus post-judgment interest. On February 12, 2018, the District Court awarded post-arbitration fees and costs of approximately \$98,000. The judgment was appealed by Waterstone to the Seventh Circuit Court of Appeals, where oral argument was held on May 29, 2018. On October 22, 2018, the Seventh Circuit issued a ruling vacating the District Court's order enforcing the arbitration award. If the District Court determines the agreement only allows for individual arbitration, the award would be vacated and the case sent to individual arbitration for a new proceeding. If the District Court determines the arbitration agreement nevertheless allows for collective arbitration, the District Court could confirm the prior award.

If the judgment is upheld in full, the Company has estimated that the award, which includes attorney's fees, costs, and interest, could be as high as \$11 million. However, Waterstone has meaningful appellate rights and intends to vigorously defend its interests in this matter, including arguing for complete reversal on appeal. Although the Company believes there is a strong basis to vacate the award, there remains a reasonable possibility that the Court's judgment will be affirmed in whole or in part, with the possible range of loss from \$0 to \$11 million. We do not believe that the loss is probable at this time, as that term is used in assessing loss contingencies. Accordingly, in accordance with the authoritative guidance in the evaluation of contingencies, the Company has not recorded an accrual related to this matter.

Werner v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a putative collection action lawsuit that was filed on August 4, 2017 in the United States District Court for the Western District of Wisconsin, Werner et al. v. Waterstone Mortgage Corporation. Plaintiffs allege that Waterstone Mortgage Corporation violated the Fair Labor Standards Act (FLSA) by failing to pay loan officers minimum and overtime wages. On October 26, 2017, Plaintiffs moved for conditional certification and to provide notice to the putative class. On February 9, 2018, the Court denied Plaintiffs' motion for conditional certification and notice. The Company intends to continue to vigorously defend its interests in this matter and pursue all possible defenses against the claims. Given the early stage of the litigation, the Company is not yet able to make a determination as to the likelihood of an unfavorable outcome in this matter, or is it able to estimate the range of any possible loss.

Off-Balance Sheet Commitments

The following table details the amounts and expected maturities of significant off-balance sheet commitments as of September 30, 2018.

	More than One Year	More than Three Years	Over Five
	One Year	Through	Through

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	Total	or Less	Three	Five	Years
	(In Thousands)		Years	Years	Years
Real estate loan commitments (1)	\$29,213	\$29,213	\$ -	\$ -	\$ -
Unused portion of home equity lines of credit (2)	14,850	14,850	-	-	-
Unused portion of construction loans (3)	49,850	49,850	-	-	-
Unused portion of business lines of credit	17,740	17,740	-	-	-
Standby letters of credit	839	839	-	-	-
Total Other Commitments	\$112,492	\$112,492	\$ -	\$ -	\$ -

General: Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and generally have fixed expiration dates or other termination clauses.

(1) Commitments for loans are extended to customers for up to 90 days after which they expire.

(2) Unused portions of home equity loans are available to the borrower for up to 10 years.

(3) Unused portions of construction loans are available to the borrower for up to one year.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Management of Market Risk

General. The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, WaterStone Bank's board of directors has established an Asset/Liability Committee which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the board of directors. Management monitors the level of interest rate risk on a regular basis and the Asset/Liability Committee meets at least weekly to review our asset/liability policies and interest rate risk position, which are evaluated quarterly.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. We have implemented the following strategies to manage our interest rate risk: (i) emphasizing variable rate loans including variable rate one- to four-family, and commercial real estate loans as well as three to five year commercial real estate balloon loans; (ii) reducing and shortening the expected average life of the investment portfolio; and (iii) whenever possible, lengthening the term structure of our deposit base and our borrowings from the FHLB. These measures should reduce the volatility of our net interest income in different interest rate environments.

Income Simulation. Simulation analysis is an estimate of our interest rate risk exposure at a particular point in time. At least quarterly we review the potential effect changes in interest rates may have on the repayment or repricing of rate sensitive assets and funding requirements of rate sensitive liabilities. Our most recent simulation uses projected repricing of assets and liabilities at September 30, 2018 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rate assumptions may have a significant impact on interest income simulation results. Because of the large percentage of loans and mortgage-backed securities we hold, rising or falling interest rates may have a significant impact on the actual prepayment speeds of our mortgage related assets that may in turn affect our interest rate sensitivity position. When interest rates rise, prepayment speeds slow and the average expected lives of our assets would tend to lengthen more than the expected average lives of our liabilities and therefore would most likely have a positive impact on net interest income and earnings.

The following interest rate scenario displays the percentage change in net interest income over a one-year time horizon assuming increases of 100, 200 and 300 basis points and a decreases of 100 basis points. The results incorporate actual cash flows and repricing characteristics for balance sheet accounts following an instantaneous parallel change in market rates based upon a static (no growth balance sheet).

Analysis of Net Interest Income Sensitivity

	Immediate Change in Rates			
	+300	+200	+100	-100
	(Dollar Amounts in Thousands)			
As of September 30, 2018				
Dollar Change	\$ 305	420	373	(666)
Percentage Change	0.59 %	0.81	0.72	(1.29)

At September 30, 2018, a 100 basis point instantaneous increase in interest rates had the effect of increasing forecast net interest income over the next 12 months by 0.72% while a 100 basis point decrease in rates had the effect of decreasing net interest income by 1.29%.

Item 4. Controls and Procedures

Disclosure Controls and Procedures: Company management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

Internal Control Over Financial Reporting: There have been no material changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

WaterStone Bank and its wholly owned subsidiary, Waterstone Mortgage Corporation are involved in various legal actions arising in the normal course of business, including the proceeding specifically discussed below. While the ultimate outcome of pending proceedings cannot be predicted with certainty, it is the opinion of management, after consultation with counsel representing us in such proceedings, that the resolution of these proceedings will not have a material adverse effect on our consolidated financial position or results of operation.

Herrington et al. v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a class action lawsuit that was filed in the United States District Court for the Western District of Wisconsin and subsequently compelled to arbitration before the American Arbitration Association. The plaintiff class alleged that Waterstone Mortgage Corporation violated certain provisions of the Fair Labor Standards Act (FLSA) and failed to pay loan officers consistent with their employment agreements. On July 5, 2017, the arbitrator issued a Final Award finding Waterstone Mortgage Corporation liable for unpaid minimum wages, overtime, unreimbursed business expenses, and liquidated damages under the FLSA. On December 8, 2017, the District Court confirmed the award in large part, and entered a judgment against Waterstone in the amount of \$7,267,919 in damages to Claimants, \$3,298,851 in attorney fees and costs, and a \$20,000 incentive fee to Plaintiff Herrington, plus post-judgment interest. On February 12, 2018, the District Court awarded post-arbitration fees and costs of approximately \$98,000. The judgment was appealed by Waterstone to the Seventh Circuit Court of Appeals, where oral argument was held on May 29, 2018. On October 22, 2018, the Seventh Circuit issued a ruling vacating the District Court's order enforcing the arbitration award. If the District Court determines the agreement only allows for individual arbitration, the award would be vacated and the case sent to individual arbitration for a new proceeding. If the District Court determines the arbitration agreement nevertheless allows for collective arbitration, the District Court could confirm the prior award.

If the judgment is upheld in full, the Company has estimated that the award, which includes attorney's fees, costs, and interest, could be as high as \$11 million. However, Waterstone has meaningful appellate rights and intends to vigorously defend its interests in this matter, including arguing for complete reversal on appeal. Although the Company believes there is a strong basis to vacate the award, there remains a reasonable possibility that the Court's judgment will be affirmed in whole or in part, with the possible range of loss from \$0 to \$11 million. We do not believe that the loss is probable at this time, as that term is used in assessing loss contingencies. Accordingly, in accordance with the authoritative guidance in the evaluation of contingencies, the Company has not recorded an accrual related to this matter.

Werner v. Waterstone Mortgage Corporation

Waterstone Mortgage Corporation is a defendant in a putative collection action lawsuit that was filed on August 4, 2017 in the United States District Court for the Western District of Wisconsin, Werner et al. v. Waterstone Mortgage Corporation. Plaintiffs allege that Waterstone Mortgage Corporation violated the Fair Labor Standards Act (FLSA) by failing to pay loan officers minimum and overtime wages. On October 26, 2017, Plaintiffs moved for conditional certification and to provide notice to the putative class. On February 9, 2018, the Court denied Plaintiffs' motion for conditional certification and notice. The Company intends to continue to vigorously defend its interests in this matter and pursue all possible defenses against the claims. Given the early stage of the litigation, the Company is not yet able to make a determination as to the likelihood of an unfavorable outcome in this matter, or is it able to estimate the range of any possible loss.

Item 1A. Risk Factors

There have been no material changes in risk factors applicable to the Company from those disclosed in "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

Following are the Company's monthly common stock repurchases during the third quarter of 2018:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares that May Yet Be Purchased Under the Plan ^(a)
July 1, 2018 - July 31, 2018	17,000	\$ 17.01	17,000	694,200
August 1, 2018 - August 31, 2018	166,500	16.99	166,500	527,700
September 1, 2018 - September 30, 2018	138,400	17.06	138,400	389,300
Total	321,900	\$ 17.02	321,900	389,300

^(a) On September 4, 2015, the Board of Directors terminated the then-existing plan and authorized the repurchase of 1,500,000 shares of common stock.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

(a) Exhibits: See Exhibit Index, which follows the signature page hereof.

Signatures

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

WATERSTONE FINANCIAL, INC.
(Registrant)

Date: October 30, 2018

/s/ Douglas S. Gordon
Douglas S. Gordon
Chief Executive Officer
Principal Executive Officer

Date: October 30, 2018

/s/ Mark R. Gerke
Mark R. Gerke
Chief Financial Officer
Principal Financial Officer

EXHIBIT INDEX

WATERSTONE FINANCIAL, INC.

Form 10-Q for Quarter Ended September 30, 2018

Exhibit No.	Description	Filed Herewith
<u>31.1</u>	<u>Sarbanes-Oxley Act Section 302 Certification signed by the Chief Executive Officer of Waterstone Financial, Inc.</u>	X
<u>31.2</u>	<u>Sarbanes-Oxley Act Section 302 Certification signed by the Chief Financial Officer of Waterstone Financial, Inc.</u>	X
<u>32.1</u>	<u>Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer of Waterstone Financial, Inc.</u>	X
<u>32.2</u>	<u>Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer of Waterstone Financial, Inc.</u>	X
101	The following financial statements from Waterstone Financial, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in Extensive Business Reporting Language (XBRL): (i) consolidated statements of financial condition, (ii) consolidated statements of income, (iii) consolidated statements of comprehensive income, (iv) consolidated statements of changes in shareholders' equity, (v) consolidated statements of cash flows and (vi) the notes to consolidated financial statements.	X