First Financial Northwest, Inc.
Form 10-Q
September 20, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007

or

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

For the transition period from _____ to _____

Commission File Number: 001-33652

FIRST FINANCIAL NORTHWEST, INC.

(Exact name of registrant as specified in its charter)

United States	**26-0610707**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer I.D. Number)
201 Wells Avenue South, Renton, Washington	**98057**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(425) 255-4400**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]*

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of June 30, 2007, no shares of the issuer's common stock, $.01 par value per share, were outstanding.*

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* The issuer became subject to the filing requirements of Sections 13 and 15(d) when its Registration Statement on Form S-1 ("Registration Statement") was declared effective by the Securities and Exchange Commission on August 10, 2007. The Registration Statement included financial statements for the year ended December 31, 2006 and for the three months ended March 31, 2007. Therefore, this Form 10-Q is being filed pursuant to Rule 13a-13 of the Securities Exchange Act of 1934, as amended, in order to file financial statements for the second fiscal quarter subsequent to the year reported in the Registration Statement.

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FIRST FINANCIAL NORTHWEST, INC.
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PART 1 - FINANCIAL INFORMATION

Item 1 - Financial Statements

First Financial Northwest, Inc., a Washington corporation, was formed in connection with the conversion of First Financial Holdings, MHC from the mutual to the stock form of organization. As of the date hereof, the conversion has not been completed and First Financial Northwest, Inc. has not issued any shares of its common stock, and has no assets or liabilities, and has not conducted any business other than that of an organizational nature. For a further discussion of First Financial Northwest, Inc.'s formation and operations, see the Registration Statement. Based on the foregoing, the information presented in this Form 10-Q is for First Financial Holdings, MHC and its subsidiary, First Financial of Renton, Inc., and First Savings Bank of Renton.

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Item 1. Financial Statements

FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY

Consolidated Balance Sheets

(Dollars in Thousands)

(Unaudited)

Assets	June 30, 2007	December 31, 2006
Cash on hand and in banks	$ 21,341	12,135
Interest-bearing deposits	604	7,238
Federal funds sold	13,515	7,290
Mortgage servicing rights	1,343	1,560
Investment securities available for sale	131,910	149,051
Investment securities held to maturity (fair value of $85,862 and $87,724, respectively)	86,376	86,786

Loans receivable, net of allowances for loan losses of $2,946 and $1,971, respectively	790,540	700,328
Premises and equipment, net	13,668	13,737
Federal Home Loan Bank stock, at cost	4,671	4,671
Accrued interest receivable	5,034	4,710
Prepaid expenses and other assets	3,249	2,363
Federal income tax receivable	150	636
Deferred tax assets, net	990	--
Goodwill	14,206	14,206
Total assets		

	$	1,087,597	1,004,711
Liabilities and Equity			
Liabilities:			
Deposits	$	866,542	750,710
Accrued interest payable		171	176
Advances from Federal Home Loan Bank		110,000	147,000
Advance payments by borrowers for taxes and insurance		1,886	1,105
Other liabilities		1,937	1,622
Deferred tax liabilities, net		--	56
Total liabilities			

		980,536
		900,669
Commitments and contingencies		
Equity:		
Retained earnings		
		110,473
		106,753
Accumulated other comprehensive (loss), net of tax		
		(3,412)
		(2,711)
Total equity		
		107,061
		104,042
Total liabilities and equity		
	$	
		1,087,597
		1,004,711

See accompanying notes to unaudited consolidated financial statements.

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FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY

Consolidated Statements of Income

(Dollars in Thousands)

(Unaudited)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Interest income:				
Interest and fees on loans	$ 13,445	10,594	26,144	20,639
Interest on federal funds sold	100	85	205	170
Investment securities available for sale	1,516	1,872	3,120	3,750
Investment securities held to maturity	73	58	146	111
Tax-exempt investment securities held to maturity	880	893	1,762	1,787
Interest bearing deposits with banks	79	79	185	273
Dividends on Federal Home Loan Bank stock	7	--	12	--
Total interest income	16,100	13,581	31,574	26,730
Interest expense:				
Interest expense on deposits	8,846	7,479	17,554	14,366
Interest expense on Federal Home Loan Bank advances	2,324	1,457	4,390	2,490
Total interest expense	11,170	8,936	21,944	16,856
Net interest income	4,930	4,645	9,630	9,874
Provision for loan losses	375	160	975	320
Net interest income after provision for loan losses	4,555	4,485	8,655	9,554
Noninterest income:				
Other	59	38	89	1
Total noninterest income	59	38	89	1
Noninterest expense:				
Salaries and employee benefits	1,273	1,082	2,245	1,917
Occupancy and equipment	276	323	525	614
Other general and administrative	465	451	1,068	1,083
Total noninterest expense	2,014	1,856	3,838	3,614
Income before federal income taxes	2,600	2,667	4,906	5,941
Federal income tax expense	638	504	1,186	1,493
Net income	$ 1,962	2,163	3,720	4,448

See accompanying notes to unaudited consolidated financial statements.

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FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY
Consolidated Statements of Equity and Comprehensive Income

(Dollars in Thousands)

(Unaudited)

		Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net	Total
Balances at December 31, 2005	$	99,665	(3,312)	96,353
Comprehensive income:				
Net income		7,088		7,088
Other comprehensive income, net of tax:				
Decrease in unrealized losses on securities available for sale, net of tax		--	601	601
Total comprehensive income				7,689
Balances at December 31, 2006		106,753	(2,711)	104,042
Comprehensive income:				
Net income		3,720		3,720
Other comprehensive loss, net of tax:				
Increase in unrealized losses on securities available for sale, net of tax		--	(701)	(701)
Total comprehensive income				3,019
Balances at June 30, 2007	$	110,473	(3,412)	107,061

See accompanying notes to unaudited consolidated financial statements.

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FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY
Consolidated Statements of Cash Flows
(Dollars in Thousands)
(Unaudited)

		Six Months Ended June 30, 2007	2006
Cash flows from operating activities:			
Net income	$	3,720	4,448
Adjustments to reconcile net income to net cash provided by operating activities, net of effect of acquisition:			
Provision for loan losses		975	320
Depreciation and amortization of			

premises and equipment	361	360
Amortization of mortgage servicing rights	217	378
Loss from disposal of premises and equipment		43
Net amortization of premiums and discounts on investment securities	547	723
Mutual funds dividends	(148)	(119)
Deferred federal income taxes	(686)	(284)
Cash provided by (used in) changes in operating assets and liabilities:		
Net (increase) decrease in other assets	(886)	194
Net (increase) in accrued interest receivable	(324)	(95)
Net increase (decrease) in accrued interest payable	(6)	20
Net increase in advance payments	781	7
Net increase (decrease) in other liabilities	316	(803)
Net (increase) decrease in federal income taxes payable and receivable	485	(836)
Net cash provided by operating activities	5,352	4,356
Cash flows from investing activities, net of affect of acquisition:		
Proceeds from principal repayments on mortgage-backed securities available for sale	15,781	19,287
Proceeds from principal repayments on mortgage-backed securities and related securities held to maturity	110	70
Proceeds from maturities of investment securities held to maturity	710	570
Purchases of investment securities available for sale	(509)	(2,027)
Purchases of mortgage-backed securities available for sale	-	(3,894)
Purchases of investment securities held to maturity	-	(943)
Origination and purchases of loans receivable, net of principal repayments	(91,186)	(98,471)
Purchases of premises and equipment	(293)	(500)
Net cash used in investing activities	(75,387)	(85,908)

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FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY
Consolidated Statements of Cash Flows, Continued
(Dollars in Thousands)
(Unaudited)

		Six Months Ended June 30,	
		2007	2006
Cash flows from financing activities:			
Advances from Federal Home Loan Bank		63,000	35,000
Repayments of advances from Federal Home Loan Bank		(100,000)	--
Net increase in deposits		115,832	37,249
Net cash provided by financing activities		78,832	72,249
Net increase (decrease) in cash		8,797	(9,303)
Cash and cash equivalents at beginning of period		26,663	26,183
Cash and cash equivalents at end of period	$	35,460	16,880
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest	$	21,949	16,876
Federal income taxes		1,387	2,007

See accompanying notes to unaudited consolidated financial statements.

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FIRST FINANCIAL HOLDINGS, MHC
AND SUBSIDIARY

Notes to the Unaudited Consolidated Financial Statements

Note 1 -- Nature of Business

First Financial Holdings, MHC is a mutual holding company incorporated in the State of Washington in June 2002. First Financial Holdings, MHC is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiary First Financial of Renton, Inc., a mid tier bank holding company.

First Savings Bank of Renton is a Washington-chartered stock savings bank and is the wholly owned subsidiary of First Financial of Renton, Inc. First Savings Bank is a community-based savings bank primarily serving King and to a lesser extent, Pierce and Snohomish counties, Washington through a full-service banking office and automated teller machine. First Savings Bank's business consists of attracting deposits from the public and utilizing those deposits, along with its subsidiary Executive House, Inc., to originate one-to-four, multifamily, construction/land development, commercial and consumer loans.

Note 2 -- Basis of Presentation

The accompanying consolidated financial statements have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These consolidated financial statements should be read with our December 31, 2006 audited consolidated financial statements and its accompanying notes included in our Registration Statement on Form S-1. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. In preparing the consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expense. Actual results could differ from those estimates.

Note 3 -- Plan of Reorganization

On November 15, 2006, the Board of Directors of First Financial Holdings, MHC and its subsidiary, First Financial of Renton, Inc., and First Savings Bank, adopted, and on April 18, 2007, July 18, 2007 and July 31, 2007, amended, a Plan of Conversion and Reorganization, pursuant to which First Financial Holdings, MHC will convert from a mutual holding company structure to a stock holding company structure. In connection with the conversion, a new stock holding company, First Financial Northwest, Inc., was incorporated on June 1, 2007 under the laws of the state of Washington. As provided in the Plan of Conversion and Reorganization, First Financial Northwest, Inc. will offer and sell shares of its common stock to eligible depositors of First Savings Bank, and, possibly, the public.

The conversion is subject to the approval of First Financial Holdings, MHC's members, which consist of the depositors and borrowers of First Savings Bank, First Financial Holdings, MHC has received conditional approval of the conversion from the Office of Thrift Supervision and the Washington Department of Financial Institutions. In addition, the offering of First Financial Northwest, Inc.'s common stock has been approved by the Office of Thrift Supervision and the Securities and Exchange Commission. Following the completion of the conversion, First

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Financial Holdings, MHC and First Financial of Renton, Inc. will cease to exist as separate legal entities and First Savings Bank will become a wholly-owned subsidiary of First Financial Northwest, Inc. to be known as "First Savings Bank Northwest."

First Financial Northwest, Inc.'s common stock offered will be priced based upon the estimated pro forma market value of First Financial Holdings, MHC First Financial of Renton and First Savings Bank of Renton as determined by an independent appraisal. The cost of the conversion and issuing the capital stock will be deferred and deducted from the proceeds of the offering. In the event the conversion and offering is not completed, any deferred costs will be charged to operations. Through June 30, 2007, First Financial Holdings, MHC had incurred approximately $1.3 million in conversion costs which are included in other assets.

As part of the conversion and reorganization, First Savings Bank is electing to be treated as a savings association. As a result, First Financial Northwest, Inc., as a savings and loan holding company, will be subject to the regulations of the Office of Thrift Supervision. First Savings Bank will continue to be regulated by the Federal Deposit Insurance Corporation and the Washington Department of Financial Institutions.

Additionally, in accordance with Office of Thrift Supervision regulations, at the time of the conversion from a mutual holding company to a stock holding company, First Savings Bank will substantially restrict retained earnings by establishing a liquidation account. The liquidation account will be maintained for the benefit of eligible holders who continue to maintain their accounts at First Savings Bank after the conversion. The liquidation account will be reduced annually to the extent that eligible account holders have reduced their qualifying deposits. Subsequent increases will not restore an eligible account holder's interest in the liquidation account. In the event of a complete liquidation of the First Savings Bank, and only in such event, each account holder will be entitled to receive a distribution from the liquidation account in an amount proportionate to the adjusted qualifying account balances then held. First Savings Bank may not pay dividends if those dividends would reduce equity capital below the required liquidation account amount.

Note 4 -- Recently Issued Accounting Pronouncements

Effective January 1, 2007, we adopted Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of June 30, 2007 and January 1, 2007, we had an insignificant amount of unrecognized tax benefits. Our policy is to recognize interest and penalties on unrecognized tax benefits in Federal income tax expense in the Consolidated Statements of Income. The amount of interest and penalties for the three and six months ended June 30, 2007 was immaterial. The tax years subject to examination by the federal taxing authorities are the years end December 31, 2006, 2005, 2004, and 2003. First Financial Holdings, MHC is not subject to state income tax.

On February 15, 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. This statement further establishes certain additional disclosure requirements. This statement is effective for financial statements issued for the year beginning on January 1, 2008, with earlier adoption permitted. Management is currently evaluating the impact and timing of the adoption of this statement of our financial condition and results of operations.

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On September 15, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. This statement defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This statement is effective for financial statements issued for the year beginning on January 1, 2008, with earlier adoption permitted. Management is currently evaluating the impact and timing of the adoption of this statement on our financial condition and results of operations.

Note 5 -- Investment Securities Available for Sale

Investment securities available for sale are summarized as follows:

	June 30, 2007				
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(Dollars in Thousands)			
Mortgage-backed and related securities:					
FNMA certificates	$	75,730	31	3,080	72,681
FHLMC certificates		41,294	8	1,788	39,514
GNMA certificates		12,079	10	165	11,924
U.S. Government agencies		2,009	--	13	1,996
Mutual funds (1)		5,967	--	172	5,795
	$	137,079	49	5,218	131,910

	December 31, 2006				
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(Dollars in Thousands)			
Mortgage-backed and related securities:					
FNMA certificates	$	85,195	30	2,450	82,775
FHLMC certificates		45,816	14	1,325	44,505
GNMA certificates		14,315	--	224	14,091
U.S. Government agencies		2,015	--	6	2,009
Mutual funds (1)		5,819	--	148	5,671
	$	153,160	44	4,153	149,051

(1) The fund invests primarily in private label securities backed by or representing an interest in mortgages or domestic residential housing or manufactured housing with additional investments in U.S. Government or agency securities.

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The amortized cost and estimated fair value of investment and mortgage-backed and related securities available for sale at June 30, 2007, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2007	
	Amortized Cost	Fair Value

		(Dollars in Thousands)	
Due within one year	$	5,967	5,795
Due after one year through five years		958	942
Due after five years through 10 years		43,785	42,198
Due after ten years		86,369	82,975
	$	137,079	131,910

Incorporated within the above maturity schedule are mortgage-backed securities which are allocated using the contractual maturity as a basis.

There were no sales of investment securities available for sale during the three or six months ended June 30, 2007 and 2006.

Note 6 - Investment Securities Held to Maturity

The amortized cost and estimated fair value of investment securities held to maturity are as follows:

		June 30, 2007			
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
			(Dollars in Thousands)		
Tax-exempt municipal bonds	$	77,832	573	853	77,552
Taxable muncipal bonds		1,666	--	44	1,622
U.S. Government agencies		3,943	--	74	3,869
Mortgage-backed and related securities:					
FNMA certificates		2,935	--	116	2,819
	$	86,376	573	1,087	85,862

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		December 31, 2006			
		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
			(Dollars in Thousands)		
Tax-exempt municipal bonds	$	78,598	1,386	323	79,661
Taxable muncipal bonds		1,678	4	20	1,662
U.S. Government agencies		3,443	4	46	3,401
Mortgage-backed and related securities:					
FNMA certificates		3,067	--	67	3,000

	$ 86,786	1,394	456	87,724

The amortized cost and fair value of investment securities held to maturity at June 30, 2007, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2007	
	Amortized Cost	Fair Value
Due within one year	$ 300	301
Due after one year through five years	13,316	13,142
Due after five years through ten years	20,334	20,168
Due after ten years	52,426	52,251
Total	$ 86,376	85,862

There were no sales of investment securities held to maturity during the three or six months ended June 30, 2007 and 2006.

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

	June 30, 2007					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(Dollars in Thousands)					
FNMA certificates	$ 911	(35)	70,860	(3,161)	71,771	(3,196)
FHLMC certificates	--	--	38,458	(1,788)	38,458	(1,788)
GNMA certificates	--	--	8,092	(164)	8,092	(164)
Mutual funds	--	--	5,967	(172)	5,967	(172)
Other	--	--	1,996	(13)	1,996	(13)
Municipal bonds	12,052	(189)	20,806	(708)	32,858	(897)
U.S. Government agencies	501	(8)	3,369	(67)	3,870	(75)
	$ 13,464	(232)	149,548	(6,073)	163,012	(6,305)

Temporarily impaired investment securities are a result of market value changes and are expected to regain the lost value with market shifts; other-than-temporarily impaired investment securities can result from events such as a significant adverse change in the regulatory, economic or technological environment of the issuer; an adverse change in the general market condition of the geographical area or industry in which the issuer operates; a significant deterioration in the earning performance, credit rating or asset quality of the issuer, which would lead management to believe the security is other than temporarily impaired.

We had no investment securities at June 30, 2007 with other-than-temporary impairments.

Certain investment securities shown above currently have fair values less than amortized cost and therefore contain unrealized losses. We have evaluated these investment securities and has determined that the decline in value is temporary. For fixed income investment securities, the unrealized loss is related to the change in market interest rates since purchase. The decline in value is not related to any company or industry specific event. We anticipate full recovery of amortized cost with respect to these investment securities at maturity or sooner in the event of a more favorable market interest rate environment and has the ability

and the intent to hold these investment securities until recovery. Given that the mutual fund invests primarily in mortgage-related investments with interest rate adjustment features and the rise in short-term rates, we do not believe the unrealized loss on the mutual fund is other than temporary and has the intent and ability to hold this investment until recovery.

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Note 8 - Loans Receivable

Loans receivable consist of the following:

		June 30, 2007	December 31, 2006
		(Dollars in Thousands)	
One to four family residential	$	394,554	373,192
Multi-family residential		81,974	79,701
Commercial real estate		176,157	153,924
Construction and land development		227,655	153,401
Home equity		5,153	3,038
Savings account loans		160	296
Other loans		187	203
		885,840	763,755
Less:			
Loans in process		89,222	58,731
Deferred loan fees		3,132	2,725
Allowance for loan losses		2,946	1,971
	$	790,540	700,328

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

Forward-Looking Statements

This report contains forward-looking statements, which can be identified by the use of words such as "believes," "expects," "anticipates," "estimates" or similar expressions. Forward-looking statements include, but are not limited to:

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

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- changes in consumer spending, borrowing and savings habits;
- our ability to successfully manage its growth;
- legislative or regulatory changes that adversely affect our business;
- adverse changes in the securities markets; and
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board.

Any of the forward-looking statements that we make in this Form 10-Q and in the other public statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no obligation to publish revised forward-looking statements to reflect the occurrence of unanticipated events or circumstances after the date hereof.

Overview

First Savings Bank is a community-based savings bank primarily serving King and to a lesser extent, Pierce and Snohomish counties, Washington through our full-service banking office and automated teller machine. The local economy and housing market has remained relatively strong as compared to other parts of the country. We are in the business of attracting deposits from the public through our office and utilizing those deposits to originate loans. Historically, we have been a traditional fixed rate portfolio lender originating residential home loans. We do not participate in the subprime mortgage

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market. Our business strategy centers on the continued transition to commercial banking activities in order to expand our net interest margin. Since December 31, 2002 we have increased the amount of our construction/land development loans from 2.42% to 25.70% of our total loan portfolio at June 30, 2007 while reducing our one-to-four-family residential loans from 64.36% to 44.54% over the same period. At June 30, 2007 our construction/land development loans totaled $227.7 million or 25.70% of our loan portfolio, substantially all which are short-term adjustable rate loans. In contrast, our residential mortgage loans, commercial real estate and multi-family loans that comprise almost all of the balance of our loan portfolio are generally long term fixed rate loans.

Our primary source of pre-tax income is net interest income. Net interest income is the difference between interest income, which is the income that we earn on our loans and investments, and interest expense, which is the interest that we pay on our deposits and borrowings. Changes in levels of interest rates affect our net interest income. The recent interest rate environment, which has caused short-term market interest rates to rise, while longer term interest rates have not, has had a negative impact on our interest rate spread and net interest margin, which has reduced profitability and caused a decrease in our return on average assets and return on average equity. To offset the negative impact the current interest rate environment is having on our profitability, we are seeking to find means of increasing interest income while controlling expenses. Consistent with this strategy, we acquired Executive House and are working to further reduce the percentage of our assets that are lower-yielding residential loans and mortgage-backed securities and to increase the percentage of our assets consisting of construction/land development loans, commercial real estate and multi-family loans that have higher risk-adjusted returns. Although historically our loan losses have been low, we expect to increase our allowance for loan losses and allocate more of our allowance to non-residential loans consistent with any increase in the percentage of our loan portfolio mix these loans represent.

Our operating expenses consist primarily of compensation and benefits, occupancy and equipment, data processing, marketing, postage and supplies, professional services and deposit insurance premiums. Compensation and benefits consist primarily of the salaries and wages paid to our employees, payroll taxes and expenses for retirement and other employee benefits. Occupancy and