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Sound Financial Bancorp, Inc.
Form 10-Q
May 13, 2016

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

FORM 10-Q

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

For the quarterly period ended March 31, 2016

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 001-35633

Sound Financial Bancorp, Inc.
(Exact Name of Registrant as Specified in its Charter)

Maryland 45-5188530
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

2005 5th Avenue, Suite 200, Seattle, Washington 98121
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (206) 448-0884

None

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate website, 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 NO

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if smaller reporting company)

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

As of May 10, 2016, there were 2,481,389 shares of the registrant's common stock outstanding.

SOUND FINANCIAL BANCORP, INC.
 FORM 10-Q
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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Balance Sheets (unaudited)

(In thousands, except share amounts)

| | March 31, 2016 | December 31, 2015 |
|---|-------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 49,679 | \$ 48,264 |
| Available-for-sale securities, at fair value | 6,286 | 6,696 |
| Loans held for sale | 1,186 | 2,091 |
| Loans | 462,432 | 459,469 |
| Allowance for loan losses | (4,709) | (4,636) |
| Total loans, net | 457,723 | 454,833 |
| Accrued interest receivable | 1,595 | 1,608 |
| Bank-owned life insurance (“BOLI”), net | 11,830 | 11,746 |
| Other real estate owned (“OREO”) and repossessed assets, net | 832 | 769 |
| Mortgage servicing rights, at fair value | 3,095 | 3,249 |
| Federal Home Loan Bank (“FHLB”) stock, at cost | 1,903 | 2,212 |
| Premises and equipment, net | 5,252 | 5,335 |
| Other assets | 4,157 | 3,957 |
| Total assets | \$ 543,538 | \$ 540,760 |
| LIABILITIES | | |
| Deposits | | |
| Interest-bearing | 393,473 | 389,151 |
| Noninterest-bearing demand | 54,648 | 50,873 |
| Total deposits | 448,121 | 440,024 |
| Borrowings | 31,374 | 40,435 |
| Accrued interest payable | 82 | 72 |
| Other liabilities | 7,316 | 5,140 |
| Advance payments from borrowers for taxes and insurance | 1,091 | 569 |
| Total liabilities | 487,984 | 486,240 |
| COMMITMENTS AND CONTINGENCIES (NOTE 7) | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, \$0.01 par value, 10,000,000 shares authorized, none issued or Outstanding | - | - |
| Common stock, \$0.01 par value, 40,000,000 shares authorized, 2,481,389 and 2,469,206 shares issued and outstanding as of March 31, 2016 and December 31, 2015, respectively | 25 | 25 |
| Additional paid-in capital | 23,110 | 23,002 |
| Unearned shares - Employee Stock Ownership Plan (“ESOP”) | (911) | (911) |
| Retained earnings | 33,160 | 32,240 |
| Accumulated other comprehensive income, net of tax | 170 | 164 |
| Total stockholders' equity | 55,554 | 54,520 |
| Total liabilities and stockholders' equity | \$ 543,538 | \$ 540,760 |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Income (unaudited)

(In thousands, except shares and per share amounts)

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2016 | 2015 |
| INTEREST INCOME | | |
| Loans, including fees | \$5,952 | \$5,322 |
| Interest and dividends on investments, cash and cash equivalents | 89 | 55 |
| Total interest income | 6,041 | 5,377 |
| INTEREST EXPENSE | | |
| Deposits | 688 | 661 |
| Borrowings | 29 | 28 |
| Total interest expense | 717 | 689 |
| Net interest income | 5,324 | 4,688 |
| PROVISION FOR LOAN LOSSES | | |
| Net interest income after provision for loan losses | 5,174 | 4,588 |
| NONINTEREST INCOME | | |
| Service charges and fee income | 593 | 645 |
| Earnings on cash surrender value of bank-owned life insurance | 84 | 84 |
| Mortgage servicing income | 204 | 255 |
| Fair value adjustment on mortgage servicing rights | (114) | (178) |
| Loss on sale of securities | - | (31) |
| Net gain on sale of loans | 210 | 396 |
| Total noninterest income | 977 | 1,171 |
| NONINTEREST EXPENSE | | |
| Salaries and benefits | 2,563 | 2,255 |
| Operations | 972 | 903 |
| Regulatory assessments | 155 | 66 |
| Occupancy | 385 | 325 |
| Data processing | 386 | 403 |
| Net loss on OREO and repossessed assets | - | 72 |
| Total noninterest expense | 4,461 | 4,024 |
| Income before provision for income taxes | 1,690 | 1,735 |
| Provision for income taxes | 584 | 527 |
| Net income | \$1,106 | \$1,208 |
| Earnings per common share: | | |
| Basic | \$0.45 | \$0.48 |
| Diluted | \$0.43 | \$0.46 |
| Weighted average number of common shares outstanding: | | |
| Basic | 2,477,751 | 2,524,873 |
| Diluted | 2,571,604 | 2,602,161 |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(In thousands)

| | Three Months Ended March | |
|---|--------------------------|----------|
| | 31, | |
| | 2016 | 2015 |
| Net income | \$ 1,106 | \$ 1,208 |
| Available for sale securities: | | |
| Unrealized holding gains arising during the period, net of taxes of \$4 and \$25, respectively | 6 | (85) |
| Reclassification adjustment for net losses realized in earnings, net of tax benefit of \$0 and \$35, respectively | - | 67 |
| Other comprehensive income (loss), net of tax | 6 | (18) |
| Comprehensive income | \$ 1,112 | \$ 1,190 |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Stockholders' Equity
For the Three Months Ended March 31, 2016 and 2015 (unaudited)
(In thousands, except number of shares)

| | Shares | Common Stock | Additional Paid-in Capital | Unearned ESOP Shares | Retained Earnings | Accumulated Other Comprehensive Gain (Loss), net of tax | Total Stockholders' Equity |
|---|-----------|-----------------|----------------------------------|----------------------------|----------------------|--|----------------------------------|
| Balances at December 31, 2014 | 2,524,645 | \$ 25 | \$ 23,552 | \$ (1,140) | \$ 28,024 | \$ 183 | \$ 50,644 |
| Net income | | | | | 1,208 | | 1,208 |
| Other comprehensive loss, net of tax | | | | | | (18) | (18) |
| Share-based compensation | | | 103 | | | | 103 |
| Cash dividends on common stock (\$0.05 per share) | | | | | (125) | | (125) |
| Restricted stock awards | 10,208 | | | | | | - |
| Common stock forfeited and retired | (7,535) | | | | | | - |
| Common stock repurchased | (2,500) | | (48) | | | | (48) |
| Exercise of stock options | 1,133 | | 11 | | | | 11 |
| Balances at March 31, 2015 | 2,525,951 | \$ 25 | \$ 23,618 | \$ (1,140) | \$ 29,107 | \$ 165 | \$ 51,775 |

| | Shares | Common Stock | Additional Paid-in Capital | Unearned ESOP Shares | Retained Earnings | Accumulated Other Comprehensive Gain (Loss), net of tax | Total Stockholders' Equity |
|---|-----------|-----------------|----------------------------------|----------------------------|----------------------|--|----------------------------------|
| Balances at December 31, 2015 | 2,469,206 | \$ 25 | \$ 23,002 | \$ (911) | \$ 32,240 | \$ 164 | \$ 54,520 |
| Net income | | | | | 1,106 | | 1,106 |
| Other comprehensive income, net of tax | | | | | | 6 | 6 |
| Share-based compensation | | | 102 | | | | 102 |
| Cash dividends on common stock (\$0.75 per share) | | | | | (186) | | (186) |
| Restricted stock awards issued | 11,606 | | | | | | - |
| Exercise of stock options | 577 | | 6 | | | | 6 |
| Balances at March 31, 2016 | 2,481,389 | \$ 25 | \$ 23,110 | \$ (911) | \$ 33,160 | \$ 170 | \$ 55,554 |

See notes to condensed consolidated financial statements

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Condensed Consolidated Statements of Cash Flows (unaudited)
(In thousands)

| | Three Months Ended March 31, | |
|---|------------------------------|-----------|
| | 2016 | 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 1,106 | \$ 1,208 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Accretion of net premium on investments | 10 | 42 |
| Loss on sale of securities | - | 31 |
| Provision for loan losses | 150 | 100 |
| Depreciation and amortization | 195 | 145 |
| Compensation expense related to stock options and restricted stock | 102 | 103 |
| Fair value adjustment on mortgage servicing rights | 114 | 178 |
| Additions to mortgage servicing rights | (108) | (217) |
| Amortization of mortgage servicing rights | 148 | 177 |
| Increase in cash surrender value of BOLI | (84) | (84) |
| Gain on sale of loans | (210) | (396) |
| Proceeds from sale of loans | 13,827 | 21,511 |
| Originations of loans held for sale | (12,712) | (21,731) |
| (Gain) loss on sale and write-downs of OREO and repossessed assets | (8) | 38 |
| Change in operating assets and liabilities: | | |
| Accrued interest receivable | 13 | 49 |
| Other assets | (203) | 20 |
| Accrued interest payable | 10 | 9 |
| Other liabilities | 2,176 | (1,335) |
| Net cash (used by) from operating activities | 4,526 | (152) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from principal payments, maturities and sales of available for sale securities | 409 | 2,707 |
| FHLB stock redeemed | 309 | 24 |
| Net decrease (increase) in loans | (2,515) | 6,764 |
| Proceeds from sale of OREO and other repossessed assets | 132 | 231 |
| Purchases of premises and equipment, net | (824) | (194) |
| Net cash from (used by) investing activities | (2,489) | 9,532 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in deposits | 8,097 | 8,411 |
| Proceeds from borrowings | 27,500 | 21,000 |
| Repayment of borrowings | (36,561) | (33,161) |
| Dividends paid on common stock | (186) | (125) |
| Net change in advances from borrowers for taxes and insurance | 522 | 466 |
| Proceeds from stock option exercises | 6 | 11 |
| Repurchase of common stock | - | (48) |
| Net cash used by financing activities | (622) | (3,446) |
| Net increase in cash and cash equivalents | 1,415 | 5,934 |
| Cash and cash equivalents, beginning of period | 48,264 | 29,289 |
| Cash and cash equivalents, end of period | \$ 49,679 | \$ 35,223 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Cash paid for income taxes | \$ 300 | \$ 625 |

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| | | |
|--|--------|--------|
| Interest paid on deposits and borrowings | \$ 707 | \$ 680 |
| Noncash net transfer from loans to OREO and repossessed assets | \$ 187 | \$ 445 |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial Bancorp, Inc., and its wholly owned subsidiary, Sound Community Bank. References in this document to Sound Financial Bancorp refer to Sound Financial Bancorp, Inc. and references to the “Bank” refer to Sound Community Bank. References to “we,” “us,” and “our” or the “Company” means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank, unless the context otherwise requires.

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC on March 30, 2016 (“2015 Form 10-K”). The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2015, included in the 2015 Form 10-K. Certain amounts in the prior quarters’ consolidated financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported consolidated net income, retained earnings, stockholders’ equity or earnings per share.

Note 2 – Accounting Pronouncements Recently Issued or Adopted

In August 2015, the FASB issued ASU No. 2015-15, Interest—Imputation of Interest (Subtopic 835-30), Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements. The ASU provides guidance not previously included in ASU 2015-03 regarding debt issuance related to line-of-credit arrangements. This ASU allows an entity to present debt issuance costs as an asset and subsequently amortize the deferred debt issuance costs over the term of the line-of-credit arrangement, regardless if there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-05 is effective for fiscal years beginning after December 15, 2015. This ASU is not expected to have a material effect on the Company’s consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805). The ASU simplifies the accounting for measurement period adjustments. The amendments require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period when the adjustment amounts are determined. The acquirer is required to record in the same period’s financial statements the effect on earnings from changes in depreciation, amortization, or other income effects resulting from the change to provisional amounts, calculated as if the accounting had been completed at the acquisition date. The acquirer must present separately on the income statement, or disclose in the notes, the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the provisional amount had been recognized at the acquisition date. ASU 2015-16 is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. This ASU is not expected to have a material effect on the Company’s consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. The ASU simplifies accounting for deferred taxes by requiring that all deferred tax assets or liabilities

be classified as noncurrent. This replaces the prior guidance which required deferred taxes to be separated into current and noncurrent amounts. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The adoption of ASU No. 2015-17 is not expected to have a material impact on the Company's consolidated financial statements.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendment requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The amendment also requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU No. 2016-01 is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted for certain provisions. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize, on the balance sheet, the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. A contract novation refers to replacing one of the parties to a derivative instrument with a new party. This ASU clarifies that a change in counterparty in a derivative instrument does not, in and of itself, require dedesignation of that hedging relationship and therefore discontinue the application of hedge accounting. ASU 2016-05 is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted in any interim or annual period. The adoption of ASU 2016-05 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net). The amendments in this ASU require entities to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The adoption of ASU No. 2016-08 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation - Stock Compensation. The ASU includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. The ASU is effective for annual and interim periods beginning after December 15, 2016. The adoption of ASU is being reviewed for any material impact there may be on the Company's consolidated financial statements.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Note 3 – Investments

The amortized cost and fair value of our available-for-sale (“AFS”) securities and the corresponding amounts of gross unrealized gains and losses at the dates indicated were as follows (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
| March 31, 2016 | | | | |
| Municipal bonds | \$ 1,912 | \$ 193 | \$ - | \$ 2,105 |
| Agency mortgage-backed securities | 3,683 | 105 | (22) | 3,766 |
| Non-agency mortgage-backed securities | 434 | - | (19) | 415 |
| Total | \$ 6,029 | \$ 298 | \$ (41) | \$ 6,286 |
| December 31, 2015 | | | | |
| Municipal bonds | \$ 1,912 | \$ 184 | \$ - | \$ 2,096 |
| Agency mortgage-backed securities | 4,088 | 102 | (18) | 4,172 |
| Non-agency mortgage-backed securities | 449 | - | (21) | 428 |
| Total | \$ 6,449 | \$ 286 | \$ (39) | \$ 6,696 |

The amortized cost and fair value of AFS securities at March 31, 2016, by contractual maturity, are shown below (in thousands). Expected maturities of AFS securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | At March 31, 2016 | |
|--------------------------|-------------------|---------------|
| | Amortized Cost | Fair Value |
| Due in five to ten years | \$ 260 | \$ 281 |
| Due after ten years | 5,769 | 6,005 |
| Total | \$ 6,029 | \$ 6,286 |

There were no pledged securities at March 31, 2016 or December 31, 2015.

For the three months ended March 31, 2016, there were no sales of AFS securities. There were sales of \$1.7 million of AFS securities generating gross losses of \$31,000 and no gross gains during the three months ended March 31, 2015.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following tables summarize at the dates indicated the aggregate fair value and gross unrealized loss by length of time of those investments that have been continuously in an unrealized loss position (in thousands):

| | March 31, 2016 | | | | | |
|---------------------------------------|----------------|-----------------|---------------------|-----------------|------------|-----------------|
| | Less Than 12 | | | | | |
| | Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Agency mortgage-backed securities | \$- | \$ - | \$ 1,317 | \$ (22) | \$ 1,317 | \$ (22) |
| Non-agency mortgage-backed securities | - | - | 415 | (19) | 415 | (19) |
| Total | \$- | \$ - | \$ 1,732 | \$ (41) | \$ 1,732 | \$ (41) |

| | December 31, 2015 | | | | | |
|---------------------------------------|-------------------|-----------------|---------------------|-----------------|------------|-----------------|
| | Less Than 12 | | | | | |
| | Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Agency mortgage-backed securities | \$- | \$ - | \$ 1,370 | \$ (18) | \$ 1,370 | \$ (18) |
| Non-agency mortgage-backed securities | - | - | 428 | (21) | 428 | (21) |
| Total | \$- | \$ - | \$ 1,798 | \$ (39) | \$ 1,798 | \$ (39) |

The following table presents the cumulative roll forward of credit losses recognized in earnings during the three months ended March 31, 2016 and 2015 relating to the Company's non-agency mortgage backed securities (in thousands):

| | Three Months Ended | |
|---|--------------------|----------------|
| | March 31, 2016 | March 31, 2015 |
| Estimated credit losses, beginning balance | \$ - | \$ 450 |
| Additions for credit losses not previously recognized | - | - |
| Reduction for increases in cash flows | - | - |
| Reduction of related OTTI due to sales | - | (450) |
| Reduction for realized losses | - | - |
| Estimated credit losses, ending balance | \$ - | \$ - |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

At March 31, 2016, our securities portfolio consisted of 11 agency mortgage-backed securities, one non-agency mortgage-backed security and five municipal securities with a fair value of \$6.3 million. At December 31, 2015, our securities portfolio consisted of 12 agency mortgage-backed securities, one non-agency mortgage-backed securities and five municipal securities with a fair value of \$6.7 million. At March 31, 2016 one of the 11 agency mortgage-backed securities was in an unrealized loss position compared to one of the 12 agency mortgage-backed securities held at December 31, 2015. All of the agency mortgage-backed securities in an unrealized loss position at March 31, 2016 and December 31, 2015 were issued or guaranteed by U.S. governmental agencies. The unrealized losses were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities, and not related to the underlying credit of the issuers or the underlying collateral. It is expected that these securities will not be settled at a price less than the amortized cost of each investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because we do not intend to sell the securities in this class and it is not likely that we will be required to sell these securities before recovery of their amortized cost basis, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered an other-than-temporary impairment (“OTTI”).

As of March 31, 2016 and December 31, 2015, the one non-agency mortgage-backed security was in an unrealized loss position. The unrealized loss was caused by changes in interest rates causing a decline in the fair value subsequent to the purchase. The contractual terms of this investment does not permit the issuer to settle the security at a price less than par. Management does not intend to sell this non-agency mortgage-backed security and it is unlikely that the Company will be required to sell this security before recovery of its amortized cost basis. Management’s impairment evaluation indicated that this security possesses qualitative and quantitative factors that do not suggest an OTTI. These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. Based upon the results of the evaluation of the quantitative and qualitative factors, the non-agency mortgage-backed security does not reflect OTTI during the three months ended March 31, 2016 or the year ended December 31, 2015.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Note 4 – Loans

The composition of the loan portfolio at the dates indicated, excluding loans held for sale, was as follows (in thousands):

| | At March 31, 2016 | At December 31, 2015 |
|----------------------------|-------------------------|----------------------------|
| Real estate loans: | | |
| One- to four- family | \$ 143,104 | \$ 141,125 |
| Home equity | 32,022 | 31,573 |
| Commercial and multifamily | 173,353 | 175,312 |
| Construction and land | 57,752 | 57,043 |
| Total real estate loans | 406,231 | 405,053 |
| Consumer loans: | | |
| Manufactured homes | 14,247 | 13,798 |
| Other consumer | 23,389 | 23,030 |
| Total consumer loans | 37,636 | 36,828 |
| Commercial business loans | 20,230 | 19,295 |
| Total loans | 464,097 | 461,176 |
| Deferred fees | (1,665) | (1,707) |
| Total loans, gross | 462,432 | 459,469 |
| Allowance for loan losses | (4,709) | (4,636) |
| Total loans, net | \$ 457,723 | \$ 454,833 |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of March 31, 2016 (in thousands):

| | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Unallocated | Total |
|---------------------------------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-------------|----------|
| Allowance for loan losses: | | | | | | | | | |
| Individually evaluated for impairment | \$640 | \$140 | \$265 | \$24 | \$63 | \$25 | \$47 | \$- | \$1,204 |
| Collectively evaluated for impairment | 1,093 | 457 | 1,002 | 439 | 139 | 208 | 117 | 50 | 3,505 |
| Ending balance | \$1,733 | \$597 | \$1,267 | \$463 | \$202 | \$233 | \$164 | \$50 | \$4,709 |
| Loans receivable: | | | | | | | | | |
| Individually evaluated for impairment | \$5,465 | \$937 | \$4,912 | \$89 | \$380 | \$27 | \$500 | \$- | \$12,310 |
| Collectively evaluated for | 137,639 | 31,085 | 168,441 | 57,663 | 13,867 | 23,362 | 19,730 | - | 451,787 |

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impairment

| | | | | | | | | | |
|----------------|------------|-----------|------------|-----------|-----------|-----------|-----------|------|------------|
| Ending balance | \$ 143,104 | \$ 32,022 | \$ 173,353 | \$ 57,752 | \$ 14,247 | \$ 23,389 | \$ 20,230 | \$ - | \$ 464,097 |
|----------------|------------|-----------|------------|-----------|-----------|-----------|-----------|------|------------|

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2015 (in thousands):

| | One-to-four family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Unallocated | Total |
|---------------------------------------|--------------------|-------------|----------------------------|-----------------------|--------------------|----------------|---------------------|-------------|-----------|
| Allowance for loan losses: | | | | | | | | | |
| Individually evaluated for impairment | \$647 | \$110 | \$36 | \$18 | \$63 | \$- | \$8 | \$- | \$882 |
| Collectively evaluated for impairment | 1,192 | 497 | 885 | 364 | 238 | 188 | 149 | 241 | 3,754 |
| Ending balance | \$1,839 | \$607 | \$921 | \$382 | \$301 | \$188 | \$157 | \$241 | \$4,636 |
| Loans receivable: | | | | | | | | | |
| Individually evaluated for impairment | \$5,779 | \$904 | \$1,966 | \$91 | \$361 | \$5 | \$114 | \$- | \$9,220 |
| Collectively evaluated for impairment | 135,346 | 30,669 | 173,346 | 56,952 | 13,437 | 23,025 | 19,181 | - | 451,956 |
| Ending balance | \$141,125 | \$31,573 | \$175,312 | \$57,043 | \$13,798 | \$23,030 | \$19,295 | \$- | \$461,176 |

The following table summarizes the activity in allowance for loan losses during the three months ended March 31, 2016 (in thousands):

| | Beginning Allowance | Charge-offs | Recoveries | Provision | Ending Allowance |
|----------------------------|---------------------|-------------|------------|-----------|------------------|
| One-to four- family | \$ 1,839 | \$ (65) | \$ - | \$ (41) | \$ 1,733 |
| Home equity | 607 | - | 2 | (12) | 597 |
| Commercial and multifamily | 921 | - | - | 346 | 1,267 |
| Construction and land | 382 | - | - | 81 | 463 |
| Manufactured homes | 301 | - | 2 | (101) | 202 |
| Other consumer | 188 | (18) | 2 | 61 | 233 |
| Commercial business | 157 | - | - | 7 | 164 |
| Unallocated | 241 | - | - | (191) | 50 |
| Total | \$ 4,636 | \$ (83) | \$ 6 | \$ 150 | \$ 4,709 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in the allowance for loan losses during the three months ended March 31, 2015 (in thousands):

| | Beginning Allowance | Charge-offs | Recoveries | Provision | Ending Allowance |
|----------------------------|------------------------|-------------|------------|-----------|---------------------|
| One-to four- family | \$ 1,442 | \$ (21) | \$ - | \$ 8 | \$ 1,429 |
| Home equity | 601 | (19) | 4 | (72) | 514 |
| Commercial and multifamily | 1,244 | - | - | 162 | 1,406 |
| Construction and land | 399 | - | - | 15 | 414 |
| Manufactured homes | 193 | - | 3 | (12) | 184 |
| Other consumer | 167 | (24) | 6 | 5 | 154 |
| Commercial business | 108 | - | - | (4) | 104 |
| Unallocated | 233 | - | - | (2) | 231 |
| Total | \$ 4,387 | \$ (64) | \$ 13 | \$ 100 | \$ 4,436 |

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

When we classify problem loans as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address the risk specifically (if the loan is impaired) or we may allow the loss to be addressed in the general allowance (if the loan is not impaired). General allowances represent loss reserves which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem loans. When the Company classifies problem loans as a loss, we charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose us to sufficient risk to warrant classification as substandard, doubtful or loss but possess identified weaknesses are classified as either watch or special mention assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by our banking regulators, which can order the establishment of additional loss allowances. Pass rated loans are loans that are not otherwise classified or criticized.

The following table represents the internally assigned grades as of March 31, 2016 by type of loan (in thousands):

| Grade: | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Total |
|--------------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|------------|
| Pass | \$ 138,973 | \$ 30,747 | \$ 166,208 | \$ 52,883 | \$ 14,040 | \$ 23,308 | \$ 19,408 | \$ 445,567 |
| Watch | 1,202 | 586 | 2,764 | 4,869 | 118 | 56 | 433 | 10,028 |
| Special Mention | 1,408 | - | 1,423 | - | 32 | - | - | 2,863 |
| Substandard | 1,521 | 689 | 2,958 | - | 57 | 25 | 389 | 5,639 |
| Doubtful | - | - | - | - | - | - | - | - |
| Loss | - | - | - | - | - | - | - | - |

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| | | | | | | | | |
|-------|------------|----------|------------|-----------|-----------|-----------|-----------|-----------|
| Total | \$ 143,104 | \$32,022 | \$ 173,353 | \$ 57,752 | \$ 14,247 | \$ 23,389 | \$ 20,230 | \$464,097 |
|-------|------------|----------|------------|-----------|-----------|-----------|-----------|-----------|

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table represents the internally assigned grades as of December 31, 2015 by type of loan (in thousands):

| | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Total |
|-------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|------------|
| Grade: | | | | | | | | |
| Pass | \$ 136,879 | \$ 30,310 | \$ 169,072 | \$ 55,984 | \$ 13,621 | \$ 22,967 | \$ 18,449 | \$ 447,282 |
| Watch | 1,015 | 609 | 4,810 | 1,059 | 96 | 58 | 846 | 8,493 |
| Special | | | | | | | | |
| Mention | 1,409 | - | 1,430 | - | 33 | - | - | 2,872 |
| Substandard | 1,822 | 654 | - | - | 48 | 5 | - | 2,529 |
| Doubtful | - | - | - | - | - | - | - | - |
| Loss | - | - | - | - | - | - | - | - |
| Total | \$ 141,125 | \$ 31,573 | \$ 175,312 | \$ 57,043 | \$ 13,798 | \$ 23,030 | \$ 19,295 | \$ 461,176 |

Nonaccrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on nonaccrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment of obligations as they become due, as well as when required by regulatory provisions.

The following table presents the recorded investment in nonaccrual loans as of March 31, 2016 and December 31, 2015, by type of loan (in thousands):

| | March 31, 2016 | December 31, 2015 |
|----------------------|-------------------|----------------------|
| One- to four- family | \$ 981 | \$ 1,157 |
| Home equity | 352 | 344 |
| Manufactured homes | 13 | 27 |
| Other consumer | 24 | - |
| Commercial Business | 7 | - |
| Total | \$ 1,377 | \$ 1,528 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table represents the aging of the recorded investment in past due loans as of March 31, 2016 by type of loan (in thousands):

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days and Greater Past Due | 90 Days and Greater Past Due and Still Accruing | Total Past Due | Current | Total Loans |
|----------------------------|------------------------|---------------------------|---------------------------------------|--|-------------------|------------|----------------|
| One-to four- family | \$ 2,615 | \$ - | \$ 752 | \$ - | \$ 3,367 | \$ 139,737 | \$ 143,104 |
| Home equity | 295 | - | 209 | - | 504 | 31,518 | 32,022 |
| Commercial and multifamily | 2,209 | - | - | - | 2,209 | 171,144 | 173,353 |
| Construction and land | 117 | - | - | - | 117 | 57,635 | 57,752 |
| Manufactured homes | 139 | - | 13 | 17 | 169 | 14,078 | 14,247 |
| Other consumer | 6 | 1 | 24 | - | 31 | 23,358 | 23,389 |
| Commercial business | 157 | - | 7 | - | 164 | 20,066 | 20,230 |
| Total | \$ 5,538 | \$ 1 | \$ 1,005 | \$ 17 | \$ 6,561 | \$ 457,536 | \$ 464,097 |

The following table represents the aging of the recorded investment in past due loans as of December 31, 2015 by type of loan (in thousands):

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days and Greater Past Due | 90 Days and Greater Past Due and Still Accruing | Total Past Due | Current | Total Loans |
|----------------------------|------------------------|---------------------------|---------------------------------------|--|-------------------|------------|----------------|
| One-to four- family | \$ 2,453 | \$ 265 | \$ 881 | \$ 117 | \$ 3,716 | \$ 137,409 | \$ 141,125 |
| Home equity | 352 | 60 | 296 | - | 708 | 30,865 | 31,573 |
| Commercial and multifamily | 203 | - | - | - | 203 | 175,109 | 175,312 |
| Construction and land | 65 | - | - | - | 65 | 56,978 | 57,043 |
| Manufactured homes | 103 | 27 | - | - | 130 | 13,668 | 13,798 |
| Other consumer | 17 | 26 | - | - | 43 | 22,987 | 23,030 |
| Commercial business | 154 | 8 | - | - | 162 | 19,133 | 19,295 |
| Total | \$ 3,347 | \$ 386 | \$ 1,177 | \$ 117 | \$ 5,027 | \$ 456,149 | \$ 461,176 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Nonperforming Loans. Loans are considered nonperforming when they are placed on nonaccrual and/or when they are considered to be nonperforming troubled debt restructurings (“TDRs”) and/or when they are 90 days or greater past due and still accruing interest. A TDR is a loan to a borrower who is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession of some kind. Once a TDR has performed according to its modified terms for six months and the collection of principal and interest under the revised terms is deemed probable, we remove the TDR from nonperforming status. Nonperforming TDRs include TDRs that are not considered performing or TDRs that have become 31 or more days past due.

The following table represents the credit risk profile of our loan portfolio based on payment activity as of March 31, 2016 by type of loan (in thousands):

| | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Total |
|---------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Performing | \$141,527 | \$31,588 | \$173,353 | \$57,752 | \$14,169 | \$23,365 | \$20,223 | \$461,977 |
| Nonperforming | 1,577 | 434 | - | - | 78 | 24 | 7 | 2,120 |
| Total | \$143,104 | \$32,022 | \$173,353 | \$57,752 | \$14,247 | \$23,389 | \$20,230 | \$464,097 |

The following table represents the credit risk profile of our loan portfolio based on payment activity as of December 31, 2015 by type of loan (in thousands):

| | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Total |
|---------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Performing | \$139,485 | \$31,145 | \$175,312 | \$57,043 | \$13,736 | \$23,030 | \$19,295 | \$459,046 |
| Nonperforming | 1,640 | 428 | - | - | 62 | - | - | 2,130 |
| Total | \$141,125 | \$31,573 | \$175,312 | \$57,043 | \$13,798 | \$23,030 | \$19,295 | \$461,176 |

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the loan. In the process of identifying loans as impaired, we take into consideration factors which include payment history and status, collateral value, financial condition of the borrower, and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered on a case by case basis, after taking into consideration the totality of circumstances surrounding the loan and the borrower(s), including payment history, the amount of any payment shortfall, length and reason for delay, and likelihood of return to stable performance. Impairment is measured on a loan by loan basis for all loans in the portfolio. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the allowance for loan losses.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents loans individually evaluated for impairment as of March 31, 2016 by type of loan (in thousands):

| | March 31, 2016 | | | |
|----------------------------|----------------------|----------------------|-------------------|----------------------|
| | Recorded Investment | | | |
| | Unpaid | | | |
| | Principal Balance | Without Allowance | With Allowance | Related Allowance |
| One- to four- family | \$5,583 | \$ 2,210 | \$ 3,255 | \$ 640 |
| Home equity | 1,017 | 360 | 577 | 140 |
| Commercial and multifamily | 4,912 | 2,202 | 2,710 | 265 |
| Construction and land | 89 | - | 89 | 24 |
| Manufactured homes | 380 | 82 | 298 | 63 |
| Other consumer | 27 | 2 | 25 | 25 |
| Commercial business | 500 | - | 500 | 47 |
| Total | \$12,508 | \$ 4,856 | \$ 7,454 | \$ 1,204 |

| | December 31, 2015 | | | |
|----------------------------|----------------------|----------------------|-------------------|----------------------|
| | Recorded Investment | | | |
| | Unpaid | | | |
| | Principal Balance | Without Allowance | With Allowance | Related Allowance |
| One- to four- family | \$6,011 | \$ 499 | \$ 5,280 | \$ 647 |
| Home equity | 994 | 162 | 742 | 110 |
| Commercial and multifamily | 1,966 | 1,430 | 536 | 36 |
| Construction and land | 91 | - | 91 | 18 |
| Manufactured homes | 366 | - | 361 | 63 |
| Other consumer | 5 | - | 5 | - |
| Commercial business | 114 | - | 114 | 8 |
| Total | \$9,547 | \$ 2,091 | \$ 7,129 | \$ 882 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents loans individually evaluated for impairment as of March 31, 2015 by type of loan (in thousands):

| | Three Months Ended March 31, 2016 | | Three Months Ended March 31, 2015 | |
|----------------------------|--------------------------------------|----------------------------------|--------------------------------------|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| One- to four- family | \$ 5,623 | \$ 68 | \$ 4,155 | \$ 47 |
| Home equity | 921 | 12 | 1,224 | 13 |
| Commercial and multifamily | 3,439 | 67 | 2,845 | 29 |
| Construction and land | 90 | 1 | 180 | 1 |
| Manufactured homes | 371 | 7 | 404 | 7 |
| Other consumer | 16 | 1 | 34 | - |
| Commercial business | 307 | 7 | 123 | 2 |
| Total | \$ 10,767 | \$ 163 | \$ 8,965 | \$ 99 |

Forgone interest on nonaccrual loans was \$22,000 and \$23,000 for the three months ended March 31, 2016 and 2015, respectively. There were no commitments to lend additional funds to borrowers whose loans were classified as nonaccrual, TDR or impaired at March 31, 2016 or December 31, 2015.

Troubled debt restructurings. Loans classified as TDRs totaled \$5.8 million and \$6.0 million at March 31, 2016 and December 31, 2015, respectively, and are included in impaired loans. The Company has granted a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

Rate Modification: A modification in which the interest rate is changed.

Term Modification: A modification in which the maturity date, timing of payments, or frequency of payments is changed.

Payment Modification: A modification in which the dollar amount of the payment is changed. Interest only modifications in which a loan is converted to interest only payments for a period of time are included in this category.

Combination Modification: Any other type of modification, including the use of multiple categories above.

There were no new TDRs identified during the quarter ending March 31, 2016. At March 31, 2016, there were no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. There were no loans modified as TDRs within the previous 12 months for which there was a payment default during the three months ended March 31, 2016 and 2015.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Note 5 – Fair Value Measurements

The following tables present information about the level in the fair value hierarchy for the Company's financial assets and liabilities, whether or not recognized or recorded at fair value as of March 31, 2016 and December 31, 2015 (in thousands):

| | March 31, 2016 | | Fair Value Measurements Using: | | |
|-------------------------------|----------------|----------------------|--------------------------------|---------|---------|
| | Carrying Value | Estimated Fair Value | Level 1 | Level 2 | Level 3 |
| FINANCIAL ASSETS: | | | | | |
| Cash and cash equivalents | \$49,679 | \$49,679 | \$49,679 | \$- | \$- |
| Available for sale securities | 6,286 | 6,286 | - | 5,871 | 415 |
| Loans held for sale | 1,186 | 1,186 | - | 1,186 | - |
| Loans receivable, net | 457,723 | 455,205 | - | - | 455,205 |
| Accrued interest receivable | 1,595 | 1,595 | 1,595 | - | - |
| Mortgage servicing rights | 3,095 | 3,095 | - | - | 3,095 |
| FHLB stock | 1,903 | 1,903 | - | - | 1,903 |

FINANCIAL LIABILITIES:

| | | | | | |
|--------------------------|---------|---------|---|---------|---|
| Non-maturity deposits | 281,377 | 281,377 | - | 281,377 | - |
| Time deposits | 166,744 | 165,739 | - | 165,739 | - |
| Borrowings | 31,374 | 31,366 | - | 31,366 | - |
| Accrued interest payable | 82 | 82 | - | 82 | - |

| | December 31, 2015 | | Fair Value Measurements Using: | | |
|-------------------------------|-------------------|----------------------|--------------------------------|---------|---------|
| | Carrying Value | Estimated Fair Value | Level 1 | Level 2 | Level 3 |
| FINANCIAL ASSETS: | | | | | |
| Cash and cash equivalents | \$48,264 | \$48,264 | \$48,264 | \$- | \$- |
| Available for sale securities | 6,696 | 6,696 | - | 6,268 | 428 |
| Loans held for sale | 2,091 | 2,091 | - | 2,091 | - |
| Loans receivable, net | 454,833 | 454,854 | - | - | 454,854 |
| Accrued interest receivable | 1,608 | 1,608 | 1,608 | - | - |
| Mortgage servicing rights | 3,249 | 3,249 | - | - | 3,249 |
| FHLB Stock | 2,212 | 2,212 | - | - | 2,212 |

FINANCIAL LIABILITIES:

| | | | | | |
|--------------------------|---------|---------|---|---------|---|
| Non-maturity deposits | 271,639 | 271,639 | - | 271,639 | - |
| Time deposits | 168,881 | 168,091 | - | 168,091 | - |
| Borrowings | 40,435 | 40,421 | - | 40,421 | - |
| Accrued interest payable | 72 | 72 | - | 72 | - |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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The following tables present the balance of assets measured at fair value on a recurring basis as of March 31, 2016 and December 31, 2015 (in thousands):

| <u>Description</u> | Fair Value at March 31, 2016 | | | |
|---------------------------------------|------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Municipal bonds | \$2,105 | \$ - | \$2,105 | \$ - |
| Agency mortgage-backed securities | 3,766 | - | 3,766 | - |
| Non-agency mortgage-backed securities | 415 | - | - | 415 |
| Mortgage servicing rights | 3,095 | - | - | 3,095 |

| <u>Description</u> | Fair Value at December 31, 2015 | | | |
|---------------------------------------|---------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Municipal bonds | \$2,096 | \$ - | \$2,096 | \$ - |
| Agency mortgage-backed securities | 4,172 | - | 4,172 | - |
| Non-agency mortgage-backed securities | 428 | - | - | 428 |
| Mortgage servicing rights | 3,249 | - | - | 3,249 |

For the three months ended March 31, 2016 and 2015 there were no transfers between Level 1 and Level 2 or between Level 2 and Level 3.

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at March 31, 2016:

| Financial Instrument | Valuation Technique | Unobservable Input(s) | Range (Weighted Average) |
|---------------------------------------|----------------------|--|----------------------------------|
| Mortgage Servicing Rights | Discounted cash flow | Prepayment speed assumption Discount rate | 107-441% (204%) 10-12% (10.0) |
| Non-agency mortgage-backed securities | Discounted cash flow | Discount rate | 7-9% (8%) |

Generally, any significant increases in the constant prepayment rate and discount rate utilized in the fair value measurement of the mortgage servicing rights will result in a negative fair value adjustment (and decrease in the fair value measurement). Conversely, a decrease in the constant prepayment rate and discount rate will result in a positive fair value adjustment (and increase in the fair value measurement). An increase in the weighted average life assumptions will result in a decrease in the constant prepayment rate and conversely, a decrease in the weighted average life will result in an increase of the constant prepayment rate.

The following table provides a reconciliation of assets and liabilities (excluding mortgage servicing rights) measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three months ended March 31, 2016 and 2015 (in thousands):

| | Three Months Ended March 31, | |
|----------------------------------|------------------------------|----------|
| | 2016 | 2015 |
| Beginning balance, at fair value | \$ 428 | \$ 2,345 |
| OTTI impairment losses | - | - |
| Sales and principal payments | (15) | (1,744) |

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| | | | |
|-------------------------------|--------|--------|---|
| Change in unrealized loss | 2 | (105 |) |
| Ending balance, at fair value | \$ 415 | \$ 496 | |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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Mortgage servicing rights are measured at fair value using significant unobservable input (Level 3) on a recurring basis and a reconciliation of this asset can be found in Note 6 – Mortgage Servicing Rights.

The following tables present the balance of assets measured at fair value on a nonrecurring basis at the dates indicated (in thousands):

| | Fair Value at March 31, 2016 | | | |
|-----------------------------|------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| OREO and repossessed assets | \$ 832 | \$ - | \$ - | \$ 832 |
| Impaired loans | 12,310 | - | - | 12,310 |

| | Fair Value at December 31, 2015 | | | |
|-----------------------------|---------------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| OREO and repossessed assets | \$ 769 | \$ - | \$ - | \$ 769 |
| Impaired loans | 9,220 | - | - | 9,220 |

There were no liabilities carried at fair value, measured on a recurring or nonrecurring basis, at March 31, 2016 or December 31, 2015.

The following table provides a description of the valuation technique, observable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a nonrecurring basis at March 31, 2016:

| Financial Instrument | Valuation Technique(s) | Unobservable Input(s) | Range (Weighted Average) |
|----------------------|--|---|--------------------------|
| OREO | Appraisal | Adjustment for differences between comparable sales | 0-57% (13.1%) |
| Impaired loans | Appraisal or discounted cash flow approach | Adjustment for differences between comparable sales | 0-100% (9.8%) |

A description of the valuation methodologies used for impaired loans and OREO is as follows:

Impaired Loans - The fair value of collateral dependent loans is based on the current appraised value of the collateral or internally developed models utilizing a calculation of expected discounted cash flows which contain management's assumptions.

OREO and Repossessed Assets – The fair value of OREO and repossessed assets is based on the current appraised value of the collateral or internally developed models utilizing a calculation of expected discounted cash flows which contain management's assumptions.

The following methods and assumptions were used to estimate the fair value of other financial instruments:

Cash and cash equivalents, accrued interest receivable and payable - The estimated fair value is equal to the carrying amount.

AFS Securities – AFS securities are recorded at fair value based on quoted market prices, if available. If quoted market prices are not available, management utilizes third-party pricing services or broker quotations from dealers in the specific instruments. Level 2 securities include those traded on an active exchange, as well as U.S. government and its agencies securities. Level 3 securities include private label mortgage-backed securities.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Loans Held for Sale - The fair value of fixed-rate residential loans is based on whole loan forward prices obtained from government sponsored enterprises. At March 31, 2016 and December 31, 2015, loans held for sale were carried at cost as no impairment was required.

Loans - The estimated fair value for all fixed rate loans is determined by discounting the estimated cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and maturities. The estimated fair value for variable rate loans is the carrying amount. The fair value for all loans also takes into account projected loan losses as a part of the estimate.

Mortgage Servicing Rights –The fair value of mortgage servicing rights is determined through a discounted cash flow analysis, which uses interest rates, prepayment speeds, discount rates, and delinquency rate assumptions as inputs.

FHLB stock - The estimated fair value is equal to the par value of the stock, which approximates fair value.

Deposits - The estimated fair value of deposit accounts (savings, demand deposit, and money market accounts) is the carrying amount. The fair values of fixed-maturity time certificates of deposit are estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

Borrowings - The fair value of borrowings are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Off-balance-sheet financial instruments - The fair value for the Company's off-balance-sheet loan commitments are estimated based on fees charged to others to enter into similar agreements taking into account the remaining terms of the agreements and credit standing of the Company's customers. The estimated fair value of these commitments is not significant.

We assume interest rate risk (the risk that general interest rate levels will change) as a result of our normal operations. As a result, the fair values of our financial instruments will change when interest rate levels change, which may be favorable or unfavorable to us. Management attempts to match maturities of assets and liabilities to the extent necessary or possible to minimize interest rate risk. However, borrowers with fixed-rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by establishing early withdrawal penalties for certificates of deposit, creating interest rate floors for certain variable rate loans, adjusting terms of new loans and deposits, by borrowing at fixed rates for fixed terms and investing in securities with terms that mitigate our overall interest rate risk.

Note 6 – Mortgage Servicing Rights

The unpaid principal balances of loans serviced for the Federal National Mortgage Association at March 31, 2016 and December 31, 2015, totaled approximately \$358.0 million and \$360.4 million, respectively, and was not included in the Company's financial statements. We also service loans for other financial institutions for which a servicing fee is received. The unpaid principal balances of loans serviced for other financial institutions at March 31, 2016 and December 31, 2015, totaled approximately \$10.5 million and \$9.4 million, respectively, and was not included in the Company's financial statements.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

A summary of the change in the balance of mortgage servicing rights during the three months ended March 31, 2016 and 2015 were as follows (in thousands):

| | Three Months Ended March 31, | |
|---|------------------------------------|---------|
| | 2016 | 2015 |
| Beginning balance, at fair value | \$3,249 | \$3,028 |
| Servicing rights that result from transfers of financial assets | 108 | 217 |
| Changes in fair value: | | |
| Due to changes in model inputs or assumptions ⁽¹⁾ | (114) | (178) |
| Other ⁽²⁾ | (148) | (177) |
| Ending balance, at fair value | \$3,095 | \$2,890 |

⁽¹⁾ Represents changes in discount rates and prepayment speed assumptions, which are primarily affected by changes in interest rates.

⁽²⁾ Represents changes due to collection or realization of expected cash flows over time.

The key economic assumptions used in determining the fair value of mortgage servicing rights at the dates indicated are as follows:

| | As of | | |
|--|----------------------|----------------------|---|
| | March 31, 2016 | December 31, 2015 | |
| Prepayment speed (Public Securities Association "PSA" model) | 204 % | 178 | % |
| Weighted-average life (years) | 6.1 | 6.7 | |
| Yield to maturity discount rate | 10.0% | 10.0 | % |

The amount of contractually specified servicing, late and ancillary fees earned and recorded in mortgage servicing income on the Condensed Consolidated Statements of Income was \$204,000 and \$255,000 for the three months ended March 31, 2016 and 2015, respectively.

Note 7 – Commitments and Contingencies

In the normal course of operations, the Company engages in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit.

Note 8 – Borrowings and FHLB Stock

The Company utilizes a loan agreement with the FHLB of Des Moines. The terms of the agreement call for a blanket pledge of a portion of the Company's mortgage, commercial and multifamily portfolio based on the outstanding balance. At March 31, 2016 and December 31, 2015, the amount available to borrow under this credit facility was \$172.7 million and \$174.0 million, respectively. At March 31, 2016, the credit facility was collateralized as follows:

one- to four- family mortgage loans with a carrying value of \$125.9 million, commercial and multifamily mortgage loans with a carrying value of \$156.6 million and home equity loans with a carrying value of \$8.8 million. The Company had outstanding borrowings under this arrangement of \$31.4 million and \$40.4 million at March 31, 2016 and December 31, 2015, respectively. Additionally, the Company had outstanding letters of credit from the FHLB of Seattle with a notional amount of \$52.0 million at March 31, 2016 and \$47.5 million at December 31, 2015 to secure public deposits. The remaining amount available to borrow as of March 31, 2016 and December 31, 2015, was \$89.3 million and \$86.1 million, respectively.

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As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding FHLB advances. At March 31, 2016 and December 31, 2015 the Company had recorded a \$1.9 million and \$2.2 million, respectively, investment in FHLB stock.

The Company participates in the Federal Reserve Bank Borrower-in-Custody program, which gives the Company access to the discount window. The terms of the program call for a pledge of specific assets. The Company had unused borrowing capacity of \$23.5 million and \$25.9 million and no outstanding borrowings under this program at March 31, 2016 and December 31, 2015, respectively.

The Company has access to a Fed Funds line of credit from the Pacific Coast Banker's Bank. The line has a two-year term maturing on June 30, 2016 and is renewable biannually. The Company had unused borrowing capacity of \$2.0 million and no outstanding borrowings under this agreement at March 31, 2016 and December 31, 2015.

The Company has access to a Fed Funds line of credit from Zions Bank under a Fed Funds Sweep and Line Agreement established September 26, 2014. The agreement allows access to a Fed Funds line of up to \$9.0 million and requires the Company to maintain cash balances with Zions Bank of \$250,000. The agreement has no maturity date. There were no outstanding borrowings on this line of credit at March 31, 2016 or December 31, 2015.

The Company has access to an unsecured line of credit from The Independent Bank. As of March 31, 2016, the amount available under this line of credit was \$10.0 million. There were no outstanding borrowings on this line of credit as of March 31, 2016.

Note 9 – Earnings Per Common Share

Basic earnings per common share is computed by dividing net income (which has been adjusted for distributed and undistributed earnings to participating securities) by the weighted-average number of common shares outstanding for the period, reduced for average unallocated ESOP shares and average unvested restricted stock awards. Unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method described in ASC 260-10-45-60B. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock (such as stock awards and options) were exercised or converted to common stock, or resulted in the issuance of common stock that then shared in the Company's earnings. Diluted earnings per common share is computed by dividing net income by the weighted-average number of common shares outstanding for the period increased for the dilutive effect of unexercised stock options and unvested restricted stock awards. The dilutive effect of the unexercised stock options and unvested restricted stock awards is calculated under the treasury stock method utilizing the average market value of the Company's stock for the period.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

Earnings per share are summarized for the periods presented in the following table (in thousands, except per share data):

| | Three Months Ended March 31, | |
|---|------------------------------|----------|
| | 2016 | 2015 |
| Net income | \$ 1,106 | \$ 1,208 |
| Less net income attributable to participating securities ⁽¹⁾ | 42 | 37 |
| Net income available to shareholders | \$ 1,064 | \$ 1,171 |
| Weighted average number of shares outstanding, basic | 2,478 | 2,525 |
| Effect of potentially dilutive common shares ⁽²⁾ | 94 | 77 |
| Weighted average number of shares outstanding, diluted | 2,572 | 2,602 |
| Earnings per share, basic | \$ 0.45 | \$ 0.48 |
| Earnings per share, diluted | \$ 0.43 | \$ 0.46 |

⁽¹⁾Represents dividends paid and undistributed earnings allocated to non-vested restricted stock awards.

⁽²⁾Represents the effect of the assumed exercise of stock options and vesting of non-participating restricted shares, based on the treasury stock method.

There were no shares considered anti-dilutive for the three months ended March 31, 2016 or 2015.

Note 10 – Stock-based Compensation

Stock Options and Restricted Stock

The Company currently has two existing Equity Incentive Plans, a 2008 Equity Incentive Plan (the “2008 Plan”) and a 2013 Equity Incentive Plan (the “2013 Plan”, and collectively the “Plans”), both of which were approved by shareholders. The Plans permit the grant of restricted stock, restricted stock units, stock options, and stock appreciation rights. Under the 2008 Plan, 126,287 shares of common stock were approved for awards for stock options and 50,514 shares of common stock were approved for awards for restricted stock. Under the 2013 Plan, 141,750 shares of common stock were approved for awards for stock options and stock appreciation rights and 56,700 shares of common stock were approved for awards for restricted stock.

As of March 31, 2016, cumulative awards for stock options totaling 237,019 shares and awards for restricted stock totaling 107,688 shares of Company common stock have been granted, net of any forfeitures, to participants in the Plans. During the three months ended March 31, 2016 and 2015, share-based compensation expense totaled \$102,000 and \$103,000, respectively.

Stock Option Awards

The stock option awards granted under the 2008 Plan to date provide for vesting in 20 percent annual increments commencing one year from the grant date. The stock option awards granted in 2014 under the 2013 Plan vested 20% of a recipient’s award immediately, with the remaining award vesting in four equal annual installments commencing one year from the grant date. The stock option awards granted in 2015 and 2016 under the 2013 Plan vested 33% of a recipient’s award immediately, with the remaining award vesting in two equal annual installments commencing one year from the grant date. All of the options granted are exercisable for a period of 10 years from the date of grant, subject to vesting. The following is a summary of the Company’s stock option plan awards during the three months

ended March 31, 2016:

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Notes to Condensed Consolidated Financial Statements (unaudited)

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term In Years | Aggregate Intrinsic Value |
|---|---------|---------------------------------|--|---------------------------|
| Outstanding at the beginning of the year | 184,407 | \$ 14.56 | 6.97 | \$1,490,009 |
| Granted | 10,993 | \$ 22.31 | | |
| Exercised | (577) | \$ 9.66 | | |
| Forfeited | - | | | |
| Expired | - | | | |
| Outstanding at March 31, 2016 | 194,823 | \$ 15.01 | 6.91 | \$1,537,609 |
| Exercisable | 111,272 | \$ 13.25 | 5.95 | \$1,073,725 |
| Expected to vest, assuming a 0% forfeiture rate over the vesting term | 83,551 | \$ 17.35 | 8.20 | \$463,884 |

As of March 31, 2016, there was \$484,000 of total unrecognized compensation cost related to non-vested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 2.75 years.

The fair value of each option award granted is estimated on the date of grant using a Black-Scholes model. The assumptions used for the three months ended March 31, 2016 are presented in the table below:

| | |
|---|------------|
| Annual dividend yield | 1.03 % |
| Expected volatility | 25.48% |
| Risk-free interest rate | 1.64 % |
| Expected term | 6.92 years |
| Weighted-average grant date fair value per option granted | \$5.78 |

The assumptions used for the three months ended March 31, 2015 are presented in the table below:

| | |
|---|------------|
| Annual dividend yield | 1.20 % |
| Expected volatility | 24.80% |
| Risk-free interest rate | 1.35 % |
| Expected term | 7.50 years |
| Weighted-average grant date fair value per option granted | \$3.83 |

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Notes to Condensed Consolidated Financial Statements (unaudited)

Restricted Stock Awards

The fair value of the restricted stock awards is equal to the fair value of the Company's stock at the date of grant. Compensation expense is recognized over the vesting period that the awards are based. The restricted stock awards granted under the 2008 Plan to date provide for vesting in 20 percent annual increments commencing one year from the grant date. The restricted stock awards granted in 2014 under the 2013 Plan vested 20% of a recipient's award immediately, with the remaining award vesting in four equal annual installments commencing one year from the grant date. The restricted stock awards granted in 2015 and 2016 under the 2013 Plan vested 33% of a recipient's award immediately, with the remaining award vesting in two equal annual installments commencing one year from the grant date.

The following is a summary of the Company's non-vested restricted stock awards during the three months ended March 31, 2016:

| | Shares | Weighted-Average Grant-Date Fair Value Per Share |
|--|----------|--|
| Non-vested Shares | | |
| Non-vested at January 1, 2016 | 31,553 | \$ 16.32 |
| Granted | 11,606 | \$ 22.31 |
| Vested | (15,941) | \$ 17.59 |
| Forfeited | - | - |
| Expired | - | - |
| Non-vested at March 31, 2016 | 27,218 | \$ 18.06 |
| Expected to vest assuming a 0% forfeiture rate over the vesting term | 27,218 | \$ 18.06 |

As of March 31, 2016, there was \$590,000 of unrecognized compensation cost related to non-vested restricted stock granted under the Plans remaining. The cost is expected to be recognized over the weighted-average vesting period of 1.77 years. The total fair value of shares vested for the three months ended March 31, 2016 and 2015 was \$345,345 and \$222,000, respectively.

Employee Stock Ownership Plan

In January 2008, the ESOP borrowed \$1.2 million from the Company to purchase common stock of the Company. In August 2012, in conjunction with the Company's conversion to a full stock company from the mutual holding company structure, the ESOP borrowed an additional \$1.1 million from the Company to purchase common stock of the Company. Both loans are being repaid principally by the Bank through contributions to the ESOP over a period of ten years. The interest rate on the loans is fixed at 4.0% and 2.25%, per annum, respectively. As of March 31, 2016, the remaining balances of the ESOP loans were \$270,000 and \$701,000, respectively.

Neither the loan balances nor the related interest expense are reflected on the condensed consolidated financial statements.

At March 31, 2016, the ESOP was committed to release 21,443 shares of the Company's common stock to participants and held 88,243 unallocated shares remaining to be released in future years. The fair value of the 195,528 restricted shares held by the ESOP trust was \$4.4 million at March 31, 2016. ESOP compensation expense included in salaries and benefits was \$136,000 and \$102,000 for the three months ended March 31, 2016 and 2015, respectively.

Note 11 – Subsequent Event

On April 26, 2016, the Company declared a quarterly cash dividend of \$0.075 per common share, payable on May 26, 2016 to shareholders of record at the close of business May 10, 2016.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain matters discussed in this Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of 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, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to:

- changes in economic conditions, either nationally or in our market area;
- fluctuations in interest rates;
- the risks of lending and investing activities, including changes in the level and direction of loan delinquencies and write-offs and changes in estimates of the adequacy of our allowance for loan losses;
- the possibility of other-than-temporary impairments of securities held in our securities portfolio;
- our ability to access cost-effective funding;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values and both residential and commercial and multifamily real estate market conditions in our market area;
- secondary market conditions for loans and our ability to sell loans in the secondary market;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all;
- legislative or regulatory changes such as the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including changes related to Basel III;
- monetary and fiscal policies of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the U.S. Government and other governmental initiatives affecting the financial services industry;

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· results of examinations of Sound Financial Bancorp and Sound Community Bank by their regulators, including the possibility that the regulators may, among other things, require us to increase our allowance for loan losses or to write-down assets, change Sound Community Bank's regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;

· 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 balance sheet;

· staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;

· our ability to keep pace with technological changes, including our ability to identify and address cyber-security risks such as data security breaches, "denial of service" attacks, "hacking" and identity theft;

· our ability to retain key members of our senior management team;

· costs and effects of litigation, including settlements and judgments;

· our ability to implement our business strategies;

· 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 stock;

· adverse changes in the securities markets;

· the inability of key third-party providers to perform their obligations to us;

· changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and

· other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described from time to time in our filings with the U.S. Securities and Exchange Commission (the "SEC") .

We wish to advise readers not to place undue reliance on any forward-looking statements and that the factors listed above could materially affect our financial performance and could cause our actual results for future periods to differ materially from any such forward-looking statements expressed with respect to future periods and could negatively affect our stock price performance.

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We do not undertake and specifically decline any obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

General

Sound Financial Bancorp, a Maryland corporation, is a bank holding company for its wholly owned subsidiary, Sound Community Bank. Substantially all of Sound Financial Bancorp's business is conducted through Sound Community Bank, a Washington state-chartered commercial bank. As a Washington commercial bank, the Bank's regulators are the Washington State Department of Financial Institutions ("WDFI") and the Federal Deposit Insurance Corporation ("FDIC"). The Federal Reserve is the primary federal regulator for Sound Financial Bancorp.

Sound Community Bank's deposits are insured up to applicable limits by the FDIC. At March 31, 2016, Sound Financial Bancorp had total consolidated assets of \$543.5 million, net loans of \$457.7 million, deposits of \$448.1 million and stockholders' equity of \$55.6 million. The shares of Sound Financial Bancorp are traded on The NASDAQ Capital Market under the symbol "SFBC." Our executive offices are located at 2005th Avenue, Suite 200, Seattle, Washington, 98121.

Our principal business consists of attracting retail and commercial deposits from the general public and investing those funds, along with borrowed funds, in loans secured by first and second mortgages on one- to four-family residences (including home equity loans and lines of credit), commercial and multifamily, consumer and commercial business loans and construction and land loans. We offer a variety of secured and unsecured consumer loan products, including manufactured home loans, floating home loans, automobile loans, boat loans and recreational vehicle loans. As part of our business, we focus on residential mortgage loan originations, the majority of which we sell to the Federal National Mortgage Association. We sell loans which conform to the underwriting standards of Fannie Mae ("conforming") with servicing retained to maintain the direct customer relationship and to continue providing strong customer service to our borrowers. We also originate loans which do not conform to the underwriting standards of Fannie Mae ("non-conforming") loans to be held in our loan portfolio and for sale with servicing released. We originate and retain a significant amount of commercial real estate loans, including those secured by owner-occupied and nonowner-occupied commercial real estate, multifamily property, manufactured home parks and construction and land development loans.

Critical Accounting Policies

Certain of our accounting policies are important to an understanding of our financial condition, since they require management to make difficult, complex or subjective judgments, which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances that could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, and accounting mortgage servicing rights, other real estate owned and deferred income taxes. Our methodologies for analyzing the allowance for loan losses, mortgage servicing rights, other real estate owned and deferred tax asset accounts are described in our 2015 Form 10-K. There have been no significant changes in the Company's application of accounting policies since December 31, 2015.

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Comparison of Financial Condition at March 31, 2016 and December 31, 2015

General. Total assets increased by \$2.8 million, or 0.5%, to \$543.5 million at March 31, 2016 from \$540.8 million at December 31, 2015. This increase was primarily the result of a \$3.0 million, or 0.6%, increase in the net loan portfolio and a \$1.4 million, or 2.9%, increase in cash and cash equivalents, partially offset by a \$410,000, or 6.1% decrease in our available-for-sale securities. Excess liquidity from an \$8.1 million, or 1.8%, increase in deposits was primarily used to pay down borrowings by \$9.1 million.

Cash and Securities. Cash, cash equivalents and our available-for-sale securities in the aggregate increased by \$1.0 million, or 1.8%, to \$56.0 million at March 31, 2016 from \$55.0 million at December 31, 2015. Cash and cash equivalents increased by \$1.4 million, or 2.9%, to \$49.7 million at March 31, 2016. Available-for-sale securities, which consist primarily of agency mortgage-backed securities, decreased by \$410,000, or 6.1%, from \$6.7 million at December 31, 2015 to \$6.3 million at March 31, 2016 as a result of principal repayments and prepayments. There were no sales of securities during the three months ended March 31, 2016. For the three months ended March 31, 2015, we sold \$1.7 million of available for sale non-agency mortgage-backed securities generating a gross loss of \$31,000. For further analysis on our investment securities, see Note 3 – Investments in the Notes to Consolidated Financial Statements under Item 1 of this report.

Loans. Our gross loan portfolio increased \$3.0 million, or 0.6%, to \$462.4 million at March 31, 2016 from \$459.5 million at December 31, 2015.

Loans held for sale decreased \$905,000, or 43.3%, to \$1.2 million at March 31, 2016 from \$2.1 million at December 31, 2015. The decrease in loans held for sale was a result of the timing of loan sales.

The following table reflects the changes in the types of loans in our portfolio at March 31, 2016, as compared to December 31, 2015 (dollars in thousands):

| | March 31, 2016 | December 31, 2015 | Amount Change | Percent Change | |
|----------------------------|-------------------|----------------------|------------------|-------------------|---|
| One-to-four-family | \$ 143,104 | \$ 141,125 | \$ 1,979 | 1.4 | % |
| Home equity | 32,022 | 31,573 | 449 | 1.4 | |
| Commercial and multifamily | 173,353 | 175,312 | (1,959) | (1.1) |) |
| Construction and land | 57,752 | 57,043 | 709 | 1.2 | |
| Manufactured homes | 14,247 | 13,798 | 449 | 3.3 | |
| Other consumer | 23,389 | 23,030 | 359 | 1.6 | |
| Commercial business | 20,230 | 19,295 | 935 | 4.8 | |
| Deferred loan fees | (1,665) | (1,707) | 42 | 2.5 | |
| Total loans, gross | \$ 462,432 | \$ 459,469 | \$ 2,963 | 0.6 | % |

The increases in our gross loan portfolio were primarily a result of our loan production exceeding our loan pay downs and pay-offs. At March 31, 2016, commercial and multifamily real estate loans accounted for 37.4% of the gross loan portfolio and residential real estate loans accounted for 30.8% of the loan portfolio. Home equity, manufactured, and other consumer loans accounted for 15.0% of the loan portfolio including floating home loans of \$18.7 million or 4.0% of the portfolio at March 31, 2016. Construction and land loans accounted for 12.5% of the loan portfolio and commercial business loans accounted for the remaining 4.4% of the loan portfolio.

Mortgage Servicing Rights. At March 31, 2016 and December 31, 2015, we had \$3.1 million and \$3.2 million, respectively, in mortgage servicing rights recorded at fair value. We record mortgage servicing rights on loans sold to Fannie Mae and other financial institutions with servicing retained and upon acquisition of a servicing portfolio. We stratify our capitalized mortgage servicing rights based on the type, term and interest rates of the underlying loans.

Mortgage servicing rights are carried at fair value. If the fair value of our mortgage servicing rights fluctuates significantly, our financial results could be materially impacted.

Nonperforming Assets. At March 31, 2016, nonperforming assets totaled \$3.0 million, or 0.5% of total assets, compared to \$2.9 million, or 0.5% of total assets at December 31, 2015.

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The table below sets forth the amounts and categories of nonperforming assets at the dates indicated (dollars in thousands):

| | Nonperforming Assets | | | |
|---|-------------------------|----------------------------|------------------|-------------------|
| | At March 31, 2016 | At December 31, 2015 | Amount Change | Percent Change |
| Nonaccrual loans | \$1,377 | \$ 1,528 | \$ (151) | 32.1 % |
| Accruing loans 90 days or more delinquent | 17 | 117 | (100) | (85.5) |
| Nonperforming TDRs | 726 | 485 | 241 | 49.7 |
| Total nonperforming loans | 2,120 | 2,130 | (10) | (0.5) |
| OREO and repossessed assets | 832 | 769 | 63 | 8.2 |
| Total nonperforming assets | \$2,952 | \$ 2,899 | \$ 53 | 1.8 % |

Nonperforming loans, consisting of nonaccrual loans, accruing loans 90 days or more delinquent and nonperforming TDRs, decreased to \$2.1 million or 0.46% of total gross loans at March 31, 2016 from \$2.1 million or 0.47% of total gross loans at December 31, 2015. This decrease reflects a \$10,000 decline in nonperforming loans during the three months ended March 31, 2016 primarily due to a fewer nonaccrual loans. Our largest nonperforming loan at March 31, 2016 was a \$324,000 one-to-four-family residential loan.

OREO and repossessed assets increased during the three months ended March 31, 2016, due to newly foreclosed one-to four-family property having a higher valuation than the OREO property sold during the quarter. During the three months ended March 31, 2016, we repossessed a single one- to four- family property valued at \$170,000 and one manufactured home valued at \$18,000 and we sold a single one- to four- family property valued at \$132,000 with a gain on sale of \$8,000. Our largest OREO at March 31, 2016 consisted of a commercial building with a recorded value of \$600,000 located in Clallam County, Washington. Our next largest OREO properties were a \$170,000 one-to four- family property located in Clallam County, Washington and a \$35,000 parcel of land located in Clallam County, Washington.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover losses that are probable and can be estimated on the date of evaluation in accordance with generally accepted accounting principles in the United States. It is our best estimate of probable incurred credit losses in our loan portfolio. The \$237,000 increase in the allowance for loan losses compared to the comparable period last year was primarily due to an increase in the specific reserve for impaired loans.

Our allowance for loan losses at March 31, 2016 was \$4.7 million, or 1.02% of total loans receivable compared to \$4.6 million, or 1.01% of total loans receivable at December 31, 2015. The allowance for loan losses includes the \$150,000 provision for loan losses established during the three months ended March 31, 2016.

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The following table reflects the adjustments in our allowance for loan losses during the periods indicated (dollars in thousands):

| | Three Months Ended March 31, | | |
|---|---------------------------------|----------------------------|--|
| | 2016 | 2015 | |
| Balance at beginning of period | \$ 4,636 | \$ 4,387 | |
| Charge-offs | (83) | (64) | |
| Recoveries: | 6 | 13 | |
| Net charge-offs | (77) | (51) | |
| Provisions charged to operations | 150 | 100 | |
| Balance at end of period | \$ 4,709 | \$ 4,436 | |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.07 % | 0.05 % | |
| | At March 31, 2016 | At December 31, 2015 | |
| Allowance as a percentage of nonperforming loans (end of period) | 222.12 % | 217.65 % | |
| Allowance as a percentage of total loans (end of period) | 1.02 % | 1.01 % | |

Specific loan loss reserves increased \$322,000 at March 31, 2016 compared to December 31, 2015, while general loan loss reserves decreased \$249,000 at March 31, 2016, compared to December 31, 2015. The increase in specific loan loss reserves was primarily due to an increase in impaired loans during the current period. There are three loans which were reported as impaired as of March 31, 2016 which were not impaired as of December 31, 2015. These loans include one multi-family loan totaling \$2.2 million located in Port Angeles, Washington and two loans to one borrower totaling \$1.2 million secured by a commercial building and a guarantor's primary residence, both of which are located in King County, Washington. The decrease in general loan loss reserves was due to a decrease in our historical loss ratio on loans. Net charge-offs for the three months ended March 31, 2016 were \$77,000, or 0.07%, of average loans on an annualized basis, compared to \$51,000, or 0.05% of average loans for the same period in 2015. As of March 31, 2016, the allowance for loan losses as a percentage of total loans receivable and nonperforming loans was 1.02% and 222.12%, respectively, compared to 1.01% and 217.65%, respectively, at December 31, 2015.

Deposits. Total deposits increased by \$8.1 million, or 1.8%, to \$448.1 million at March 31, 2016 from \$440.0 million at December 31, 2015, primarily as a result of a \$8.3 million, or 6.5%, increase in interest-bearing demand accounts, a \$3.3 million, or 6.9% increase in noninterest-bearing demand accounts, and a \$414,000, or 1.1%, increase in savings accounts. These increases were partially offset by a \$2.2 million, or 4.1%, decrease in money market accounts and a \$2.1 million or 1.3% decrease in certificates of deposit. The increase in interest-bearing demand accounts was primarily a result of emphasis on our rewards checking product as well as a competitively priced interest-bearing demand account. The increase in noninterest-bearing demand accounts was primarily a result of our continued emphasis on attracting relatively low-cost core deposit accounts from small businesses. The decrease in certificates of deposit was due in part to low rates on these types of deposits. The decrease in money market accounts was primarily the result of customers placing these funds in higher yielding interest-bearing demand accounts. The increases in these deposit accounts reflect our continuing retail sales efforts to attract low-cost core deposit accounts. At March 31, 2016, brokered deposits were \$2.9 million compared to \$4.6 million at December 31, 2015.

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A summary of deposit accounts with the corresponding weighted average cost of funds is presented below (dollars in thousands):

| | As of March 31, 2016 | | As of December 31, 2015 | | |
|----------------------------|----------------------|----------------|-------------------------|----------------|---|
| | Amount | Wtd. Avg. Rate | Amount | Wtd. Avg. Rate | |
| Noninterest-bearing demand | \$ 51,365 | --- | % \$ 48,067 | --- | % |
| Interest-bearing demand | 135,653 | 0.38 | 127,392 | 0.42 | |
| Savings | 39,247 | 0.20 | 38,833 | 0.18 | |
| Money market | 51,829 | 0.20 | 54,046 | 0.16 | |
| Certificates | 166,744 | 1.19 | 168,880 | 1.22 | |
| Escrow ⁽¹⁾ | 3,283 | --- | 2,806 | --- | |
| Total deposits | \$ 448,121 | 0.61 | % \$ 440,024 | 0.63 | % |

(1)Escrow balances shown in noninterest-bearing deposits on the consolidated balance sheets

Borrowings. FHLB advances decreased \$9.1 million, or 22.4%, to \$31.4 million at March 31, 2016, with a weighted-average cost of 0.52%, from \$40.4 million at December 31, 2015, with a weighted-average cost of 0.39%. The increase in average rate was due to an increase in the overnight borrowing rate in the current period compared to December 31, 2015 reflecting the recent increase in the federal funds rate. Excess funds from increased deposits and loan repayments during the quarter ended March 31, 2016 were used to reduce borrowings. We rely on FHLB advances to fund interest-earning assets when deposits alone cannot fully fund interest-earning asset growth. This reliance on borrowings, rather than deposits, may increase our overall cost of funds.

Stockholders' Equity. Total stockholders' equity increased \$1.0 million, or 1.9%, to \$55.6 million at March 31, 2016 from \$54.5 million at December 31, 2015. This increase primarily reflects \$1.1 million in net income and share-based compensation of \$102,000, partially offset by the payment of a cash dividend of \$186,000 to common stockholders during the current quarter.

Comparison of Results of Operation for the Three Months Ended March 31, 2016 and 2015

General. Net income decreased \$101,000 to \$1.1 million, or \$0.43 per diluted common share, for the three months ended March 31, 2016, compared to \$1.2 million, or \$0.46 per diluted common share, for the three months ended March 31, 2015. The primary reasons for the decrease in net income were decreases in noninterest income and increases in noninterest expense. An increase in net interest income was offset by a higher loan loss provision. Net interest income increased primarily a result of higher average loan balances partially offset by higher average balances of interest-bearing deposits, in particular interest-bearing demand deposits, in the current period compared to a year ago. The provision for loan losses increased due to higher net charge-offs and higher loan balances. Noninterest income decreased due to lower gain on sale of loans and lower services charges and fee income. Noninterest expense was higher primarily as a result of increases in salaries and benefits, operating costs, occupancy expense and regulatory assessments.

Interest Income. Interest income increased by \$664,000, or 12.3%, to \$6.0 million for the three months ended March 31, 2016, from \$5.4 million for the three months ended March 31, 2015. The increase in interest income primarily reflected an increase in the average balance of interest-earning assets and an increase in the yield on loans and investments.

Our weighted average yield on interest-earning assets was 4.78% for the three months ended March 31, 2016, compared to 4.66% for the three months ended March 31, 2015. The weighted average yield on loans increased to

5.18% for the three months ended March 31, 2016 from 4.94% for the three months ended March 31, 2015 due to higher rates on new loans. The average balance of gross loans receivable increased \$28.7 million, or 6.6%, for the three months ended March 31, 2016, as compared to the same period last year. The weighted average yield on available-for-sale securities and interest bearing cash was 0.83% for the three months ended March 31, 2016, compared to 0.33% for the three months ended March 31, 2015. The average balance of the investment portfolio, which included interest-bearing cash balances and available-for-sale securities increased \$13.8 million, or 47.1%. The overall yield on the investment portfolio increased 50 basis points due the increase in rates paid on overnight deposits and due to prior period income including a charge for other than temporary impairment.

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Interest Expense. Interest expense increased \$28,000 or 4.1%, to \$717,000 for the three months ended March 31, 2016, from \$689,000 for the three months ended March 31, 2015. This increase reflects a \$40.1 million, or 9.8%, increase in the average balances of deposits, partially offset by a \$1.7 million, or 7.3%, decrease in the average balances of FHLB advances for the three months ended March 31, 2016, as compared to the same period last year. Our weighted average cost of interest-bearing liabilities was 0.68% for the three months ended March 31, 2016, compared to 0.71% for the same period last year.

Interest paid on deposits increased \$27,000, or 4.1%, to \$688,000 for the three months ended March 31, 2016, from \$661,000 for the three months ended March 31, 2015. This increase primarily resulted from higher average balances of deposits outstanding in the period and the amortization of the premium paid on deposits purchased in the third quarter of 2014. Our weighted average cost of deposits during the three months ended March 31, 2016 was 0.61%, as compared to 0.64% during the three months ended March 31, 2015. This decrease was the primarily the result of lower interest costs on interest bearing checking and money market accounts.

Interest expense on borrowings increased \$1,000, or 3.6%, to \$29,000 for the three months ended March 31, 2016, from \$28,000 for the three months ended March 31, 2015. The increase was primarily the result of higher rates paid on the borrowings. Our average cost of borrowings was 0.52% for the three months ended March 31, 2016, compared to 0.46% for the three months ended March 31, 2015. This increase was a result of an increase in overnight borrowing rates in the current period compared to the prior periods reflecting the recent increase in the federal funds rate.

Net Interest Income. Net interest income increased \$636,000, or 13.6%, to \$5.3 million for the three months ended March 31, 2016, from \$4.7 million for the three months ended March 31, 2015. The increase resulted from increased interest income due to higher average loan balances, partially offset by higher interest expense due to higher average balances of interest-bearing deposits and amortization of the deposit premium related to the branch acquisitions in the third quarter of 2014. Our net interest margin increased to 4.25% for the three months ended March 31, 2016, compared to 4.06% for the three months ended March 31, 2015 due primarily to higher average loan yields reflecting the increase in the amount of higher yielding nonresidential loans in our portfolio.

Provision for Loan Losses. We establish provisions for loan losses, which are charged to earnings, at a level required to reflect management's best estimate of the probable incurred credit losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect borrowers' ability to repay, estimated value of any underlying collateral, peer group data, prevailing economic conditions, and current factors. Large groups of smaller balance homogeneous loans, such as one-to four-family, small commercial and multifamily, home equity and consumer loans, are evaluated in the aggregate using historical loss factors adjusted for current economic conditions and other relevant data. Loans for which management has concerns about the borrowers' ability to repay, are evaluated individually, and specific loss allocations are provided for these loans when necessary.

A provision of \$150,000 was made during the three months ended March 31, 2016, compared to a provision of \$100,000 during the three months ended March 31, 2015. The increased provision during the current period primarily reflects an increase in impaired loans. The additional provision was also partly due to higher average net loan balances and higher net loan charge-offs in the quarter ended March 31, 2016. At March 31, 2016, classified assets totaled \$6.9 million compared to \$3.7 million at December 31, 2015. There are three loans which are reported as classified as of March 31, 2016 which were not classified as of December 31, 2015, primarily due to the increase in impaired loans discussed above.

For the three months ended March 31, 2016, the annualized percentage of net charge-offs to average loans increased two basis points to 0.07%, from 0.05% for the three months ended March 31, 2015. The percentage of nonperforming loans to total loans decreased 36 basis points to 0.46% at March 31, 2016 from 0.77% at March 31, 2015.

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While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of our allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Noninterest Income. Noninterest income decreased \$194,000, or 16.6%, to \$977,000 for the three months ended March 31, 2016, as compared to \$1.2 million for the three months ended March 31, 2015 as reflected below (dollars in thousands):

| | Three Months Ended March 31, | | Amount Change | Percent Change |
|--|------------------------------|----------|------------------|-------------------|
| | 2016 | 2015 | | |
| Service charges and fee income | \$ 592 | \$ 645 | \$ (53) | (8.2)% |
| Earnings on cash surrender value of BOLI | 84 | 84 | - | - |
| Mortgage servicing income | 204 | 255 | (51) | (20.0) |
| Fair value adjustment on mortgage servicing rights | (113) | (178) | 65 | 36.5 |
| Loss on sale of securities | - | (31) | 31 | - |
| Net gain on sale of loans | 210 | 396 | (186) | (47.0) |
| Total noninterest income | \$ 977 | \$ 1,171 | \$ (194) | (16.6)% |

The decrease in noninterest income compared to the year ago quarter was primarily a result of lower gain on sale of loans, service charges and loan fee income and mortgage servicing income, partially offset by a lower negative fair value adjustment on mortgage servicing rights. The decrease in service charges and fee income was primarily the result of lower loan fees. The decrease in mortgage servicing income was due to lower mortgage interest rates in the first quarter of 2016 as compared to the same period last year, which lead to a lower valuation for new mortgage servicing rights. Lower gains on the sale of loans were due to lower originations due to reduced refinance activity and longer closing times due to the recent implementation of new mortgage regulations. The improvement in the fair value adjustment on mortgage servicing rights was a result of normal fluctuations in the pricing of this asset based on prepayment speeds and expected cash flows from this asset.

Noninterest Expense. Noninterest expense increased \$437,000, or 10.9%, to \$4.5 million during the three months ended March 31, 2016 as compared to \$4.0 million during the three months ended March 31, 2015, as reflected below (dollars in thousands):

| | Three Months Ended March | | Amount Change | Percent Change |
|--|-----------------------------|---------|------------------|-------------------|
| | 31, 2016 | 2015 | | |
| Salaries and benefits | \$2,563 | \$2,255 | \$ 308 | 13.7 % |
| Operations | 972 | 903 | 69 | 7.6 |
| Regulatory assessments | 155 | 66 | 89 | 134.8 |
| Occupancy | 385 | 325 | 60 | 18.5 |
| Data processing | 386 | 403 | (17) | (4.2) |
| Losses and expenses on OREO and repossessed assets | - | 72 | (72) | 100.0 |
| Total noninterest expense | \$4,461 | \$4,024 | \$ 437 | 10.9 % |

Noninterest expense was higher primarily as a result of higher salaries and benefits due to an increase in full time equivalent employees, operating and occupancy expenses, as well as higher regulatory expense, partially offset by

lower OREO related expenses. These increases were the result of an increase in staffing, administrative office expansion and higher regulatory exam fees.

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Income Tax Expense. For the three months ended March 31, 2016, we incurred income tax expense of \$584,000 on our pre-tax income as compared to \$527,000 for the three months ended March 31, 2015. The effective tax rates for the three ended March 31, 2016 and 2015 were 34.5% and 30.4%, respectively.

Liquidity

The Management Discussion and Analysis in Item 7 of the Company's 2015 Form 10-K contains an overview of the Company's and the Bank's liquidity management, sources of liquidity and cash flows. This discussion updates that disclosure for the three months ended March 31, 2016.

The Bank's primary sources of funds are deposits, principal and interest payments on loans and borrowings. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank's primary investing activity is loan originations. The Bank maintains liquidity levels it believes to be adequate to fund loan commitments, investment opportunities, deposit withdrawals and other financial commitments. At March 31, 2016 the Bank had \$56.0 million in cash and investment securities available for sale and \$1.2 million in loans held for sale generally available for its cash needs. Also, based on existing collateral pledged, the Bank had the ability to borrow an additional \$89.3 million in Federal Home Loan Bank advances, \$23.5 million through the Federal Reserve's Discount Window, \$9.0 million through a Fed Funds line at Zions Bank, \$2.0 million through a Fed Funds line at Pacific Coast Banker's Bank and \$10.0 million through an unsecured line of credit with The Independent Bank. The Bank uses these sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At March 31, 2016, outstanding loan commitments, including unused lines and letters of credit totaled \$60.0 million. Certificates of deposit scheduled to mature in one year or less at March 31, 2016, totaled \$105.0 million. Based on our competitive pricing and historical experience, we believe that a majority of maturing deposits will remain with the Bank.

Cash and cash equivalents increased \$1.4 million to \$49.7 million as of March 31, 2016, from \$48.3 million as of December 31, 2015. Net cash provided by operating activities was \$4.6 million for the three months ended March 31, 2016. Net cash of \$2.5 million was used by investing activities during the three months ended March 31, 2016 and consisted primarily of an increase in net loans. The \$622,000 of cash used in financing activities during the three months ended March 31, 2016 was primarily the net result of an \$8.1 million net increase in deposits which was used to pay down FHLB advances.

As a separate legal entity from the Bank, the Company must provide for its own liquidity. At March 31, 2016, the Company, on an unconsolidated basis, had \$227,000 in cash, noninterest-bearing deposits and liquid investments generally available for its cash needs. The Company's principal source of liquidity is dividends from the Bank and ESOP loan repayments.

Except as set forth above, management is not aware of any trends, events, or uncertainties that will have, or that are reasonably likely to have a material impact on liquidity, capital resources or operations.

Off-Balance Sheet Activities

In the normal course of operations, we engage in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit. For the three months ended March 31, 2016, we engaged in no off-balance sheet transactions likely to have a material effect on our financial condition, results of operations or cash flows.

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A summary of our off-balance sheet loan commitments at March 31, 2016 is as follows (in thousands):

| | |
|---|----------|
| Residential mortgage commitments | \$2,084 |
| Undisbursed portion of loans originated | 35,863 |
| Unused lines of credit | 21,916 |
| Irrevocable letters of credit | 185 |
| Total loan commitments | \$60,048 |

Capital

Sound Community Bank is subject to minimum capital requirements imposed by regulations of the FDIC. Capital adequacy requirements are quantitative measures established by regulation that require Sound Community Bank to maintain minimum amounts and ratios of capital.

Based on its capital levels at March 31, 2016, Sound Community Bank exceeded all regulatory capital requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for Sound Community Bank to maintain a “well-capitalized” status under the regulatory capital categories of the FDIC. Based on capital levels at March 31, 2016, Sound Community Bank was considered to be well-capitalized under applicable regulatory requirements. Management monitors the capital levels to provide for current and future business opportunities and to maintain Sound Community Bank’s “well-capitalized” status.

The actual regulatory capital amounts and ratios calculated for Sound Community Bank at March 31, 2016 were as follows (dollars in thousands):

| | Actual | | Minimum For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|----------|--------|---|---------|---|----------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of March 31, 2016 | | | | | | |
| Tier 1 Capital to average assets | \$54,199 | 10.14% | \$ 21,377 | ≥ 4.0 % | \$ 26,721 | > 5.0 % |
| Common Equity Tier 1 (“CET1”) risk-based capital ratio | \$54,199 | 12.12% | \$ 20,117 | ≥ 4.5 % | \$ 29,057 | ≥ 6.5 % |
| Tier 1 Capital to risk-weighted assets | \$54,199 | 12.12% | \$ 26,882 | ≥ 6.0 % | \$ 35,763 | ≥ 8.0 % |
| Total Capital to risk-weighted assets | \$59,063 | 13.21% | \$ 35,763 | ≥ 8.0 % | \$ 44,704 | ≥ 10.0 % |

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement began to be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019.

For a bank holding company with less than \$1.0 billion in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company’s subsidiary banks to be well capitalized under the prompt corrective action regulations. If Sound Financial Bancorp was subject to regulatory guidelines for bank holding companies with \$1.0 billion or more in assets, at March 31, 2016 Sound Financial Bancorp would have exceeded all regulatory capital requirements. The estimated regulatory capital ratios calculated for Sound Financial Bancorp as of March 31, 2016 were 10.28% for Tier 1 leverage-based capital, 12.29% for both Common Equity Tier 1 risk-based capital, Tier 1 Capital to risk-based assets and 13.38% for total risk-based capital.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company provided information about market risk in Item 7A of its 2015 Form 10-K. There have been no material changes in our market risk since our 2015 Form 10-K.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a -15(e) under the Securities Exchange Act of 1934 (the "Act")), as of March 31, 2016, was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2016, the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is: (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and the Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

We intend to continually review and evaluate the design and effectiveness of the Company's disclosure controls and procedures and to improve the Company's controls and procedures over time and to correct any deficiencies that we may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While we believe the present design of the disclosure controls and procedures is effective to achieve this goal, future events affecting our business may cause the Company to modify its disclosure controls and procedures.

The Company does not expect that its disclosure controls and procedures will prevent all errors and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies and procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

(b) Changes in Internal Control over Financial Reporting.

There were no changes in our internal control over financial reporting (as defined in Rule 13a - 15(f) under the Act) that occurred during the three months ended March 31, 2016, that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1 Legal Proceedings

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A Risk Factors

Not required; the Company is a smaller reporting company.

Item 2 Unregistered Sales of Equity Securities and use of Proceeds

(a) Not applicable

(b) Not applicable

(c) There were no repurchases of the Company's common stock during the three months ended March 31, 2016.

Item 3 Defaults Upon Senior Securities

Nothing to report.

Item 4 Mine Safety Disclosures

Not Applicable

Item 5. Other Information

Nothing to report.

Item 6. Exhibits

Exhibits:

- 3.1 Articles of Incorporation of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 3.2 Bylaws of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 4.0 Form of Common Stock Certificate of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 10.1 Employment Agreement by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Registration Statement on Form SB-2 filed with the SEC on September 20, 2007 (File No. 333-146196))
- 10.2 Amended and Restated Supplemental Executive Retirement Agreement by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 27, 2015 (File No. 001-35633))

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Amended and Restated Long Term Compensation Agreement by and between Sound Community Bank and
10.3 Laura Lee Stewart (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on
November 27, 2015 (File No. 001-35633))

Amended and Restated Confidentiality, Non-Competition and Non-Solicitation Agreement by and between
10.4 Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Current Report on
Form 8-K filed with the SEC on November 27, 2015 (File No. 001-35633))

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| | |
|-------|---|
| 10.5 | 2008 Equity Incentive Plan (incorporated herein by reference to the Annual Report on Form 10-K filed with the SEC on March 31, 2009 (File No. 000-52889)) |
| 10.6 | Forms of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreements under the 2008 Equity Incentive Plan (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 29, 2009 (File No. 000-52889)) |
| 10.7 | Summary of Annual Bonus Plan (incorporated herein by reference to the Registration Statement on Form SB-2 filed with the SEC on September 20, 2007 (File No. 333-146196)) |
| 10.8 | 2013 Equity Incentive Plan (included as Exhibit 10.13 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 and incorporated herein by reference (File No. 001-35633)) |
| 10.9 | Form of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreement under the 2013 Equity Incentive Plan (included as Exhibit 10.14 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 and incorporated herein by reference (File No. 001-35633)) |
| 10.10 | Change of Control Agreement dated October 30, 2013, by and among Sound Financial Bancorp, Inc., Sound Community Bank and Matthew P. Deines (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 1, 2013 (File No. 001-35633)) |
| 11 | Statement re computation of per share earnings (See Note 9 of the Notes to Condensed Consolidated Financial Statements contained in Item 1, Part I of this Current Report on Form 10-Q.) |
| 31.1 | Rule 13(a)-14(a) Certification (Chief Executive Officer) |
| 31.2 | Rule 13(a)-14(a) Certification (Chief Financial Officer) |
| 32 | Section 1350 Certification |
| 101 | Interactive Data Files |

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SIGNATURES

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

Sound Financial Bancorp, Inc.

Date: May 13, 2016 By: /s/ Laura Lee Stewart
Laura Lee Stewart
President and Chief Executive Officer

Date: May 13, 2016 By: /s/ Matthew P. Deines
Matthew P. Deines
Executive Vice President and Chief Financial Officer

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EXHIBIT INDEX

Exhibit No.

31.1 Rule 13(a)-14(a) Certification (Chief Executive Officer)

31.2 Rule 13(a)-14(a) Certification (Chief Financial Officer)

32 Section 1350 Certification

101 Interactive Data Files

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