TIMBERLAND BANCORP INC
Form 10-K
December 18, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended September 30, 2012 OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 0-23333

TIMBERLAND BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington	91-1863696
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
624 Simpson Avenue, Hoquiam, Washington	98550
(Address of principal executive offices)	(Zip Code)
Registrant's telephone number, including area code:	(360) 533-4747

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value $.01 per share	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Act. YES NO X

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

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

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

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company X

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO X

As of November 30, 2012, the registrant had 7,045,036 shares of common stock issued and outstanding. The aggregate market value of the common stock held by nonaffiliates of the registrant, based on the closing sales price of the registrant's common stock as quoted on the NASDAQ Global Market on March 31, 2012, was $32.8 million (7,045,036 shares at $4.66). For purposes of this calculation, common stock held by officers and directors of the registrant and the Timberland Bank Employee Stock Ownership Plan and Trust are considered nonaffiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Definitive Proxy Statement for the 2013 Annual Meeting of Stockholders (Part III).

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As used throughout this report, the terms "we," "our," or "us," refer to Timberland Bancorp, Inc. and its consolidated subsidiary, unless the context otherwise requires.

PART I

Item 1. Business

General

Timberland Bancorp, Inc. ("Company"), a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB ("Bank") upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At September 30, 2012, on a consolidated basis, the Company had total assets of $737.0 million, total deposits of $597.9 million and total shareholders' equity of $90.3 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to the Bank and its subsidiary.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally chartered mutual savings and loan association, and in 1972, changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." On December 29, 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation ("FDIC"). The Bank has been a member of the Federal Home Loan Bank ("FHLB") System since 1937. The Bank is regulated by the Washington Department of Financial Institutions, Division of Banks ("Division" or "DFI") and the FDIC.

The Bank is a community-oriented bank which has traditionally offered a variety of savings products to its retail customers while concentrating its lending activities on real estate mortgage loans and commercial business loans. Lending activities have historically been focused primarily on the origination of loans secured by real estate, including construction loans and land development, one- to four-family residential loans, multi-family loans, commercial real estate loans and land loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market under Federal Home Loan Mortgage Corporation ("Freddie Mac") guidelines. During the past several years, the Bank adjusted its lending strategy and began reducing its exposure to speculative construction and land development lending.

The Company maintains a website at www.timberlandbank.com. The information contained on that website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own internet access charges, the Company makes available free of charge through that website the Company's Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after these materials have been electronically filed with, or furnished to, the Securities and Exchange Commission ("SEC").

Corporate Overview

Sale of Preferred Stock Received in the Troubled Asset Relief Program ("TARP") Capital Purchase Program ("CPP"). On November 13, 2012, the Company's outstanding 16,641 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, ("Series A Preferred Stock") with a liquidation value of $1,000 per share, originally issued to the U.S. Treasury Department ("Treasury") on December 23, 2008 as part of the CPP, was sold by the Treasury as part of its efforts to manage and recover its investments under the TARP. While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrant to purchase up to 370,899 shares of the Company's common stock at a price of $6.73

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per share at any time through December 23, 2018. The preferred stock has a 5.0% dividend through December 23, 2013, after which the rate increases to 9.0% until the preferred shares are redeemed by the Company.

Agreements with Banking Regulators. In December 2009, the FDIC determined that the Bank required supervisory attention and agreed to terms on a Memorandum of Understanding (the “Bank MOU”) with the Bank. The terms of the Bank MOU restricted the Bank from certain activities, and required that the Bank obtain the prior written approval, or nonobjection, of the FDIC and/or the DFI to engage in certain activities. On December 12, 2012, the FDIC and the Division notified the Bank that the Bank MOU had been rescinded.

In addition, on February 1, 2010, the Federal Reserve Bank of San Francisco (“FRB”) determined that the Company required additional supervisory attention and entered into a Memorandum of Understanding with the Company (the “Company MOU”). Under the agreement, the Company must among other things obtain prior written approval, or non-objection, from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock. The FRB denied the Company’s requests to pay eight dividend payments on its Series A Preferred Stock issued under the TARP CPP from the May 15, 2010 payment through and including the February 15, 2012 dividend payment. On May 21, 2012, the FRB gave the Company permission to pay $1.0 million in dividend payments on its Series A Preferred Stock, which left the Company five dividend payments in arrears. On August 17, 2012, the FRB approved the Company's requests to pay all outstanding dividends on its Series A Preferred Stock, including the August 15, 2012 dividend payment. The Company subsequently paid the November 15, 2012 dividend on the Series A Preferred Stock. There can be no assurances that our regulators will approve such payments or dividends in the future.

For additional information regarding the Bank MOU and Company MOU, see “Item 1A, Risk Factors – The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions.”

Market Area

The Bank considers Grays Harbor, Pierce, Thurston, Kitsap, King and Lewis counties, Washington as its primary market areas. The Bank conducts operations from:

- its main office in Hoquiam (Grays Harbor County);
- five branch offices in Grays Harbor County (Ocean Shores, Montesano, Elma, and two branches in Aberdeen);
- five branch offices in Pierce County (Edgewood, Puyallup, Spanaway, Tacoma, and Gig Harbor);
- five branch offices in Thurston County (Olympia, Yelm, Tumwater, and two branches in Lacey);
- two branch offices in Kitsap County (Poulsbo and Silverdale);
- a branch office in King County (Auburn); and
- three branch offices in Lewis County (Winlock, Toledo and Chehalis).

For additional information, see “Item 2. Properties.”

Hoquiam, with a population of approximately 9,000, is located in Grays Harbor County which is situated along Washington State’s central Pacific coast. Hoquiam is located approximately 110 miles southwest of Seattle and 145 miles northwest of Portland, Oregon.

The Bank considers its primary market area to include six submarkets: primarily rural Grays Harbor County with its historical dependence on the timber and fishing industries; Thurston and Kitsap counties with their dependence

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on state and federal government; Pierce and King counties with their broadly diversified economic bases; and Lewis County with its dependence on retail trade, manufacturing, industrial services and local government. Each of these markets presents operating risks to the Bank. The Bank's expansion into Pierce, Thurston, Kitsap, King and Lewis counties represents the Bank's strategy to diversify its primary market area to become less reliant on the economy of Grays Harbor County.

Grays Harbor County has a population of 73,000 according to the U.S. Census Bureau 2011 estimates and a median family income of $57,400 according to 2012 estimates from the Department of Housing and Urban Development ("HUD"). The economic base in Grays Harbor County has been historically dependent on the timber and fishing industries. Other industries that support the economic base are tourism, agriculture, shipping, transportation and technology. According to the Washington State Employment Security Department, the unemployment rate in Grays Harbor County decreased to 12.0% at September 30, 2012 from 12.5% at September 30, 2011. The median price of a resale home in Grays Harbor County for the quarter ended September 30, 2012 decreased 0.6% to $125,300 from $126,000 for the comparable prior year period. The number of home sales increased 18.0% for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The Bank has six branches (including its home office) located throughout the county. The downturn in Grays Harbor County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Pierce County is the second most populous county in the state and has a population of 795,000 according to the U.S. Census Bureau 2011 estimates. The county's median family income is $71,700 according to 2012 HUD estimates. The economy in Pierce County is diversified with the presence of military related government employment (Joint Base Lewis-McChord), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for the Pierce County area decreased to 8.5% at September 30, 2012 from 9.3% at September 30, 2011. The median price of a resale home in Pierce County for the quarter ended September 30, 2012 increased 6.6% to $204,600 from $192,000 for the comparable prior year period. The number of home sales decreased 0.5% for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The Bank has five branches in Pierce County and these branches have historically been responsible for a substantial portion of the Bank's construction lending activities. The downturn in Pierce County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Thurston County has a population of 252,000 according to the U.S. Census Bureau 2011 estimates and a median family income of $75,000 according to 2012 HUD estimates. Thurston County is home of Washington State's capital (Olympia) and its economic base is largely driven by state government related employment. According to the Washington State Employment Security Department, the unemployment rate for the Thurston County area decreased to 7.4% at September 30, 2012 from 8.0% in 2011. The median price of a resale home in Thurston County for the quarter ended September 30, 2012 decreased 2.6% to $217,800 from $223,600 for the same quarter one year earlier. The number of home sales increased 20.3% for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The Bank has five branches in Thurston County. This county has historically had a stable economic base primarily attributable to the state government presence; however the downturn in Thurston County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Kitsap County has a population of 251,000 according to the U.S. Census Bureau 2011 estimates and a median family income of $75,600 according to 2012 HUD estimates. The Bank has two branches in Kitsap County. The economic base of Kitsap County is largely supported by military related government employment through the United States Navy. According to the Washington State Employment Security Department, the unemployment rate for the Kitsap County area decreased to 7.1% at September 30, 2012 from 7.5% at September 30, 2011. The median price of a resale home in Kitsap County for the quarter ended September 30, 2012 increased 6.1% to $249,800 from $235,500, the same quarter one year earlier. The number of home sales increased 16.9% for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The downturn in Kitsap County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

King County is the most populous county in the state and has a population of 1.9 million according to the U.S. Census Bureau 2011 estimates. The Bank has one branch in King County. The county's median family income is $88,000 according to 2012 HUD estimates. King County's economic base is diversified with many industries including shipping, transportation, aerospace (Boeing), computer technology and biotech industries. According to the Washington State Employment Security Department, the unemployment rate for the King County area decreased to 6.9% at September 30, 2012 from 8.1% at September 30, 2011. The median price of a resale home in King County for the quarter ended September 30, 2012 increased 8.5% to $379,900 from $350,000, for the same quarter one year earlier. The number of home sales increased 20.7% for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The downturn in King County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Lewis County has a population of 75,000 according to the U.S. Census Bureau 2011 estimates and a median family income of $57,400 according to 2012 HUD estimates. The economic base in Lewis County is supported by manufacturing, retail trade, local government and industrial services. According to the Washington State Employment Security Department, the unemployment rate in Lewis County decreased to 11.8% at September 30, 2012 from 12.1% at September 30, 2011. The median price of a resale home in Lewis County for the quarter ended September 30, 2012 increased 1.3% to $142,900 from $141,100, for the same quarter one year earlier. The number of home sales was unchanged for the quarter ended September 30, 2012 compared to the same quarter one year earlier. The Bank currently has three branches located in Lewis County. The downturn in Lewis County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Lending Activities

General. Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences, or by commercial real estate and loans for the construction of one- to four-family residences. During the past several years, the Bank adjusted its lending strategy and began reducing its exposure to speculative construction and land development lending as well as land loans. The Bank's net loans receivable, including loans held for sale, totaled $538.5 million at September 30, 2012, representing 73.1% of consolidated total assets, and at that date commercial real estate, construction and land development loans (including undisbursed loans in process), and land loans were $352.3 million, or 62.0%, of total loans. Construction and land development loans, land loans and commercial real estate loans typically have higher rates of return than one- to four-family loans; however, they also present a higher degree of risk. See "-Lending Activities - Commercial Real Estate Lending," "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Land Lending."

The Bank's internal loan policy limits the maximum amount of loans to one borrower to 25% of its Tier 1 capital. At September 30, 2012, the maximum amount which the Bank could have lent to any one borrower and the borrower's related entities was approximately $20.0 million under this policy. At September 30, 2012, the largest amount outstanding to any one borrower and the borrower's related entities was $16.2 million which was secured by commercial buildings located in Pierce and Kitsap counties. These loans were all performing according to the loan repayment terms at September 30, 2012. The next largest amount outstanding to any one borrower and the borrower's related entities was $9.9 million. These loans were secured by a multi-family building, a commercial building, several one- to four-family properties, and several land parcels. All of the loans were secured by properties located in Grays Harbor County, except for a $1.8 million multi-family loan secured by property located in Clark County and $336,000 in loans secured by a one- to four-family property and a land parcel located in Clatsop County, Oregon. These loans were performing according to their loan repayment terms at September 30, 2012.

Loan Portfolio Analysis. The following table sets forth the composition of the Bank's loan portfolio by type of loan as of the dates indicated.

	At September 30,									
	2012		2011		2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
Mortgage Loans:										
One- to four-family(1)	$106,979	18.82 %	$114,680	20.47 %	$121,014	21.65 %	$110,556	18.58 %	$112,299	18.35 %
Multi-family	47,521	8.36	30,982	5.53	32,267	5.77	25,638	4.31	25,927	4.24
Commercial	256,254	45.08	246,037	43.92	208,002	37.21	188,205	31.62	146,223	23.90
Construction and land development	56,406	9.92	52,484	9.37	69,271	12.39	139,728	23.48	186,344	30.46
Land	39,655	6.98	49,236	8.79	62,999	11.27	65,642	11.03	60,701	9.92
Total mortgage loans	506,815	89.16	493,419	88.08	493,553	88.29	529,769	89.02	531,494	86.87
Consumer Loans:										
Home equity and second mortgage	32,814	5.77	36,008	6.43	38,418	6.87	41,746	7.01	48,690	7.96
Other	6,183	1.10	8,240	1.47	9,086	1.62	9,827	1.66	10,635	1.73
Total consumer loans	38,997	6.87	44,248	7.90	47,504	8.49	51,573	8.67	59,325	9.69
Commercial business loans	22,588	3.97	22,510	4.02	17,979	3.22	13,775	2.31	21,018	3.44
Total loans	568,400	100.00%	560,177	100.00%	559,036	100.00%	595,117	100.00%	611,837	100.00%
Less:										
Undisbursed portion of construction loans in process	(16,325)		(18,265)		(17,952)		(31,298)		(43,353)	
Deferred loan origination fees	(1,770)		(1,942)		(2,229)		(2,439)		(2,747)	
Allowance for loan losses	(11,825)		(11,946)		(11,264)		(14,172)		(8,050)	
Total loans receivable, net	$538,480		$528,024		$527,591		$547,208		$557,687	

(1) Includes loans held-for-sale of $1.4 million, $4.0 million, $3.0 million, $630,000 and $1.8 million at September 30, 2012, 2011, 2010, 2009 and 2008, respectively.

Residential One- to Four-Family Lending. At September 30, 2012, $107.0 million, or 18.8%, of the Bank's loan portfolio consisted of loans secured by one- to four-family residences. The Bank originates both fixed-rate loans and adjustable-rate loans.

Generally, one- to four-family fixed-rate loans and five and seven year balloon reset loans (which are loans that are originated with a fixed interest rate for the initial five or seven years, and thereafter incur one interest rate change in which the new rate remains in effect for the remainder of the loan term) are originated to meet the requirements for sale in the secondary market to Freddie Mac. From time to time, however, a portion of these fixed-rate loans, which include five and seven year balloon reset loans, may be retained in the loan portfolio to meet the Bank's asset/liability management objectives. The Bank uses an automated underwriting program, which preliminarily qualifies a loan as conforming to Freddie Mac underwriting standards when the loan is originated. At September 30, 2012, $45.0 million, or 42.1%, of the Bank's one- to four-family loan portfolio consisted of fixed-rate mortgage loans.

The Bank also offers adjustable-rate mortgage ("ARM") loans. All of the Bank's ARM loans are retained in its loan portfolio. The Bank offers several ARM products which adjust annually after an initial period ranging from one to five years and are typically subject to a limitation on the annual interest rate increase of 2% and an overall limitation of 6%. These ARM products generally are priced utilizing the weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year plus a margin of 2.88% to 4.00%. The Bank also offers ARM loans tied to the prime rate or to the London Inter-Bank Offered Rate ("LIBOR") indices which typically do not have periodic, or lifetime adjustment limits. Loans tied to these indices normally have margins ranging up to 3.5%. ARM loans held in the Bank's portfolio do not permit negative amortization of principal. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment. At September 30, 2012, $62.0 million, or 57.9%, of the Bank's one- to four-family loan portfolio consisted of ARM loans.

A portion of the Bank's ARM loans are "non-conforming" because they do not satisfy acreage limits, or various other requirements imposed by Freddie Mac. Some of these loans are also originated to meet the needs of borrowers who cannot otherwise satisfy Freddie Mac credit requirements because of personal and financial reasons (i.e., divorce, bankruptcy, length of time employed, etc.), and other aspects, which do not conform to Freddie Mac's guidelines. Such borrowers may have higher debt-to-income ratios, or the loans are secured by unique properties in rural markets for which there are no sales of comparable properties to support the value according to secondary market requirements. These loans are known as non-conforming loans and the Bank may require additional collateral or lower loan-to-value ratios to reduce the risk of these loans. The Bank believes that these loans satisfy a need in its local market area. As a result, subject to market conditions, the Bank intends to continue to originate these types of loans.

The retention of ARM loans in the Bank's loan portfolio helps reduce the Bank's exposure to changes in interest rates. There are, however, unquantifiable credit risks resulting from the potential of increased interest to be paid by the customer as a result of increases in interest rates. It is possible that during periods of rising interest rates the risk of default on ARM loans may increase as a result of repricing and the increased costs to the borrower. The Bank attempts to reduce the potential for delinquencies and defaults on ARM loans by qualifying the borrower based on the borrower's ability to repay the ARM loan assuming that the maximum interest rate that could be charged at the first adjustment period remains constant during the loan term. Another consideration is that although ARM loans allow the Bank to increase the sensitivity of its asset base due to changes in the interest rates, the extent of this interest sensitivity is limited by the periodic and lifetime interest rate adjustment limits. Because of these considerations, the Bank has no assurance that yield increases on ARM loans will be sufficient to offset increases in the Bank's cost of funds.

While fixed-rate, single-family residential mortgage loans are normally originated with 15 to 30 year terms, these loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full upon sale of the property pledged as security or upon refinancing the original loan. In addition, substantially all mortgage loans in the Bank's loan portfolio contain due-on-sale clauses providing that the Bank may declare the unpaid amount due and payable upon the sale of the property securing the loan. Typically, the Bank enforces these due-on-sale clauses to the extent permitted by law and as business judgment dictates. Thus, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates received on outstanding loans.

The Bank requires that fire and extended coverage casualty insurance be maintained on the collateral for all of its real estate secured loans and flood insurance, if appropriate.

The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or the purchase price. However, the Bank usually obtains private mortgage insurance ("PMI") on the portion of the principal amount that exceeds 80% of the appraised value of the security property. The maximum loan-to-value ratio on mortgage loans secured by non-owner-occupied properties is generally 80% (90% for loans originated for sale in the secondary market to Freddie Mac). At September 30, 2012, 14 single family loans totaling $3.4 million were not performing according to their terms. See "- Lending Activities - Non-performing Loans and Delinquencies."

Construction and Land Development Lending. Prompted by unfavorable economic conditions in its primary market area in the 1980s, the Bank sought to establish a market niche and, as a result, began originating construction loans outside of Grays Harbor County. In recent periods, construction lending activities have been primarily in the Pierce, King, Thurston, Grays Harbor, and Kitsap County markets although, as a result of the current economic environment, the Bank has sharply curtailed speculative construction and land development lending.

The Bank currently originates three types of residential construction loans: (i) custom construction loans, (ii) owner/builder construction loans and (iii) speculative construction loans (on a limited basis). The Bank believes that its computer tracking system has enabled it to establish processing and disbursement procedures to meet the needs of these borrowers which the Bank believes reduces many of the risks inherent with construction lending. The Bank also originates construction loans for the development of multi-family and commercial properties. Our construction loans generally provide for the payment of interest only during the construction phase.

At September 30, 2012 and 2011, the composition of the Bank's construction and land development loan portfolio was as follows:

	At September 30,			
	2012		2011	
	Outstanding Balance	Percent of Total	Outstanding Balance	Percent of Total
	(Dollars in thousands)			
Custom and owner/builder construction	$ 33,345	59.12 %	$ 26,205	49.93 %
Speculative construction	1,880	3.33	1,919	3.66
Multi-family (including condominium)	345	0.61	9,322	17.76
Land development	589	1.04	2,175	4.14
Commercial real estate	20,247	35.90	12,863	24.51
Total	$ 56,406	100.00 %	$ 52,484	100.00 %

Custom construction loans are made to home builders who, at the time of construction, have a signed contract with a home buyer who has a commitment to purchase the finished home. Custom construction loans are generally originated for a term of six to 12 months, with fixed interest rates currently ranging from 5.75% to 7.88% and with loan-to-value ratios of 80% of the appraised estimated value of the completed property or sales price, whichever is less.

Owner/builder construction loans are originated to home owners rather than home builders and are typically converted to or refinanced into permanent loans at the completion of construction. The construction phase of an owner/builder construction loan generally lasts up to 12 months with fixed interest rates currently ranging from 5.75% to 7.88%, and with loan-to-value ratios of 80% (or up to 95% with PMI) of the appraised estimated value of the completed property. At the completion of construction, the loan is converted to or refinanced into either a fixed-rate mortgage loan, which conforms to secondary market standards, or an ARM loan for retention in the Bank's portfolio. At September 30, 2012, custom and owner/builder construction loans totaled $33.3 million, or 59.1%, of the total construction and land development loan portfolio. At September 30, 2012, the largest outstanding custom and owner/builder construction loan had an outstanding balance of $1.5 million (including $1.3 million of undisbursed loans in process) and was performing according to its repayment terms.

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified either during or after the construction period, with the risk that the builder will have to debt service the speculative construction loan and finance real estate taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home buyer is identified and a sale is consummated. Historically, the Bank has originated loans to approximately 50 builders located in the Bank's primary market area, each of which generally would have one to eight speculative loans outstanding from the Bank during a 12 month period. Rather than originating lines of credit to home builders to construct several homes at once, the Bank generally originates and underwrites a separate loan for each home. Speculative construction loans are generally originated for a term of 12 months, with current rates ranging from 3.38% to 7.50%, and with a loan-to-value ratio of no more than 80% of the appraised estimated value of the completed property. The Bank is currently originating speculative construction loans on a limited basis. At September 30, 2012, speculative construction loans totaled $1.9 million, or 3.3%, of the total construction and land development loan portfolio. At September 30, 2012, the Bank had one borrower with an aggregate outstanding speculative loan balance of more than $500,000. The largest aggregate outstanding balance to one borrower for speculative construction loans, totaled $700,000 and was comprised of a single loan that was past maturity by 91 days and not performing according to its restructured terms. At September 30, 2012, three speculative construction loans totaling $1.0 million were not performing according to their original or restructured terms. See "- Lending Activities - Non-performing Loans and Delinquencies."

The Bank historically originated loans to real estate developers with whom it had established relationships for the purpose of developing residential subdivisions (i.e., installing roads, sewers, water and other utilities; generally with ten to 50 lots). The Bank is not currently originating any new land development loans. At September 30, 2012, the Bank had five land development loans totaling $589,000, or 1.0% of construction and land development loans receivable, all of which were not performing according to their terms. Land development loans are secured by a lien on the property and typically made for a period of two to five years with fixed or variable interest rates, and are made with loan-to-value ratios generally not exceeding 75%. Land development loans are generally structured so that the Bank is repaid in full upon the sale by the borrower of approximately 80% of the subdivision lots. A majority of the Bank's land development loans are secured by property located in its primary market area. In addition, in the case of a corporate borrower, the Bank also generally obtains personal guarantees from corporate principals and reviews their personal financial statements.

Land development loans secured by land under development involve greater risks than one- to four-family residential mortgage loans because these loans are advanced upon the predicted future value of the developed property upon completion. If the estimate of the future value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank has historically attempted to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75% of the estimated developed value of the secured property. The Bank is not currently originating any new land development loans.

The Bank also provides construction financing for multi-family and commercial properties. At September 30, 2012, these loans amounted to $20.6 million, or 36.5% of construction and land development loans. These loans are secured by condominiums, apartment buildings, mini-storage facilities, office buildings, hotels and retail rental space predominantly located in the Bank's primary market area. At September 30, 2012, the largest outstanding multi-family construction loan was secured by an apartment building project in Pierce County and had a balance of $345,000 and was not performing according to its terms. At September 30, 2012, the largest outstanding commercial real estate construction loan had a balance of $6.1 million (including $1.1 million of undisbursed loans in process). This loan was secured by a medical office building being constructed in Thurston County and was performing according to its terms.

All construction loans must be approved by a member of one of the Bank's Loan Committees or the Bank's Board of Directors, or in the case of one- to four-family construction loans meeting Freddie Mac guidelines, by a qualified Bank underwriter. See "- Lending Activities - Loan Solicitation and Processing." Prior to preliminary approval of any construction loan application, an independent fee appraiser inspects the site and the Bank reviews the existing or proposed improvements, identifies the market for the proposed project and analyzes the pro forma data and assumptions on the project. In the case of a speculative or custom construction loan, the Bank reviews the experience and expertise of the builder. After preliminary approval has been given, the application is processed, which includes obtaining credit reports, financial statements and tax returns on the borrowers and guarantors, an independent appraisal of the project, and any other expert reports necessary to evaluate the proposed project. In the event of cost overruns, the Bank generally requires that the borrower increase the funds available for construction by depositing its own funds into a secured savings account, the proceeds of which are used to pay construction costs.

Loan disbursements during the construction period are made to the builder, materials supplier or subcontractor, based on a line item budget. Periodic on-site inspections are made by qualified independent inspectors to document the reasonableness of draw requests. For most builders, the Bank disburses loan funds by providing vouchers to borrowers, which when used by the borrower to purchase supplies are submitted by the supplier to the Bank for payment.

The Bank originates construction loan applications primarily through customer referrals, contacts in the business community and occasionally real estate brokers seeking financing for their clients.

Construction lending affords the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does its single-family permanent mortgage lending. Construction lending, however, is generally considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, the borrower may be confronted with a project whose value is insufficient to assure full repayment and the Bank may incur a loss. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the payoff for the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The Bank has sought to address these risks by adhering to strict underwriting policies, disbursement procedures, and monitoring practices. The Bank's construction loans are primarily secured by properties in its primary market area, and changes in the local and state economies and real estate markets have adversely affected the Bank's construction loan portfolio.

Multi-Family Lending. At September 30, 2012, the Bank had $47.5 million, or 8.4% of the Bank's total loan portfolio, secured by multi-family dwelling units (more than four units) located primarily in the Bank's primary market area. Multi-family loans are generally originated with variable rates of interest ranging from 2.00% to 3.50% over the one-year constant maturity U.S. Treasury Bill Index or a matched term FHLB advance, with principal and interest payments fully amortizing over terms of up to 30 years. At September 30, 2012 the Bank's largest multi-family loan had an outstanding principal balance of $7.5 million and was secured by an apartment building located in the Bank's primary market area. At September 30, 2012, this loan was performing according to its terms. At September 30, 2012, three loans with a balance of $1.4 million were not performing according to their repayment terms. See "- Lending Activities - Non-performing Loans and Delinquencies."

The maximum loan-to-value ratio for multi-family loans is generally limited to not more than 80%. The Bank generally requests its multi-family loan borrowers with loan balances in excess of $750,000 to submit financial statements and rent rolls on the properties securing such loans. The Bank also inspects such properties annually. The Bank generally imposes a minimum debt coverage ratio of approximately 1.20 for loans secured by multi-family properties.

Multi-family mortgage lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four- family residential lending. However, loans secured by multi-family properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by multi-family properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. If the borrower is other than an individual, the Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements.

Commercial Real Estate Lending. Commercial real estate loans totaled $256.3 million, or 45.1% of the total loan portfolio at September 30, 2012. The Bank originates commercial real estate loans generally at variable interest rates with principal and interest payments fully amortizing over terms of up to 30 years. These loans are secured by properties, such as restaurants, motels, mini-storage facilities, office buildings and retail/wholesale facilities, located in the Bank's primary market area. At September 30, 2012, the largest commercial real estate loan was secured by an office building in Grays Harbor County and had a balance of $6.6 million and was performing according to its terms. At September 30, 2012, 11 commercial real estate loans totaling $6.0 million were not performing according to their terms. See “- Lending Activities - Non-performing Loans and Delinquencies.”

The Bank typically requires appraisals of properties securing commercial real estate loans. For loans that are less than $250,000, the Bank may use the tax assessed value and a property inspection in lieu of an appraisal. Appraisals are performed by independent appraisers designated by the Bank, all of which are reviewed by management. The Bank considers the quality and location of the real estate, the credit history of the borrower, the cash flow of the project and the quality of management involved with the property. The Bank generally imposes a minimum debt coverage ratio of approximately 1.20 for originated loans secured by income producing commercial properties. Loan-to-value ratios on commercial real estate loans are generally limited to not more than 80%. If the borrower is other than an individual, the Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by generally limiting the maximum loan-to-value ratio to 80% and scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also requests annual financial information and rent rolls on the subject property from the borrowers on loans over $750,000.

Land Lending. The Bank has historically originated loans for the acquisition of land upon which the purchaser can then build or make improvements necessary to build or to sell as improved lots. Currently the Bank is not offering land loans to new customers and is attempting to decrease its land loan portfolio. At September 30, 2012, land loans totaled $39.7 million, or 7.0% of the Bank's total loan portfolio as compared to $49.2 million, or 8.8% of the Bank's total loan portfolio at September 30, 2011. Land loans originated by the Bank generally have maturities of five to ten years. The largest land loan had an outstanding balance of $3.9 million at September 30, 2012 and was performing according to its repayment terms. At September 30, 2012, 24 land loans totaling $8.6 million were not performing according to their terms. See "- Lending Activities - Non-performing Loans and Delinquencies."

Loans secured by undeveloped land or improved lots involve greater risks than one- to four-family residential mortgage loans because these loans are more difficult to evaluate. If the estimate of value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75%.

Consumer Lending. Consumer loans generally have shorter terms to maturity and higher interest rates than mortgage loans. Consumer loans include home equity lines of credit, second mortgage loans, savings account loans, automobile loans, boat loans, motorcycle loans, recreational vehicle loans and unsecured loans. Consumer loans are made with both fixed and variable interest rates and with varying terms. At September 30, 2012, consumer loans amounted to $39.0 million, or 6.9%, of the total loan portfolio.

At September 30, 2012, the largest component of the consumer loan portfolio consisted of second mortgage loans and home equity lines of credit, which totaled $32.8 million, or 5.8%, of the total loan portfolio. Home equity lines of credit and second mortgage loans are made for purposes such as the improvement of residential properties, debt consolidation and education expenses, among others. The majority of these loans are made to existing customers and are secured by a first or second mortgage on residential property. The loan-to-value ratio is typically 80% or less, when taking into account both the first and second mortgage loans. Second mortgage loans typically carry fixed interest rates with a fixed payment over a term between five and 15 years. Home equity lines of credit are generally made at interest rates tied to the prime rate or the 26 week Treasury Bill. Second mortgage loans and home equity lines of credit have greater credit risk than one- to four-family residential mortgage loans because they are secured by mortgages subordinated to the existing first mortgage on the property, which may or may not be held by the Bank.

Consumer loans entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. The Bank believes that these risks are not as prevalent in the case of the Bank's consumer loan portfolio because a large percentage of the portfolio consists of second mortgage loans and home equity lines of credit that are underwritten in a manner such that they result in credit risk that is substantially similar to one- to four-family residential mortgage loans. At September 30, 2012, three consumer loans totaling $268,000 were delinquent in excess of 90 days. See "- Lending Activities - Non-performing Loans and Delinquencies."

Commercial Business Lending. Commercial business loans totaled $22.6 million, or 4.0% of the loan portfolio at September 30, 2012. Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property and are made at variable rates of interest equal to a negotiated margin above the prime rate. The Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements. The largest commercial business loan had an outstanding balance of $1.9 million at September 30, 2012 and was performing according to its terms. At September 30, 2012, all commercial business loans were performing according to their repayment terms. See "- Lending Activities - Non-performing Loans and Delinquencies."

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary and often insufficient source of repayment.

Loan Maturity. The following table sets forth certain information at September 30, 2012 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loans having no stated maturity and overdrafts are reported as due in one year or less.

	Within 1 Year	After 1 Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years (In thousands)	After 10 Years	Total
Mortgage loans:						
One- to four-family (1)	$7,408	$2,170	$3,004	$10,801	$83,596	$106,979
Multi-family	1,570	6,547	1,255	37,365	784	47,521
Commercial	12,618	22,028	53,067	154,782	13,759	256,254
Construction and land development(2)	56,406	--	--	--	--	56,406
Land	18,847	13,562	4,187	2,014	1,045	39,655
Consumer loans:						
Home equity and second mortgage	5,083	1,887	3,594	9,274	12,976	32,814
Other	1,590	523	400	601	3,069	6,183
Commercial business loans	8,180	1,517	5,407	5,686	1,798	22,588
Total	$111,702	$48,234	$70,914	$220,523	$117,027	568,400
Less:						
Undisbursed portion of construction loans in process						(16,325)
Deferred loan origination fees						(1,770)
Allowance for loan losses						(11,825)
Loans receivable, net						$538,480

(1) Includes $1.4 million of loans held-for-sale.
(2) Includes construction/permanent loans that convert to permanent mortgage loans once construction is completed.

The following table sets forth the dollar amount of all loans due after one year from September 30, 2012, which have fixed interest rates and have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates (In thousands)	Total
Mortgage loans:			
One- to four-family(1)	$39,812	$59,759	$99,571
Multi-family	9,886	36,065	45,951
Commercial	51,703	191,933	243,636
Construction and land development	--	--	--
Land	13,971	6,837	20,808

Consumer loans:			
Home equity and second mortgage	14,976	12,755	27,731
Other	4,245	348	4,593
Commercial business loans	6,505	7,903	14,408
Total	$141,098	$315,600	$456,698

(1) Includes loans held-for-sale.

Scheduled contractual principal repayments of loans do not reflect the actual life of these assets. The average life of loans is substantially less than their contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give the Bank the right to declare loans immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan interest rates are substantially higher than interest rates on existing mortgage loans and, conversely, decrease when interest rates on existing mortgage loans are substantially higher than current mortgage loan interest rates.

Loan Solicitation and Processing. Loan originations are obtained from a variety of sources, including walk-in customers, and referrals from builders and realtors. Upon receipt of a loan application from a prospective borrower, a credit report and other data are obtained to verify specific information relating to the loan applicant's employment, income and credit standing. An appraisal of the real estate offered as collateral generally is undertaken by a certified appraiser retained by the Bank.

Loan applications are initiated by loan officers and are required to be approved by an authorized loan underwriter, one of the Bank's Loan Committees or the Bank's Board of Directors. The Bank's Consumer Loan Committee consists of three underwriters, each of whom can approve one- to four-family mortgage loans and other consumer loans up to and including the current Freddie Mac single-family limit. Certain consumer loans up to and including $25,000 may be approved by individual loan officers and the Bank's Consumer Lending Department Manager may approve consumer loans up to and including $75,000. The Bank's Regional Manager of Commercial Lending has individual lending authority for loans up to and including $250,000, excluding speculative construction loans and unsecured loans. The Bank's Commercial Loan Committee, which consists of the Bank's President, Chief Credit Administrator, Executive Vice President of Lending, Regional Manager of Community Lending, and Regional Manager of Commercial Lending, may approve commercial real estate loans and commercial business loans up to and including $1.5 million. The Bank's President, Chief Credit Administrator and Executive Vice President of Lending also have individual lending authority for loans up to and including $750,000. The Bank's Board Loan Committee, which consists of two rotating non-employee Directors and the Bank's President, may approve loans up to and including $3.0 million. Loans in excess of $3.0 million, as well as loans of any amount granted to a single borrower whose aggregate loans exceed $3.0 million, must be approved by the Bank's Board of Directors.

Loan Originations, Purchases and Sales. During the years ended September 30, 2012, 2011 and 2010, the Bank's total gross loan originations were $228.3 million, $160.2 million and $182.5 million, respectively. Periodically, the Bank purchases participation interests in construction and land development loans, commercial real estate loans, and multi-family loans, secured by properties generally located in Washington State, from other lenders. These purchases are underwritten to the Bank's underwriting guidelines and are without recourse to the seller other than for fraud. During the year ended September 30, 2012, the Bank purchased loan participation interests of $2.0 million. There were no loan participation interests purchased during the years ended September 30, 2011 and 2010. The Bank also periodically purchases contracts secured by one- to four-family residencies from individuals. During the year ended September 30, 2012, the Bank did not purchase any contracts. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Multi-Family Lending."

Consistent with its asset/liability management strategy, the Bank's policy generally is to retain in its portfolio all ARM loans originated and to sell fixed rate one- to four-family mortgage loans in the secondary market to Freddie Mac; however, from time to time, a portion of fixed-rate loans may be retained in the Bank's portfolio to meet its asset-liability objectives. Loans sold in the secondary market are generally sold on a servicing retained basis. At September 30, 2012, the Bank's loan servicing portfolio, which is not included in the Company's consolidated financial statements, totaled $304.9 million.

The Bank also periodically sells participation interests in construction and land development loans, commercial real estate loans, and land loans to other lenders. These sales are usually made to avoid concentrations in a particular loan type or concentrations to a particular borrower. The Bank sold $3.6 million in loan participation interests to other lenders during the year ended September 30, 2012. The Bank did not sell any loan participation interests to other lenders during the years ended September 30, 2011 and 2010.

The following table shows total loans originated, purchased, sold and repaid during the periods indicated.

	Year Ended September 30,		
	2012	2011	2010
Loans originated:		(In thousands)	
Mortgage loans:			
One- to four-family	$ 103,887	$ 57,620	$ 72,015
Multi-family	20,882	2,009	7,772
Commercial	48,450	38,262	27,248
Construction and land development	39,907	40,724	35,369
Land	1,858	3,793	11,712
Consumer	8,856	7,424	10,286
Commercial business loans	4,415	10,325	18,130
Total loans originated	228,255	160,157	182,532
Loans purchased:			
Mortgage loans:			
One- to four-family	--	187	50
Multi-family	56	--	--
Commercial business	1,955	--	--
Total loans purchased	2,011	187	50
Total loans originated and purchased	230,266	160,344	182,582
Loans sold:			
Partial loans sold	(3,600)	--	--
Whole loans sold	(97,357)	(62,480)	(68,330)
Total loans sold	(100,957)	(62,480)	(68,330)
Loan principal repayments	(121,086)	(96,723)	(150,333)
Other items, net	2,233	(708)	16,464
Net increase (decrease) in loans receivable	$ 10,456	$ 433	$ (19,617)

Loan Origination Fees. The Bank receives loan origination fees on many of its mortgage loans and commercial business loans. Loan fees are a percentage of the loan which are charged to the borrower for funding the loan. The amount of fees charged by the Bank is generally up to 2.0% of the loan amount. Current accounting principles generally accepted in the United States of America require fees received and certain loan origination costs for originating loans to be deferred and amortized into interest income over the contractual life of the loan. Net deferred fees or costs associated with loans that are prepaid are recognized as income at the time of prepayment. Unamortized deferred loan origination fees totaled $1.8 million at September 30, 2012.

Non-performing Loans and Delinquencies. The Bank assesses late fees or penalty charges on delinquent loans of approximately 5% of the monthly loan payment amount. A majority of loan payments are due on the first day of the month; however, the borrower is given a 15 day grace period to make the loan payment. When a mortgage loan borrower fails to make a required payment when due, the Bank institutes collection procedures. A notice is mailed to the borrower 16 days after the date the payment is due. Attempts to contact the borrower by telephone generally begin on or before the 30th day of delinquency. If a satisfactory response is not obtained, continuous follow-up contacts are attempted until the loan has been brought current. Before the 90th day of delinquency, attempts are made to establish (i) the cause of the delinquency, (ii) whether the cause is temporary, (iii) the attitude of the borrower toward repaying the debt, and (iv) a mutually satisfactory arrangement for curing the default.

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If the borrower is chronically delinquent and all reasonable means of obtaining payment on time have been exhausted, foreclosure is initiated according to the terms of the security instrument and applicable law. Interest income on loans in foreclosure is reduced by the full amount of accrued and uncollected interest.

When a consumer loan borrower or commercial business borrower fails to make a required payment on a loan by the payment due date, the Bank institutes similar collection procedures as for its mortgage loan borrowers. All loans becoming 90 days or more past due are placed on non-accrual status, with any accrued interest reversed against interest income, unless they are well secured and in the process of collection.

The Bank's Board of Directors is informed monthly as to the status of loans that are delinquent by more than 30 days, and the status of all foreclosed and repossessed property owned by the Bank.

The following table sets forth information with respect to the Company's non-performing assets at the dates indicated.

	At September 30,				
	2012	2011	2010	2009	2008
Loans accounted for on a non-accrual basis:			(Dollars in thousands)		
Mortgage loans:					
One- to four-family	$3,382	$2,150	$3,691	$1,343	$300
Multi-Family	1,449	--	--	--	--
Commercial	6,049	6,571	7,252	5,004	714
Construction and land development	1,570	3,522	7,609	17,594	9,840
Land	8,613	8,935	5,460	5,023	726
Consumer loans	268	367	806	258	160
Commercial business loans	--	44	46	65	250
Total	21,331	21,589	24,864	29,287	11,990
Accruing loans which are contractually past due 90 days or more	1,198	1,754	1,325	796	--
Total of non-accrual and 90 days past due loans	22,529	23,343	26,189	30,083	11,990
Non-accrual investment securities	2,442	2,796	3,390	477	--
Other real estate owned and other repossessed assets	13,302	10,811	11,519	8,185	511
Total non-performing assets (1)	$38,273	$36,950	$41,098	$38,745	$12,501
Troubled debt restructured loans on accrual status (2)	$13,410	$18,166	$8,995	$--	$272
Non-accrual and 90 days or more past due loans as a percentage of loans receivable, net	4.09 %	4.32 %	4.86 %	5.36 %	2.12 %
Non-accrual and 90 days or more past due					

loans as a percentage of total assets	3.06 %	3.16 %	3.53 %	4.28 %	1.76 %
Non-performing assets as a percentage of total assets	5.19 %	5.01 %	5.53 %	5.52 %	1.83 %
Loans receivable, net (3)	$550,305	$539,970	$538,855	$561,380	$565,737
Total assets	$736,954	$738,224	$742,687	$701,676	$681,883

(1) Does not include troubled debt restructured loans on accrual status.

(2) Does not include troubled debt restructured loans totaling $10.1 million, $7.4 million and $7.4 million reported as non-accrual loans at September 30, 2012, 2011 and 2010, respectively.

(3) Includes loans held-for-sale and is before the allowance for loan losses.

The Bank's non-accrual loans decreased by $258,000 to $21.3 million at September 30, 2012 from $21.6 million at September 30, 2011, primarily as a result of a $2.0 million decrease in construction and land development loans on non-accrual status, a $522,000 decrease in commercial real estate loans on non-accrual status and a $322,000 decrease in land loans on non-accrual status. These decreases were partially offset by a $1.4 million increase in multi-family loans on non-accrual status and a $1.2 million increase in one- to four-family loans on non-accrual status. The largest non-performing loan was secured by a mini-storage facility in King County and had a balance of $2.7 million at September 30, 2012. A discussion of our largest non-performing loans is set forth below under "Asset Classification."

Additional interest income which would have been recorded for the year ended September 30, 2012 had non-accruing loans been current in accordance with their original terms totaled $4.0 million.

Other Real Estate Owned and Other Repossessed Assets. Real estate acquired by the Bank as a result of foreclosure or by deed-in-lieu of foreclosure is classified as other real estate owned ("OREO") until sold. When property is acquired, it is recorded at the estimated fair market value less estimated costs to sell. At September 30, 2012, the Bank had $13.3 million of OREO and other repossessed assets consisting of 56 individual properties, an increase of $2.5 million from $10.8 million at September 30, 2011. The OREO properties consisted of eight commercial real estate properties totaling $6.5 million, 35 land parcels totaling $4.2 million, 12 single family homes totaling $1.7 million and a condominium project of $842,000. The largest OREO property was a commercial real estate property with a balance of $2.8 million.

Restructured Loans. Under accounting principles generally accepted in the United States of America, the Bank is required to account for certain loan modifications or restructurings as "troubled debt restructurings." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower does not necessarily always constitute troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. The Bank had restructured loans totaling $23.5 million at September 30, 2012, of which $10.1 million were on non-accrual status.

Impaired Loans. A loan is considered impaired when it is probable the Bank will be unable to collect all contractual principal and interest payments due in accordance with the original or modified terms of the loan agreement. To determine specific valuation allowances, impaired loans are measured based on the estimated fair value of the collateral less estimated cost to sell if the loan is considered collateral dependent. Impaired loans not considered to be collateral dependent are measured based on the present value of expected future cash flows.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Bank considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the collateral value, reasons for delay, payment record, the amount past due and the number of days past due. At September 30, 2012, the Bank had $40.8 million in impaired loans. For additional information on impaired loans, see Note 4 of the Notes to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Other Loans of Concern. Loans not reflected in the table above as non-performing, but where known information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrower to comply with present repayment terms and that may result in disclosure of such loans as non-performing assets in the future are commonly referred to as "other loans of concern" or "potential problem loans." The amount included in potential problem loans results from an evaluation, on a loan-by-loan basis, of loans classified as "substandard" and "special mention," as those terms are defined under "Asset Classification" below. The amount of potential problem loans was $43.5 million at September 30, 2012 and $61.1 million at September 30, 2011. The vast majority of these loans are collateralized by real estate. See "- Asset Classification" below for additional information regarding our problem loans.

Asset Classification. Applicable regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, regulatory examiners have authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard loans are classified as those loans that are inadequately protected by the current net worth, and paying capacity of the obligor, or of the collateral pledged. Assets classified as substandard have a well-defined weakness, or weaknesses that jeopardize the repayment of the debt. If the weakness, or weaknesses are not corrected there is the distinct possibility that some loss will be sustained. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the Bank is not warranted. When the Bank classifies problem assets as either substandard or doubtful, it is required to establish allowances for loan losses in an amount deemed prudent by management. These allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities and the risks associated with particular problem assets. When the Bank classifies problem assets as loss, it charges off the balance of the asset against the allowance for loan losses. Assets which do not currently expose the Bank to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention. The Bank’s determination of the classification of its assets and the amount of its valuation allowances is subject to review by the FDIC and the Division which can require the establishment of additional loss allowances.

The aggregate amounts of the Bank’s classified and special mention loans (as determined by the Bank), and of the Bank's allowances for loan losses at the dates indicated, were as follows:

	At September 30,		
	2012	2011	2010
	(In thousands)		
Loss	$--	$--	$--
Doubtful	--	--	--
Substandard(1)(2)	33,082	56,980	56,796
Special mention(1)	32,944	27,419	13,070
Total classified and special mention loans	$66,026	$84,399	$69,866
Allowance for loan losses	$11,825	$11,946	$11,264

(1) For further information concerning the change in classified assets, see “- Lending Activities - Non-performing Loans and Delinquencies.”
(2) Includes non-performing loans.

The Bank’s classified and special mention loans decreased by $18.4 million from September 30, 2011 to $66.0 million at September 30, 2012, primarily as a result of a $23.9 million decrease in loans classified as substandard.

Special mention loans are defined as those credits deemed by management to have some potential weakness that deserve management’s close attention. If left uncorrected these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category are not adversely classified and currently do not expose the Bank to sufficient risk to warrant a substandard classification. Thirteen individual loans comprised $24.4 million, or 74.1%, of the $32.9 million in loans classified as special mention. They include five multi-family loans totaling $8.8 million, five commercial real estate loans totaling $11.6 million, two one- to four-family loans totaling $1.5 million and a commercial real estate construction loan with a balance of $2.5 million. All of these loans were current and paying in accordance with their required loan repayment terms at September 30, 2012, except one loan with a balance of $3.4 million that was 60 days past due.

The aggregate amount of loans classified as substandard at September 30, 2012 decreased by $23.9 million to $33.1 million from $57.0 million at September 30, 2011. At September 30, 2012, 89 loans were classified as substandard compared to 134 loans at September 30, 2011.

Of the $33.1 million in loans classified as substandard at September 30, 2012, $21.3 million were on non-accrual status and $298,000 were past due 90 days or more and still accruing. Troubled debt restructured loans totaling $16.9 million were classified as substandard at September 30, 2012, with $10.1 million in troubled debt restructured loans on non-accrual status and $6.8 million in troubled debt restructured loans on accrual status. The largest loan classified as substandard at September 30, 2012 had a balance of $4.7 million and was secured by a mini-storage facility in Pierce County. This loan was performing according to its restructured loan repayment terms at September 30, 2012. The next largest loan classified as substandard at September 30, 2012 had a balance of $2.7 million and was secured by a mini-storage facility in King County and was on non-accrual status at September 30, 2012.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover estimated losses in the loan portfolio. The Bank has established a comprehensive methodology for the determination of provisions for loan losses that takes into consideration the need for an overall general valuation allowance. The Bank’s methodology for assessing the adequacy of its allowance for loan losses is based on its historic loss experience for various loan segments; adjusted for changes in economic conditions, delinquency rates, and other factors. Using these loss estimate factors, management develops a range of probable loss for each loan category. Certain individual loans for which full collectibility may not be assured are evaluated individually with loss exposure based on estimated discounted cash flows or net realizable collateral values. The total estimated range of loss based on these two components of the analysis is compared to the loan loss allowance balance. Based on this review, management will adjust the allowance as necessary to maintain directional consistency with trends in the loan portfolio.

In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. The Bank increases its allowance for loan losses by charging provisions for loan losses against the Bank's income.

The Board of Directors reviews the adequacy of the allowance for loan losses at least quarterly based on management's assessment of current economic conditions, past loss and collection experience, and risk characteristics of the loan portfolio.

At September 30, 2012, the Bank’s allowance for loan losses totaled $11.8 million. The Bank’s allowance for loan losses as a percentage of total loans receivable and non-performing loans was 2.15% and 52.48%, respectively, at September 30, 2012 and 2.21% and 51.18%, respectively, at September 30, 2011.

Management believes that the amount maintained in the allowance is adequate to absorb probable losses in the portfolio. Although management believes that it uses the best information available to make its determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly and adversely affected if circumstances differ substantially from the assumptions used in making the determinations.

While the Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses may adversely affect the Bank's financial condition and results of operations.

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The following table sets forth an analysis of the Bank's allowance for loan losses for the periods indicated.

	Year Ended September 30,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Allowance at beginning of year	$11,946	$11,264	$14,172	$8,050	$4,797
Provision for loan losses	3,500	6,758	10,550	10,734	3,900
Allocated to loan commitments	--	--	--	(169)	--
Recoveries:					
Mortgage loans:					
One- to four-family	74	151	--	--	--
Multi-family	14	41	--	--	--
Commercial	--	--	13	--	--
Construction	505	109	104	--	--
Land	97	46	153	83	--
Consumer loans:					
Home equity and second mortgage	14	42	86	--	--
Other	--	2	6	5	1
Commercial business loans	2	1	--	--	--
Total recoveries	706	392	362	88	1
Charge-offs:					
Mortgage loans:					
One- to four-family	276	543	200	46	--
Multi-family	14	--	--	--	--
Construction	885	3,972	8,012	3,108	648
Commercial	1,215	47	1,888	235	--
Land	1,251	1,704	3,285	705	--
Consumer loans:					
Home equity and second mortgage	232	150	399	162	--
Other	24	30	36	25	--
Commercial business loans	430	22	--	250	--
Total charge-offs	4,327	6,468	13,820	4,531	648
Net charge-offs	3,621	6,076	13,458	4,443	647
Allowance at end of year	$11,825	$11,946	$11,264	$14,172	$8,050
Allowance for loan losses as a percentage of total loans receivable (net)(1) outstanding at the end of the year	2.15 %	2.21 %	2.09 %	2.52 %	1.42 %
Net charge-offs as a percentage of average loans outstanding during the year	0.66 %	1.13 %	2.45 %	0.79 %	0.12 %
Allowance for loan losses as a percentage of non-performing loans at end of year	52.48 %	51.18 %	43.01 %	47.11 %	67.14 %

(1) Total loans receivable (net) includes loans held for sale and is before the allowance for loan losses.

The following table sets forth the allocation of the allowance for loan losses by loan category at the dates indicated.

	At September 30,									
	2012		2011		2010		2009		2008	
	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans
	(Dollars in thousands)									
Mortgage loans:										
One- to four-family	$1,558	18.82 %	$760	20.47 %	$530	21.65 %	$616	18.58 %	$476	18.35 %
Multi-family	1,156	8.36	1,076	5.53	392	5.77	431	4.31	248	4.24
Commercial	4,247	45.08	4,035	43.92	3,173	37.21	2,719	31.63	1,521	23.90
Construction and land development	943	9.92	1,618	9.37	1,626	12.39	5,132	23.48	3,254	30.46
Land	2,392	6.98	2,795	8.79	3,709	11.27	3,348	11.03	1,435	9.92
Non-mortgage loans:										
Consumer loans	1,013	6.87	875	7.90	461	8.49	1,216	8.66	457	9.69
Commercial business loans	516	3.97	787	4.02	1,373	3.22	710	2.31	659	3.44
Total allowance for loan losses	$11,825	100.00 %	$11,946	100.0 %	$11,264	100.00 %	$14,172	100.00 %	$8,050	100.00 %

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Investment Activities

The investment policies of the Bank are established and monitored by the Board of Directors. The policies are designed primarily to provide and maintain liquidity, to generate a favorable return on investments without incurring undue interest rate and credit risk, and to compliment the Bank's lending activities. These policies dictate the criteria for classifying securities as either available-for-sale or held-to-maturity. The policies permit investment in various types of liquid assets permissible under applicable regulations, which includes U.S. Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks, banker's acceptances, federal funds, mortgage-backed securities, and mutual funds. The Company's investment policy also permits investment in equity securities in certain financial service companies.

At September 30, 2012, the Bank's investment portfolio totaled $8.3 million, primarily consisting of $3.9 million of mortgage-backed securities available-for-sale, $1.0 million of mutual funds available-for-sale, and $3.3 million of mortgage-backed securities held-to-maturity. The Bank does not maintain a trading account for any investments. This compares with a total investment portfolio of $10.9 million at September 30, 2011, primarily consisting of $5.7 million of mortgage-backed securities available-for-sale, $1.0 million of mutual funds available-for-sale, and $4.1 million of mortgaged-backed securities held-to-maturity. The composition of the portfolios by type of security, at each respective date is presented in the following table.

	At September 30,					
	2012		2011		2010	
	Recorded Value	Percent of Total	Recorded Value	Percent of Total	Recorded Value	Percent of Total
			(Dollars in thousands)			
Held-to-Maturity:						
U.S. agency securities	$27	0.33 %	$27	0.25 %	$28	0.17 %
Mortgage-backed securities	3,312	39.98	4,118	37.91	5,038	31.13
Available-for-Sale (at fair value):						
Mortgage-backed securities	3,932	47.46	5,717	52.63	10,131	62.59
Mutual funds	1,013	12.23	1,000	9.21	988	6.11
Total portfolio	$8,284	100.00 %	$10,862	100.0 %	$16,185	100.00 %

The following table sets forth the maturities and weighted average yields of the investment and mortgage-backed securities in the Bank's investment securities portfolio at September 30, 2012. Mutual funds, which by their nature do not have maturities, are classified in the one year or less category.

	One Year or Less			After One to Five Years			After Five to Ten Years			After Ten Years		
	Amount	Yield		Amount	Yield		Amount	Yield		Amount	Yield	
	(Dollars in thousands)											
Held-to-Maturity:												
U.S. agency securities	$13	3.25	%	$--	--	%	$14	3.98	%	$--	--	%
Mortgage-backed securities	--	--		15	4.76		10	1.37		3,287	5.00	
Available-for-Sale:												
Mortgage-backed securities	--	--		71	5.88		--	--		3,861	4.05	
Mutual funds	1,013	2.19		--	--		--	--		--	--	
Total portfolio	$1,026	2.20	%	$86	4.95	%	$24	2.90	%	$7,148	4.49	%

There were no securities which had an aggregate book value in excess of 10% of the Bank’s total equity at September 30, 2012. At September 30, 2012, the Bank had $2.8 million of private label mortgage-backed securities of which $2.4 million was on non-accrual status. For additional information regarding investment securities, see “Item 1A, Risk Factors – Other-than-temporary impairment charges in our investment securities portfolio could result in additional losses” and Note 3 of the Notes to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major sources of the Bank's funds for lending and other investment purposes. Scheduled loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and money market conditions. Borrowings through the FHLB-Seattle and the FRB may be used to compensate for reductions in the availability of funds from other sources.

Deposit Accounts. Substantially all of the Bank's depositors are residents of Washington. Deposits are attracted from within the Bank's market area through the offering of a broad selection of deposit instruments, including money market deposit accounts, checking accounts, regular savings accounts and certificates of deposit. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers current market interest rates, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. The Bank actively seeks consumer and commercial checking accounts through checking account acquisition marketing programs. At September 30, 2012, the Bank had 37.7% of total deposits in non-interest bearing accounts and NOW checking accounts.

At September 30, 2012 the Bank had $77.5 million of jumbo certificates of deposit of $100,000 or more. The Bank had no brokered certificates of deposits at September 30, 2012. The Bank believes that its jumbo certificates of deposit, which represented 13.0% of total deposits at September 30, 2012, present similar interest rate risk compared to its other deposits.

The following table sets forth information concerning the Bank's deposits at September 30, 2012.

Category	Weighted Average Interest Rate		Amount (In thousands)	Percentage of Total Deposits	
Non-interest bearing	--	%	$75,296	12.60	%
Negotiable order of withdrawal (“NOW”) checking	0.43		150,139	25.11	
Savings	0.28		87,493	14.63	
Money market	0.48		79,549	13.30	
Subtotal	0.40		$392,477	65.64	
Certificates of Deposit(1)					
Maturing within 1 year	0.78		131,655	22.02	
Maturing after 1 year but within 2 years	1.23		38,597	6.46	
Maturing after 2 years but within 5 years	2.02		35,057	5.86	
Maturing after 5 years	1.74		140	0.02	
Total certificates of deposit	1.07		205,449	34.36	
Total deposits	0.63	%	$597,926	100.00	%

(1) Based on remaining maturity of certificates.

The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of September 30, 2012. Jumbo certificates of deposit have principal balances of $100,000 or more and the rates paid on these accounts are generally negotiable.

Maturity Period	Amount (In thousands)
Three months or less	$ 12,075
Over three through six months	13,646
Over six through twelve months	18,201
Over twelve months	33,618
Total	$ 77,540

Deposit Flow. The following table sets forth the balances of deposits in the various types of accounts offered by the Bank at the dates indicated.

	At September 30,							
	2012			2011			2010	
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total
	(Dollars in thousands)							
Non-interest-bearing	$75,296	12.60 %	$ 10,802	$64,494	10.88 %	$ 5,739	$58,755	10.15 %
NOW checking	150,139	25.11	(5,160)	155,299	26.20	1,995	153,304	26.48
Savings	87,493	14.63	3,857	83,636	14.11	16,188	67,448	11.65
Money market	79,549	13.30	18,521	61,028	10.30	5,305	55,723	9.63
Certificates of deposit which mature:								
Within 1 year	131,655	22.02	(25,506)	157,161	26.52	(20,750)	177,911	30.74
After 1 year, but within 2 years	38,597	6.46	(1,196)	39,793	6.71	(3,239)	43,032	7.43
After 2 years, but within 5 years	35,057	5.86	4,416	30,641	5.17	8,255	22,386	3.87
Certificates maturing thereafter	140	0.02	(486)	626	0.11	316	310	0.05
Total	$597,926	100.0 %	$ 5,248	$592,678	100.0 %	$ 13,809	$578,869	100.00 %

Certificates of Deposit by Rates. The following table sets forth the certificates of deposit in the Bank classified by rates as of the dates indicated.

	At September 30, 2012	2011	2010
	(In thousands)		
0.00 - 1.99%	$ 174,456	$ 193,790	$ 194,142
2.00 - 3.99%	30,552	33,345	48,059
4.00 - 5.99%	441	1,086	1,374
6.00% - and over	--	--	64
Total	$ 205,449	$ 228,221	$ 243,639

Certificates of Deposit by Maturities. The following table sets forth the amount and maturities of certificates of deposit at September 30, 2012.

	Amount Due Less Than One Year	One to Two Years	After Two to Five Years	After Five Years	Total
	(In thousands)				
0.00 - 1.99%	$ 126,785	$ 31,755	$ 15,776	$ 140	$ 174,456
2.00 - 3.99%	4,598	6,673	19,281	--	30,552
4.00 - 5.99%	272	169	--	--	441
Total	$ 131,655	$ 38,597	$ 35,057	$ 140	$ 205,449

Deposit Activities. The following table sets forth the deposit activities of the Bank for the periods indicated.

	Year Ended September 30, 2012	2011	2010
	(In thousands)		
Beginning balance	$ 592,678	$ 578,869	$ 505,661
Net deposits before interest credited	1,297	7,673	65,401
Interest credited	3,951	6,136	7,807
Net increase in deposits	5,248	13,809	73,208
Ending balance	$ 597,926	$ 592,678	$ 578,869

Borrowings. Deposits and loan repayments are generally the primary source of funds for the Bank's lending and investment activities and for general business purposes. The Bank has the ability to use advances from the FHLB-Seattle to supplement its supply of lendable funds and to meet deposit withdrawal requirements. The FHLB-Seattle functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB-Seattle, the Bank is required to own capital stock in the FHLB-Seattle and is authorized to apply for advances on the security of such stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States government) provided certain creditworthiness standards have been met. Advances are made pursuant to several different credit programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. At September 30, 2012, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount of 30% of the Bank's total assets, limited by available collateral, under which $45.0 million was outstanding. The Bank also utilizes overnight repurchase agreements with customers. These overnight repurchase agreements are classified as other borrowings and totaled $855,000 at September 30, 2012. The Bank also maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. At September 30, 2012, the Bank had no outstanding balance and $58.0 million in unused borrowing capacity on this borrowing line.

The following table sets forth certain information regarding borrowings including repurchase agreements by the Bank at the end of and during the periods indicated:

	At or For the Year Ended September 30,		
	2012	2011	2010
	(Dollars in thousands)		
Average total borrowings	$ 48,302	$ 55,511	$ 78,402
Weighted average rate paid on total borrowings	4.13 %	4.32 %	4.03 %
Total borrowings outstanding at end of period	$ 45,855	$ 55,729	$ 75,622

The following table sets forth certain information regarding short-term borrowings including repurchase agreements by the Bank at the end of and during the periods indicated. Borrowings are considered short-term when the original maturity is less than one year.

	At or For the Year Ended September 30,		
	2012	2011	2010
	(Dollars In thousands)		
Maximum amount outstanding at any month end:			
FHLB advances	$ --	$ --	$ --
Repurchase agreements	948	729	750
FRB borrowings	--	--	10,000
Average outstanding during period:			
FHLB advances	$ --	$ --	$ --
Repurchase agreements	699	511	539
FRB borrowings	--	--	384
Total average outstanding during period	$ 669	$ 511	$ 923
Weighted average rate paid during period:			
FHLB advances	-- %	-- %	-- %
Repurchase agreements	0.05	0.05	0.05
FRB borrowings	--	--	0.66
Total weighted average rate paid during period	0.05	0.05	0.30

(table continued on following page)

	At or For the Year Ended September 30, 2012		2011		2010	
	(Dollars in thousands)					
Outstanding at end of period:						
FHLB advances	$ --		$ --		$ --	
Repurchase agreements	855		729		622	
FRB borrowings	--		--		--	
Total outstanding at end of period	$ 855		$ 729		$ 622	
Weighted average rate at end of period:						
FHLB advances	--	%	--	%	--	%
Repurchase agreements	0.05		0.05		0.05	
FRB borrowings	--		--		--	
Total weighted average rate at end of period	0.05		0.05		0.05	

Bank Owned Life Insurance

The Bank has purchased life insurance policies covering certain officers. These policies are recorded at their cash surrender value, net of any cash surrender charges. Increases in cash surrender value, net of policy premiums, and proceeds from death benefits are recorded in non-interest income. At September 30, 2012, the cash surrender value of bank owned life insurance ("BOLI") was $16.5 million.

Regulation of the Bank

General. The Bank, as a state-chartered savings bank, is subject to regulation and oversight by the Division and the applicable provisions of Washington law and regulations of the Division adopted thereunder. The Bank also is subject to regulation and examination by the FDIC, which insures the deposits of the Bank to the maximum extent permitted by law, and requirements established by the Federal Reserve. State law and regulations govern the Bank's ability to take deposits and pay interest thereon, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers, and to establish branch offices. Under state law, savings banks in Washington also generally have all of the powers that federal savings banks have under federal laws and regulations. The Bank is subject to periodic examination and reporting requirements by and of the Division and the FDIC.

In December 2009, the FDIC and the Division agreed to terms on the Bank MOU informal supervisory agreement. The terms of the Bank MOU restricted the Bank from certain activities, and required that the Bank obtain the prior written approval, or non-objection, of the FDIC and/or the DFI to engage in certain activities. On December 12, 2012, the FDIC and the Division notified the Bank that the Bank MOU had been rescinded. In addition, on February 1, 2010, the FRB determined that the Company required additional supervisory attention and entered into the Company MOU. Under the Company MOU, the Company must among other things obtain prior written approval, or non-objection, from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock. The FRB denied the Company's requests to pay certain quarterly dividends on its Series A Preferred Stock issued under the CPP from May 15, 2010 through the August 15, 2012 dividend payment. The FRB recently approved the Company's requests to pay the deferred dividends on the Series A Preferred Stock. The Company has made all dividend payments and was current on the Series A Preferred Stock dividend payments at September 30, 2012. The Company subsequently paid the November 15, 2012 dividend on the Series A Preferred Stock. The Company must continue to pay dividends on the Series A Preferred Stock and there can be no assurances that the FRB will approve such payments or dividends in the future. For additional information regarding the Bank MOU and the Company MOU, see “Item 1A, Risk Factors - The Company and the Bank are required to comply with the terms of separate memorandums of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions.” and “– Risks specific to our participation in TARP.”

New Legislation.The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. The following discussion summarizes significant aspects of the Dodd-Frank Act that may affect the Bank and the Company. For certain of these changes, implementing regulations have not been promulgated, so we cannot determine the full impact of the Dodd-Frank Act on our business and operations at this time.

The following aspects of the Dodd-Frank Act are related to the operations of the Bank:

- The Consumer Financial Protection Bureau ("CFPB"), an independent consumer compliance regulatory agency within the Federal Reserve has been established. The CFPB is empowered to exercise broad regulatory, supervisory and enforcement authority over financial institutions with total assets of over $10 billion with respect to both new and existing consumer financial protection laws. Financial institutions with assets of less than $10 billion, like the Bank, will continue to be subject to supervision and enforcement by their primary federal banking regulator with respect to federal consumer financial protection laws. The CFPB also has authority to promulgate new consumer financial protection regulations and amend existing consumer financial protection regulations;

- The Federal Deposit Insurance Act was amended to direct federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries;

- The prohibition on payment of interest on demand deposits was repealed, effective July 21, 2011;

- Deposit insurance is permanently increased to $250,000 and unlimited deposit insurance for noninterest-bearing transaction accounts is extended through December 31, 2012;

- The deposit insurance assessment base for FDIC insurance is the depository institution's average consolidated total assets less the average tangible equity during the assessment period; and

- The minimum reserve ratio of the FDIC's Deposit Insurance Fund ("DIF") increased to 1.35 percent of estimated annual insured deposits or the comparable percentage of the assessment base; however, the FDIC is directed to "offset the effect" of the increased reserve ratio for insured depository institutions with total consolidated assets of less than $10 billion. Pursuant to the Dodd-Frank Act, the FDIC recently issued a rule setting a designated reserve ratio at 2.0% of insured deposits.

The following aspects of the Dodd-Frank Act are related to the operations of Timberland Bancorp:

- Tier 1 capital treatment for "hybrid" capital items like trust preferred securities is eliminated subject to various grandfathering and transition rules. The federal banking agencies must promulgate new rules on regulatory capital within 18 months from July 21, 2010, for both depository institutions and their holding companies, to include leverage capital and risk-based capital measures at least as stringent as those now applicable to the Bank under the prompt corrective action regulations;

- Public companies are required to provide their shareholders with a non-binding vote: (i) at least once every three years on the compensation paid to executive officers, and (ii) at least once every six years on whether they should have a "say on pay" vote every one, two or three years;

- A separate, non-binding shareholder vote is required regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments;

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- Securities exchanges are required to prohibit brokers from using their own discretion to vote shares not beneficially owned by them for certain "significant" matters, which include votes on the election of directors, executive compensation matters, and any other matter determined to be significant;

- Stock exchanges are prohibited from listing the securities of any issuer that does not have a policy providing for (i) disclosure of its policy on incentive compensation payable on the basis of financial information reportable under the securities laws, and (ii) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid erroneously during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information;

- Disclosure in annual proxy materials is required concerning the relationship between the executive compensation paid and the financial performance of the issuer;

- Item 402 of Regulation S-K is amended to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees; and

- Smaller reporting companies are exempt from complying with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act.

Insurance of Accounts and Regulation by the FDIC. The Deposit Insurance Fund ("DIF") of the FDIC insures deposit accounts in the Bank up to $250,000 per separately insured depositor. Noninterest bearing transaction accounts have unlimited coverage until December 31, 2012. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. Our deposit insurance premiums for the year ended September 30, 2012, were $942,000. Those premiums have increased in recent years due to recent strains on the FDIC deposit insurance fund due to the large cost of bank failures and increases in the number of troubled banks.

As a result of a decline in the reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) and concerns about expected failure costs and available liquid assets in the DIF, the FDIC adopted a rule requiring each insured institution to prepay on December 30, 2009 the estimated amount of its quarterly assessments for the fourth quarter of 2009 and all quarters through the end of 2012. The prepaid amount is recorded as an asset with a zero risk weight and the institution will continue to record quarterly expenses for deposit insurance. For purposes of calculating the prepaid amount, assessments were measured at the institution's assessment rate as of September 30, 2009, with a uniform increase of three basis points effective January 1, 2011, and were based on the institution's assessment base for the third quarter of 2009, with growth assumed quarterly at an annual rate of 5%. If events cause actual assessments during the prepayment period to vary from the prepaid amount, institutions will pay excess assessments in cash, or receive a rebate of prepaid amounts not exhausted after collection of assessments due on June 13, 2013, as applicable. Collection of the prepayment does not preclude the FDIC from changing assessment rates or revising the risk-based assessment system in the future. The balance of the Bank's prepaid assessment at September 30, 2012 was $1.2 million.

The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules, effective as of the second quarter of 2011, which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible equity capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as the Bank. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the deposit insurance fund. The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances which would result in termination of the Bank's deposit insurance.

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution’s category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a Tier 1 risk-based capital ratio of not less than 4%, and a leverage ratio of not less than 4%. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by an institution to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At September 30, 2012, the Bank was categorized as “well capitalized” under the prompt corrective action regulations of the FDIC. For additional information on capital requirements, see Note 18 of the Notes to the Consolidated Financial Statements contained in “Item 8, Financial Statements and Supplemental Data.”

Capital Requirements. Federally insured savings institutions, such as the Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core (“Tier 1”) capital and supplementary (“Tier 2”) capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement for a bank to be considered adequately capitalized specifies a minimum ratio of Tier 1 capital to average total assets of 4%. At September 30, 2012, the Bank had a Tier 1 leverage capital ratio of 10.9%. The FDIC retains the right to require a particular institution to maintain a higher capital level based on the its particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines for a bank to be considered adequately capitalized, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets (the Tier 1 risk based capital ratio) must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect a bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At September 30, 2012, the Bank's ratio of total capital to risk-weighted assets was 15.8% and the ratio of Tier 1 capital to risk-weighted assets was 14.5%.

The Division requires that net worth equal at least 5% of total assets. At September 30, 2012, the Bank had a net worth of 10.7% of total assets.

The table below sets forth the Bank's capital position relative to its FDIC capital requirements at September 30, 2012. The definitions of the terms used in the table are those provided in the capital regulations issued by the FDIC and reflect the higher Tier 1 leverage capital ratio that the Bank was required to comply with in connection with the Bank MOU that was in effect at September 30, 2012. On December 12, 2012, the FDIC and the Division notified the Bank that the Bank MOU had been rescinded. For additional information regarding the MOU, see “Item 1A, Risk Factors – The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions.”

	At September 30, 2012			
		Amount	Percent of Adjusted Total Assets (1)	
	(Dollars in thousands)			
Tier 1 (leverage) capital	$	79,911	10.9	%
Tier 1 (leverage) capital requirement (2)		73,013	10.0	
Excess	$	6,898	0.9	%
Tier 1 risk adjusted capital	$	79,911	14.5	%
Tier 1 risk adjusted capital requirement		33,036	6.0	
Excess	$	46,875	8.5	%
Total risk-based capital	$	86,856	15.8	%
Total risk-based capital requirement		55,059	10.0	

Excess	$	31,797	5.8	%

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(1) For the Tier 1 (leverage) capital and Washington regulatory capital calculations, percent of total average assets of $730.1 million. For the Tier 1 risk-based capital and total risk-based capital calculations, percent of total risk-weighted assets of $550.6 million.

(2) As a Washington-chartered savings bank, the Bank is subject to the capital requirements of the FDIC and the Division. The FDIC requires state-chartered savings banks, including the Bank, to have a minimum leverage ratio of Tier 1 capital to total assets of at least 3%, provided, however, that all institutions, other than those (i) receiving the highest rating during the examination process and (ii) not anticipating any significant growth, are required to maintain a ratio of 1% to 2% above the stated minimum, with an absolute total capital to risk-weighted assets of at least 8%. Under the MOU, the Bank is required to maintain at least a 10.0% Tier 1 leverage capital ratio.

Events beyond the control of the Bank, such as a downturn in the economy in areas where the Bank has most of its loans, could adversely affect future earnings and, consequently, the ability of the Bank to meet its capital requirements under the MOU. See "Item 1A, Risk Factors – The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

New Proposed Capital Rules. On June 7, 2012, the Federal Reserve and FDIC approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The proposed rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to various documents released by the Basel Committee on Banking Supervision. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as "well capitalized": (i) a new common equity Tier 1 risk-based capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a total risk-based capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

The proposed rules set forth certain changes for the calculation of risk-weighted assets, which the Bank would be required to utilize beginning January 1, 2015. The proposed rule utilizes an increased number of credit risk and other exposure categories and risk weights, and also addresses: (i) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; and (iv) revised capital treatment for derivatives and repo-style transactions.

In particular, the proposed rules would expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures. Higher risk weights would apply to a variety of exposure categories. Specifics include, among others:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

- For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a "category 1" or "category 2" residential mortgage exposure (based on eight criteria that include, among others, the term, seniority of the lien, use of negative amortization, balloon payments and certain rate increases).

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

- Providing for a 100% risk weight for claims on securities firms.

- Eliminating the current 50% cap on the risk weight for OTC derivatives.

Federal Home Loan Bank System. The Bank is a member of the FHLB-Seattle, which is one of 12 regional FHLBs that administer the home financing credit function of savings institutions. Each FHLB serves as a reserve or central bank for its members within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System. It makes loans or advances to members in accordance with policies and procedures, established by the Board of Directors of the FHLB, which are subject to the oversight of the Federal Housing Finance Board. All advances from the FHLB are required to be fully secured by sufficient collateral as determined by the FHLB. In addition, all long-term advances are required to provide funds for residential home financing. See "Business – Deposit Activities and Other Sources of Funds – Borrowings."

As a member, the Bank is required to purchase and maintain stock in the FHLB-Seattle. At September 30, 2012, the Bank had $5.7 million in FHLB stock, which was in compliance with this requirement. The Bank did not receive any dividends from the FHLB-Seattle for the year ended September 30, 2012. Subsequent to December 31, 2008, the FHLB-Seattle announced that it was below its regulatory risk-based capital requirement and was precluded from paying dividends or repurchasing capital stock. In September 2012, the FHLB-Seattle announced that it had been reclassified as adequately capitalized by its regulator, the Federal Housing Finance Agency. The FHLB-Seattle also announced that it had been granted authority to repurchase up to $25 million of excess capital stock per quarter, provided they receive a non-objection from the Federal Housing Finance Agency. In September 2012, the FHLB-Seattle repurchased $50,000 of its stock, at par, from the Bank. The FHLB-Seattle is not anticipated to resume dividend payments until its financial results improve. The FHLB-Seattle has not indicated when dividend payments may resume.

The FHLBs continue to contribute to low- and moderately-priced housing programs through direct loans or interest subsidies on advances targeted for community investment and low- and moderate-income housing projects. These contributions have affected adversely the level of FHLB dividends paid and could continue to do so in the future. These contributions could also have an adverse effect on the value of FHLB stock in the future. A reduction in value of the Bank's FHLB stock may result in a decrease in net income and possibly capital.

Standards for Safety and Soundness. The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to: internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program also must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that the Bank fails to meet any standard prescribed by the guidelines, it may require the Bank to submit to the agency an acceptable plan to achieve compliance with the standard. FDIC regulations establish deadlines for the submission and review of such safety and soundness compliance plans. Management of the Bank is not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance.

Real Estate Lending Standards. FDIC regulations require the Bank to adopt and maintain written policies that establish appropriate limits and standards for real estate loans. These standards, which must be consistent with safe and sound banking practices, must establish loan portfolio diversification standards, prudent underwriting standards (including loan-to-value ratio limits) that are clear and measurable, loan administration procedures, and documentation, approval and reporting requirements. The Bank is obligated to monitor conditions in its real estate markets to ensure that its standards continue to be appropriate for current market conditions. The Bank's Board of Directors is required to review and approve the Bank's standards at least annually. The FDIC has published guidelines for compliance with these regulations, including supervisory limitations on loan-to-value ratios for different categories of real estate loans. Under the guidelines, the aggregate amount of all loans in excess of the supervisory loan-to-value ratios should not exceed 100% of total capital, and the total of all loans for commercial, agricultural, multifamily or other non-one- to four-family residential properties in excess of the supervisory loan-to-value ratio should not exceed 30% of total capital. Loans in excess of the supervisory loan-to-value ratio limitations must be identified in the Bank's records and reported at least quarterly to the Bank's Board of Directors. The Bank is in compliance with the record and reporting requirements. As of September 30, 2012, the Bank's aggregate loans in excess of the supervisory loan-to-value ratios were 26% of total capital and the Bank's loans on commercial, agricultural, multifamily or other non-one- to four-family residential properties in excess of the supervisory loan-to-value ratios were 21% of total capital.

Activities and Investments of Insured State-Chartered Financial Institutions. Federal law generally limits the activities and equity investments of FDIC-insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (i) acquiring or retaining a majority interest in a subsidiary, (ii) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank's total assets, (iii) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (iv) acquiring or retaining the voting shares of a depository institution owned by another FDIC-insured institution if certain requirements are met.

Washington State has enacted a law regarding financial institution parity. Primarily, the law affords Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

Environmental Issues Associated With Real Estate Lending. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), is a federal statute that generally imposes strict liability on all prior and present "owners and operators" of sites containing hazardous waste. However, Congress acted to protect secured creditors by providing that the term “owner and operator” excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this “secured creditor exemption” has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan.

To the extent that legal uncertainty exists in this area, all creditors, including the Bank, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System. The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal (NOW) accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to reserve requirements, as are any non-personal time deposits at a savings bank. As of September 30, 2012, the Bank’s deposit with the Federal Reserve and vault cash exceeded its Regulation D reserve requirements.

Affiliate Transactions. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates, including their bank holding companies. Transactions deemed to be a “covered transaction” under Section 23A of the Federal Reserve Act and between a subsidiary bank and its parent company or the nonbank subsidiaries of the bank holding company are limited to 10% of the bank subsidiary’s capital and surplus and, with respect to the parent company and all such nonbank subsidiaries, to an aggregate of 20% of the bank subsidiary’s capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

Community Reinvestment Act. Banks are also subject to the provisions of the Community Reinvestment Act of 1977 (“CRA”), which requires the appropriate federal bank regulatory agency to assess a bank’s performance under the CRA in meeting the credit needs of the community serviced by the bank, including low and moderate income neighborhoods. The regulatory agency’s assessment of the bank’s record is made available to the public. Further, a bank’s performance must be considered in connection with a bank’s application to, among other things, establish a new branch office that will accept deposits, relocate an existing office or merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. The Bank received a “satisfactory” rating during its most recent examination.

Dividends. Dividends from the Bank constitute the major source of funds available for dividends which may be paid to the Company shareholders. The amount of dividends payable by the Bank to the Company depends upon the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies. Under the Bank MOU that was in effect as of September 30, 2012, the Bank was not allowed to pay dividends to the Company without first obtaining prior regulatory approval. According to Washington law, the Bank may not declare or pay a cash dividend on its capital stock if it would cause its net worth to be reduced below (i) the amount required for liquidation accounts or (ii) the net worth requirements, if any, imposed by the Director of the Division. In addition, dividends on the Bank's capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of the Bank, without the approval of the Director of the Division.

The amount of dividends actually paid during any one period will be strongly affected by the Bank's management policy of maintaining a strong capital position. Federal law further provides that no insured depository institution may pay a cash dividend if it would cause the institution to be “undercapitalized,” as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe and unsound practice.

Other Consumer Protection Laws and Regulations. The Bank is subject to a broad array of federal and state consumer protection laws and regulations that govern almost every aspect of its business relationships with consumers. While the list set forth below is not exhaustive, these include the Truth-in-Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Right to Financial Privacy Act, the Home Ownership and Equity Protection Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Homeowners Protection Act, the Check Clearing for the 21st

Century Act, laws governing flood insurance, laws governing consumer protections in connection with the sale of insurance, federal and state laws prohibiting unfair and deceptive business practices, and various regulations that implement some or all of the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans, and providing other services. Failure to comply with these laws and regulations can subject the Bank to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

Regulation of the Company

General. The Company, as the sole shareholder of the Bank, is a bank holding company and is registered as such with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations promulgated thereunder. This regulation and oversight is generally intended to ensure that Timberland Bancorp, Inc. limits its activities to those allowed by law and that it operates in a safe and sound manner without endangering the financial health of the Bank.

As a bank holding company, the Company is required to file quarterly reports with the Federal Reserve and any additional information required by the Federal Reserve and will be subject to regular examinations by the Federal Reserve. The Federal Reserve also has extensive enforcement authority over bank holding companies, including the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices.

The Bank Holding Company Act. Under the BHCA, the Company is supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both.

Under the BHCA, the Federal Reserve may approve the ownership of shares by a bank holding company in any company the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. These activities generally include, among others, operating a savings institution, mortgage company, finance company, escrow company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

Acquisitions. The BHCA prohibits a bank holding company, with certain exceptions, from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. A bank holding company that meets certain supervisory and financial standards and elects to be designated as a financial holding company may also engage in certain securities, insurance and merchant banking activities and other activities determined to be financial in nature or incidental to financial activities.

Interstate Banking. The Federal Reserve may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than such holding company's home state, without regard to whether the transaction is prohibited by the laws of any state except with respect to the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the law of the host state. The Federal Reserve may not approve an application if the applicant controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

The federal banking agencies are authorized to approve interstate merger transactions without regard to whether such transaction is prohibited by the law of any state, unless the home state of one of the banks adopted a law prior to June 1, 1997 which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions will also be subject to the nationwide and statewide insured deposit concentration amounts described above.

Dividends. The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earning retention that is consistent with the company's capital needs, asset quality and overall financial condition, and that it is inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. Under the terms of the Company MOU, the Company may not accept dividends from the Bank without the prior consent of the FDIC and the Division. The Company’s ability to pay dividends with respect to common stock is subject to obtaining approval from the FRB. Under Washington corporate law, the Company generally may not pay dividends if after that payment it would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than its total liabilities.

Stock Repurchases. Bank holding companies, except for certain “well-capitalized” and highly rated bank holding companies, are required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of their consolidated net worth. The Federal Reserve may disapprove a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order, or any condition imposed by, or written agreement with, the Federal Reserve. Under the Company MOU, the Company may not purchase or redeem any of its stock without prior FRB approval.

Capital Requirements. The Federal Reserve has established capital adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Bank. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with $500 million or more in total consolidated assets.

The Company’s total risk based capital must equal 8% of risk-weighted assets and one half of the 8%, or 4%, must consist of Tier 1 (core) capital and its Tier 1 (core) capital must equal 4% of total assets. As of September 30, 2012, the Company’s total risk based capital was 16.8% of risk-weighted assets, its risk based capital of Tier 1 (core) capital was 15.5% of risk-weighted assets and its Tier 1 (core) capital was 11.7% of average assets.

Sarbanes-Oxley Act of 2002. As a public company, the Company is subject to the Sarbanes-Oxley Act of 2002, which implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from corporate wrongdoing. The Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002 in response to public concerns regarding corporate accountability in connection with several accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SEC and Sarbanes-Oxley-related regulations and policies include very specific additional disclosure requirements and new corporate governance rules. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

Taxation

Federal Taxation

General. The Company and the Bank report their operations on a fiscal year basis using the accrual method of accounting and are subject to federal income taxation in the same manner as other corporations. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company.

Corporate Alternative Minimum Tax. The Internal Revenue Code imposes a tax on alternative minimum taxable income ("AMTI") at a rate of 20%. In addition, only 90% of AMTI can be offset by net operating loss carryovers. AMTI is increased by an amount equal to 75% of the amount by which the Bank's adjusted current earnings exceeds its AMTI (determined without regard to this preference and prior to reduction for net operating losses).

Dividends-Received Deduction. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends-received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank owns more than 20% of the stock of a corporation distributing a dividend, then 80% of any dividends received may be deducted.

Audits. The Company is no longer subject to United States federal tax examination by tax authorities for years ended on or before September 30, 2008.

Washington Taxation. The Bank is subject to a business and occupation tax imposed under Washington law at the rate of 1.80% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties is exempt from such tax.

Competition

The Bank operates in an intensely competitive market for the attraction of deposits (generally its primary source of lendable funds) and in the origination of loans. Historically, its most direct competition for deposits has come from commercial banks, thrift institutions and credit unions in its primary market area. In times of high interest rates, the Bank experiences additional significant competition for investors' funds from short-term money market securities and other corporate and government securities. The Bank's competition for loans comes principally from mortgage bankers, commercial banks and other thrift institutions. Such competition for deposits and the origination of loans may limit the Bank's future growth and earnings prospects.

Subsidiary Activities

The Bank has one wholly-owned subsidiary, Timberland Service Corporation ("Timberland Service"), whose primary function is to act as the Bank's escrow department and offer non-deposit investment services.

Personnel

As of September 30, 2012, the Bank had 241 full-time employees and 18 part-time and on-call employees. The employees are not represented by a collective bargaining unit and the Bank believes its relationship with its employees is good.

Executive Officers of the Registrant

The following table sets forth certain information with respect to the executive officers of the Company and the Bank.

Executive Officers of the Company and Bank

Name	Age at September 30, 2012	Position Company	Position Bank
Michael R. Sand	58	President and Chief Executive Officer	President and Chief Executive Officer
Dean J. Brydon	45	Executive Vice President, Chief Financial Officer and Secretary	Executive Vice President, Chief Financial Officer and Secretary
Robert A. Drugge	61	Executive Vice President	Executive Vice President of Lending
Jonathan A. Fischer	38	Senior Vice President and Chief Operating Officer	Senior Vice President and Chief Operating Officer
Edward C. Foster	55	Senior Vice President and Chief Credit Administrator	Senior Vice President and Chief Credit Administrator
Marci A. Basich	43	Senior Vice President and Treasurer	Senior Vice President and Treasurer
Kathie M. Bailey	60	Senior Vice President	Senior Vice President and Chief Operations Officer

Biographical Information.

Michael R. Sand has been affiliated with the Bank since 1977 and has served as President of the Bank and the Company since January 23, 2003. On September 30, 2003, he was appointed as Chief Executive Officer of the Bank and Company. Prior to appointment as President and Chief Executive Officer, Mr. Sand had served as Executive Vice President and Secretary of the Bank since 1993 and as Executive Vice President and Secretary of the Company since its formation in 1997.

Dean J. Brydon has been affiliated with the Bank since 1994 and has served as the Chief Financial Officer of the Company and the Bank since January 2000 and Secretary of the Company and Bank since January 2004. Mr. Brydon is a Certified Public Accountant.

Robert A. Drugge has been affiliated with the Bank since April 2006 and has served as Executive Vice President of Lending since September 2006. Prior to joining Timberland, Mr. Drugge was employed at Bank of America as a senior officer and most recently served as Senior Vice President and Commercial Banking Manager. Mr. Drugge began his banking career at Seafirst in 1974, which was acquired by Bank America Corp. and became known as Bank of America.

Jonathan A. Fischer has been affiliated with the Bank since October 1997 and has served as Chief Operating Officer since August 23, 2012. Prior to that, Mr. Fischer served as the Chief Risk Officer since October 2010. Mr.

Fischer also served as the Compliance Officer, Community Reinvestment Act Officer, and Privacy Officer since January 2000.

Edward C. Foster has been affiliated with the Bank, and has served as Chief Credit Administrator since February 2012. Prior to joining the Bank, Mr. Foster was employed by the FDIC, where he served as a Loan Review Specialist from January 2011 to February 2012. Mr. Foster owned a Credit Administration Consulting Business from February 2010 to January 2011. Prior to that, Mr. Foster served as the Chief Credit Officer for Carson River Community Bank from April 2008 through February 2010. Before joining Carson River Community Bank, Mr. Foster served as a Senior Regional Credit Officer for Omni National Bank from September 2006 through March 2008.

Marci A. Basich has been affiliated with the Bank since 1999 and has served as Treasurer of the Company and the Bank since January 2002. Ms. Basich is a Certified Public Accountant.

Kathie M. Bailey has been affiliated with the Bank since 1984 and has served as Senior Vice President and Chief Operations Officer since 2003.

Item 1A. Risk Factors

We assume and manage a certain degree of risk in order to conduct our business strategy. In addition to the risk factors described below, other risks and uncertainties not specifically mentioned, or that are currently known to, or deemed to be immaterial by management, also may materially and adversely affect our financial position, results of operations and/or cash flows. Before making an investment decision, you should carefully consider the risks described below together with all of the other information included in this Form 10-K. If any of the circumstances described in the following risk factors actually occur to a significant degree, the value of our common stock could decline, and you could lose all or part of your investment.

The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions.

In December 2009, the FDIC and the Division determined that the Bank required additional supervisory attention and on December 29, 2009 entered into the Bank MOU. Under the terms of the Bank MOU, the Bank, without the prior written approval, or nonobjection, of the FDIC and/or the DFI, was not allowed to:

- appoint any new director or senior executive officer or change the responsibilities of any current senior executive officers;
- pay cash dividends to its holding company, Timberland Bancorp, Inc.; or
- engage in any transactions that would materially change the balance sheet composition including growth in total assets of five percent or more or significant changes in funding sources, such as by increasing brokered deposits.

Other material provisions of the Bank MOU required the Bank to:

- maintain Tier 1 Capital of not less than 10.0% of the Bank’s adjusted total assets pursuant to Part 325 of the FDIC Rules and Regulations, and maintain capital ratios above “well capitalized” thresholds as defined under Section 325.103 of the FDIC Rules and Regulations;
- maintain a fully funded allowance for loan and lease losses, the adequacy of which shall be deemed to be satisfactory to the FDIC and the DFI;
- formulate and implement a written profit plan acceptable to the FDIC and the DFI;
- eliminate from its books all assets classified “Loss” that have not been previously collected or charged-off;
- reduce the dollar volume by 50% of the assets classified “Substandard” and “Doubtful” at April 30, 2009;
- develop a written plan for reducing the aggregate amount of its acquisition, development and construction loans; and
- revise, adopt and fully implement a written liquidity and funds management policy.

On December 12, 2012, the FDIC and the Division notified the Bank that the Bank MOU had been rescinded.

In addition on February 1, 2010, the FRB determined that the Company required additional supervisory attention and entered into the Company MOU. Under the terms of the Company MOU, the Company, without prior written approval, or non-objection, of the FRB, may not:

- appoint any new director or senior executive officer or change the responsibilities of any current senior executive officers;
- receive dividends or any other form of payment or distribution representing a reduction in capital from the Bank;
- declare or pay any dividends, or make any other capital distributions;
- incur, renew, increase, or guarantee any debt;
- issue any trust preferred securities; or
- purchase or redeem any of its stock.

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The Company MOU will remain in effect until stayed, modified, terminated or suspended by the FRB. If the Company is found not in compliance with the MOU, it could be subject to various remedies, including among others, the power to enjoin "unsafe or unsound" practices, to require affirmative action to correct any conditions resulting from any violation or practice, to direct an increase in capital, to restrict growth, to remove officers and/or directors, and to assess civil monetary penalties. Management of the Company and the Bank have been taking action and implementing programs to comply with the requirements of the Company MOU. Compliance will be determined by the FRB. The FRB may determine in its sole discretion that the issues raised by the Company MOU have not been addressed satisfactorily, or that any current or past actions, violations or deficiencies could be the subject of further regulatory enforcement actions. Such enforcement actions could involve penalties or further limitations on the Company's business and negatively affect its ability to implement its business plan, pay dividends on its common stock or the value of its common stock, as well as its financial condition and result of operations.

The current weak economic conditions in the market areas we serve may continue to adversely impact our earnings and could increase the credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the state of Washington. A continuing decline in the economies of our local market areas of Grays Harbor, Pierce, Thurston, King, Kitsap and Lewis counties in which we operate, and which we consider to be our primary market areas, could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, Washington has experienced substantial home price declines and increased foreclosures and has experienced above average unemployment rates.

Continued weakness or a further deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- loan delinquencies, problem assets and foreclosures may increase;
- demand for our products and services may decline possibly resulting in a decrease in our total loans or assets;
- collateral for loans made may decline further in value, exposing us to increased risk loans, reducing customers' borrowing power, and reducing the value of assets and collateral associated with existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our low-cost or non-interest bearing deposits may decrease and the composition of our deposits may be adversely affected.

Our real estate construction and land development loans expose us to significant risks.

We make real estate construction loans to individuals and builders, primarily for the construction of residential properties. We originate these loans whether or not the collateral property underlying the loan is under contract for sale. At September 30, 2012, construction and land development loans totaled $56.4 million, or 9.9% of our total loan portfolio, of which $35.6 million were for residential real estate projects. Approximately $33.3 million of our residential construction loans were made to finance the construction of owner-occupied homes and are structured to be converted to permanent loans at the end of the construction phase. Land development loans, which are loans made with land as security, totaled $589,000, or 0.1% of our total loan portfolio at September 30, 2012. In general, construction and land development lending involves additional risks because of the inherent difficulty in estimating a property's value both before and at completion of the project as well as the estimated cost of the project. Construction costs may exceed original estimates as a result of increased materials, labor or other costs. In addition, because of current uncertainties in the residential real estate market, property values have become more difficult to determine. Construction loans and land development loans often involve the disbursement of funds with repayment dependent, in part, on the success of the project and the ability of the borrower to sell or lease the property or refinance the indebtedness, rather than the ability of the borrower or guarantor to repay principal and interest. These loans are also generally more difficult to monitor. In addition, speculative construction loans to builders are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences. At September 30, 2012, $1.9 million of our construction portfolio was comprised of speculative one- to four-family construction loans.

Approximately $2.3 million, or 4.0%, of our total real estate construction and land development loans were non-performing at September 30, 2012. A material increase in our non-performing construction and loan development loans could have a material adverse effect on our financial condition and results of operation.

Our emphasis on commercial real estate lending may expose us to increased lending risks.

Our current business strategy includes the expansion of commercial real estate lending. This type of lending activity, while potentially more profitable than single-family residential lending, is generally more sensitive to regional and local economic conditions, making loss levels more difficult to predict. Collateral evaluation and financial statement analysis in these types of loans requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. In our primary market of southwest Washington, a further downturn in the real estate market, could increase loan delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. Many of our commercial borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss.

At September 30, 2012, we had $256.3 million of commercial real estate mortgage loans, representing 45.1% of our total loan portfolio. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower's project is reduced as a result of leases not being obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial real estate loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment.

A secondary market for most types of commercial real estate loans is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these loans. As a result of these characteristics, if we foreclose on a commercial real estate loan, our holding period for the collateral typically is longer than for one- to four-family residential mortgage loans because there are fewer potential purchasers of the collateral. Accordingly, charge-offs on commercial real estate loans may be larger as a percentage of the total principal outstanding than those incurred with our residential or consumer loan portfolios.

The level of our commercial real estate loan portfolio may subject us to additional regulatory scrutiny.

The FDIC, the Federal Reserve and the Office of the Comptroller of the Currency have promulgated joint guidance on sound risk management practices for financial institutions with concentrations in commercial real estate lending. Under this guidance, a financial institution that, like us, is actively involved in commercial real estate lending should perform a risk assessment to identify concentrations. A financial institution may have a concentration in commercial real estate lending if, among other factors (i) total reported loans for construction, land development, and other land represent 100% or more of total capital, or (ii) total reported loans secured by multifamily and non-farm residential properties, loans for construction, land development and other land, and loans otherwise sensitive to the general commercial real estate market, including loans to commercial real estate related entities, represent 300% or more of total capital. The particular focus of the guidance is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be at greater risk to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance states that management should employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing. We have concluded that we have a concentration in commercial real estate lending under the foregoing standards because our balance in commercial real estate loans at September 30, 2012 represents more than 300% of total capital. While we believe we have implemented policies and procedures with respect to our commercial real estate loan portfolio consistent with this guidance, bank regulators could require us to implement additional policies and procedures consistent with their interpretation of the guidance that may result in additional costs to us.

Repayment of our commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.

At September 30, 2012, we had $22.6 million or 4.0% of total loans in commercial business loans. Commercial business lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and credit worthiness of the borrower and secondarily on the underlying collateral provided by the borrower.

Our business may be adversely affected by credit risk associated with residential property.

At September 30, 2012, $139.8 million, or 24.6% of our total loan portfolio, was secured by one- to four-family mortgage loans and home equity loans. This type of lending is generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. The decline in residential real estate values as a result of the downturn in the Washington housing market has reduced the value of the real estate collateral securing these types of loans and increased the risk that we would incur losses if borrowers default on their loans.

Many of our residential mortgage loans are secured by liens on mortgage properties in which the borrowers have little or no equity because either we originated the loan with a relatively high combined loan-to-value ratio or because of the decline in home values in our market areas. Residential loans with combined higher loan-to-value ratios will be more sensitive to declining property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. In addition, if the borrowers sell their homes, such borrowers may be unable to repay their loans in full from the sale proceeds. Further, a significant amount of our home equity lines of credit consist of second mortgage loans. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. For these reasons, we may experience higher rates of delinquencies, default and losses on our residential loans.

Our provision for loan losses and net charge-offs have increased during recent years compared to historical averages and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could adversely affect our results of operations.

For the fiscal years ended September 30, 2012, 2011 and 2010 we recorded a provision for loan losses of $3.5 million, $6.8 million and $10.6 million, respectively. We also recorded net loan charge-offs of $3.6 million, $6.1 million and $13.5 million for the fiscal years ended September 30, 2012, 2011 and 2010, respectively. During these last three fiscal years, we experienced higher loan delinquencies and credit losses than our historical averages. Our non-performing loans and assets have historically reflected unique operating difficulties for individual borrowers rather than weakness in the overall economy of the Pacific Northwest; however, more recently the deterioration in the general economy has become a significant contributing factor to the increased levels of delinquencies and non-performing loans. Slower sales and excess inventory in the housing market have been the primary causes of the increase in delinquencies and foreclosures for construction and land development loans and land loans, which represent 48.3% of our non-performing loans at September 30, 2012. Further, our portfolio is concentrated in construction and land development loans, land loans and commercial and commercial real estate loans, all of which have a higher risk of loss than residential mortgage loans.

If current weak conditions in the housing and real estate markets continue, we expect that we will continue to experience further delinquencies and credit losses. As a result, we could be required to make further increases in our provision for loan losses to increase our allowance for loan losses. Our allowance for loan losses was 2.15% of total loans held for investment and 52.48% of non-performing loans at September 30, 2012. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and our capital.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business and each loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- the cash flow of the borrower and/or the project being financed;
- the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- the duration of the loan;
- the credit history of a particular borrower; and
- changes in economic and industry conditions.

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through periodic comprehensive reviews and consideration of several factors, including, but not limited to:

- an ongoing review of the quality, size and diversity of the loan portfolio;
- evaluation of non-performing loans;
- historical default and loss experience;
- existing economic conditions;
- risk characteristics of the various classifications of loans; and
- the amount and quality of collateral, including guarantees; securing the loans.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses we will need additional provisions to replenish the allowance for loan losses. Any additional provisions will result in a decrease in net income and possibly capital, and may have a material adverse effect on our financial condition and results of operations.

If our non-performing assets increase, our earnings will be adversely affected.

At September 30, 2012 our non-performing assets (which consist of non-accruing loans, accruing loans 90 days or more past due, non-accrual investment securities, and other real estate owned and other repossessed assets) were $38.3 million, or 5.19% of total assets. Our non-performing assets adversely affect our net income in various ways:

- We do not record interest income on non-accrual loans or non-performing investment securities, except on a cash basis when the collectibility of the principal is not in doubt.
- We must provide for probable loan losses through a current period charge to the provision for loan losses.
- Non-interest expense increases when we must write down the value of properties in our other real estate owned portfolio to reflect changing market values.
- Non-interest income decreases when we must recognize other-than-temporary impairment on non-performing investment securities.
- There are legal fees associated with the resolution of problem assets, as well as carrying costs, such as taxes, insurance, and maintenance costs related to our OREO.
- The resolution of non-performing assets requires the active involvement of management, which can distract them from more profitable activity.

If additional borrowers become delinquent and do not pay their loans and we are unable to successfully manage our non-performing assets, our losses and troubled assets could increase significantly, which could have a material adverse effect on our financial condition and results of operations.

We have classified an additional $13.4 million in loans as performing troubled debt restructurings at September 30, 2012.

If our investments in real estate are not properly valued or sufficiently reserved to cover actual losses, or if we are required to increase our valuation allowances, our earnings could be reduced.

We obtain updated valuations in the form of appraisals and broker price opinions when a loan has been foreclosed and the property is taken in as OREO, and at certain other times during the assets holding period. Our net book value ("NBV") in the loan at the time of foreclosure and thereafter is compared to the updated estimated market value of the foreclosed property less estimated selling costs (fair value). A charge-off is recorded for any excess in the asset's NBV over its fair value. If our valuation process is incorrect or if the property declines in value after foreclosure, the fair value of our OREO may not be sufficient to recover our NBV in such assets, resulting in the need for a valuation allowance.

In addition, bank regulators periodically review our OREO and may require us to recognize further valuation allowances. Significant charge-offs to our OREO, may have a material adverse effect on our financial condition and results of operations.

Other-than-temporary impairment charges in our investment securities portfolio could result in additional losses.

During the year ended September 30, 2012, we recognized a $214,000 other than temporary impairment ("OTTI") charge on private label mortgage backed securities we hold for investment. Management concluded that the decline of the estimated fair value below the cost of these securities was other than temporary and recorded a credit loss through non-interest income. At September 30, 2012 our remaining private label mortgage backed securities portfolio totaled $2.8 million.

We closely monitor our investment securities for changes in credit risk. The valuation of our investment securities also is influenced by external market and other factors, including implementation of Securities and Exchange Commission and Financial Accounting Standards Board guidance on fair value accounting, default rates on residential mortgage securities, rating agency actions, and the prices at which observable market transactions occur. The current market environment significantly limits our ability to mitigate our exposure to valuation changes in our investment securities by selling them. Accordingly, if market conditions deteriorate further and we determine our holdings of private label mortgage backed securities or other investment securities are other than temporarily impaired, our results of operations could be adversely affected.

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An increase in interest rates, change in the programs offered by Freddie Mac or our ability to qualify for their programs may reduce our mortgage revenues, which would negatively impact our non-interest income.

The sale of residential mortgage loans to Freddie Mac provides a significant portion of our non-interest income. Any future changes in their program, our eligibility to participate in such program, the criteria for loans to be accepted or laws that significantly affect the activity of Freddie Mac could, in turn, materially adversely affect our results of operations if we could not find other purchasers. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold. This would result in a decrease in mortgage revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with our loan sale activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

Our real estate lending also exposes us to the risk of environmental liabilities.

In the course of our business, we may foreclose and take title to real estate, and we could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation, and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition and results of operations could be materially and adversely affected.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference, or spread, between the interest earned on loans, securities and other interest-earning assets and the interest paid on deposits, borrowings, and other interest-bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. In a changing interest rate environment, we may not be able to manage this risk effectively. Changes in interest rates also can affect: (1) our ability to originate and/or sell loans; (2) the value of our interest-earning assets, which would negatively impact shareholders' equity, and our ability to realize gains from the sale of such assets; (3) our ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of our borrowers to repay adjustable or variable rate loans. Interest rates are highly sensitive to many factors, including government monetary policies, domestic and international economic and political conditions and other factors beyond our control. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially affected.

In addition, a substantial majority of our real estate secured loans held are adjustable-rate loans. Any rise in prevailing market interest rates may result in increased payments for borrowers who have adjustable rate mortgage loans, increasing the possibility of defaults that may adversely affect our profitability.

Increases in deposit insurance premiums and special FDIC assessments can adversely affect our earnings.

The Dodd-Frank Act established 1.35% as the minimum reserve ratio. The FDIC has adopted a plan under which it will meet this ratio by the statutory deadline of September 30, 2020. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $10 billion of the increase in the minimum reserve ratio to 1.35% from the former minimum of 1.15%. The FDIC has not announced how it will implement this offset. In addition to the statutory minimum ratio, the FDIC must set a designated reserve ratio, or DRR, which may exceed the statutory minimum. The FDIC has set 2.0% as the DRR.

As required by the Dodd-Frank Act, the FDIC has adopted final regulations under which insurance premiums are based on an institution's average consolidated total assets less average tangible equity capital instead of its deposits. While our FDIC insurance premiums initially will be reduced by these regulations, it is possible that our future insurance premiums will increase under the final regulations.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition, growth and prospects.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. We rely on customer deposits and advances from the FHLB of Seattle, borrowings from the Federal Reserve Bank of San Francisco and other borrowings to fund our operations. At September 30, 2012, we had $45.0 million of FHLB advances outstanding with an additional $214.8 million of available borrowing capacity through the FHLB and the FRB. Although we have historically been able to replace maturing deposits and advances if desired, we may not be able to replace such funds in the future if, among other things, our financial condition, the financial condition of the FHLB or FRB, or market conditions change. Our access to funding sources in amounts adequate to finance our activities or on terms which are acceptable could be impaired by factors that affect us specifically or the financial services industry or economy in general such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the Washington markets where our deposits are concentrated or adverse regulatory action against us.

Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. Although we consider our sources of funds adequate for our liquidity needs, we may seek additional debt in the future to achieve our long-term business objectives. Additional borrowings, if sought, may not be available to us or, if available, may not be available on reasonable terms. If additional financing sources are unavailable, or are not available on reasonable terms, our financial condition, results of operations, growth and future prospects could be materially adversely affected. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our income may not increase proportionately to cover our costs.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, that are expected to increase our costs of operations.

The Bank is subject to extensive examination, supervision and comprehensive regulation by the FDIC and the DFI, and the Company is subject to examination and supervision by the Federal Reserve. The FDIC, DFI and the Federal Reserve govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution's operations, reclassify assets, determine the adequacy of an institution's allowance for loan losses and determine the level of deposit insurance premiums assessed.

Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has significantly changed the bank regulatory structure and will affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on the Bank. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less average tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor.

The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments and authorizes the SEC to promulgate rules that would allow stockholders to nominate their own candidate using a company's proxy materials. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.

The Dodd-Frank Act creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Financial institutions such as the Bank with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

On June 7, 2012, the Federal Reserve, FDIC and OCC approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The proposed rules implement the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Various provisions of the Dodd-Frank Act increase the capital requirements of bank holding companies, such as the Company. The leverage and risk-based capital ratios of these entities may not be lower than the leverage and risk-based capital ratios for insured depository institutions. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes “capital” for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios, and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to the Company and the Bank.

In addition, in the current economic and regulatory environment, regulators of banks and bank holding companies have become more likely to impose capital requirements on bank holding companies and banks that are more stringent than those required by applicable existing regulations.

The application of more stringent capital requirements for the Company and the Bank could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying dividends or buying back shares.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. At some point, we may need to raise additional capital to support continued growth. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. Accordingly, we cannot make assurances that we will be able to raise additional capital. If we cannot raise additional capital when needed, our operations could be materially impaired and our financial condition and liquidity could be materially and adversely affected. As a result, we may have to raise additional capital on terms that may be dilutive to our shareholders. In addition, if we are unable to raise additional capital when required by the FDIC, we may be subject to adverse regulatory action. See "– The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

We may experience future goodwill impairment, which could reduce our earnings.

We performed our test for goodwill impairment for fiscal year 2012, but no impairment was identified. Our assessment of the fair value of goodwill is based on an evaluation of market capitalizations for similar financial institutions, discounted cash flows from forecasted earnings, our current market capitalization, and a valuation of our assets and liabilities. Our evaluation of the fair value of goodwill involves a substantial amount of judgment. If our judgment was incorrect, or if events or circumstances change, and an impairment of goodwill was deemed to exist, we would be required to write down our goodwill resulting in a charge to earnings, which would adversely affect our results of operations, perhaps materially; however, it would have no impact on our liquidity, operations or regulatory capital.

Our investment in Federal Home Loan Bank of Seattle stock may become impaired.

At September 30, 2012, we owned $5.7 million in FHLB stock. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. Our FHLB stock has a par value of $100, is carried at cost, and it is subject to recoverability testing per accounting guidance for the impairment of long lived assets. The FHLB has announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the "FHFA"), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. As a result, the FHLB has not paid a dividend since the fourth quarter of 2008. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in its balance sheet. As a result, we have not recorded an other-than-temporary impairment on our investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. In addition, on October 25, 2010, the

FHLB of Seattle received a Consent Order from the FHFA. The FHLB of Seattle reported, in its Form 10-Q for the quarter ended September 30, 2012, that it continues to address the requirements of the Consent Agreement and that, as of September 30, 2012, it met all minimum financial metrics required under the Consent Agreement. Further, the FHLB of Seattle reported that in September, 2012 that the FHFA reclassified the FHLB of Seattle to be adequately capitalized. Any dividends on, or repurchases of, the FHLB of Seattle stock continue to require consent of the FHFA. The FHFA recently approved the FHLB of Seattle to repurchase a portion of its stock and $50,000 of FHLB of Seattle stock was purchased from the Bank in September, 2012. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

We may experience further decreases in the fair value of our mortgage servicing rights, which could reduce our earnings.

Mortgage servicing rights ("MSRs") are capitalized at estimated fair value when acquired through the origination of loans that are subsequently sold with servicing rights retained. At September 30, 2012 our MSRs totaled $2.0 million. MSRs are amortized to servicing income on loans sold over the period of estimated net servicing income. The estimated fair value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. On a quarterly basis we evaluate the fair value of MSRs for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. Our methodology for estimated the fair value of MSRs is highly sensitive to changes in assumptions, such as prepayment speeds. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs portfolio. For example, a decrease in mortgage interest rates typically increases the prepayment speeds of MSRs and therefore decreases the fair value of the MSRs. We recorded a $10,000 valuation recovery to our MSRs during the year ended September 30, 2012, which increased our earnings. Future decreases in mortgage interest rates could decrease the fair value of our MSRs, which would decrease our earnings.

Our assets as of September 30, 2012 include a deferred tax asset and we may not be able to realize the full amount of such asset.

We recognize deferred tax assets and liabilities based on differences between the financial statement recorded amounts and the tax bases of assets and liabilities. At September 30, 2012, the net deferred tax asset was approximately $3.6 million. The net deferred tax asset results primarily from our provision for loan losses recorded for financial reporting purposes, which has been larger than net loan charge-offs deducted for tax reporting purposes.

We regularly review our net deferred tax assets for recoverability based on our expectations of future earnings and expected timing of reversals of temporary differences and record a valuation allowance if deemed necessary. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. We believe the recorded net deferred tax asset at September 30, 2012 is fully realizable; however, if we determine that we will be unable to realize all or part of the net deferred tax asset, we would adjust the net deferred tax asset, which could negatively impact our financial condition and results of operations.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company's stockholders. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. Additionally, actions by regulatory agencies or significant litigation against us could require us to devote significant time and resources to defending our business and may lead to penalties that materially affect us. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

The Series A Preferred Stock impacts net income (loss) to our common shareholders and net income (loss) per common share and the warrant we issued to Treasury may be dilutive to holders of our common stock.

On November 13, 2012, our outstanding 16,641 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, ("Series A Preferred Stock") with a redemption value of $1,000 per share, originally issued to the U.S. Treasury Department ("Treasury") on December 23, 2008 as part of the CPP, was sold by the Treasury as part of its efforts to manage and recover its investments under the TARP. While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrant to purchase up to 370,899 shares of our common stock at a price of $6.73 per share at any time through December 23, 2018. The dividends declared or accrued on the Series A Preferred Stock reduce the net income (increase the net loss) to common shareholders and our net income (loss) per common share. The Series A Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of the Company. Additionally, the ownership interest of the existing holders of our common stock will be diluted to the extent the warrant we issued to Treasury in conjunction with the sale of the Series A Preferred Stock is exercised. The shares of common stock underlying the warrant represent approximately 5.0% of the shares of our common stock outstanding as of September 30, 2012 (including the shares issuable upon exercise of the warrant in total shares outstanding). Although Treasury has agreed not to vote any of the shares of common stock it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any shares of common stock acquired upon exercise of the warrant is not bound by this restriction.

If we are unable to redeem our Series A Preferred Stock by December 2013, the cost of this capital to us will increase substantially.

The Company MOU prohibits us from redeeming our outstanding capital stock without the prior written approval of the Federal Reserve Bank of San Francisco. If we are unable to redeem our Series A Preferred Stock prior to December 23, 2013, the cost of this capital to us will increase substantially on that date, from 5.0% per annum (approximately $830,000 annually) to 9.0% per annum (approximately $1.5 million annually). Depending on our financial condition at the time, this increase in the annual dividend rate on the Series A Preferred Stock could have a material negative effect on our liquidity and ability to pay dividends to common shareholders.

Regulatory and contractual restrictions may limit or prevent us from paying dividends on our common stock.

Holders of our common stock are only entitled to receive such dividends as our Board may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so. We suspended our cash dividend during the quarter ended June 30, 2010 and we do not know if we will resume the payment of dividends in the future. Further, we are unable to pay any dividends on our common stock unless we are current on our payments to dividend holders of our preferred stock, including the Series A preferred stock, at any time outstanding or depositary shares representing such preferred stock then outstanding. In this regard, the FRB previously denied the Company’s requests to pay eight dividend payments on its Series A Preferred Stock from the May 15, 2010 payment through the August 15, 2012 payment. The FRB recently approved the Company's requests to pay prior unpaid dividends on the Series A Preferred Stock. As of September 30, 2012, the Company has made all dividend payments on its Series A Preferred Stock. No assurance can be given, however, that the FRB will continue to permit the Company to pay dividends on the Series A Preferred Stock. In addition, under the terms of the Company MOU the payment of dividends by the Company to its shareholders is subject to the prior written non-objection of the FRB. As an entity separate and distinct from the Bank, the Company derives substantially all of its revenue in the form of dividends from the Bank. Accordingly, the Company is and will be dependent upon dividends from the Bank to satisfy its cash needs and to pay dividends on its common stock. The inability to receive dividends from the Bank could have a material adverse effect on the Company's business, financial condition and results of operations. The Bank's ability to pay dividends is subject to its ability to earn net income and, to meet certain regulatory requirements. As discussed above, under the Bank MOU, which was in effect as of September 30, 2012, the Bank could not pay dividends to the Company without prior approval from the FDIC and DFI, which also limits the Company's ability to pay dividends on its common stock. On December 12, 2012, the FDIC and the Division notified the Bank that the Bank MOU had been rescinded. The lack of a cash dividend could adversely affect the market price of our common stock.

Changes in accounting standards may affect our performance.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time there are changes in the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a retrospective adjustment to prior financial statements.

We are subject to a variety of operational risks, including legal and compliance risk, fraud and theft risk and the risk of operational errors, which may adversely affect our business, results of operations and reputation.

We are from time to time subject to claims and proceedings related to our operations. These claims and legal actions, which could include supervisory or enforcement actions by our regulators, or criminal proceedings, could involve large monetary claims, including civil money penalties or fines imposed by government authorities, and significant defense costs. To mitigate the cost of some of these claims, we maintain insurance coverage in amounts and with deductibles that we believe are appropriate for our operations.

Both internal and external fraud and theft are risks. If personal, non-public, confidential or proprietary information of customers in possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include, for example, if such information were erroneously provided to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or if such information were to be intercepted or otherwise inappropriately taken by third parties.

Operational errors include clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Because of our large transaction volume and our necessary dependence upon automated systems to record and process these transactions there is a risk that technical flaws or tampering or manipulation of those automated systems arising from events wholly or partially beyond our control may give rise to a disruption of service to customers and to financial loss or liability. We are exposed to the risk that our business continuity and data security systems may prove to be inadequate.

The occurrence of any of these risks could result in a diminished ability to operate our business, additional costs to correct defects, potentially liability to clients, reputational damage and regulatory intervention, any of which could adversely affect our business, financial condition and results of operations.

We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where the Bank conducts its business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President, and certain other employees. In addition, our success has been and continues to be highly dependent upon the services of our directors, and we may not be able to identify and attract suitable candidates to replace such directors.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

At September 30, 2012 the Bank operated 22 full service facilities. The following table sets forth certain information regarding the Bank's offices, all of which are owned, except for the Tacoma office, the Gig Harbor office and the Lacey office at 1751 Circle Lane SE, which are leased.

Location	Location	Approximate Square Footage	Deposits at September 30, 2012 (In thousands)
Main Office:			
624 Simpson Avenue Hoquiam, Washington 98550	1966	7,700	$ 67,019
Branch Offices:			
300 N. Boone Street Aberdeen, Washington 98520	1974	3,400	32,369
201Main Street South Montesano, Washington 98563	2004	3,200	29,903
361 Damon Road Ocean Shores, Washington 98569	1977	2,100	23,355
2418 Meridian Avenue East Edgewood, Washington 98371	1980	2,400	38,490
202 Auburn Way South Auburn, Washington 98002	1994	4,200	25,918
12814 Meridian Avenue East (South Hill) Puyallup, Washington 98373	1996	4,200	33,467
1201 Marvin Road, N.E. Lacey, Washington 98516	1997	4,400	20,952
101 Yelm Avenue W. Yelm, Washington 98597	1999	3,400	16,950
20464 Viking Way NW Poulsbo, Washington 98370	1999	1,800	13,706
2419 224th Street E. Spanaway, Washington 98387	1999	3,900	30,429
801 Trosper Road SW Tumwater, Washington 98512	2001	3,300	29,193

7805 South Hosmer Street Tacoma, Washington 98408	2001	5,000	31,441
2401 Bucklin Hill Road Silverdale, Washington 98383	2003	4,000	41,498

(Table continues on following page)

Location	Year Opened	Approximate Square Footage	Deposits at September 30, 2012
423 Washington Street SE Olympia, Washington 98501	2003	3,000	$ 20,559
3105 Judson Street Gig Harbor, Washington 98335	2004	2,700	28,168
117 N. Broadway Aberdeen, Washington 98520	2004	3,700	24,054
313 West Waldrip Street Elma, Washington 98541	2004	5,900	21,357
1751 Circle Lane SE Lacey, Washington 98503	2004	900	15,152
101 2nd Street Toledo, Washington 98591	2004	1,800	22,513
209 NE 1st Street Winlock, Washington 98586	2004	3,400	15,337
714 W. Main Street Chehalis, Washington 98532	2009	4,600	16,096
Loan Center/Data Center:			
120 Lincoln Street Hoquiam, Washington 98550	2003	6,000	N/A
Administrative Offices:			
305 8th Street Hoquiam, Washington 98550	2004	4,100	N/A

Management believes that all facilities are appropriately insured and are adequately equipped for carrying on the business of the Bank.

At September 30, 2012 the Bank operated 23 proprietary ATMs that are part of a nationwide cash exchange network.

Item 3. Legal Proceedings

Periodically, there have been various claims and lawsuits involving the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. The Bank is not a party to any pending legal proceedings that it believes would have a material adverse effect on the financial condition or operations of the Bank.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock is traded on the Nasdaq Global Market under the symbol “TSBK.” As of November 30, 2012, there were 7,045,036 shares of common stock issued and approximately 560 shareholders of record. The following table sets forth the high and low sales prices of, and dividends paid on, the Company's common stock for each quarter during the years ended September 30, 2012 and 2011. The high and low price information was provided by the Nasdaq Stock Market.

Fiscal 2012	High	Low	Dividends per Common Share
First Quarter	$ 4.60	$ 3.25	$ --
Second Quarter	4.79	3.86	--
Third Quarter	5.31	4.55	--
Fourth Quarter	6.11	4.75	--

Fiscal 2011	High	Low	Dividends per Common Share
First Quarter	$ 4.30	$ 3.28	$ --
Second Quarter	5.95	3.62	--
Third Quarter	6.38	4.75	--
Fourth Quarter	6.25	3.90	--

Dividends

Dividend payments by the Company are dependent primarily on dividends received by the Company from the Bank. Under federal regulations, the dollar amount of dividends the Bank may pay is dependent upon its capital position and recent net income. Generally, if the Bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed in the FDIC regulations. However, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual to stock conversion. In addition, for the year ended September 30, 2012, the Bank was subject to restrictions on its ability to pay dividends to the Company under the terms of the Bank MOU. This restriction has been lifted effective with the termination of the Bank MOU by the FDIC and the Division on December 12, 2012. The Company is also subject to restrictions on its ability to pay dividends to stockholders under the terms of the Company MOU. Further, the Company also is subject to restrictions on its ability to pay dividends pursuant to the terms of the Series A Preferred Stock in the event all Series A Preferred Stock dividends are not paid. For additional information regarding the Company’s and the Bank’s restrictions on the payment of dividends during the year ended September 30, 2012, see “Item 1A, Risk Factors – The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions,” and “– Regulatory and contractual restrictions may limit or prevent us from paying dividends on our common stock.”

Equity Compensation Plan Information

The equity compensation plan information presented under subparagraph (d) in Part III, Item 12. of this Form 10-K is incorporated herein by reference.

Stock Repurchases

The Company is subject to restrictions on its ability to repurchase its common stock pursuant to the terms of the Company MOU. In addition, pursuant to the terms of the Series A Preferred Stock, the Company generally may not repurchase its common stock unless it is current on dividend payments on the Series A Preferred Stock. For additional information, see Item 1A, "Risk Factors – The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

The following graph compares the cumulative total shareholder return on our common stock with the cumulative total return on the Nasdaq U.S. Companies Index and with the SNL $250 to $500 Million Asset Thrift Index and the SNL $500 million to $1 Billion Asset Thrift Index, peer group indices. Total return assumes the reinvestment of all dividends and that the value of the Company's Common Stock and each index was $100 on September 30, 2007.

	Period Ended					
Index	09-30-07	09-30-08	09-30-09	09-30-10	09-30-11	09-30-12
Timberland Bancorp, Inc.	$100.00	$50.24	$33.16	$29.15	$29.15	$43.29
NASDAQ Composite	100.00	78.08	80.06	90.26	92.97	121.46
SNL $250M-$500 M Thrift Index*	100.00	85.04	79.72	81.39	92.00	109.76
SNL $500M-$1 B Thrift Index*	100.00	74.87	62.68	60.13	62.48	78.58

* Source: SNL Financial LC, Charlottesville, VA

Item 6. Selected Financial Data

The following table sets forth certain information concerning the consolidated financial position and results of operations of the Company and its subsidiary at and for the dates indicated. The consolidated data is derived in part from, and should be read in conjunction with, the Consolidated Financial Statements of the Company and its subsidiary presented herein.

	At September 30,				
	2012	2011	2010	2009	2008
	(In thousands)				
SELECTED FINANCIAL CONDITION DATA:					
Total assets	$736,954	$738,224	$742,687	$701,676	$681,883
Loans receivable and loans held for sale, net	538,480	528,024	527,591	547,208	557,687
MBS and other investments held-to-maturity	3,339	4,145	5,066	7,087	14,233
MBS and other investments available-for-sale	4,945	6,717	11,119	13,471	17,098
FHLB Stock	5,655	5,705	5,705	5,705	5,705
Cash and due from financial institutions, interest-bearing deposits in banks and fed funds sold	96,668	112,065	111,786	66,462	42,874
Certificates of deposit held for investment	23,490	18,659	18,047	3,251	--
OREO and other repossessed assets	13,302	10,811	11,519	8,185	511
Deposits	597,926	592,678	578,869	505,661	498,572
FHLB advances	45,000	55,000	75,000	95,000	104,628
Federal Reserve Bank advances	--	--	--	10,000	--
Shareholders' equity	90,319	86,205	85,408	87,199	74,841

	Year Ended September 30,				
	2012	2011	2010	2009	2008
	(In thousands, except per share data)				
SELECTED OPERATING DATA:					
Interest and dividend income	$31,605	$33,966	$36,596	$38,801	$43,338
Interest expense	5,947	8,533	10,961	13,504	16,413
Net interest income	25,658	25,433	25,635	25,297	26,295
Provision for loan losses	3,500	6,758	10,550	10,734	3,900
Net interest income after provision for loan losses	22,158	18,675	15,085	14,563	23,025
Non-interest income	9,781	8,681	5,696	6,949	4,178
Non-interest expense	25,568	25,963	24,641	22,739	20,349
Income (loss) before income taxes	6,371	1,393	(3,860)	(1,227)	6,854
Provision (benefit) for federal and state income taxes	1,781	304	(1,569)	(985)	2,849
Net income (loss)	4,590	1,089	(2,291)	(242)	4,005
Preferred stock dividends	(832)	(832)	(832)	(643)	--
Preferred stock accretion	(240)	(225)	(210)	(129)	--

Net income (loss) to common shareholders	$3,518	$32	$(3,333)	$(1,014)	$4,005
Net income (loss) per common share:					
Basic	$0.52	$--	$(0.50)	$(0.15)	$0.62
Diluted	$0.52	$--	$(0.50)	$(0.15)	$0.61
Dividends per common share	$--	$--	$0.04	$0.39	$0.43
Dividend payout ratio (1)	N/A	N/A	N/A	N/A	74.33 %

(1) Cash dividends to common shareholders divided by net income (loss) to common shareholders.

	At September 30,				
	2012	2011	2010	2009	2008
OTHER DATA:					
Number of real estate loans outstanding	2,704	2,796	2,919	3,062	3,261
Deposit accounts	55,848	56,152	55,598	53,941	53,501
Full-service offices	22	22	22	22	21

	At or For the Year Ended September 30,									
	2012		2011		2010		2009		2008	
KEY FINANCIAL RATIOS:										
Performance Ratios:										
Return (loss) on average assets (1)	0.62	%	0.15	%	(0.32	)%	(0.04	)%	0.61	%
Return (loss) on average equity (2)	5.21		1.26		(2.65	)	(0.28	)	5.35	
Interest rate spread (3)	3.65		3.58		3.63		3.64		3.98	
Net interest margin (4)	3.81		3.78		3.87		4.01		4.41	
Average interest-earning assets to average interest-bearing liabilities	117.42		115.24		114.51		117.42		115.70	
Noninterest expense as a percent of average total assets	3.48		3.54		3.43		3.35		3.10	
Efficiency ratio (5)	72.15		76.11		78.65		70.52		65.42	
Book value per common share	$10.52		$9.97		$9.89		10.17		$10.74	
Asset Quality Ratios:										
Non-accrual and 90 days or more past due loans as a percent of total loans receivable, net	4.09	%	4.32	%	4.86	%	5.36	%	2.12	%
Non-performing assets as a percent of total assets (6)	5.19		5.01		5.53		5.52		1.83	
Allowance for loan losses as a percent of total loans receivable, net (7)	2.15		2.21		2.09		2.59		1.44	
Allowance for loan losses as a percent of non-performing loans (8)	52.48		51.18		43.01		47.11		67.14	
Net charge-offs to average outstanding loans	0.66		1.13		2.45		0.79		0.12	
Capital Ratios:										
Total equity-to-assets ratio	12.26	%	11.68	%	11.50	%	12.43	%	10.98	%
Average equity to average assets	11.98		11.81		12.05		12.72		11.47	

(1) Net income (loss) divided by average total assets.
(2) Net income (loss) divided by average total equity.
(3) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities.
(4) Net interest income (before provision for loan losses) as a percentage of average interest-earning assets.

(5) Non-interest expenses divided by the sum of net interest income and non-interest income.
(6) Non-performing assets include non-accrual loans, loans past due 90 days or more and still accruing, non-accrual investment securities, other real estate owned and other repossessed assets.
(7) Loans receivable includes loans held for sale and is before the allowance for loan losses.
(8) Non-performing loans include non-accrual loans and loans past due 90 days or more and still accruing. Troubled debt restructured loans that are on accrual status are not included.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist in understanding the consolidated financial condition and results of operations of the Company. The information contained in this section should be read in conjunction with the Consolidated Financial Statements and accompanying notes thereto included in Item 8 of this Annual Report on Form 10-K.

Special Note Regarding Forward-Looking Statements

Certain matters discussed on this Annual Report on Form 10-K may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not statements of historical fact and often include the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause our actual results to differ materially from the results anticipated, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our loan loss reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System and of our bank subsidiary by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute a formal or informal enforcement action or require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits or impose additional requirements or restrictions, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including a regulatory memorandum of understanding (“MOU”) to which we are subject; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; the impact of the Dodd Frank Wall Street Reform and Consumer Protection Act and the implementation of related rules and regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risks associated with the loans on our consolidated balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common and preferred stock; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks described elsewhere in this Form 10-K.

Any of the forward-looking statements that we make in this Form 10-K and in the other public statements we make are based upon management's beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this annual report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. We caution readers not to place undue reliance on any forward-looking statements. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for fiscal 2013 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's results of operations and stock price performance.

Critical Accounting Policies and Estimates

The Company has established various accounting policies that govern the application of accounting principles generally accepted in the United States of America ("GAAP") in the preparation of the Company's Consolidated Financial Statements. The Company has identified five policies, that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements. These policies relate to the methodology for the determination of the allowance for loan losses, the valuation of mortgage servicing rights ("MSRs"), the determination of other than temporary impairments in the market value of investment securities, the determination of goodwill impairment and the determination of the recorded value of other real estate owned. These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis contained herein and in the notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K. In particular, Note 1 of the Notes to Consolidated Financial Statements, "Summary of Significant Accounting Policies," generally describes the Company's accounting policies. Management believes that the judgments, estimates and assumptions used in the preparation of the Company's Consolidated Financial Statements are appropriate given the factual circumstances at the time. However, given the sensitivity of the Company's Consolidated Financial Statements to these critical policies, the use of other judgments, estimates and assumptions could result in material differences in the Company's results of operations or financial condition.

Allowance for Loan Losses. The allowance for loan losses is maintained at a level sufficient to provide for probable loan losses based on evaluating known and inherent risks in the portfolio. The allowance is based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. The detailed analysis includes methods to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The appropriate allowance for loan loss level is estimated based upon factors and trends identified by management at the time the consolidated financial statements are prepared.

While the Company believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Company's loan portfolio, will not request the Company to significantly increase or decrease its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed elsewhere in this document. Although management believes the level of the allowance as of

September 30, 2012 was adequate to absorb probable losses inherent in the loan portfolio, a decline in local economic conditions, results of examinations by the Company's or the Bank's regulators or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations.

Mortgage Servicing Rights. MSRs are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans.

The estimated fair value is evaluated at least annually by a third party firm for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs' portfolio. The Company's methodology for estimating the fair value of MSRs is highly sensitive to changes in assumptions. For example, the determination of fair value uses anticipated prepayment speeds. Actual prepayment experience may differ and any difference may have a material effect on the fair value. Thus, any measurement of MSRs' fair value is limited by the conditions existing and assumptions as of the date made. Those assumptions may not be appropriate if they are applied at different times.

Other-Than-Temporary Impairment (OTTI) in the Estimated Fair Value of Investment Securities. Unrealized investment securities losses on available for sale and held to maturity securities are evaluated at least quarterly by a third-party firm to determine whether declines in value should be considered "other than temporary" and therefore be subject to immediate loss recognition through earnings for the portion related to credit losses. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is less than the recorded value primarily as a result of changes in interest rates, when there has not been significant deterioration in the financial condition of the issuer, and the Company has the intent and the ability to hold the security for a sufficient time to recover the recorded value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the recorded value primarily as a result of current market conditions and not a result of deterioration in the financial condition of the underlying borrowers or the underlying collateral (in the case of mutual funds) and the Company has the intent and the ability to hold the security for a sufficient time to recover the recorded value. Other factors that may be considered in determining whether a decline in the value of either a debt or equity security is "other than temporary" include ratings by recognized rating agencies; capital strength and near-term prospects of the issuer, and recommendation of investment advisors or market analysts. Therefore, continued deterioration of current market conditions could result in additional impairment losses recognized within the Company's investment portfolio.

Goodwill. Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired and liabilities assumed. Goodwill is presumed to have an indefinite useful life and is analyzed annually for impairment. An annual test is performed during the third quarter of each fiscal year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired. If the estimated fair value of the Company's sole reporting unit exceeds the recorded value of the reporting unit, goodwill is not considered impaired and no additional analysis is necessary.

One of the circumstances evaluated when determining if an impairment test of goodwill is needed more frequently than annually is the extent and duration that the Company's market capitalization (total common shares outstanding multiplied by current stock price) is less than the total equity applicable to common shareholders. During the quarter ended June 30, 2012, the Company engaged a third party firm to perform the annual test for goodwill impairment. The test concluded that recorded goodwill was not impaired. As of September 30, 2012, there have been no events or changes in the circumstances that would indicate a potential impairment. No assurance can be given, however, that the Company will not record an impairment loss on goodwill in the future.

Other Real Estate Owned ("OREO") and Other Repossessed Assets. Other real estate owned and other repossessed assets consist of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at the estimated fair value of the properties less estimated costs of disposal. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed. Valuations are periodically performed by management, and a charge to earnings is recorded if the recorded value of a property exceeds its estimated net realizable value.

New Accounting Pronouncements

For a discussion of new accounting pronouncements and their impact on the Company, see Note 1 of the Notes to the Consolidated Financial Statements contained in “Item 8. Financial Statements and Supplementary Data.”

Operating Strategy

The Company is a bank holding company which operates primarily through its subsidiary, the Bank. The Bank is a community-oriented bank which has traditionally offered a wide variety of savings products to its retail customers while concentrating its lending activities on real estate loans. Weak economic conditions and ongoing stress on the housing and financial markets have prevailed since 2008 in portions of the United States, including Washington State where we hold substantially all of our loans and conduct all of our operations. The majority of our loans are secured by collateral and made to borrowers located in Washington State. Western Washington, which includes our primary market areas, has experienced home price declines, increased foreclosures, and has experienced above average unemployment rates. As a result, our credit losses during these periods were at significantly higher levels than our historical experience and our net interest income and other operating revenues and expenses have also been adversely affected. In response to the financial challenges in our market areas we have taken actions to manage our capital, reduce our exposure to speculative construction and land development loans and maintain higher levels of on balance sheet liquidity. We continue to originate residential fixed rate mortgage loans primarily for sale in the secondary market. We also continue to manage the growth of our commercial and multi-family real estate loan portfolios in a disciplined fashion while continuing to dispose of other real estate owned properties and increase retail deposits.

We believe the resolution of problem financial institutions and continued bank consolidation in Western Washington will provide opportunities for the Company to increase market share within the communities it serves. We are currently pursuing the following strategies:

Improve Asset Quality. We are focused on monitoring existing performing loans, resolving non-performing assets and selling foreclosed assets. We have sought to reduce the level of non-performing assets through collections, write-downs, modifications and sales of other real estate owned properties. We have taken proactive steps to resolve our non-performing loans, including negotiating payment plans, forbearances, loan modifications and loan extensions and accepting short payoffs on delinquent loans when such actions have been deemed appropriate.

Expand our presence within our existing market areas by capturing opportunities resulting from changes in the competitive environment. We currently conduct our business primarily in Western Washington. We have a community bank strategy that emphasizes responsive and personalized service to our customers. As a result of FDIC bank resolutions and anticipated consolidation of banks in our market areas, we believe there is an opportunity for a community and customer focused bank to expand its customer base. By offering timely decision making, delivering appropriate banking products and services, and providing customer access to our senior managers we believe community banks, such as Timberland Bank, can distinguish themselves from larger banks operating in our market areas. We believe we have a significant opportunity to attract additional borrowers and depositors and expand our market presence and market share within our extensive branch footprint.

Continue generating revenues through mortgage banking operations. The substantial majority of the fixed rate residential mortgage loans we originate are sold into the secondary market with servicing retained. This strategy produces gains on the sale of such loans and reduces the interest rate and credit risk associated with fixed rate residential lending. We will continue to originate custom construction and owner builder loans for sale into the secondary market upon the completion of construction.

Portfolio Diversification. In recent years, we have strictly limited the origination of speculative construction, land development and land loans in favor of loans that possess credit profiles representing less risk to the Bank. We will continue originating owner/builder and custom construction loans, multi-family loans, commercial business loans and certain commercial real estate loans which offer higher risk adjusted returns, shorter maturities and more sensitivity to interest rate fluctuations. We anticipate capturing more of each customer's banking relationship by cross selling our loan and deposit products and offering additional services to our customers.

Increase Core Deposits and other Retail Deposit Products. We focus on establishing a total banking relationship with our customers with the intent of internally funding our loan portfolio. We anticipate that the continued focus on customer relationships will increase our level of core deposits and locally-based retail certificates of deposit. In addition to our retail branches we maintain technology based products such as business cash management and a business remote deposit product that enables us to compete effectively with banks of all sizes.

Limit Exposure to Increasing Interest Rates. For many years the majority of the loans the Bank has retained in its portfolio have generally possessed periodic interest rate adjustment features or have been relatively short term in nature. Loans originated for portfolio retention have included ARM loans, short term construction loans, and to a lesser extent commercial business loans with interest rates tied to a market index such as the prime rate. Longer term fixed-rate mortgage loans have generally been originated for sale into the secondary market.

Market Risk and Asset and Liability Management

General. Market risk is the risk of loss from adverse changes in market prices and rates. The Bank's market risk arises primarily from interest rate risk inherent in its lending, investment, deposit and borrowing activities. The Bank, like other financial institutions, is subject to interest rate risk to the extent that its interest-earning assets reprice differently than its interest-bearing liabilities. Management actively monitors and manages its interest rate risk exposure. Although the Bank manages other risks, such as credit quality and liquidity risk, in the normal course of business management considers interest rate risk to be its most significant market risk that could potentially have the largest material effect on the Bank's financial condition and results of operations. The Bank does not maintain a trading account for any class of financial instruments nor does it engage in hedging activities. Furthermore, the Bank is not subject to foreign currency exchange rate risk or commodity price risk.

Qualitative Aspects of Market Risk. The Bank's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates. The Bank has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the difference between asset and liability maturities and interest rates. The principal element in achieving this objective is to increase the interest-rate sensitivity of the Bank's interest-earning assets by retaining in its portfolio, short-term loans and loans with interest rates subject to periodic adjustments. The Bank relies on retail deposits as its primary source of funds. As part of its interest rate risk management strategy, the Bank promotes transaction accounts and certificates of deposit with terms of up to six years.

The Bank has adopted a strategy that is designed to substantially match the interest rate sensitivity of assets relative to its liabilities. The primary elements of this strategy involve originating ARM loans for its portfolio, maintaining residential construction loans as a portion of total net loans receivable because of their generally shorter terms and higher yields than other one- to four-family residential mortgage loans, matching asset and liability maturities, investing in short-term securities, originating fixed-rate loans for retention or sale in the secondary market, and retaining the related mortgage servicing rights.

Sharp increases or decreases in interest rates may adversely affect the Bank's earnings. Management of the Bank monitors the Bank's interest rate sensitivity through the use of a model provided by FIMAC Solutions, LLC (“FIMAC”), a company that specializes in providing the financial services industry interest risk rate risk and balance sheet management services. Based on a rate shock analysis prepared by FIMAC based on data at September 30, 2012, an immediate increase in interest rates of 200 basis points would increase the Bank's projected net interest income by approximately 6.7%, primarily because a larger portion of the Bank's interest rate sensitive assets than interest rate sensitive liabilities would reprice within a one year period. See "- Quantitative Aspects of Market Risk" below for additional information. Management has sought to sustain the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. Pursuant to this strategy, the Bank actively originates adjustable-rate loans for retention in its loan portfolio. Fixed-rate mortgage loans with maturities greater than seven years generally are originated for the immediate or future resale in the secondary mortgage market. At September 30, 2012, adjustable-rate mortgage loans constituted $315.6 million or 69.1%, of the Bank's total mortgage loan portfolio due after one year. Although the Bank has sought to originate ARM loans, the ability to originate such loans depends to a great extent on market interest rates and borrowers' preferences. In lower interest rate environments, borrowers often prefer fixed-rate loans.

Consumer, commercial business and construction and land development loans typically have shorter terms and higher yields than permanent residential mortgage loans, and accordingly reduce the Bank’s exposure to fluctuations in interest rates. At September 30, 2012, the consumer, commercial business and construction and land development portfolios amounted to $39.0 million, $22.6 million and $56.4 million, or 6.9%, 4.0% and 9.9% of total loans receivable (including loans held for sale), respectively.

Quantitative Aspects of Market Risk. The model provided for the Bank by FIMAC estimates the changes in net portfolio value ("NPV") and net interest income in response to a range of assumed changes in market interest rates. The model first estimates the level of the Bank's NPV (market value of assets, less market value of liabilities, plus or minus the market value of any off-balance sheet items) under the current rate environment. In general, market values are estimated by discounting the estimated cash flows of each instrument by appropriate discount rates. The model then recalculates the Bank's NPV under different interest rate scenarios. The change in NPV under the different interest rate scenarios provides a measure of the Bank's exposure to interest rate risk. The following table is provided by FIMAC based on data at September 30, 2012.

Hypothetical Interest Rate Scenario(3) (Basis Points)	Net Interest Income(1)(2) Estimated Value	$ Change from Base	% Change from Base	Current Market Value Estimated Value	$ Change from Base	% Change from Base
	(Dollars in thousands)					
+400	$ 27,685	$ 3,096	12.59 %	$ 106,252	$ 505	0.48 %
+300	27,058	2,469	10.04	106,194	447	0.42
+200	26,244	1,655	6.73	106,082	335	0.32
+100	25,386	797	3.24	105,945	198	0.19
BASE	24,589	--	--	105,747	--	--
-100	23,519	(1,070)	(4.35)	107,132	1,385	1.31
-200	22,717	(1,872)	(7.62)	119,856	14,109	13.34

____
(1) Does not include loan fees.
(2) Includes BOLI income, which is included in non-interest income on the Consolidated Financial Statements.
(3) No rates in the model are allowed to go below zero.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan repayments and deposit decay, and should not be relied upon as indicative of actual results. Furthermore, the computations do not reflect any actions management may undertake in response to changes in interest rates.

In the event of a 100 basis point decrease in interest rates, the Bank would be expected to experience a 1.3% increase in NPV and a 4.4% decrease in net interest income. In the event of a 200 basis point increase in interest rates, a 0.3% increase in NPV and a 6.7% increase in net interest income would be expected. Based upon the modeling described above, the Bank's asset and liability structure generally results in decreases in net interest income in a declining interest rate scenario and increases in net interest income in a rising rate scenario. This structure also generally results in an increase in NPV when rates increase or decrease.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates could possibly deviate significantly from those assumed in calculating the table.

Comparison of Financial Condition at September 30, 2012 and September 30, 2011

The Company's total assets decreased by $1.2 million, or 0.2%, to $737.0 million at September 30, 2012 from $738.2 million at September 30, 2011. The decrease was primarily attributable to a decrease in cash and cash equivalents and a decrease in mortgage-backed securities and other investments. These decreases were partially offset by an increase in net loans receivable, an increase in certificates of deposit ("CDs") held for investment and an increase in OREO and other repossessed assets.

Net loans receivable increased by $10.5 million, or 2.0%, to $538.5 million at September 30, 2012 from $528.0 million at September 30, 2011, primarily a result of increases in multi-family, commercial real estate, commercial real estate construction and custom and owner / builder construction loan balances. These increases were partially offset by decreases to land, one-to four-family, multi-family construction, consumer and land development loan balances.

Total deposits increased by $5.2 million, or 0.9%, to $597.9 million at September 30, 2012 from $592.7 million at September 30, 2011, primarily as a result of increases in money market, non-interest bearing and savings account balances. These increases were partially offset by decreases in CDs and N.O.W. checking account balances.

Shareholders' equity increased by $4.1 million, or 4.8%, to $90.3 million at September 30, 2012 from $86.2 million at September 30, 2011. The increase was primarily due to net income for the year ended September 30, 2012, and was partially offset by preferred stock dividends. As of September 30, 2012, the Company exceeded all regulatory capital requirements required for bank holding company regulatory purposes. For additional details see Note 18 of the Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data" and "Item 1. Business - Regulation of the Company - Capital Requirements."

A more detailed explanation of the changes in significant balance sheet categories follows:

Cash and Cash Equivalents and CDs Held for Investment: Cash and cash equivalents and CDs held for investment decreased by $10.6 million, or 8.1%, to $120.2 million at September 30, 2012 from $130.7 million at September 30, 2011. The decrease was primarily due to a $15.4 million decrease in cash and cash equivalents, which was partially offset by a $4.8 million increase in CDs held for investment. The Company continued to maintain high levels of liquidity primarily for regulatory and asset-liability management purposes.

Mortgage-backed Securities and Other Investments: Mortgage-backed securities and other investments decreased by $2.6 million, or 23.7%, to $8.3 million at September 30, 2012 from $10.9 million at September 30, 2011. The decrease was primarily as a result of regular amortization and prepayments on mortgage-backed securities, the sale of a $722,000 U.S. government agency MBS and OTTI charges recorded on private label residential MBS. For additional details on mortgage-backed securities and other investments, see "Item 1, Business -Investment Activities" and Note 3 of the Notes to the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

Loans Receivable and Loans Held for Sale, Net of Allowance for Loan Losses: Net loans receivable, including loans held for sale, increased by $10.5 million, or 2.0% to $538.5 million at September 30, 2011 from $528.0 million at September 30, 2011. The increase was primarily a result of a $16.5 million increase in multi-family loan balances, a $10.2 million increase in commercial real estate loan balances, a $7.4 million increase in commercial real estate construction loan balances, a $7.1 million increase in custom and owner / builder construction loan balances and a $1.9 million decrease in the undisbursed portion of construction loans in process. These increases to net loans receivable were partially offset by a $9.6 million decrease in land loan balances, a $9.0 million decrease in multi-family construction loan balances, a $7.7 million decrease in one-to four-family loan balances, a $5.3 million decrease in consumer loan balances and a $1.6 million decrease in land development loan balances. The increase in multi-family loan balances and the decrease in multi-family construction loan balances were in part due to several multi-family construction projects completing the construction phase and converting to permanent financing.

Loan originations increased by 42.5% to $228.3 million for the year ended September 30, 2012 from $160.2 million for the year ended September 30, 2011. The increase in loan originations was primarily due to increased demand for commercial real estate loans and multi-family loans and increased refinanced activity for single family home loans. The Company continued to sell longer-term fixed rate loans for asset-liability management purposes and to generate non-interest income. The Company sold $97.4 million in fixed rate one- to four-family mortgage loans during the year ended September 30, 2012 compared to $62.5 million for the fiscal year ended September 30, 2011. For additional information on loans, see "Item 1, Business Lending Activities" and Note 4 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Premises and Equipment: Premises and equipment increased by $496,000, or 2.9%, to $17.9 million at September 30, 2012 from $17.4 million at September 30, 2011. The increase was primarily due to the remodeling of a vacant branch office building into office space for administrative personnel. For additional information on premises and equipment, see "Item 2, Properties" and Note 6 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Other Real Estate Owned: OREO and other repossessed assets increased by $2.5 million, or 23.0% to $13.3 million at September 30, 2012 from $10.8 million at September 30, 2011. The increase was primarily due to the addition of $9.4 million in OREO properties and other repossessed assets and was partially offset by the disposition of $6.0 million in OREO properties and other repossessed assets and lower of cost or fair value losses of $1.0 million. At September 30, 2012, the OREO balance was comprised of 56 individual properties. The properties consisted of eight commercial real estate properties totaling $6.5 million, 35 land parcels totaling $4.2 million, 12 single family homes totaling $1.7 million and a condominium project of $842,000. The largest OREO property was a commercial office building with a balance of $2.8 million. For additional information on OREOs, see "Item 1, Business Lending Activities Nonperforming Assets" and Note 7 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Bank Owned Life Insurance ("BOLI"): BOLI increased $607,000, or 3.8%, to $16.5 million at September 30, 2012 from $15.9 million at September 30, 2011 due to net BOLI earnings.

Goodwill and Core Deposit Intangible ("CDI"): The value of goodwill at $5.7 million at September 30, 2012 remained unchanged from September 30, 2011. The amortized value of CDI decreased by $148,000 to $249,000 at September 30, 2012 from $397,000 at September 30, 2011 due to scheduled amortization. The Company performed its annual review of goodwill during the quarter ended June 30, 2012 and determined that there was no impairment. For additional information on goodwill and CDI, see Note 1 and Note 8 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

Mortgage Servicing Rights ("MSRs"): MSRs decreased $97,000, or 4.6%, to $2.0 million at September 30, 2012 from $2.1 million at September 30, 2011, as the amortization of MSRs exceeded the capitalized value of MSRs added during the year. The principal amount of loans serviced for Freddie Mac increased $6.0 million, or 2.0% to $304.9 million at September 30, 2012 from $298.9 million at September 30, 2011. The Company recorded a $10,000 valuation reserve recovery on MSRs during the year ended September 30, 2012. For additional information on MSRs, see Note 5 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

Prepaid FDIC Insurance Assessment: The prepaid FDIC insurance assessment decreased $917,000, or 43.6%, to $1.2 million at September 30, 2012 from $2.1 million at September 30, 2011 as a portion of the prepaid amount was expensed.

Deposits: Deposits increased by $5.2 million, or 0.9%, to $597.9 million at September 30, 2012 from $592.7 million at September 30, 2011. The increase was primarily a result of an $18.5 million increase in money market account balances, a $10.8 million increase in non-interest account balances and a $3.9 million increase in savings account balances. These increases were partially offset by a $22.8 million decrease in CD account balances and a $5.2 million decrease in N.O.W. checking account balances. The increases in money market account balances and savings account balances and the decrease in CD accounts were in part due to the low interest rate environment, as some depositors opted to place maturing CD funds into non-maturity accounts to retain flexibility if interest rates increased. The Company also
experienced deposit inflows due to a number of customers transferring funds from other financial institutions during the year ended September 30, 2012. For additional information on deposits, see "Item 1, Business Deposit Activities and Other Sources of Funds" and Note 9 of the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

FHLB Advances: FHLB advances decreased by $10.0 million, or 18.2%, to $45.0 million at September 30, 2012 from $55.0 million at September 30, 2011 as the Company used a portion of its liquid assets to repay maturing advances. For additional information on borrowings, see "Item 1, Business Deposit Activities and Other Sources of Funds Borrowings" and Note 10 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Shareholders' Equity: Total shareholders' equity increased by $4.1 million, or 4.8%, to $90.3 million at September 30, 2012 from $86.2 million at September 30, 2011. The increase was primarily due to net income of $4.6 million, a $264,000 reduction in unearned shares issued to ESOP equity account and a $65,000 reduction in the accumulated other comprehensive loss equity component. These increases to shareholders' equity were partially offset by preferred stock dividends of $832,000.

For additional information on shareholders' equity, see the Consolidated Statements of Shareholders' Equity contained in "Item 8, Financial Statements and Supplementary Data."

Comparison of Operating Results for the Years Ended September 30, 2012 and 2011

Net income for the year ended September 30, 2012 increased $3.50 million, or 321.5%, to $4.59 million compared to $1.10 million for the year ended September 30, 2011. Net income to common shareholders after adjusting for preferred stock dividends and preferred stock discount accretion increased $3.49 million for the year ended September 30, 2012 from $32,000 for the year ended September 30, 2011. Net income per diluted common share increased to $0.52 for the year ended September 30, 2012 compared to $0.00 for the year ended September 30, 2011. The increase in net income was primarily due to a decrease in the provision for loan losses, and an increase in non-interest income partially offset by an increase in the provision for income taxes. Also contributing to the improvement in net income were an increase in net interest income and a decrease in non-interest expense.

The decrease in the provision for loan losses was primarily a result of a decrease in the level of net charge-offs for the year ended September 30, 2012 compared to the prior year.

The increase in non-interest income was primarily a result of an increase in gain on sale of loans, an increase in ATM and debit card interchange transaction fees and a reduction in net OTTI on MBS and other investments. These increases to non-interest income were partially offset by a reduction in the valuation recovery on MSRs and a decrease in service charges on deposits.

The increase in net interest income was primarily attributable to an increase in the Company's net interest margin.

The decrease in non-interest expense was primarily attributable to decreases in salaries and employee benefits expense, FDIC insurance expense, other insurance expense and loan administration and foreclosure expense. These decreases to non-interest expense were partially offset by an increase OREO related expenses.

A more detailed explanation of the income statement categories is presented below.

Net Interest Income: Net interest income increased by $225,000, or 0.9%, to $25.66 million for the year ended September 30, 2012 from $25.43 million for the year ended September 30, 2011. The increase in net interest income was primarily attributable to increases in the Company's average loan receivable and its net interest margin.

Total interest and dividend income decreased by $2.36 million, or 7.0%, to $31.61 million for the year ended September 30, 2012 from $33.97 million for the year ended September 30, 2011 as the yield on interest earning assets decreased to 4.69% from 5.04%. The decrease in the weighted average yield on interest earning assets was primarily a result of a decrease in overall market rates.

Total interest expense decreased by $2.59 million to $5.95 million for the year ended September 30, 2012 from $8.53 million for the year ended September 30, 2011 as the average rate paid on interest-bearing liabilities decreased to 1.04% for the year ended September 30, 2012 from 1.46% for the year ended September 30, 2011. The decrease in funding costs was primarily a result of a decrease in overall market rates, a change in the composition of deposit categories and a decrease in the average level of FHLB advances.

Average loans receivable increased $6.78 million to $544.52 million for the year ended September 30, 2012 as compared to $537.74 million for the year ended September 30, 2011. The net interest margin increased three basis points to 3.81% for the year ended September 30, 2012 from 3.78% for the year ended September 30, 2011 as funding costs decreased at a greater rate than the yield on interest earning assets.

Provision for Loan Losses: The provision for loan losses decreased by $3.26 million, or 48.2%, to $3.50 million for the year ended September 30, 2012 from $6.76 million for the year ended September 30, 2011. Net charge-offs decreased by $2.46 million, or 40.4%, to $3.62 million for the year ended September 30, 2012 from $6.08 million for the year ended September 30, 2011 The net charge-offs to average outstanding loans ratio was 0.66% for the year ended September 30, 2012 and 1.13% for the year ended September 30, 2011.

The Company has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Company performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans, and other factors to determine an appropriate level of allowance for loan losses. Impaired loans are subject to an impairment analysis to determine an appropriate reserve to be held against each loan. The aggregate principal impairment amount determined at September 30, 2012 was $2.90 million.

Based on the comprehensive methodology, management deemed the allowance for loan losses of $11.83 million at September 30, 2012 (2.15% of loans receivable and loans held for sale and 52.5% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. While the Company believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Company's loan portfolio, will not request the Company to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that, substantial increases will not be necessary should the quality of any loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations. For additional information, see "Item 1, Business - Lending Activities -- Allowance for Loan Losses."

Non-interest Income: Total non-interest income increased by $1.10 million, or 12.7%, to $9.78 million for the year ended September 30, 2012 from $8.68 million for the year ended September 30, 2011. This increase was primarily a result of a $924,000 increase in gain on sale of loans, a $261,000 increase in ATM and debit card interchange transaction fees and a $233,000 reduction in net OTTI on MBS and other investments. These increases to non-interest income were partially offset by a $395,000 decrease in the valuation recovery on MSRs and a $112,000 decrease in service charges on deposits.

The increased income from loan sales was primarily a result of an increase in the amount of residential loans sold in the secondary market for the year ended September 30, 2012. The sale of one-to four-family mortgage loans increased to $97.4 million for the year ended September 30, 2012 from $62.5 million for the year ended September 30, 2011. The increased loan sales were primarily due to increased refinance activity that was attributable to decreased interest rates for fixed rate mortgage loans. The increased ATM and debit card interchange transaction fees were primarily due to several deposit promotions designed to increase ATM and debit card usage. The decrease in OTTI charges on MBS and other investments was primarily due to a reduction in the level of private label MBS in the Company's investment portfolio. At September 30, 2012, the Company's remaining private label MBS had been reduced to $2.78 million from an original acquired balance of $15.30 million.

The Company's valuation recovery on MSRs decreased by $395,000 to $10,000 for the year ended September 30, 2012 from $$405,000 for the year ended September 30, 2011. The valuation of the MSRs was based on a third party valuation of the MSR asset. At September 30, 2012, the MSR asset had a remaining valuation allowance of $475,000 available for future recovery.

The reduction in service charges on deposits was a result of fewer overdrafts on checking accounts.

Non-interest Expense: Total non-interest expense decreased by $395,000, or 1.5%, to $25.57 million for the year ended September 30, 2012 from $25.96 million for the year ended September 30, 2011. The decrease was primarily attributable to a $528,000 decrease in salaries and employee benefits, a $219,000 decrease in FDIC insurance expense, a $147,000 decrease in other insurance expense and a $143,000 decrease in loan administration and foreclosure expense. These decreases to non-interest expense were partially offset by a $608,000 increase in OREO and other repossessed assets expense.

The decrease in salaries and employee benefits expense was partially a result of an increased level of loan originations. Under GAAP, the portion of a loan origination fee that is attributable to the estimated employee costs to generate the loan is recorded as a reduction to salaries and employee benefit expense. With the increase in loan originations, the loan origination fees that reduced salaries and employee benefit expense increased by $480,000 during the year ended September 30, 2012 compared to the year ended September 30, 2011.

The decrease in FDIC insurance expense was primarily due to changes in the assessment calculation as a result of the implementation of the Dodd-Frank Act. The decrease in other insurance expense was primarily a result of reduced insurance premiums. The decrease in loan administration and foreclosure expense was primarily a result of decreased foreclosure related expenses.

The increase in OREO related expenses was primarily a result of an increase in the number of OREO properties held and valuation write-downs based on updated appraisals received for several properties.

The Company's efficiency ratio improved to 72.15% for the year ended September 30, 2012 from 76.11% for the year ended September 30, 2011.

Provision for Federal and State Income Taxes: The provision for federal and state income taxes increased by $1.48 million, or 485.9% to $1.78 million for the year ended September 30, 2012 from $304,000 for the year ended September 30, 2011, primarily due to increased income before income taxes. The Company's effective federal and state income tax rate was 28.0% for the year ended September 30, 2012 compared to 21.8% for the year ended September 30, 2011. The difference in the effective tax rate was primarily due to a higher percentage of income subject to tax. Also impacting the effective tax rate were changes to the Company's deferred tax valuation allowance. During the year ended September 30, 2012, income taxes were reduced by approximately $205,000 due to a deferred tax valuation recovery based on the expected implementation of certain tax planning strategies. The deferred tax valuation allowance relates to a capital loss carryforward on the sale of securities in fiscal 2008.

For additional information on federal income taxes, see Note 13 of the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Comparison of Operating Results for the Years Ended September 30, 2011 and 2010

Net income was $1.09 million for the year ended September 30, 2011 compared to a net loss of $(2.29 million) for the year ended September 30, 2010. Net income to common shareholders after adjusting for preferred stock dividends and preferred stock discount accretion was $32,000 for the year ended September 30, 2011 compared to net loss to common shareholders of $(3.33 million) for the year ended September 30, 2010. Net income per diluted common share was $0.00 for the year ended September 30, 2011 compared to a loss per diluted common share of $(0.50) for the year ended September 30, 2010. The improved earnings were primarily due to decreased provision for loan losses and increased non-interest income, which were partially offset by increased non-interest expenses and decreased net interest income. Net income per diluted common share was $0.00 for the year ended September 30, 2011 compared to a loss per diluted common share of $(0.50) for the year ended September 30, 2010.

The decrease in the provision for loan losses was primarily a result of a decrease in the level of net charge-offs, a decrease in non-performing loans and a decrease in the Company's construction and land development loan balances.

The increase in non-interest income was primarily a result of a reduction in net OTTI on MBS and other investments and a net change in the valuation recovery (allowance) on MSRs. These increases to non-interest income were partially offset by a decrease in service charges on deposits.

The increase in non-interest expense was primarily attributable to increases in salaries and employee benefits expense, OREO related expenses, loan foreclosure related expenses and ATM expenses. These increases to non-interest expense were partially offset by a decrease in FDIC insurance expense.

The decrease in net interest income was primarily attributable to interest margin compression as the yield on interest earning assets decreased at a greater rate than funding costs decreased.

A more detailed explanation of the income statement categories is presented below.

Net Interest Income: Net interest income decreased by $202,000, or 0.8%, to $25.43 million for the year ended September 30, 2011 from $25.64 million for the year ended September 30, 2010. The decrease in net interest income was primarily attributable to interest margin compression as the yield on interest earning assets decreased at a greater rate than funding costs.

Total interest and dividend income decreased by $2.63 million, or 7.2%, to $33.97 million for the year ended September 30, 2011 from $36.60 million for the year ended September 30, 2010 as the yield on interest earning assets decreased to 5.04% from 5.53%. The decrease in the weighted average yield on interest earning assets was primarily a result of a decrease in overall market rates, an increase in the level of lower yielding cash equivalents and other liquid assets and a change in the composition of the loan portfolio as the level of higher yielding construction and land development loans decreased.

Total interest expense decreased by $2.43 million, or 22.2%, to $8.53 million for the year ended September 30, 2011 from $10.96 million for the year ended September 30, 2010 as the average rate paid on interest-bearing liabilities decreased to 1.46% for the year ended September 30, 2011 from 1.90% for the year ended September 30, 2010. The decrease in funding costs was primarily a result of a decrease in overall market rates and a decrease in the level of average FHLB advances.

The net interest margin decreased nine basis points to 3.78% for the year ended September 30, 2011 from 3.87% for the year ended September 30, 2010 as the yield on interest earning assets decreased at a greater rate than the funding costs decreased. The margin compression was primarily due to a decrease in overall market rates and an increased level of average liquid assets with lower yields.

Provision for Loan Losses: The provision for loan losses decreased by $3.79 million, or 35.9%, to $6.76 million for the year ended September 30, 2011 from $10.55 million for the year ended September 30, 2010. The decrease in the provision for loan losses was primarily a result of a decrease in the level of net charge-offs, a decrease in non-performing loans and a decrease in the Company's construction and land development loan balances. The Company had net charge-offs of $6.08 million for the year ended September 30, 2011 compared to net charge-offs of $13.46 million for the year ended September 30, 2010. The net charge-offs to average outstanding loans ratio was 1.13% for the year ended September 30, 2011 compared to 2.45% for the year ended September 30, 2010.

Non-interest Income: Total non-interest income increased by $2.99 million, or 52.4%, to $8.68 million for the year ended September 30, 2011 from $5.70 million for the year ended September 30, 2010. This increase was primarily a result of a $1.73 million reduction in net OTTI on MBS and other investments, a $1.30 million net change in the valuation recovery (allowance) on MSRs and a $292,000 increase in ATM transaction fees. These increases to non-interest income were partially offset by a $333,000 decrease in service charges on deposits.

The Company's net OTTI loss on MBS and other investments decreased by $1.73 million to $447,000 for the year ended September 30, 2011 from $2.18 million for the year ended September 30, 2010. The OTTI charges for both years were on private label MBS that were acquired from an in-kind redemption from the AMF family of mutual funds in June 2008. At September 30, 2011, the Company's remaining private label MBS had been reduced to $3.42 million from an original acquired balance of $15.30 million. The Company recorded a $405,000 MSR valuation recovery during the year ended September 30, 2011 compared to an $890,000 valuation allowance recorded during the year ended September 30, 2010. The partial recovery of the valuation allowance was primarily due to an increase in the expected life and corresponding estimated fair value of the MSR portfolio. The increased income from ATM transaction fees was primarily due to several deposit promotions designed to increase ATM and debit card usage. The reduction in service charges on deposits was primarily a result of fewer overdrafts on checking accounts.

Non-interest Expense: Total non-interest expense increased by $1.32 million, or 5.4%, to $25.96 million for the year ended September 30, 2011 from $24.64 million for the year ended September 30, 2010. The increase was primarily attributable to a $512,000 increase in salaries and employee benefits, a $492,000 increase in OREO and other repossessed assets expense, a $478,000 increase in loan administration and foreclosure related expenses, a $197,000 increase in deposit operations related expenses and a $104,000 increase in ATM expenses. These increases to non-interest expense were partially offset by a $498,000 decrease in FDIC insurance expense. The comparison between periods for FDIC insurance expense was affected by a non-recurring accrual adjustment in the prior year which increased the expense by $400,000 for the year ended September 30, 2010.

The increase in salaries and employee benefits expense was partially a result of a decreased level of loan originations. Under GAAP, the portion of a loan origination fee that is attributable to the estimated employee costs to generate the loan is recorded as a reduction to salaries and employee benefit expense. With the decrease in loan originations, the loan origination fees that reduced salaries and employee benefit expense decreased by $127,000 during the year ended September 30, 2011 compared to the year ended September 30, 2010. The comparison between periods for salaries and employee benefits was also affected by a change in the Bank's vacation accrual policy during the prior year which reduced salaries and employee benefits expense by $340,000 during the year ended September 30, 2010.

The increase in OREO related expenses and loan foreclosure related expenses were primarily a result of an increase in the number of OREO properties held and an increase in foreclosure activity. The OREO related expenses were also increased as a result of valuation write-downs based on updated appraisals received for several properties.

The Company's efficiency ratio improved to 76.11% for the year ended September 30, 2011 from 78.65% for the year ended September 30, 2010.

Provision (Benefit) for Federal and State Income Taxes: The Company recorded a provision for federal and state income taxes of $304,000 for the year ended September 30, 2011 as income before income taxes was $1.39 million. This compares to a benefit for federal and state income taxes of $(1.57 million) recorded for the year ended September 30, 2010 as the loss before income taxes was $(3.86 million). The Company's effective federal and state income tax (benefit) rate was 21.8% for the year ended September 30, 2011 compared to (40.6%) for the year ended September 30, 2010. The change in the effective tax (benefit) rate is primarily due to changes in the percentage of non-taxable income (such as BOLI) and changes to the Company's deferred tax valuation allowance. In periods with income before income taxes, the effective tax rate is reduced by non-taxable income items. In periods with a loss before income taxes, the effective benefit rate is increased by non-taxable income items and other adjustments that increase the tax benefit.

Average Balances, Interest and Average Yields/Cost

The earnings of the Company depend largely on the spread between the yield on interest-earning assets and the cost of interest-bearing liabilities, as well as the relative amount of the Company's interest-earning assets and interest- bearing liability portfolios.

The following table sets forth, for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the periods presented.

	Year Ended September 30,											
	2012				2011				2010			
	Average Balance	Interest and Dividends	Yield/ Cost		Average Balance	Interest and Dividends	Yield/ Cost		Average Balance	Interest and Dividends	Yield/ Cost	
	(Dollars in thousands)											
Interest-earning assets:												
Loans receivable (1)(2)	$ 544,524	$ 30,831	5.66	%	$ 537,740	$ 32,976	6.13	%	$ 555,050	$ 35,344	6.43	%
Mortgage-backed securities and other investments	8,479	404	4.75		11,625	612	5.26		17,513	910	5.20	
FHLB stock and equity securities	6,707	32	0.48		6,680	31	0.46		6,679	35	0.52	
Interest-bearing deposits	114,514	338	0.30		117,491	347	0.29		82,455	307	0.37	
Total interest-earning assets	674,224	31,605	4.69		673,536	33,966	5.04		661,697	36,596	5.53	
Non-interest-earning assets	60,927				59,792				56,482			
Total assets	$ 735,151				$ 733,328				$ 718,179			
Interest-bearing liabilities:												
Savings accounts	87,020	245	0.28		$ 73,696	459	0.62		$ 63,695	454	0.71	
Money market accounts	70,111	334	0.48		57,996	435	0.75		59,988	677	1.13	
NOW accounts	152,983	651	0.43		157,095	1,415	0.90		141,240	1,749	1.24	
Certificates of deposit	215,759	2,721	1.26		240,174	3,827	1.59		234,550	4,927	2.10	
Short-term borrowings(3)	699	--	0.05		511	--	0.05		923	3	0.33	
Long-term borrowings (4)	47,603	1,996	4.19		55,000	2,397	4.35		77,479	3,151	4.07	
Total interest bearing liabilities	574,175	5,947	1.04		584,472	8,533	1.46		577,875	10,961	1.90	
Non-interest bearing liabilities	72,888				62,225				53,734			
Total liabilities	647,063				646,697				631,609			
Shareholders' equity	88,088				86,631				86,570			
Total liabilities and shareholders' equity	$ 735,151				$ 733,328				$ 718,179			
Net interest income		$ 25,658				$ 25,433				$ 25,635		

Interest rate spread.	3.65 %	3.58 %	3.63 %
Net interest margin (5)	3.81 %	3.78 %	3.87 %
Ratio of average interest-earning assets to average interest-bearing liabilities	117.42 %	115.24 %	114.51 %

(1) Does not include interest on loans on non-accrual status. Includes loans originated for sale. Amortized net deferred loan fees, late fees, extension fees and prepayment penalties (2012, $802; 2011, $835; and 2010, $829) included with interest and dividends.
(2) Average balance includes non-accrual loans.
(3) Includes FHLB, FRB and PCBB advances with original maturities of less than one year and other short-term borrowings-repurchase agreements.
(4) Includes FHLB advances with original maturities of one year or greater.
(5) Net interest income divided by total average interest earning assets.

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on net interest income on the Company. Information is provided with respect to the (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate), and (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change (sum of the prior columns). Changes in both rate and volume have been allocated to rate and volume variances based on the absolute values of each.

	Year Ended September 30, 2012 Compared to Year Ended September 30, 2011 Increase (Decrease) Due to			Year Ended September 30, 2011 Compared to Year Ended September 30, 2010 Increase (Decrease) Due to		
	Rate	Volume	Net Change	Rate	Volume	Net Change
	(In thousands)					
Interest-earning assets:						
Loans receivable (1)	$(2,555)	$411	$(2,144)	$(1,283)	$(1,085)	$(2,368)
Mortgage-backed securities and other investments	(55)	(154)	(209)	11	(309)	(298)
FHLB stock and equity securities	1	--	1	(4)	--	(4)
Interest-bearing deposits	--	(9)	(9)	(72)	112	40
Total net change in income on interest-earning assets	(2,609)	248	(2,361)	(1,348)	(1,282)	(2,630)
Interest-bearing liabilities:						
Savings accounts	(286)	72	(214)	(61)	66	5
Money market accounts	(180)	79	(101)	(220)	(21)	(241)
NOW accounts	(728)	(36)	(764)	(515)	180	(335)
Certificates of deposit	(744)	(362)	(1,106)	(1,216)	115	(1,101)
Short-term borrowings	--	--	--	(1)	(1)	(2)
Long-term borrowings	(88)	(313)	(401)	212	(966)	(754)
Total net change in expense on interest-bearing liabilities	(2,026)	(559)	(2,586)	(1,801)	(627)	(2,428)
Net change in net interest income	$(583)	$808	$225	$453	$(655)	$(202)

(1) Excludes interest on loans on non-accrual status. Includes loans originated for sale.

Liquidity and Capital Resources

The Bank's primary sources of funds are customer deposits, proceeds from principal and interest payments on loans, the sale of loans, maturing securities and FHLB advances. While the maturity and scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, to satisfy other financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At September 30, 2012, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was 20.31%. At September 30, 2012, the Bank maintained an uncommitted credit facility with the FHLB that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which $45.0 million was outstanding. The Bank also maintains a short-tem borrowing line with the Federal Reserve Bank with total credit based on eligible collateral. At September 30, 2012 the Bank had no outstanding balance on this borrowing line.

Liquidity management is both a short and long-term responsibility of the Bank's management. The Bank adjusts its investments in liquid assets based upon management's assessment of (i) expected loan demand, (ii) projected loan sales, (iii) expected deposit flows, and (iv) yields available on interest- bearing deposits. Excess liquidity is invested generally in interest-bearing overnight deposits and other short-term government and agency obligations. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB and collateral for repurchase agreements.

The Bank's primary investing activity is the origination of mortgage loans. During the years ended September 30, 2012, 2011 and 2010, the Bank originated $215.0 million, $142.4 million and $154.1 million of mortgage loans, respectively. At September 30, 2011, the Bank had loan commitments totaling $31.8 million and undisbursed loans in process totaling $16.3 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. Certificates of deposit that are scheduled to mature in less than one year from September 30, 2012 totaled $131.7 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Bank’s liquidity is also affected by the volume of loans sold and loan principal payments. During the years ended September 30, 2012, 2011 and 2010, the Bank sold $97.4 million, $62.5 million and $68.3 million in fixed rate, one- to four-family mortgage loans, respectively. During the years ended September 30, 2012, 2011 and 2010, the Bank received $121.1 million, $96.7 million and $150.3 million in principal repayments, respectively.

The Bank’s liquidity has been impacted by increases in deposit levels. During the years ended September 30, 2012, 2011 and 2010, deposits increased by $5.2 million, $13.8 million and $73.2 million, respectively.

Cash and cash equivalents, certificate of deposits held for investment and mortgage-backed securities and other investments decreased to $128.4 million at September 30, 2012 from $141.6 million at September 30, 2011.

Sources of capital and liquidity for the Company include distributions from the Bank and the issuance of debt or equity securities. Dividends and other capital distributions from the Bank are subject to regulatory restrictions and approval. For additional information regarding the Bank's restrictions on the payment of dividends, see "Item 1A, Risk Factors The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. At September 30, 2012, the Bank was in compliance with all applicable capital requirements, including the higher Tier 1 leverage capital ratio that the Bank was required to comply with under the terms of the Bank MOU that was in effect at September 30, 2012. For additional details see Note 18 of the Notes to Consolidated Financial Statements contained in “Item 8. Financial Statements and Supplementary Data” and “Item 1. Business - Regulation of the Bank - Capital Requirements.”

Contractual obligations. The following table presents, as of September 30, 2012, the Company's significant fixed and determinable contractual obligations, within the categories described below, by payment date or contractual maturity. These contractual obligations, except for the operating lease obligations are included in the Consolidated Balance Sheet. The payment amounts represent those amounts contractually due at September 30, 2012.

	Payments due by period				
Contractual obligations	Less than 1 year	1 year through 3 years	After 3 years through 5 years	After 5 years	Total
			(In thousands)		
Short-term debt obligations	$855	$--	$--	$--	$855
Long-term debt obligations	--	--	--	45,000	45,000
Operating lease obligations	211	144	144	95	594
Total contractual obligations	$1,066	$144	$144	$45,095	$46,449

Effect of Inflation and Changing Prices

The consolidated financial statements and related financial data presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America which require the measurement of financial position and operating results in terms of historical dollars, without considering the change in the relative purchasing power of money over time due to inflation. The primary impact of inflation on the operation of the Company is reflected in increased operating costs. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on a financial institution's performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The information contained under "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk and Asset and Liability Management" of this Form 10-K is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data

Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention of overriding controls. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of September 30, 2012.

TIMBERLAND BANCORP, INC. AND SUBSIDIARY

Index to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of Timberland Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of Timberland Bancorp, Inc. and Subsidiary (collectively, "the Company") as of September 30, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for each of the years in the three-year period ended September 30, 2012. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended September 30, 2012 in conformity with accounting principles generally accepted in the United States of America.

/s/ Delap LLP

Lake Oswego, Oregon
December 17, 2012

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary
September 30, 2012 and 2011

	2012	2011
Assets		
Cash and cash equivalents:		
Cash and due from financial institutions	$11,008	$11,455
Interest-bearing deposits in banks	85,660	100,610
Total cash and cash equivalents	96,668	112,065
Certificates of deposit (“CDs”) held for investment (at cost which approximates fair value)	23,490	18,659
Mortgage-backed securities (“MBS”) and other investments - held to maturity, at amortized cost (estimated fair value $3,632 and $4,229)	3,339	4,145
MBS and other investments - available for sale	4,945	6,717
Federal Home Loan Bank of Seattle (“FHLB”) stock	5,655	5,705
Loans receivable, net of allowance for loan losses of $11,825 and $11,946	537,053	523,980
Loans held for sale	1,427	4,044
Net loans receivable	538,480	528,024
Premises and equipment, net	17,886	17,390
Other real estate owned (“OREO”) and other repossessed assets, net	13,302	10,811
Accrued interest receivable	2,183	2,411
Bank-owned life insurance (“BOLI”)	16,524	15,917
Goodwill	5,650	5,650
Core deposit intangible (“CDI”)	249	397
Mortgage servicing rights (“MSRs”), net	2,011	2,108
Prepaid Federal Deposit Insurance Corporation (“FDIC”) insurance assessment	1,186	2,103
Other assets	5,386	6,122
Total assets	$736,954	$738,224
Liabilities and shareholders’ equity		
Liabilities:		
Deposits		
Non-interest-bearing demand	$75,296	$64,494
Interest-bearing	522,630	528,184
Total deposits	597,926	592,678
FHLB advances	45,000	55,000
Repurchase agreements	855	729
Other liabilities and accrued expenses	2,854	3,612
Total liabilities	646,635	652,019

Commitments and contingencies (See Note 16)	--	--
Shareholders' equity		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; 16,641 shares, Series A, issued and outstanding; redeemable at $1,000 per share	16,229	15,989
Common stock, $0.01 par value; 50,000,000 shares authorized; 7,045,036 shares issued and outstanding	10,484	10,457
Unearned shares issued to Employee Stock Ownership Plan ("ESOP")	(1,719)	(1,983)
Retained earnings	65,788	62,270
Accumulated other comprehensive loss	(463)	(528)
Total shareholders' equity	90,319	86,205
Total liabilities and shareholders' equity	$736,954	$738,224

See notes to consolidated financial statements.

Consolidated Statements of Operations

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary
Years Ended September 30, 2012, 2011 and 2010

	2012	2011	2010
Interest and dividend income			
Loans receivable	$30,831	$32,976	$35,344
MBS and other investments	404	612	910
Dividends from mutual funds and FHLB stock	32	31	35
Interest-bearing deposits in banks	338	347	307
Total interest and dividend income	31,605	33,966	36,596
Interest expense			
Deposits	3,951	6,136	7,807
FHLB advances – long-term	1,996	2,397	3,151
Federal Reserve Bank of San Francisco (“FRB”) borrowings and repurchase agreements	--	--	3
Total interest expense	5,947	8,533	10,961
Net interest income	25,658	25,433	25,635
Provision for loan losses	3,500	6,758	10,550
Net interest income after provision for loan losses	22,158	18,675	15,085
Non-interest income			
Other than temporary impairment (“OTTI”) on MBS and other investments	(206)	(236)	(998)
Adjustment for portion recognized in other comprehensive loss (before taxes)	(8)	(211)	(1,178)
Net OTTI on MBS and other investments	(214)	(447)	(2,176)
Realized losses on MBS and other investments	--	(2)	(20)
Gains on sales of MBS and other investments	22	79	--
Service charges on deposits	3,795	3,907	4,240
ATM and debit card interchange transaction fees	2,172	1,911	1,619
BOLI net earnings	607	517	491
Gains on sales of loans, net	2,472	1,548	1,547
Escrow fees	118	73	74
Fee income from non-deposit investment sales	71	92	84
Valuation recovery (allowance) on MSRs, net	10	405	(890)
Other	728	598	727
Total non-interest income, net	9,781	8,681	5,696

See notes to consolidated financial statements.

Consolidated Statements of Operations (continued)

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary
Years Ended September 30, 2012, 2011 and 2010

	2012	2011	2010
Non-Interest expense			
Salaries and employee benefits	$12,050	$12,578	$12,066
Premises and equipment	2,676	2,648	2,768
Advertising	726	800	829
OREO and other repossessed assets, net	1,982	1,374	882
ATM	794	802	698
Postage and courier	501	540	539
Amortization of CDI	148	167	191
State and local taxes	608	622	626
Professional fees	822	753	664
FDIC insurance	942	1,161	1,659
Other insurance	212	359	435
Loan administration and foreclosure	816	959	481
Data processing and telecommunications	1,265	1,172	941
Deposit operations	776	675	478
Other	1,250	1,353	1,384
Total non-interest expense	25,568	25,963	24,641
Income (loss) before income taxes	6,371	1,393	(3,860)
Provision (benefit) for federal and state income taxes	1,781	304	(1,569)
Net income (loss)	4,590	1,089	(2,291)
Preferred stock dividends	(832)	(832)	(832)
Preferred stock discount accretion	(240)	(225)	(210)
Net Income (loss) to common shareholders	$3,518	$32	$(3,333)
Net income (loss) per common share			
Basic	$0.52	$0.00	$(0.50)
Diluted	0.52	0.00	(0.50)

See notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income (Loss)

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary
Years Ended September 30, 2012, 2011 and 2010

	2012	2011	2010
Comprehensive income (loss)			
Net income (loss)	$4,590	$1,089	$(2,291)
Unrealized holding gain on securities available for sale, net of tax	14	14	491
Change in OTTI on securities held to maturity, net of tax:			
Additions	(27)	(65)	(23)
Additional amount recognized related to credit loss for which OTTI was previously recognized	8	16	580
Amount reclassified to credit loss for previously recorded market loss	24	188	209
Accretion of OTTI securities held to maturity, net of tax	46		