HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 09, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Washington	91-1857900
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA	98501
(Address of principal executive offices)	(Zip Code)

(360) 943-1500
(Registrant’s telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock	NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No ý
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required

to submit and post such files). Yes ý No ¨

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

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

Large accelerated filer ¨ Accelerated filer ý Non-accelerated filer ¨ Smaller reporting company ¨

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2016, based on the closing price of its common stock on such date, on the NASDAQ Global Select Market, of $17.58 per share, and 29,156,319 shares held by non-affiliates was $512,568,088.

The registrant had 29,955,300 shares of common stock outstanding as of February 17, 2017.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2017 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K ("Form 10-K") may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements often include the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” expressions or future or conditional verbs such as “may,” “will,” “should,” “would” and “could.” These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated, including:

- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and Washington Banking Company, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to increase our allowance for loan losses and increase our provision for loan losses;
- changes in general economic conditions, either nationally or in our market areas;
- changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;
- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;
- fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;
- results of examinations of us by the bank regulators, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;
- legislative or regulatory changes that adversely affect our business including but not limited to, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act") and implementing regulations, changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III;
- our ability to control operating costs and expenses;
- increases in premiums for deposit insurance;
- 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 risk associated with the loans on our consolidated statement of financial condition;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- failure or security breach of computer systems on which we depend;
- 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 growth strategies;
- increased competitive pressures among financial service 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;
- adverse changes in the securities markets;

- inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board (“FASB"), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and

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- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this Form 10-K.

Some of these and other factors are discussed in this Form 10-K under the caption “Item 1A. Risk Factors” and elsewhere in this Form 10-K. Such developments could have a material adverse impact on our business, financial position and results of operations.

Any forward-looking statements are based upon management’s beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this Form 10-K or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, you should not put undue reliance on any forward-looking statements discussed in this Form 10-K.

PART I. FINANCIAL INFORMATION

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the "Company”, "Heritage", "we" and "our") is a bank holding company that was incorporated in the State of Washington in August 1997. We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary, Heritage Bank (the "Bank"). The deposits of the Bank are insured by the Federal Deposit Insurance Corporation (“FDIC").

Heritage Bank is headquartered in Olympia, Washington and conducts business from its 63 branch offices located primarily along the I-5 corridor in the western Washington and the greater Portland, Oregon area. We additionally have offices located in central Washington, primarily in Yakima County.

Our business consists primarily of lending and deposit relationships with small businesses and their owners in our market areas, and attracting deposits from the general public. We also make real estate construction and land development loans and consumer loans. The Bank also originates for sale or investment purposes one-to-four family residential loans on residential properties located primarily in our market.

Business Strategy

Our business strategy is to be a community bank, seeking deposits from our communities and making loans to customers with local ties to our markets. We believe we have an innovative team providing financial services focusing on the success of our customers. We are committed to being the leading community bank in the Pacific Northwest by continuously improving customer satisfaction, employee empowerment, community investment and shareholder value. Our commitment defines our relationships, sets expectations for our actions and directs decision-making in these four fundamental areas. We will seek to achieve our business goals through the following strategies:

Expand geographically as opportunities present themselves.   We are committed to continuing the controlled expansion of our franchise through strategic acquisitions designed to increase our market share and enhance franchise value. We believe that consolidation across the community bank landscape will continue to take place and further believe that, with our capital and liquidity positions, our approach to credit management and extensive acquisition experience, we are well positioned to take advantage of acquisitions or other business opportunities in our market areas. In markets where we wish to enter or expand our business, we will also consider opening de novo branches. In the past, we have successfully integrated acquired institutions and opened de novo branches. We will continue to be disciplined and opportunistic as it pertains to future acquisitions and de novo branching focusing on the Pacific Northwest markets we know and understand.

Focus on Asset Quality.   A strong credit culture is a high priority for us. We have a well-developed credit approval structure that has enabled us to maintain a standard of asset quality that we believe is conservative while at the same time maintaining our lending objectives. We will continue to focus on loan types and markets that we know well and where we have a historical record of success. We focus on loan relationships that are well diversified in both size and industry types. With respect to commercial business lending, which is our predominant lending activity, we view ourselves as cash-flow lenders obtaining additional support from realistic collateral values, personal guarantees and secondary sources of repayment. We have a problem loan resolution process that is focused on quick detection and feasible solutions. We seek to maintain strong internal controls and subject our loans to periodic internal loan reviews.

Maintain Strong Balance Sheet. In addition to our focus on underwriting, we believe that the strength of our balance sheet has allowed us to endure the economic downturn experienced by the Pacific Northwest more successfully than many of our competitors. As of December 31, 2016, the ratio of our allowance for loan losses to loans receivable, net was 1.18% and the ratio of the allowance for loan losses to nonperforming loans was 284.93%. Our liquidity position is also strong, with $103.7 million in cash and cash equivalents as of December 31, 2016. As of December 31, 2016, the regulatory capital ratios of our subsidiary bank were well in excess of the levels required for "well-capitalized" status, and our consolidated common equity tier 1 capital to risk-weighted assets, total risk-based capital, Tier 1 risk-based capital and leverage capital ratios were 11.4%, 13.0% 12.0% and 10.3%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in the communities we serve by providing exceptional customer service, focusing on relationship development with local businesses and strategic branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. At December 31, 2016, as a percentage of our total deposits, non-maturity deposits were 88.9%. We maintain state-of-the-art technology-based products, including on-line personal financial management, business cash management, and business remote deposit products that enable us to compete effectively with banks of all sizes. Our retail management team is well-seasoned and has strong ties to the communities we serve with a strong focus on relationship building and customer service.

Emphasize business relationships with a focus on commercial lending. We will continue to provide primarily commercial business, commercial real estate and residential construction loans with an emphasis on owner occupied commercial real estate and commercial business lending, and the deposit balances that accompany these relationships. Our seasoned lending staff has extensive knowledge and can add value through a focused advisory role that we believe strengthens our customer relationships and develops loyalty. We currently have and will seek to maintain a diversified portfolio of lending relationships without concentrations in any industry.

Recruit and retain highly competent personnel to execute our strategies. Our compensation and staff development programs are aligned with our strategies to grow our loans and core deposits while maintaining our focus on asset quality. Our incentive systems are designed to achieve balanced high quality asset growth while maintaining appropriate mechanisms to reduce or eliminate incentive payments when appropriate. Our equity compensation programs and retirement benefits are designed to build and encourage employee ownership at all levels of the Company and we align employee performance objectives with corporate growth strategies and shareholder value. We have a strong corporate culture, which is supported by our commitment to internal development and promotion from within as well as the retention of management and officers in key roles.

History

The Bank was established in 1927 as a federally charted mutual savings bank. In 1992, the Bank converted to a state charted mutual savings bank under the name Heritage Savings Bank. Through the mutual holding company reorganization of the Bank and the subsequent conversion of the mutual holding company, the Bank became a stock savings bank and a wholly-owned subsidiary of the Company effective August 1997. Effective September 1, 2004, Heritage Savings Bank switched its charter from a state chartered savings bank to a state chartered commercial bank and changed its legal name from Heritage Savings Bank to Heritage Bank.

The Company acquired North Pacific Bancorporation in June 1998 and Washington Independent Bancshares and its wholly-owned subsidiary, Central Valley Bank, in March 1999. In June 2006, the Company completed the acquisition of Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A., at which time Washington State Bank, N.A. was merged into Heritage Bank.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered commercial bank headquartered in Longview, Washington (the "Cowlitz Acquisition"). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. The acquisition also included the Trust Services Division of Cowlitz Bank.

Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington (the "Pierce Acquisition"). The Pierce

Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010.
On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank (“NCB”), a full service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State (the “NCB Acquisition”). The NCB Acquisition was completed on January 9, 2013, at which time NCB was merged with and into Heritage Bank.

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On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley") and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the "Valley Acquisition") and its eight branches. The Valley Acquisition was completed on July 15, 2013.

On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013. Central Valley Bank now operates as a division of Heritage Bank.

On October 23, 2013, the Company, the Bank, Washington Banking Company ("Washington Banking") and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"), jointly announced the signing of a definitive merger agreement pursuant to which Heritage and Washington Banking entered into a strategic merger with Washington Banking merging into Heritage (the "Washington Banking Merger"). Washington Banking branches adopted the Heritage Bank name in all markets, with the exception of six branches in Whidbey Island markets which continue to operate using the Whidbey Island Bank name, as a division of Heritage Bank. The Washington Banking Merger was completed on May 1, 2014. For additional information on the Washington Banking Merger, see Note (2) Business Combinations of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

Retail Banking

We offer a full range of products and services to customers for personal and business banking needs designed to attract both short-term and long-term deposits. Deposits are our primary source of funds. Our personal and business banking customers have the option selecting from a variety of accounts. The major categories of deposit accounts that we offer are described below. These accounts, with the exception of noninterest demand accounts, generally earn interest at rates established by management based on competitive market factors and management's desire to increase or decrease certain types or maturities of deposits.

Noninterest Demand Deposits. Noninterest demand deposits are noninterest bearing and may be charged service fees based on activity and balances.

NOW Accounts. NOW accounts are interest bearing and may be charged service fees based on activity and balances. NOW accounts pay interest, but require a higher minimum balance to avoid service charges.

Money Market Accounts. Money market accounts pay an interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary.

Savings Accounts. We offer savings accounts that allow for unlimited deposits and withdrawals, provided that a $300 minimum balance is maintained.

Certificate of Deposit Accounts. We offer several types of certificate of deposit accounts ("CDs") with maturities ranging from three months to five years, which require a minimum deposit of $2,500. Negotiable CDs are offered in amounts of $100,000 or more for terms of 30 days to five years.

Personal checking accounts feature an array of benefits and options, including online banking and statements, mobile banking, mobile remote deposits, VISA debit cards and access to more than 25,000 surcharge free ATMs with the MoneyPass network.

We also offer trust services, a complete in-house trust service department that holds trust powers in the states of Washington and Oregon, and a Wealth Management department that provides objective advice from trusted advisors.

Lending Activities

Our lending activities are conducted through Heritage Bank. While our focus is on commercial business lending, we also originate consumer loans, real estate construction and land development loans and one-to-four family residential loans. Our loans are originated under policies that are reviewed and approved annually by our Board of Directors. In addition, we have established internal lending guidelines that are updated as needed. These policies and guidelines address underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely perform internal loan reviews of our loan portfolio to confirm credit quality, proper documentation and compliance with laws and regulations. Loan repayments are considered one of the primary sources of funding for the Bank.

The Company has acquired loans through mergers and acquisitions, which are designated as "purchased" loans. Prior to August 2015, certain purchased loans were covered under FDIC shared-loss agreements and were identified as "covered". The Company and the FDIC terminated the FDIC shared-loss agreements effective August 4, 2015. For additional information, see Note (6) FDIC Indemnification Asset of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Commercial Business Lending

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

At December 31, 2016 we had $2.08 billion, or 78.7%, of our total loans receivable in commercial business loans with an average outstanding loan balance of approximately $338,000 at December 31, 2016, excluding loans with no outstanding balance.

We originate commercial real estate loans within our primary market areas with a preference for loans secured by owner-occupied properties. Our underwriting standards require that commercial real estate loans not exceed 75% of the lower of appraised value at origination or cost of the underlying collateral. Cash flow debt coverage requirements range from 1.15 times to 1.25 times, depending on the type of property, and is calculated using an "underwriting" interest rate that is higher than the note rate.

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

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

Beginning in third quarter of 2015, the Bank began entering into non-hedging interest rate swap contracts with its commercial customers to accommodate the business needs of borrowers. For additional information, see Note (16) Derivative Financial Instruments of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

One-to-Four Family Residential Loans, Originations and Sales

At December 31, 2016, one-to-four family residential loans totaled $77.4 million. The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that one-to-four family residential loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. As part of our asset/liability management strategy, we typically sell a significant portion of our one-to-four family residential loans in the secondary market with no recourse and servicing released. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Asset/Liability Management." We discontinued this strategy in the second quarter of 2013 through the second quarter of 2014, and reinstated the strategy following the completion of the Washington Banking Merger. We did not service any of these sold loans during the years ended December 31, 2016 or 2015.

Real Estate Construction and Land Development

At December 31, 2016, we had $159.2 million of real estate construction and land development loans. We originate one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks present in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands.

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

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

Consumer

At December 31, 2016, we had $325.1 million of consumer loans. We originate consumer loans and lines of credit that are both secured and unsecured. The majority of our consumer loans are for relatively small amounts disbursed among many individual borrowers.

As a result of the Washington Banking Merger, we currently originate indirect consumer loans. These loans are for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in our market areas. We have limited our indirect loans purchased primarily to dealerships that are established and well known in their market areas and to applicants that are not classified as sub-prime.

Liquidity

As indicated above, our primary sources of funds are deposits and loan repayments. Scheduled loan repayments are a relatively stable source of funds, while deposits and unscheduled loan prepayments, which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions, and other factors may not be stable. Customer deposits remain an important source of funding, but these balances have been influenced in the past by adverse market conditions in the industry and may be affected by future developments such as interest rate fluctuations and new competitive pressures. In addition to customer deposits, management may utilize brokered deposits on an as-needed basis and repurchase agreements. At December 31, 2016 we had securities sold under agreement to repurchase of $22.1 million which were secured by investment securities available for sale.

As secondary sources of funding, we might utilize other borrowings on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets. Other borrowings include advances from Federal Home Loan Bank ("FHLB") of Des Moines and other credit facilities.

Federal Home Loan Bank:

The Bank is a member of the FHLB of Des Moines which is one of 11 regional FHLBs that administer the home financing credit function of savings institutions. Each FHLB serves as a reserve or central bank for its member financial institutions within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System. It makes loans or advances to members in accordance with policies and procedures, established by the Board of Directors of the FHLB, which are subject to the oversight of the Federal Housing Finance Agency ("FHFA"). We rely upon advances from the FHLB to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Des Moines serves as one of our secondary sources of liquidity. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on a percentage of an institution's assets or on the FHLB's assessment of the institution's creditworthiness. Under its current credit policies, the FHLB of Des Moines limits advances to 35% of the Bank's assets.

Advances from the FHLB of Des Moines are typically secured by our first lien one-to-four family residential loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2016, the Bank maintained a credit facility with the FHLB of Des Moines in the amount of $549.0 million, of which $79.6 million was advanced.

For membership purposes, the Bank is required to maintain an investment in the stock of the FHLB of Des Moines in an amount equal to 0.12% of the Bank's assets as calculated on an annual basis. At December 31, 2016 the Bank had an investment in FHLB stock carried at a cost basis (par value) of $7.6 million. In addition to the FHLB stock required for membership, the Bank must purchase activity stock equal to 4.0% of all outstanding borrowing balances. The activity stock is automatically redeemed in amounts equal to the FHLB advance balances as they are repaid.

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Other borrowings:
In addition to liquidity provided by FHLB, the Bank maintained an uncommitted credit facility with the Federal Reserve Bank of San Francisco of $45.9 million, of which there were no advances or borrowings outstanding. The Bank also maintains advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers' Bank to purchase federal funds of up to $90.0 million as of December 31, 2016.

Supervision and Regulation

We are subject to extensive federal and Washington State legislation, regulation, and supervision, which are primarily intended to protect depositors, the FDIC and shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Act. Among other changes, the Dodd-Frank Act established the Consumer Protection Financial Bureau ("CFPB") as an independent bureau of the Board of Governors of the Federal Reserve System ("Federal Reserve"). The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. See "—Other Regulatory Developments—The Dodd-Frank Act" herein for a discussion of this legislation. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new Federal or State legislation may have in the future.
The following is a summary discussion of certain laws and regulations applicable to Heritage Financial and Heritage Bank which is qualified in its entirety by reference to the actual laws and regulations.

Heritage Financial

As a registered bank holding company with the Federal Reserve, we are subject to comprehensive regulation and supervision by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations of the Federal Reserve. This regulation and supervision is generally intended to ensure that we limit our activities to those allowed by law and that we operate in a safe and sound manner without endangering the financial health of Heritage Bank. As a bank holding company supervised by the Federal Reserve, we are required to file annual and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require.
The Federal Reserve may examine us, and any of our subsidiaries, and assess us for the cost of such examination.
The Federal Reserve has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders or require that a holding company divest subsidiaries (including its bank subsidiary). In general, enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. The Company is also required to file certain reports with, and otherwise comply with, the rules and regulations of the SEC. The Federal Reserve may also order termination of non-banking activities by non-banking subsidiaries of bank holding companies, or divestiture of ownership and control of a non-banking subsidiary by a bank holding company. Some violations may also result in criminal penalties.
Under the BHCA we are supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd Frank Act and Federal Reserve policy provides that a bank holding company should serve as a source of strength to its subsidiary bank by having the ability to provide financial assistance to its subsidiary bank during periods of financial distress. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks is generally considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. No regulations have yet been proposed by the Federal Reserve to implement the source of strength doctrine required by the Dodd-Frank Act.
Under the prompt corrective action provisions of the Federal Deposit Insurance Act ("FDIA"), a bank holding company with an undercapitalized subsidiary bank must guarantee, within limitations, the capital restoration plan that is required to be implemented for its undercapitalized subsidiary bank. If an undercapitalized subsidiary bank fails to file an acceptable capital restoration plan or fails to implement an accepted plan the Federal Reserve may prohibit the bank holding company or its undercapitalized subsidiary bank from, among other restrictions, paying any dividend or

making any other form of capital distribution without the prior approval of the Federal Reserve. In addition, Federal Reserve policy provides that a bank holding company may pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividend and a rate of earnings retention that is consistent with the company's capital needs, asset quality and overall financial condition. In addition, under Washington corporate law, companies generally may not pay dividends if after that payment the company would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than its total liabilities.

We, and any subsidiaries which we may control, are considered “affiliates” within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary and affiliates are subject to numerous restrictions. With some exceptions, we and our subsidiaries are prohibited from tying the provision of various products or services, such as extensions of credit, to other products or services offered by us, or our affiliates.

Bank regulations require bank holding companies and banks to maintain a minimum “leverage” ratio of core capital to adjusted quarterly average total assets of at least 4%. In addition, banking regulators have adopted risk-based capital guidelines under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier 1 capital generally consists of common stockholders’ equity (which does not include unrealized gains and losses on investment securities available for sale), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. Regulatory risk-based capital guidelines require Tier 1 capital of 6% of risk-adjusted assets and minimum total capital ratio (combined Tier 1 and Tier 2) of 8% of risk-adjusted assets. In July 2013, the Federal Reserve and the FDIC approved a new rule that substantially amended the regulatory risk-based capital rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

For additional information, see “—Capital Adequacy” below.

Subsidiary Bank

Heritage Bank is a Washington-chartered commercial bank, the deposits of which are insured by the FDIC. Heritage Bank is subject to regulation by the FDIC and the Division.

Applicable Federal and State statutes and regulations which govern a bank’s operations relate to minimum capital requirements, required reserves against deposits, investments, loans, legal lending limits, mergers and consolidation, borrowings, issuance of securities, payment of dividends, establishment of branches, and other aspects of its operations, among other things. The Division and the FDIC also have authority to prohibit banks under their supervision from engaging in what they consider to be unsafe and unsound practices.

The Bank is required to file periodic reports with the FDIC and the Division, and is subject to periodic examinations and evaluations by those regulatory authorities. Based upon these evaluations, the regulators may revalue the assets of an institution and require that it establish specific reserves to compensate for the differences between the determined value and the book value of such assets. These examinations must be conducted every 12 months, with the exception that well-capitalized banks may be examined every 18 months. The FDIC and the Division may each accept the results of an examination by the other in lieu of conducting an independent examination.

Dividends paid by the Bank provide substantially all of our cash flow. Federal and Washington State bank regulatory agencies also have the general authority to restrict capital distributions by the Bank, including dividends paid by the Bank to Heritage. Such restrictions are tied to the Bank’s capital levels after giving effect to such distributions. For additional information regarding the restrictions on the payment of dividends, see “Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” herein.

Capital Adequacy

The Federal Reserve and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), the Company and the Bank became subject to new capital regulations adopted by the Federal Reserve and the FDIC, which create a new required ratio for common equity Tier 1 (“CET1”) capital, increase the minimum leverage and Tier 1 capital ratios, change the risk-weightings of certain assets for purposes of the risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios, and change what qualifies as capital for purposes of meeting the capital requirements. These regulations implement the regulatory capital reforms required by the Dodd-Frank Act and the “Basel III” requirements.

Under the new capital regulations, the minimum capital ratios are: (1) a CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total risk-based capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio (the ratio of Tier 1 capital to average total adjusted assets) of 4.0%. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income (“AOCI”) unless an institution elects to exclude AOCI from regulatory capital; and certain minority interests; all subject to applicable regulatory adjustments and deductions. Tier 1 capital generally consists of CET1 and noncumulative perpetual preferred stock. Tier 2 capital generally consists of other preferred stock and subordinated debt meeting certain conditions plus an amount of the allowance for loan and lease losses up to 1.25% of assets. Total capital is the sum of Tier 1 and Tier 2 capital.

In addition to the minimum CET1, Tier 1, leverage ratio and total capital ratios, the Company and the Bank must maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum capital levels in order to avoid limitations on paying dividends, repurchasing shares, and paying discretionary bonuses. The new capital conservation buffer requirement began to be phased in on January 1, 2016 requiring a buffer greater than 0.625% of risk-weighted assets, which amount will increase 0.625% each year until the buffer requirement is fully implemented on January 1, 2019.

To be considered "well capitalized," a bank holding company must have, on a consolidated basis, a total risk-based capital ratio of 10.0% or greater and a Tier 1 risk-based capital ratio of 6.0% or greater and must not be subject to an individual order, directive or agreement under which the Federal Reserve requires it to maintain a specific capital level. To be considered “well capitalized,” a depository institution must have a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10%, a CET1 capital ratio of at least 6.5% and a leverage ratio of at least 5% and not be subject to an individualized order, directive or agreement under which its primary federal banking regulator requires it to maintain a specific capital level. As of December 31, 2016, the Company and the Bank met the requirements to be "well capitalized" including the fully phased-in capital conservation buffer requirement.

For a complete description of the Company’s and the Bank's required and actual capital levels as of December 31, 2016, see Note (22) Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Prompt Corrective Action

Federal statutes establish a supervisory framework for FDIC-insured institutions based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution’s category depends upon where its capital levels are in relation to relevant capital measures. The well capitalized category is described above. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. To be considered adequately capitalized, an institution must have the minimum capital ratios described above. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

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

As of December 31, 2016, the Bank met the requirements to be classified as “well capitalized.” See Note (22) Regulatory Capital Requirements of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Classification of Loans

Federal regulations require that the Bank periodically evaluates the risks inherent in its loan portfolio. In addition, the Division of Banks of the Washington State Department of Financial Institutions (“Division”) and the FDIC have the authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful, and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful loans have the weaknesses of Substandard loans, with additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high probability of some loss in loans classified as Doubtful. A loan classified as Loss is considered uncollectible and of such little value that continuance as a loan of the institution is not warranted. If a loan or a portion of the loan is classified as Loss, the institution must charge-off this amount.

Deposit Insurance and Other FDIC Programs

The deposits of the Bank are insured up to $250,000 per separately insured depositor by the Deposit Insurance Fund ("DIF"), which is administered by the FDIC. The FDIC is an independent federal agency that insures the deposits, up to applicable limits, of depository institutions. As insurer of the Bank's deposits, the FDIC has supervisory and enforcement authority over Heritage Bank and this insurance is backed by the full faith and credit of the United States government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by institutions insured by the FDIC. It also may prohibit any FDIC-insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the institution and the DIF. The FDIC also has the authority to initiate enforcement actions and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The Dodd-Frank Act requires the FDIC’s deposit insurance assessments to be based on assets instead of deposits. The FDIC issued rules under which the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. During 2016, the FDIC's reserve ratio surpassed 1.15%. Under current rules, when the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the initial base assessment rates will range from two basis points to 28 basis points and when the prior assessment period is greater than 2.5%, the initial base assessment rates will range from one basis point to 25 basis points (in each case subject to adjustments for unsecured debt issued by a bank, unsecured debt issued by a bank, unsecured debt issued by other FDIC-insured institutions, and brokered deposits held by a bank). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as the Bank. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the DIF.

Other Regulatory Developments

Significant federal banking legislation has been enacted in recent years. The following summarizes some of the recent significant federal banking legislation.

The Dodd-Frank Act. The Dodd-Frank-Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations that we are subject to and that are discussed above under “- Capital Adequacy.”

The federal banking and securities regulators have issued final rules to implement Section 619 of the Dodd-Frank Act, commonly known as the “Volcker Rule” pursuant to the Dodd-Frank Act. Generally, subject to a transition period and certain exceptions, the Volcker Rule restricts insured depository institutions and their affiliated companies from engaging in short-term proprietary trading of certain securities, investing in funds with collateral comprised of less than 100% loans that are not registered with the Securities and Exchange Commission (“SEC”) and from engaging in hedging activities that do not hedge a specific identified risk. After the transition period, the Volcker Rule prohibitions and restrictions will apply to banking entities, including the Company, unless an exception applies. We are continuously reviewing our investment portfolio to determine if changes to our investment strategies may be required in order to comply with the various provisions of the Volcker Rule regulations.

In addition, among other changes, the Dodd-Frank Act requires public companies, like us, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a “say on pay” vote every one, two or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees.

Sarbanes-Oxley Act. As a public company that files periodic reports with the SEC, under the Securities Exchange Act of 1934, Heritage is subject to the Sarbanes-Oxley Act of 2002, which addresses, among other issues, corporate governance, auditing and accounting, executive compensation and enhanced and timely disclosure of corporate information.

The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Website Access to Company Reports

We post publicly available reports required to be filed with the SEC on our website, www.hf-wa.com, as soon as reasonably practicable after filing such reports with the SEC. The required reports are available free of charge through our website.

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Code of Ethics

We have adopted a Code of Ethics that applies to our principal executive officer, principal financial officer and controller. We have posted the text of our Code of Ethics at www.hf-wa.com in the section titled Investor Information: Corporate Governance. Any waivers of the code of ethics will be publicly disclosed to shareholders.

Competition

We compete for loans and deposits with other commercial banks, credit unions, mortgage bankers, and other institutions in the scope and type of services offered, interest rates paid on deposits, pricing of loans, and number and locations of branches, among other things. Many of our competitors have substantially greater resources than we do. Particularly in times of high or rising interest rates, we also face significant competition for investors' funds from short-term money market securities and other corporate and government securities.

We compete for loans principally through the range and quality of the services we provide, interest rates and loan fees, and the locations of our Bank's branches. We actively solicit deposit-related clients and compete for deposits by offering depositors a variety of savings accounts, checking accounts, cash management and other services.

Employees

We had 760 full-time equivalent employees at December 31, 2016. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

Executive Officers

The following table sets forth certain information with respect to the executive officers of the Company at December 31, 2016.

Name	Age as of December 31, 2016	Position	Has Served the Company or Heritage Bank Since
Brian L. Vance	62	President and Chief Executive Officer of Heritage; Chief Executive Officer of Heritage Bank	1996
Jeffrey J. Deuel	58	Executive Vice President of Heritage; President and Chief Operating Officer of Heritage Bank	2010
Donald J. Hinson	55	Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank	2005
David A. Spurling	63	Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank	2001
Bryan McDonald (1)	45	Executive Vice President and Chief Lending Officer of Heritage Bank	2014

(1) Former executive officer of Washington Banking Company.

The business experience of each executive officer is set forth below.

Brian L. Vance is the President and Chief Executive Officer of Heritage and Chief Executive Officer of Heritage Bank as well as a director of Heritage. Mr. Vance was appointed President and Chief Executive Officer of Heritage and Heritage Bank in 2006. In 2003, Mr. Vance was appointed President and Chief Executive Officer of Heritage Bank and in 1998, Mr. Vance was named President and Chief Operating Officer of Heritage Bank. Mr. Vance joined Heritage Bank in 1996 as its Executive Vice President and Chief Credit Officer. Prior to joining Heritage Bank, Mr. Vance was employed for 24 years with West One Bank, a bank with offices in Idaho, Utah, Oregon and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region.

Jeffrey J. Deuel was promoted to President and Chief Operating Officer of Heritage Bank and Executive Vice President of Heritage in September 2012. In November 2010, Mr. Deuel was named Executive Vice President and Chief Operating Officer of Heritage Bank and Executive Vice President of the Company. Mr. Deuel joined Heritage

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Bank in February 2010 as Executive Vice President. Mr. Deuel came to the Company with 28 years of banking experience and most recently held the position of Executive Vice President Commercial Operations with JPMorgan Chase, formerly Washington Mutual. Prior to joining Washington Mutual, Mr. Deuel was based in Philadelphia where he worked for Bank United, First Union Bank, CoreStates Bank, and First Pennsylvania Bank. During his career Mr. Deuel held a variety of leadership positions in commercial banking including lending, retail and support services, corporate strategies, credit administration, and portfolio management. He earned his Bachelor's degree at Gettysburg College.

Donald J. Hinson became Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank in September 2012. In 2007, Mr. Hinson was appointed the Senior Vice President and Chief Financial Officer of Heritage and Heritage Bank. Mr. Hinson joined Heritage Bank in 2005 as Vice President and Controller. Prior to that, he served in the banking audit practice of local and national accounting firms of Knight, Vale and Gregory and RSM McGladrey from 1994 to 2005. Mr. Hinson holds a Bachelor's of Science degree in Accounting from Central Washington University and is a licensed Certified Public Accountant.

David A. Spurling became Executive Vice President and Chief Credit Officer of Heritage and Heritage Bank in January 2014. Prior to that, he was the Senior Vice President and Chief Credit Officer of Heritage Bank beginning in 2007. Mr. Spurling joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America's government-guaranteed lending division. Mr. Spurling holds a Master's Degree in Business Administration from the University of Washington and is Credit Risk Certified by the Risk Management Association.

Bryan McDonald became Executive Vice President and Chief Lending Officer of Heritage Bank upon completion of the Washington Banking Merger effective on May 1, 2014. Prior to that, Mr. McDonald had served as President and Chief Executive Officer of Whidbey Island Bank since January 1, 2012. Mr. McDonald joined Whidbey Island Bank in 2006 as Commercial Banking Manager and he served as Senior Vice President and Chief Operating Officer of Whidbey Island Bank from April 1, 2010 until his promotion to Executive Vice President on August 26, 2010. Mr. McDonald has been serving in the banking industry since 1994, including in regional commercial lending management roles since 1996 for Washington Mutual and Peoples Bank. Mr. McDonald holds a Bachelor's and Master's Degree in Business Administration from Washington State University.

ITEM 1A. RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business strategy. The following provides a discussion of certain risks that management believes are specific to our business. This discussion should not be viewed as an all-inclusive list or in any particular order.

Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us.

We are pursuing a strategy of supplementing organic growth by acquiring other financial institutions or their businesses that we believe will help us fulfill our strategic objectives and enhance our earnings. There are risks associated with this strategy, however, including the following:

- we may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;
- higher than expected deposit attrition;
- potential diversion of our management's time and attention;
- prices at which acquisitions can be made fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we may continue to experience this condition in the future;
- the acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and

time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal effect on the acquired business and its customers, we may not realize the anticipated economic benefits of an acquisition within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful. These risks are present in our completed FDIC-assisted transactions involving our assumption of deposits and the acquisition of the assets of Cowlitz Bank and Pierce Commercial Bank in July 2010 and November 2010, respectively; in the completed open-bank acquisitions of NCB and Valley Community Bancshares in January 2013 and July 2013, respectively, and in the merger of Washington Banking Company in May 2014;

- to finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders;
- since 2006, we completed six acquisitions or mergers, including one acquisition in 2006, two acquisitions during 2010, two acquisitions during 2013 and one merger in 2014 that enhanced our rate of growth. We may not be able to continue to sustain our past rate of growth or to grow at all in the future;
- we expect our net income will increase following our acquisitions; however, we also expect our general and administrative expenses and consequently our efficiency ratios will also increase. Ultimately, we would expect our efficiency ratio to improve; however, if we are not successful in our integration process, this may not occur, and our acquisitions or branching activities may not be accretive to earnings in the short or long-term; and
- to the extent our costs of an acquisition exceed the fair value of the net assets acquired, the acquisition will generate goodwill. As discussed below under “-If the goodwill we have recorded in connection with acquisitions become impaired, our earnings and capital could be reduced,” we are required to assess our goodwill for impairment at least annually, and any goodwill impairment charge could have a material adverse effect on our results of operations and financial condition.

Our business strategy includes significant growth plans, and our financial condition and results of operations could be negatively affected if we are not successful in executing this strategy or if we fail to grow or manage our growth effectively.

We intend to pursue a significant growth strategy for our business. We regularly evaluate potential acquisitions and expansion opportunities. If appropriate opportunities present themselves, we expect to engage in selected acquisitions of financial institutions in the future, including branch acquisitions, or other business growth initiatives or undertakings. There can be no assurance that we will successfully identify appropriate opportunities, that we will be able to negotiate or finance such activities or that such activities, if undertaken, will be successful.

Our growth initiatives may require us to recruit experienced personnel to assist in such initiatives, which will increase our compensation costs. In addition, the failure to identify and retain such personnel would place significant limitations on our ability to successfully execute our growth strategy. To the extent we expand our lending beyond our current market areas, we also could incur additional risk related to those new market areas. We may not be able to expand our market presence in our existing market areas or successfully enter new markets.

If we do not successfully execute our acquisition growth plan, it could adversely affect our business, financial condition, results of operations, reputation and growth prospects. In addition, if we were to conclude that the value of an acquired business had decreased and that the related goodwill had been impaired, that conclusion would result in an impairment of goodwill charge to us, which would adversely affect our results of operations. While we believe we have the executive management resources and internal systems in place to successfully manage our future growth, there can be no assurance that suitable growth opportunities will be available or that we will successfully manage our growth. See “-If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced” and “-Our strategy of pursuing acquisitions and de novo branching exposes us to financial and operational risks that could adversely affect us” for additional risks related to our acquisition strategy.

The required accounting treatment of purchased loans we acquire through acquisitions could result in higher net interest margins and interest income in current periods and lower net interest margins and interest income in future periods.

Under generally accepted accounting principles ("GAAP"), we are required to record purchased loans acquired through acquisitions at fair value, which may differ from the outstanding balance of such loans. Estimating the fair value of such loans requires management to make estimates based on available information and facts and circumstances on the acquisition date. Actual performance could differ from management’s initial estimates. If these loans outperform our original fair value estimates, the difference between our original estimate and the actual performance of the loan (the “discount”) is accreted into net interest income. This accretable yield may change due to changes in expected timing and amount of future cash flows. The yields on our loans could decline as our acquired loan portfolio pays down or matures, and we expect downward pressure on our interest income to the extent that the runoff on our acquired loan portfolio is not replaced with comparable high-yielding loans. This could result in higher

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net interest margins and interest income in current periods and lower net interest rate margins and lower interest income in future periods.

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

The financial services industry is extensively regulated. We are subject to extensive examination, supervision and comprehensive regulation by the Federal Reserve and Heritage Bank is subject to examination, supervision and comprehensive regulation by the FDIC and the Division. The Federal Reserve, FDIC and Division govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose requirements for additional capital, restrictions on operations, the reclassification of assets, and the determination of the adequacy of the allowance for loan losses and level of deposit insurance premiums assessed. In addition, these bank regulators also have the ability to impose additional conditions in the approval of merger and acquisition transactions.

As discussed under “Item 1. Business - Supervision and Regulation - Capital Adequacy” of this Form 10-K, the Dodd-Frank Act has significantly changed the bank regulatory structure and affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years. It is difficult at this time to predict when or how any new standards will ultimately be applied to us or what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. The new administration recently announced plans to deregulate the financial industry, including making changes to the Dodd-Frank Act. If changes to the implementing rules and regulations of the Dodd-Frank Act are made, it is expected that such changes could offset the anticipated increase in operating and compliance costs (included in noninterest expense) than otherwise could occur.

We may face increased compliance costs and uncertainty in residential mortgage lending as a result of the adoption of consumer protection regulations by the Consumer Financial Protection Bureau.

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

The CFPB has issued a number of final regulations and changes to certain consumer protections under existing laws. These final rules generally prohibit creditors from extending mortgage loans without regard for the consumer’s ability to repay and add restrictions and requirements to mortgage origination and servicing practices. In addition, these rules limit prepayment penalties and require the creditor to retain evidence of compliance with the ability-to-repay requirement for three years. Compliance with these rules will likely increase our overall regulatory compliance costs and may require changes to our underwriting practices with respect to mortgage loans. Moreover, these rules may adversely affect the volume of mortgage loans that we underwrite and may subject us to increased potential liabilities related to such residential loan origination activities.

Our loan portfolio is concentrated in loans with a higher risk of loss.

Repayment of our commercial business loans, consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial loans to a variety of businesses with a focus on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial loans offered are business lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the Small Business Administration, or SBA, and are a “preferred lender” of the SBA. Commercial business lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts established on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on our assessment of the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may be unpredictable,

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and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and creditworthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Agricultural lending involves a greater degree of risk and typically involves higher principal amounts than other types of loans. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields (such as hail, drought and floods), declines in market prices for agricultural products (both domestically and internationally) and the impact of government regulations (including changes in price supports, subsidiaries and environmental regulations). In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower’s ability to repay the loan may be impaired.

At December 31, 2016, our commercial business loans (consisting of commercial and industrial loans, owner-occupied commercial real estate loans and non-owner occupied commercial real estate loans) totaled $2.08 billion, or approximately 78.7% of our total loan portfolio. Approximately $8.6 million, or 0.4%, of our total commercial business loans were nonperforming at December 31, 2016. The majority of the nonperforming commercial business loans were commercial and industrial loans.

Our non-owner occupied commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and five or more family residential real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower’s project is reduced as a result of leases not being obtained or renewed, the borrower’s ability to repay the loan may be impaired.

Commercial and five or more family residential real estate loans also expose us to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and five or more family residential real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. If we foreclose on a commercial and five or more family residential real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential loans because there are fewer potential purchasers of the collateral. Additionally, commercial and five or more family residential real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment regarding the collectability of our commercial and five or more family residential real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

As of December 31, 2016, our non-owner occupied commercial real estate loans totaled $880.9 million, or 33.4% of our total loan portfolio. Approximately $1.3 million, or 0.1%, of our non-owner occupied commercial real estate loans were nonperforming at December 31, 2016.

Our real estate construction and land development loans are based upon estimates of costs and the related value associated with the completed project. These estimates may be inaccurate. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project’s completion. Because of the uncertainties inherent in estimating construction

costs as well as the market value of a completed project and the effects of governmental regulation of real property, our estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If our estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss.
As of December 31, 2016, our real estate construction and land development loans totaled $159.2 million, or 6.0% of our total loan portfolio. Of these loans, $50.4 million, or 1.9% of our total loan portfolio, were one-to-four family

residential construction related and $108.8 million, or 4.1% of our total loan portfolio, were five-or-more family residential and commercial property construction related. Approximately $2.0 million, or 1.3%, of our total construction and land development loans were nonperforming at December 31, 2016.

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

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

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

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

- our general reserve, based on our historical default and loss experience;
- our specific reserve, based on our evaluation of impaired loans and their underlying collateral or discounted cash flows; and
- current macroeconomic factors, regulatory requirements and management's expectation of future events.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. If current conditions in the housing and real estate markets weaken, we expect we will experience increased delinquencies and credit losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on their judgments about information available to them at the time of their examination. In addition, if charge-offs in future periods exceed the allowance for loan losses we will need additional provisions to increase the allowance for loan losses.

The Financial Accounting Standards Board has adopted a new accounting standard that will be effective for our first fiscal year after December 15, 2019. This standard, referred to as Current Expected Credit Loss ("CECL") will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans and recognize the expected credit losses as allowances for credit losses. This will change the current method of providing allowances for credit losses that are probable, which may require us to increase our allowance for loan losses, and may greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for credit losses. Any increases in the allowance for loan losses will result in a decrease in net income and possibly capital, and may have a material adverse effect on our financial condition and results of operations.

If our allowance for loan losses is not adequate, we may be required to make further increases in our provision for loan losses and charge-off additional loans, which could adversely affect our results of operations and our capital.

For the year ended December 31, 2016 we recorded a provision for loan losses of $4.9 million compared to $4.4 million for the year ended December 31, 2015. We recorded net charge-offs of loans of $3.6 million for the year ended December 31, 2016 compared to $2.4 million for the year ended December 31, 2015. At December 31, 2016 our total nonperforming loans were $10.9 million, or 0.41% of loans receivable, net, compared to $9.7 million or 0.40% of loans receivable, net, at December 31, 2015. Generally, our nonperforming loans reflect operating difficulties of individual borrowers, which may be the result of current economic conditions. If economic conditions deteriorate, we expect that we could experience significantly higher delinquencies and loan charge-offs. As a result, we may be required to make further increases in our provision for loan losses in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

General economic conditions tend to impact loan segments at varying degrees. At December 31, 2016, our owner-occupied commercial real estate loans had the greatest percentage of nonaccrual loans of 34.2% as the borrowers are primarily business owners whose business results are influenced by economic conditions. Our

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commercial and industrial loan portfolio, which contained 32.4% of our nonaccrual loans at December 31, 2016, generally has the largest percentage of nonperforming loans because of the same reason as owner-occupied commercial real estate loans noted above as well as impact of the types of collateral generally securing these loans which are less marketable than commercial real estate. Sale volumes and prices as well as inventory in the housing market has been the primary cause of deterioration in our one-to-four family residential real estate construction and land development loans, which contained 18.4% of our nonaccrual loans at December 31, 2016.

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

Substantially all of our loans are to businesses and individuals in the states of Washington and Oregon. A decline in the economies of our primary market areas of the Pacific Northwest in which we operate could have a material adverse effect on our business, financial condition, results of operations and prospects. In addition, weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade and it is not known how the recent withdrawal by the United States from the Trans-Pacific Partnership trade agreement may effect these businesses.

While real estate values and unemployment rates have improved, a deterioration in economic conditions in our market areas of the Pacific Northwest could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- loan delinquencies, problem assets and foreclosures may increase;
- the sale of foreclosed assets may be slow;
- our provision for loan losses may increase;
- demand for our products and services may decline, possibly resulting in a decrease in our total loans;
- collateral for loans made may decline further in value, exposing us to increased risk of loss on existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our deposits may decrease and the composition of our deposits may be adversely affected.

If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced.

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer's balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a potential impairment exists. The evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions. At December 31, 2016, we had goodwill with a carrying amount of $119.0 million.

Declines in our stock price or a prolonged weakness in the operating environment of the financial services industry may result in a future impairment charge. Any such impairment charge could have a material adverse effect on our operating results and financial condition.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference (or "spread") between the interest earned on loans, securities and other interest earning assets and the interest paid on deposits, borrowings, and other interest bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest earning assets and interest bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest earning assets and interest paid on interest bearing liabilities. We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. Thus, in a changing interest rate environment, we may not be able to manage this risk effectively. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread, and, in turn, our profitability.

During the past several years it has been the policy of the Federal Reserve to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, market rates on the loans we have originated and the yields on securities we have purchased have been at lower levels than available prior to 2008. Our ability to lower our interest expense will be limited at these interest rate levels while the average yield on our interest earning assets may continue to decrease. In an attempt to help the overall economy, the Federal Reserve raised short-term interest rates in December 2016 from one-half to three quarters of a percent as a result of moderate improvements in the economy, particularly in improvements in the unemployment rate. It is anticipated that the Federal Reserve will make additional increases in interest rates during 2017 subject to economic conditions. As the Federal Reserve increases Fed Funds rates, overall interest rates will likely rise, which may negatively impact both the housing markets by reducing refinancing activity and new home purchases and the U.S. economic recovery.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

Changes in the method of determining the LIBOR or other reference rates may adversely impact the value of loans receivable and other financial instruments we hold that are linked to LIBOR or other reference rates in ways that are difficult to predict and could adversely impact our financial condition or results of operations.

In recent years, concerns have been raised about the accuracy of the calculation of LIBOR. Aspects of the method for determining how LIBOR is formulated and its use in the market have changed and may continue to change. Recent changes to LIBOR administration have included the introduction of statutory regulation of LIBOR by U.K. regulatory authorities; reducing the currencies for which LIBOR is calculated to five; reducing the tenors for which LIBOR is calculated to seven; delaying the publication of individual banks' LIBOR submissions for three months from submission; and requiring banks to provide LIBOR submissions based on an effective methodology on the basis of relevant criteria and information, including observable market transactions where possible. Each such change and any future changes could impact the availability and volatility of LIBOR. Similar changes have occurred or may occur with respect to other reference rates. It is not currently possible to determine whether, or to what extent, any such changes would impact the value of any loans, derivatives and other financial obligations or extensions of credit we hold or that are due to us, that are linked to LIBOR or other reference rates, or whether, or to what extent, such changes would impact our financial condition or results of operations.

Our securities portfolio may be negatively impacted by fluctuations in market value and interest rates.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. Fluctuations in market value may be caused by changes in market interest rates, rating agency actions in respect of the securities, defaults by the issuer or with respect to the underlying securities, lower market prices for securities and limited investor demand. Our securities portfolio is evaluated for other-than-temporary impairment. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. Changes in interest rates can also have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

Decreased volumes and lower gains on sales of mortgage loans sold could adversely impact our noninterest income.

We originate and sell one-to-four family residential loans. Our mortgage banking income is a significant portion of our noninterest income. We generate gains on the sale of one-to-four family residential loans pursuant to programs currently offered by Freddie Mac and other secondary market purchasers. Any future changes in their purchase programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in noninterest income. In addition, our results of operations are affected by the amount of noninterest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

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The tightening of available liquidity could limit our ability to replace deposits and fund loan demand, which could adversely affect our earnings and capital levels.

A tightening of the credit markets and the inability to obtain adequate funding to replace deposits and fund continued loan growth may negatively affect asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, maturity of investment securities and loan payments, we rely from time to time on advances from the FHLB of Des Moines, and certain other wholesale funding sources to fund loans and replace deposits. In the event of a further downturn in the economy, these additional funding sources could be negatively affected which could limit the funds available to us. Our liquidity position could be significantly constrained if we were unable to access funds from the FHLB of Des Moines or other wholesale funding sources.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high; further, the resulting dilution of our equity may adversely affect the market price of our common stock.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. At some point we may need to raise additional capital to support our continued internal growth and growth through acquisitions or be required by our regulators to increase our capital resources. Our ability to raise additional capital, however, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected. Accordingly, we cannot make assurances that we will be able to raise additional capital when needed.

We are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales of a large number of shares of common stock or preferred stock or similar securities in the market or from the perception that such sales could occur.

Our Board of Directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the NASDAQ Stock Market. In addition, our Board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms.

In addition, if we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions.

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury’s Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions. Recently, several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, no assurance can be given that these policies and procedures will be effective in preventing violations of these laws and regulations.

We are subject to certain risks in connection with our use of technology.

Our security measures may not be sufficient to mitigate the risk of a cyber-attack. Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger and virtually all other aspects of our business. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious code and cyber-attacks that could have a security impact. If one or more of these events occur, this could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us. We could also suffer significant reputational damage.

Security breaches in our internet banking activities could further expose us to possible liability and damage our reputation. Any compromise of our security also could deter customers from using our internet banking services that involve the transmission of confidential information. We rely on standard internet security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures and could result in significant legal liability and significant damage to our reputation and our business. We have experienced no known material breaches.

Our security measures may not protect us from system failures or interruptions. While we have established policies and procedures to prevent or limit the impact of systems failures and interruptions, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, we outsource certain aspects of our data processing and other operational functions to certain third-party providers. If our third-party providers encounter difficulties, or if we have difficulty in communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely impacted. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

The occurrence of any failures or interruptions may require us to identify alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Further, the occurrence of any systems failure or interruption could damage our reputation and result in a loss of customers and business, could subject us to additional regulatory scrutiny, or could expose us to legal liability. Any of these occurrences could have a material adverse effect on our financial condition and results of operations.

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.

Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes, although such losses have been relatively insignificant to date. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur.

Changes in accounting standards may affect how we record and report our performance.

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

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

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where we conduct our business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President and Chief Executive Officer, Mr. Brian L.

Vance, and certain other employees. The loss of key personnel could adversely affect our ability to successfully conduct our business.

ITEM 1B. UNRESOLVED STAFF COMMENTS

The Company has no unresolved staff comments from the SEC as it relates to the Company's financial information as reported on Form 10-K.

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ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space and main branch office which are owned by Heritage Bank and located in downtown Olympia. The Company's branch network at December 31, 2016 is comprised of 63 branches located throughout Washington and Oregon. The number of branches per county, as well as occupancy type, is detailed in the following table.

County	State	Number of Branches	Occupancy Type Owned	Occupancy Type Leased
Clark	WA	2	1	1
Cowlitz	WA	2	2	—
Island	WA	7	6	1
Kittitas	WA	1	1	—
King	WA	8	3	5
Mason	WA	1	1	—
Multnomah	OR	1	—	1
Pierce	WA	13	8	5
San Juan	WA	1	—	1
Skagit	WA	4	4	—
Snohomish	WA	10	7	3
Thurston	WA	5	4	1
Whatcom	WA	4	3	1
Yakima	WA	4	4	—
Total		63	44	19

One Island County Branch, one Skagit County Branch, one Thurston County branch and the branch in Kittitas County have land leases, which are not included in the leased section above as the building is owned.

In addition, as part of the Company's strategic initiatives, certain measures were taken to transform the Company's branching system subsequent to December 31, 2016. Four branches operating at December 31, 2016 are scheduled to be consolidated into existing Heritage Bank branches in April 2017. Three of the four branches to be closed subsequent to year-end were owned and one branch was leased.

For additional information concerning our premises and equipment and lease obligations, see Notes (8) Premises and Equipment and (15) Commitment and Contingencies, respectively, of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

ITEM 3. LEGAL PROCEEDINGS

We, and our Bank, are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Bank.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the symbol HFWA. At December 31, 2016, we had approximately 1,441 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 29,954,931 outstanding shares of common stock. This total does not reflect the number of persons or entities who hold stock in nominee or "street" name through various brokerage firms. The last reported sales price on February 17, 2017 was $25.25 per share. The following table provides sales information per share of our common stock as reported on the NASDAQ Global Select Market for the indicated quarters.

	2016 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$18.68	$18.45	$ 18.67	$ 26.10
Low	$16.54	$16.47	$ 16.92	$ 17.70

For the interim period subsequent to the 2016 fiscal year through the last reported sales price on February 17, 2017, the high and low sales information price per share of our common stock as reported on the NASDAQ Global Selected Market was $24.55 and $26.75, respectively.

	2015 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$17.16	$17.99	$ 19.30	$ 19.70
Low	$15.52	$16.76	$ 17.22	$ 18.08

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors.

The dividend activities for the years ended December 31, 2016 and 2015 and from December 31, 2016 through the date of this filing are listed below:

Declared	Cash Dividend per Share	Record Date	Paid	
January 28, 2015	$0.10	February 10, 2015	February 24, 2015	
April 22, 2015	$0.11	May 7, 2015	May 21, 2015	
July 22, 2015	$0.11	August 6, 2015	August 20, 2015	
October 21, 2015	$0.11	November 4, 2015	November 18, 2015	
October 21, 2015	$0.10	November 4, 2015	November 18, 2015	*
January 27, 2016	$0.11	February 10, 2016	February 24, 2016	
April 20, 2016	$0.12	May 5, 2016	May 19, 2016	
July 20, 2016	$0.12	August 4, 2016	August 18, 2016	
October 26, 2016	$0.12	November 8, 2016	November 22, 2016	
October 26, 2016	$0.25	November 8, 2016	November 22, 2016	*
January 25, 2017	$0.12	February 9, 2017	February 23, 2017	

* Denotes special dividend.

The primary source for dividends paid to our shareholders are dividends paid to us from Heritage Bank. There are regulatory restrictions on the ability of the Bank to pay dividends. Under federal regulations, the dollar amount of dividends the Bank may pay depends upon its capital position and recent net income. Generally, if an institution satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to the stock form of ownership, as Heritage Bank has done, may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual to stock conversion.

As a bank holding company, our ability to pay dividends is subject to the guidelines of the Federal Reserve regarding capital adequacy and dividends. The Federal Reserve's policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company's capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under Washington law, we are prohibited from paying a dividend if, after making such dividend payment, we would be unable to pay our debts as they become due in the usual course of business, or if our total liabilities, plus the amount that would be needed, in the event we were to be dissolved at the time of the dividend

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payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right of payment to the capital stock on which the applicable distribution is to be made exceed our total assets.

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. At December 31, 2016, there were approximately 933,000 shares remaining to be purchased under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. The Company's tenth stock repurchase plan was approved by the Board of Directors on August 30, 2012 and authorized the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 757,000 shares. All of the shares under the tenth stock repurchase plan were purchased except for 52,025 shares which will remain unpurchased as the eleventh plan supersedes the tenth stock repurchase program.

The following table provides total repurchased shares and average share prices under the applicable plans and years:

	Years Ended December 31,			
	2016	2015	2014	Plan Total
Tenth Plan				
Repurchased shares	—	—	108,075	704,975
Stock repurchase average share price	$—	$—	$ 16.88	$ 15.85
Eleventh Plan				
Repurchased shares	138,000	441,966	—	579,966
Stock repurchase average share price	$ 17.16	$ 16.64	$—	$ 16.76

During the years ended December 31, 2016, 2015 and 2014, the Company repurchased 29,512, 22,300 and 48,304 shares at an average price per share of $17.82, $17.09 and $16.53 to pay withholding taxes on the vesting of restricted stock that vested during the years ended December 31, 2016, 2015 and 2014, respectively, which are not considered repurchased as part of the applicable repurchase plans.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended December 31, 2016.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Cumulative Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2016—October 31, 2016	—	$ —	7,893,389	935,034
November 1, 2016—November 30, 2016	110	18.45	7,893,389	935,034
December 1, 2016—December 31, 2016	196	25.40	7,893,389	935,034
Total	306	$ 22.90	7,893,389	935,034

(1) Common shares repurchased by the Company between October 1, 2016 and December 31, 2016 represent shares of restricted stock that were canceled to pay withholding taxes.

The information regarding the Company's equity compensation plan is contained under "Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" of this Form 10-K and is incorporated by reference herein.

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Stock Performance Graph

The graph below depicts total return to shareholders during the period beginning December 31, 2011 and ending December 31, 2016. Total return includes appreciation or depreciation in market value of the Company's common stock as well as actual cash and stock dividends paid to common shareholders.

The following graph shows a five-year comparison of the total return to shareholders of the Company's common stock as compared to the NASDAQ Composite Index, the SNL Bank NASDAQ Index, and the NASDAQ Bank Index. The NASDAQ Composite Index is a comparative broad market index comprised of all domestic and international common stocks listed on the Nasdaq Stock Market. The SNL Bank NASDAQ Index is a comparative peer index comprised of banks and related holding companies listed on the NASDAQ Stock Market. The NASDAQ Bank Index is a comparative peer index comprised of banks and savings institutions and related holding companies listed on the NASDAQ Stock Market. As the SNL Bank NASDAQ Index excludes the impact of savings banks and related holding companies that are included in the NASDAQ Bank Index, the comparison to the NASDAQ Bank Index that we have used in the past is being replaced by a comparison to the SNL Bank NASDAQ Index going forward.

The graph assumes that the value of the investment in Heritage's common stock and each of the three indices was $100 on December 31, 2011, and that all dividends were reinvested.

	Years Ended December 31,					
Index	2011	2012	2013	2014	2015	2016
Heritage Financial Corporation	$100.00	$123.74	$148.08	$156.57	$173.21	$246.48
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
NASDAQ Bank	100.00	118.69	168.21	176.48	192.08	265.02
SNL U.S. Bank NASDAQ	100.00	119.19	171.31	177.42	191.53	265.56

*Information for the graph was provided by SNL Financial LC.

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ITEM 6. SELECTED FINANCIAL DATA

The following tables set forth certain information concerning our consolidated financial position and results of operations at and for the dates indicated and have been derived from our audited Consolidated Financial Statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 8. Financial Statements and Supplementary Data.”

Matters affecting comparability in the five-year summary detailed below include the Valley and NCB Acquisitions in 2013, and the Washington Banking Merger in 2014 as discussed below. See also Note (2) Business Combination of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" discussing the merger.

	Year Ended December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$138,512	$135,739	$121,106	$71,428	$69,109
Interest expense	6,006	6,120	5,681	3,724	4,534
Net interest income	132,506	129,619	115,425	67,704	64,575
Provision for loan losses	4,931	4,372	4,594	3,672	2,016
Noninterest income	31,619	32,268	16,467	9,651	7,272
Noninterest expense	106,473	106,208	99,379	59,515	50,392
Income tax expense	13,803	13,818	6,905	4,593	6,178
Net income	38,918	37,489	21,014	9,575	13,261
Earnings per common share					
Basic	$1.30	$1.25	$0.82	$0.61	$0.87
Diluted	1.30	1.25	0.82	0.61	0.87
Dividend payout ratio to common shareholders(1)	55.4 %	42.4 %	61.0 %	68.9 %	92.0 %
Performance Ratios:					
Net interest spread(2)	3.89 %	4.04 %	4.45 %	4.69 %	5.03 %
Net interest margin(3)	3.96	4.11	4.53	4.80	5.17
Efficiency ratio(4)	64.87	65.61	75.35	76.94	70.14
Noninterest expense to average assets	2.84	3.01	3.49	3.86	3.72
Return on average assets	1.04	1.06	0.74	0.62	0.98
Return on average common equity	8.01	8.08	5.61	4.58	6.52

(1) Dividend payout ratio is declared dividends per common share divided by diluted earnings per common share.

(2) Net interest spread is the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

(3) Net interest margin is net interest income divided by average interest earning assets.

(4) The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

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	December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$3,878,981	$3,650,792	$3,457,750	$1,659,038	$1,345,540
Total loans receivable, net	2,609,666	2,372,296	2,223,348	1,203,096	998,344
Investment securities	794,645	811,869	778,660	199,288	154,392
FDIC indemnification asset	—	—	1,116	4,382	7,100
Goodwill and other intangible assets	126,403	127,818	129,918	30,980	14,098
Deposits	3,229,648	3,108,287	2,906,331	1,399,189	1,117,971
Federal Home Loan Bank advances	79,600	—	—	—	—
Junior subordinated debentures	19,717	19,424	19,082	—	—
Securities sold under agreement to repurchase	22,104	23,214	32,181	29,420	16,021
Stockholders’ equity	481,763	469,970	454,506	215,762	198,938
Financial Measures:					
Book value per common share	$16.08	$15.68	$15.02	$13.31	$13.16
Stockholders' equity to assets ratio	12.4 %	12.9 %	13.1 %	13.0 %	14.8 %
Net loans to deposits (1)	81.2 %	76.6 %	76.7 %	86.0 %	89.4 %
Capital Ratios:					
Total risk-based capital ratio	13.0 %	13.7 %	15.1 %	16.8 %	19.9 %
Tier 1 risk-based capital ratio	12.0	12.7	13.9	15.5	18.7
Leverage ratio	10.3	10.4	10.2	11.3	13.6
Common equity Tier 1 capital to risk-weighted assets	11.4	12.0	N/A	N/A	N/A
Asset Quality Ratios:					
Nonperforming loans to loans receivable, net (2)	0.41 %	0.40 %	0.51 %	0.63 %	1.29 %
Allowance for loan losses to loans receivable, net (2)	1.18	1.24	1.23	2.34	2.78
Allowance for loan losses to nonperforming loans (2)	284.93	307.67	239.62	372.16	215.67
Nonperforming assets to total assets (2)	0.30	0.32	0.43	0.74	1.41
Net charge-off on loans to average loans receivable, net	0.14	0.10	0.30	0.31	0.44
Other Data:					
Number of banking offices	63	67	66	35	33
Number of full-time equivalent employees	760	717	748	373	363
Deposits per branch	51,264	46,392	44,035	39,977	33,878
Assets per full-time equivalent	5,104	5,092	4,623	4,448	3,707

(1) Total loans receivable, net plus loans held for sale divided by deposits.

(2) At December 31, 2016, 2015, 2014, 2013 and 2012, $2.8 million, $1.3 million $1.6 million, $1.7 million and $1.2 million of nonaccrual loans were guaranteed by government agencies, respectively.

The Company has focused on expanding its business over the past several years. In 2010, the Company completed two FDIC-assisted transactions for the acquisition of Cowlitz Bank in July 2010 and Pierce Commercial Bank in November 2010. In 2013, the Company completed two open-bank acquisitions of Northwest Commercial Bank in January 2013 and Valley Community Bancshares in July 2013. In May 2014, the Company completed the merger with

Washington Banking Company. These acquisitions and mergers, together with organic growth of the business, has significantly increased the Company's net assets.

During the period from December 31, 2012 through December 31, 2016 our total assets have increased $2.53 billion, or 188.3%, to $3.88 billion as of December 31, 2016 from $1.35 billion at December 31, 2012. The total loans receivable, net of allowance for loan losses grew $1.61 billion, or 161.40%, to $2.61 billion as of December 31, 2016 from $998.3 million at December 31, 2012. Our emphasis in growing our commercial business loan portfolio, in addition to mergers and acquisitions, resulted in an increase in commercial business loans of $1.22 billion, or 143.12%, since December 31, 2012. Loan increases during the five-year period are also attributable to the Washington Banking Merger and the acquisitions of Valley and Northwest Commercial Bank and our emphasis on increasing lending in our market areas.

Deposits increased $2.11 billion, or 188.9%, to $3.23 billion at December 31, 2016 from $1.12 billion at December 31, 2012. From December 31, 2012 to December 31, 2016, non-maturity deposits (total deposits less certificate of deposit accounts) increased $2.04 billion, or 246.5% to $2.87 billion at December 31, 2016. The percentage of certificate of deposit accounts to total deposits decreased to 11.1% at December 31, 2016 from 25.8% at December 31, 2012.

Stockholders' equity has increased by $282.8 million, or 142.2%, to $481.8 million at December 31, 2016 from $198.9 million at December 31, 2012 due primarily to a combination of earnings and issuances of common stock, partially offset by repurchases of common stock and declaration of cash dividends. Our net income increased by $25.7 million, or 193.5%, to $38.9 million for the year ended December 31, 2016 from $13.3 million for the year ended December 31, 2012 due primarily to growth in the Company primarily through acquisitions and mergers, which net assets generated an increase in net interest income of $67.9 million, or 105.2%, to $132.5 million for the year ended December 31, 2016 from $64.6 million during the year ended December 31, 2012. The increase in net income was also a result of a $69.4 million, or 100.4%, increase in interest income to $138.5 million for the year ended December 31, 2016 from $69.1 million for the year ended December 31, 2012 and a $24.3 million, or 334.8%, increase in noninterest income to $31.6 million for the year ended December 31, 2016 compared to $7.3 million for the year ended December 31, 2012. The increases in net interest income and noninterest expense was partially offset by a $56.1 million, or 111.3%, increase in noninterest expense to $106.5 million for the year ended December 31, 2016 from $50.4 million for the year ended December 31, 2012 as a result of the growth of the Company.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in understanding the financial condition and results of operations of the Company. The information contained in this section should be read with the December 31, 2016 audited Consolidated Financial Statements and Notes thereto included in "Item 8. Financial Statements and Supplementary Data" of this Form 10-K.

Critical Accounting Policies

The Company's Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Companies may apply certain critical accounting policies requiring management to make subjective or complex judgments, often as a result of the need to estimate the effect of matters that are inherently uncertain.

The Company considers its most critical accounting estimates to be the allowance for loan losses, estimations of expected cash flows related to purchased credit impaired loans, business combinations, other than temporary impairments in the market value of investments and consideration of potential impairment of goodwill.

Allowance for Loan Losses

The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses is maintained at the amount management believes will be appropriate to absorb probable incurred losses in the loan portfolio at the balance sheet date. The allowance for loan losses is determined by applying estimated loss factors to the credit exposure from outstanding loans.

We assess the estimated credit losses inherent in our loan portfolio by considering a number of elements including:

- historical loss experience in the loan portfolio;

- balance of potential problem loans in the loan portfolio;
- impact of environmental factors, including:

levels of and trends in delinquencies and impaired loans;
levels of and trends in charge-offs and recoveries;

trends in volume and terms of loans;
effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
experience, ability, and depth of lending management and other relevant staff;
national and local economic trends and conditions;
other external factors such as competition, legal, and regulatory;
effects of changes in credit concentrations; and
other factors

We calculate an appropriate allowance for loan losses for the loans in our loan portfolio by applying historical loss factors for homogeneous classes of the portfolio, adjusted for changes to the above-noted environmental factors. We may record specific provisions for impaired loans, including loans on nonaccrual status and troubled-debt restructured ("TDR") loans, after a careful analysis of each loan’s credit and collateral factors. Our analysis of an appropriate allowance for loan losses combines the provisions made for our non-impaired loans and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in national and local economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company’s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For additional information regarding the allowance for loan losses, its relation to the provision for loan losses, risk related to asset quality and lending activity, see “—Results of Operations for the Years Ended December 31, 2016 and 2015—Provision for Loan Losses” and “—Consolidated Financial Condition —Allowance for Loan Losses” below, “Item 1A. Risk Factors —Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio” as well as Note (5) Allowance for Loan Losses of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Estimated Expected Cash Flows related to Purchased Credit Impaired ("PCI") Loans

Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. In situations where such PCI loans have similar risk characteristics, loans may be aggregated into pools to estimate cash flows. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation.

The cash flows expected over the life of the PCI loan or pool are estimated using an internal cash flow model that projects cash flows and calculates the carrying values of the pools, book yields, effective interest income and impairment, if any, based on pool level events. Assumptions as to default rates, loss severity and prepayment speeds are utilized to calculate the expected cash flows.

Expected cash flows at the acquisition date in excess of the fair value of loans are considered to be accretable yield, which is recognized as interest income over the life of the loan or pool using a level yield method if the timing and amounts of the future cash flows of the pool are reasonably estimable. Subsequent to the acquisition date, any increases in cash flow over those expected at purchase date in excess of fair value are recorded as interest income prospectively. Any subsequent decreases in cash flow over those expected at purchase date are recognized by recording an allowance for loan losses. Any disposals of loans, including sales of loans, payments in full or foreclosures result in the removal of the loan from the loan pool at the carrying amount.

Business Combinations

The Company applies the acquisition method of accounting for business combinations. Under the acquisition method, the acquiring entity in a business combination recognizes all of the identifiable assets acquired and liabilities assumed at their acquisition date fair values. Management utilizes prevailing valuation techniques appropriate for the asset or liability being measured in determining these fair values. Any excess of the purchase price over amounts allocated to assets acquired, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. Where amounts allocated to assets acquired and liabilities assumed is greater than the purchase price, a bargain purchase gain is recognized. Acquisition-related costs are expensed as incurred unless they are directly attributable to the issuance of the Company's common stock in a business combination.

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Other-Than-Temporary Impairments in the Market Value of Investments

Unrealized losses on investment securities available for sale and held to maturity are evaluated at least quarterly to determine whether declines in value should be considered “other than temporary” and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is “other than temporary” include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore, continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Goodwill

The Company’s goodwill is assigned to Heritage Bank and is evaluated for impairment at the Heritage Bank level (reporting unit). Goodwill is reviewed for impairment annually and between annual tests if an event occurs or circumstances change that might indicate the Company’s recorded value is more than its implied value. Such indicators may include, among others: a significant adverse change in legal factors or in the general business climate; significant decline in the Company’s stock price and market capitalization; unanticipated competition; and an adverse action or assessment by a regulator. Any adverse changes in these factors could have a significant impact on the recoverability of goodwill and could have a material impact on the Company’s Consolidated Financial Statements.

The testing for impairment may begin with an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting unit's fair value as well as positive and mitigating events. When required, the goodwill impairment test involves a two-step process. The first test for goodwill impairment is done by comparing the reporting unit’s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second test would be performed to measure the amount of impairment loss, if any. To measure any impairment loss the implied fair value would be determined in the same manner as if the reporting unit were being acquired in a business combination. If the implied fair value of goodwill is less than the recorded goodwill an impairment charge would be recorded for the difference.

For the year ended December 31, 2016, the Company completed step one of the two-step process of the goodwill impairment test. Based on the results of the test, the Company concluded that the reporting unit’s fair value was greater than its carrying value and there was no impairment of goodwill.

For additional information regarding goodwill, see Note (9) Goodwill and other intangible assets of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Financial Overview

Heritage Financial Corporation is a bank holding company which primarily engages in the business activities of our wholly-owned financial institution subsidiary, Heritage Bank. We provide financial services to our local communities with an ongoing strategic focus on our commercial banking relationships, market expansion and asset quality.

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Consolidated Financial Condition

The Company's total assets increased $228.2 million, or 6.3%, to $3.88 billion at December 31, 2016 from $3.65 billion at December 31, 2015. The increase was primarily due to a $237.4 million, or 10.0%, increase in total loans receivable, net. The asset balances at December 31, 2016 and 2015 and the changes in those balances are included in the following table:

	December 31, 2016	December 31, 2015	Change 2016 vs. 2015	Percent Change 2016 vs. 2015
	(Dollars in thousands)			
Cash and cash equivalents	$103,745	$ 126,640	$(22,895)	(18.1)%
Other interest earning deposits	—	6,719	(6,719)	(100.0)
Investment securities available for sale	794,645	811,869	(17,224)	(2.1)
Loans held for sale	11,662	7,682	3,980	51.8
Total loans receivable, net	2,609,666	2,372,296	237,370	10.0
Other real estate owned	754	2,019	(1,265)	(62.7)
Premises and equipment, net	63,911	61,891	2,020	3.3
FHLB stock, at cost	7,564	4,148	3,416	82.4
Bank owned life insurance	70,355	60,876	9,479	15.6
Accrued interest receivable	10,925	10,469	456	4.4
Prepaid expenses and other assets	79,351	58,365	20,986	36.0
Other intangible assets, net	7,374	8,789	(1,415)	(16.1)
Goodwill	119,029	119,029	—	—
Total assets	$3,878,981	$ 3,650,792	$228,189	6.3 %

Investment Activities

Our investment policy is established by the Board of Directors and monitored by the Risk Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complements the Bank's lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage-backed securities is not permitted under the policy.

Investment securities available for sale decreased $17.2 million, or 2.1%, to $794.6 million at December 31, 2016 from $811.9 million at December 31, 2015. The decrease was due primarily to sales of investment securities of $140.4 million, maturities, calls and payments of investment securities of $129.4 million and net unrealized losses on investment securities as a result of market conditions which reduced bond prices of $7.9 million during the year ended December 31, 2016. The decrease was partially offset by purchases of investment securities of $267.7 million during the year ended December 31, 2016.

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The following table provides information regarding our investment securities available for sale at the dates indicated.

	December 31, 2016			December 31, 2015			December 31, 2014		
	Fair Value	% of Total Investments		Fair Value	% of Total Investments		Fair Value	% of Total Investments	
	(Dollars in thousands)								
U.S. Treasury and U.S. Government-sponsored agencies	$1,569	0.2	%	$35,577	4.4	%	$21,427	2.9	%
Municipal securities	237,256	29.9		220,993	27.2		173,037	23.3	
Mortgage-backed securities and collateralized mortgage obligations(1):									
Residential	309,176	38.9		352,024	43.4		498,737	67.1	
Commercial	208,318	26.2		179,011	22.0		43,662	5.9	
Collateralized loan obligations	10,478	1.3		15,097	1.9		—	—	
Corporate obligations	16,706	2.1		9,113	1.1		4,010	0.5	
Other securities	11,142	1.4		54	—		1,973	0.3	
Total	$794,645	100.0	%	$811,869	100.0	%	$742,846	100.0	%

(1) U.S. Government-sponsored agencies.

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2016. Equity securities are excluded because they have no stated maturity dates.

	One Year or Less			Over One to Five Years			Over Five to Ten Years			Over Ten Years		
	Fair Value	Weighted Average Yield(2)		Fair Value	Weighted Average Yield(2)		Fair Value	Weighted Average Yield(2)		Fair Value	Weighted Average Yield(2)	
	(Dollars in thousands)											
U.S. Treasury and U.S. Government-sponsored agencies	$1,000	1.47	%	$569	2.00	%	$—	—	%	$—	—	%
Municipal securities	4,651	3.19		62,452	3.26		48,525	3.44		121,628	3.77	
Mortgage-backed securities and collateralized mortgage obligations(1):												
Residential	—	—		4,575	1.26		69,176	2.19		235,425	2.12	
Commercial				52,612	2.05		120,676	2.30		35,030	2.06	
Collateralized loan obligations	—	—		—	—		10,478	2.54		—	—	
Corporate obligations	1,015	1.75		4,032	1.67		11,659	2.07		—	—	
Other securities	—	—		—	—		—	—		11,019	2.10	
Total	$6,666	2.71	%	$124,240	2.62	%	$260,514	2.48	%	$403,102	2.61	%

(1)U.S. Government-sponsored agencies.
(2)Taxable equivalent weighted average yield.

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The following table provides information regarding our investment securities held to maturity at the date indicated. The Company transferred all of its investment securities classified as held to maturity to available for sale during the year ended December 31, 2015. Based on the changes in the current rate environment, management made this change in an effort to manage more effectively the investment portfolio, including subsequently selling securities that were formerly classified as held to maturity. As there were no investment securities held to maturity at December 31, 2016 and 2015, no values are presented in the table.

	December 31, 2014		
	Amortized Cost	% of Total Investments	
	(Dollars in thousands)		
U.S. Treasury and U.S. Government-sponsored agencies	$1,591	4.4	%
Municipal securities	22,486	62.8	
Mortgage-backed securities and collateralized mortgage obligations[1]:			
Residential	5,261	14.7	
Commercial	5,605	15.7	
Private residential collateralized mortgage obligations	871	2.4	
Total	$35,814	100.0	%

[1] U.S. Government-sponsored agencies.

Loan Portfolio

The Bank is a full service commercial bank, which originates a wide variety of loans with a focus on commercial business loans. Loans receivable, net of allowance for loan losses, increased $237.4 million, or 10.0%, to $2.61 billion at December 31, 2016 from $2.37 billion at December 31, 2015. The increase in loans receivable was primarily in the non-owner occupied commercial real estate loan class which increased $126.9 million, or 16.8%, to $880.9 million during fiscal year 2016 and five or more family residential and commercial real estate construction and land development loans which increased $53.4 million, or 96.6%, to $108.8 million during 2016.

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

	December 31, 2016		2015		2014		2013		2012	
	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)	Balance	% of Total (3)
	(Dollars in thousands)									
Commercial business:										
Commercial and industrial	$637,773	24.2 %	$596,726	24.8 %	$570,453	25.3 %	$351,230	28.5 %	$327,784	31.9 %
Owner-occupied commercial real estate	558,035	21.1	572,609	23.8	574,687	25.5	303,073	24.6	236,501	23.0
Non-owner occupied commercial real estate	880,880	33.4	753,986	31.4	663,935	29.5	417,206	33.9	289,882	28.2
Total commercial business	2,076,688	78.7	1,923,321	80.0	1,809,075	80.3	1,071,509	87.0	854,167	83.1
One-to-four family residential(1)	77,391	2.9	72,548	3.0	69,530	3.1	47,859	3.9	46,915	4.6
Real estate construction and land development:										
One-to-four family residential	50,414	1.9	51,752	2.2	49,195	2.2	21,280	1.7	30,121	2.9
Five or more family residential and commercial properties	108,764	4.1	55,325	2.3	64,920	2.9	48,655	3.9	52,939	5.2
Total real estate construction and land development (2)	159,178	6.0	107,077	4.5	114,115	5.1	69,935	5.6	83,060	8.1
Consumer	325,140	12.3	298,167	12.4	259,294	11.5	45,287	3.7	44,892	4.4
Gross loans receivable	2,638,397	99.9	2,401,113	99.9	2,252,014	100.0	1,234,590	100.2	1,029,034	100.2
Deferred loan costs (fees), net	2,352	0.1	929	0.1	(937)	—	(2,670)	(0.2)	(2,096)	(0.2)
Loans receivable, net	$2,640,749	100.0%	$2,402,042	100.0%	$2,251,077	100.0 %	$1,231,920	100.0 %	$1,026,938	100.0 %

(1) Excludes loans held for sale of $11.7 million, $7.7 million, $5.6 million and $1.7 million as of December 31, 2016, 2015, and 2014, respectively. There were no loans held for sale at December 31, 2013.
(2) Balances are net of undisbursed loan proceeds.
(3) Percent of loans receivable, net.

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The following table presents at December 31, 2016 (i) the aggregate contractual maturities of loans in the named categories of our loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories.

	Maturing			
	One Year or Less	Over One to Five Years	Over Five Years	Total
	(In thousands)			
Commercial business	$260,081	$401,563	$1,415,044	$2,076,688
One-to-four family residential	1,065	3,125	73,201	77,391
Real estate construction and land development	98,652	52,517	8,009	159,178
Consumer	16,690	$93,498	$214,952	325,140
Gross loans receivable	$376,488	$550,703	$1,711,206	$2,638,397
Fixed rate loans	$115,452	$362,273	$511,325	$989,050
Variable or adjustable rate loans	261,036	188,430	1,199,881	1,649,347
Total	$376,488	$550,703	$1,711,206	$2,638,397

Included in the balance of variable or adjustable rate loans with maturity over five years in the table above are certain commercial loans in which the Bank entered into non-hedge interest rate swap contracts with the borrower and a third party. Under these derivative contract arrangements, the Bank effectively earns a variable rate of interest based on one-month LIBOR plus various margins while the customer pays a fixed rate of interest. At December 31, 2016, the Bank had 28 separate interest rate swap contracts with borrowers with notional value of $102.7 million compared to four separate interest rate swap contracts with borrowers with notional value of $20.7 million at December 31, 2015.

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The following table provides information about our nonaccrual loans, other real estate owned and performing TDR loans for the indicated dates.

	December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands)				
Nonaccrual loans:					
Commercial business	$8,580	$7,122	$8,596	$5,675	$6,068
One-to-four family residential	94	38	—	340	450
Real estate construction and land development	2,008	2,414	2,831	1,045	6,420
Consumer	227	94	145	685	320
Total nonaccrual loans(1)(2)	10,909	9,668	11,572	7,745	13,258
Other real estate owned	754	2,019	3,355	4,559	5,666
Total nonperforming assets	$11,663	$11,687	$14,927	$12,304	$18,924
Allowance for loan losses	$31,083	$29,746	$27,729	$28,824	$28,594
Nonperforming loans to loans receivable, net	0.41 %	0.40 %	0.51 %	0.63 %	1.29 %
Allowance for loan losses to loans receivable, net	1.18 %	1.24 %	1.23 %	2.34 %	2.78 %
Allowance for loan losses to nonperforming loans	284.93 %	307.67 %	239.62 %	372.16 %	215.67 %
Nonperforming assets to total assets	0.30 %	0.32 %	0.43 %	0.74 %	1.41 %
Performing TDR loans:					
Commercial business	$19,837	$17,345	$14,421	$19,496	$15,227
One-to-four family residential	227	236	245	702	888
Real estate construction and land development	2,141	3,014	3,927	6,043	361
Consumer	83	100	66	101	—
Total performing TDR loans(3)	$22,288	$20,695	$18,659	$26,342	$16,476
Accruing loans past due 90 days or more(4)	$—	$—	$—	$6	$248
Potential problem loans(5)	87,762	110,357	162,930	67,662	31,900

(1) At December 31, 2016, 2015, 2014, 2013 and 2012, $6.9 million $6.3 million, $7.3 million, $2.6 million and $9.3 million of nonaccrual loans were considered TDR loans, respectively.

(2) At December 31, 2016, 2015, 2014, 2013 and 2012, $2.8 million, $1.3 million $1.6 million, $1.7 million and $1.2 million of nonaccrual loans were guaranteed by government agencies, respectively.

(3) At December 31, 2016, 2015, 2014, 2013 and 2012, $682,000, $491,000, $751,000, $1.2 million and $965,000 of performing TDR loans were guaranteed by government agencies, respectively.

(4) There were no accruing loans past due 90 days or more that were guaranteed by government agencies at December 31, 2016, 2015, 2014 and 2013. There were accruing loans past due 90 days or more of $6,000 guaranteed by government agencies at December 31, 2012.

(5) At December 31, 2016, 2015, 2014, 2013 and 2012, $1.1 million, $3.0 million, $2.0 million, $1.8 million and $2.9 million of potential problem loans were guaranteed by government agencies, respectively.

Nonperforming Assets. Nonperforming assets consist of nonaccrual loans and other real estate owned. Nonperforming assets remained constant at $11.7 million, or 0.30% and 0.32% of total assets, respectively, at both December 31, 2016 and December 31, 2015 due to the increase in nonaccrual loans discussed below as well as a decrease in other real estate owned. Other real estate owned decreased $1.3 million, or 62.7%, to $754,000 at December 31, 2016 from $2.0 million at December 31, 2015 due primarily to dispositions of $2.5 million, which were offset partially by additions of $1.4 million during the year ended December 31, 2016.

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Nonaccrual Loans. Nonaccrual loans increased $1.2 million to $10.9 million, or 0.41% of loans receivable, net, at December 31, 2016 from $9.7 million, or 0.40% of loans receivable, net, at December 31, 2015. During the year ended December 31, 2016, there were additions to nonaccrual loans of $9.2 million, of which $1.6 million were previously performing TDR loans that were transferred to nonaccrual status. The increase in total nonaccrual loans at December 31, 2016 was partially offset by net principal payments of $6.2 million, nonaccrual loans transferred to other real estate owned of $523,000 and net charge-offs of $1.0 million. Nonaccrual loans with no related allowance for loan losses was $6.3 million and $1.9 million at December 31, 2016 and 2015, respectively. Nonaccrual loans totaling $4.6 million at December 31, 2016 had a related allowance for loan losses of $770,000 compared to nonaccrual loans of $7.7 million with related allowance for loan losses of $1.2 million at December 31, 2015.

Troubled Debt Restructured ("TDR") Loans. TDR loans are considered impaired and are separately measured for impairment whether on accrual or nonaccrual status. At December 31, 2016, nonperforming TDR loans included in the nonaccrual loan balance was $6.9 million and had a related allowance for loan losses of $437,000. At December 31, 2015, nonperforming TDR loans of $6.3 million had a related allowance for loan losses of $679,000. The performing TDR loans are not considered nonperforming assets as they continue to accrue interest despite being considered impaired due to the restructured status. Performing TDR loans as of December 31, 2016 and December 31, 2015 were $22.3 million and $20.7 million, respectively. The $1.6 million increase in performing TDR loans during the year ended December 31, 2016 was primarily due to loans restructured during the year ended December 31, 2016 of $5.9 million, offset partially by net principal reductions of $2.4 million, loans transferred to nonaccrual status of $1.6 million and net charge-offs of $286,000. The related allowance for loan losses on the performing TDR loans was $2.0 million as of December 31, 2016 and $2.1 million as of December 31, 2015.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are those that are both well-secured and in the process of collection. Potential problem loans decreased $22.6 million, or 20.5%, to $87.8 million at December 31, 2016 from $110.4 million at December 31, 2015 primarily due to net loan payments of $31.2 million, upgrade of potential problem loans to pass rated loans of $15.2 million, potential problem loans transferred to impaired status of $8.9 million and net charge-offs of $1.9 million, offset partially by loan downgrades to potential problem loans of $35.4 million during the year ended December 31, 2016.

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Allowance for Loan Losses

The following table provides information regarding changes in our allowance for loan losses at and for the indicated years:

	At or For the Years Ended December 31,				
	2016	2015	2014	2013	2012
	(Dollars in thousands)				
Allowance for loan losses at beginning of the year	$29,746	$27,729	$28,824	$28,594	$30,915
Provision for loan losses	4,931	4,372	4,594	3,672	2,016
Charge-offs:					
Commercial business	(4,153)	(1,676)	(5,252)	(3,073)	(3,726)
One-to-four family residential	—	—	(31)	(52)	(391)
Real estate construction and land development	(154)	(106)	(345)	(565)	(1,280)
Consumer	(1,778)	(1,700)	(969)	(681)	(677)
Total charge-offs	(6,085)	(3,482)	(6,597)	(4,371)	(6,074)
Recoveries:					
Commercial business	1,844	476	716	808	1,579
One-to-four family residential	2	13	7	—	—
Real estate construction and land development	83	100	43	32	125
Consumer	562	538	142	89	33
Total recoveries	2,491	1,127	908	929	1,737
Net charge-offs	(3,594)	(2,355)	(5,689)	(3,442)	(4,337)
Allowance for loan losses at end of the year	$31,083	$29,746	$27,729	$28,824	$28,594
Gross loans receivable at end of the year(1)	$2,638,397	$2,401,113	$2,252,014	$1,234,590	$1,029,034
Average loans receivable during the year(1)	2,489,730	2,316,175	1,871,696	1,124,828	996,186
Ratio of net charge-offs on loans to average loans receivable	(0.14)%	(0.10)%	(0.30)%	(0.31)%	(0.44)%

(1) Excludes loans held for sale.

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The following table shows the allocation of the allowance for loan losses at the indicated dates. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry-wide and other factors that affect loan losses in the categories shown below:

	December 31,									
	2016		2015		2014		2013		2012	
	Allowance for Loan Losses	% of Total (1)	Allowance for Loan Losses	% of Total (1)	Allowance for Loan Losses	% of Total (1)	Allowance for Loan Losses	% of Total (1)	Allowance for Loan Losses	% of Total (1)
	(Dollars in thousands)									
Commercial business	$22,382	78.8 %	$22,064	80.1 %	$20,186	80.3 %	$22,853	86.7 %	$19,302	82.9 %
One-to-four family residential	1,015	2.9	1,157	3.0	1,200	3.1	1,100	3.9	1,221	4.6
Real estate construction	2,156	6.0	1,871	4.5	2,758	5.1	2,673	5.7	5,440	8.1
Consumer	5,024	12.3	4,309	12.4	2,769	11.5	1,597	3.7	1,761	4.4
Unallocated	506	—	345	—	816	—	601	—	870	—
Total allowance for loan losses	$31,083	100.0%	$29,746	100.0%	$27,729	100.0%	$28,824	100.0%	$28,594	100.0%

(1) Represents the percent of loans receivable by loan category to total gross loans receivable.

The allowance for loan losses increased by $1.3 million, or 4.5%, to $31.1 million at December 31, 2016 from $29.7 million at December 31, 2015. As of December 31, 2016, the Bank identified $10.9 million of nonperforming loans and $22.3 million of performing TDR loans for a total of $33.2 million of impaired loans. Of these impaired loans, $10.1 million had no allowances for loan losses as their estimated collateral value or discounted expected cash flow is equal to or exceeds their carrying costs. The remaining $23.1 million had related allowances for loan losses totaling $2.7 million. As of December 31, 2015, the Bank identified $9.7 million of nonperforming loans and $20.7 million of performing TDR loans for a total of $30.4 million of impaired loans. Of these impaired loans, $6.0 million had no allowances for loan losses as their estimated collateral value or discounted expected cash flow is equal to or exceeds their carrying costs. The remaining $24.3 million had related allowances for loan losses totaling $3.3 million.

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The following table outlines the allowance for loan losses and related outstanding loan balances on loans at December 31, 2016 and 2015:

	December 31, 2016	December 31, 2015
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses	$21,791	$ 17,354
Gross loans, excluding PCI and impaired loans	2,540,751	2,283,832
Percentage	0.86 %	0.76 %
PCI Allowance:		
Allowance for loan losses	$6,558	$ 9,084
Gross PCI loans	64,448	86,919
Percentage	10.18 %	10.45 %
Specific Valuation Allowance:		
Allowance for loan losses	$2,734	$ 3,308
Gross impaired loans	33,198	30,362
Percentage	8.24 %	10.90 %
Total Allowance for Loan Losses:		
Allowance for loan losses	$31,083	$ 29,746
Gross loans receivable	2,638,397	2,401,113
Percentage	1.18 %	1.24 %

Based on the established comprehensive methodology, management deemed the allowance for loan losses of $31.1 million at December 31, 2016 (1.18% of loans receivable, net and 284.93% of nonperforming loans) appropriate to provide for probable incurred credit losses based on an evaluation of known and inherent risks in the loan portfolio at that date. This compares to an allowance for loan losses at December 31, 2015 of $29.7 million (1.24% of loans receivable, net and 307.67% of nonperforming loans).

While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolios, will not request the Bank to increase its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company’s financial condition and results of operations.

Deposits

Total deposits increased $121.4 million, or 3.90%, to $3.23 billion at December 31, 2016 from $3.11 billion at December 31, 2015. Non-maturity deposits as a percentage of total deposits increased to 88.9% at December 31, 2016 from 86.5% at December 31, 2015. The increase in this ratio was primarily due to a $111.2 million, or 14.4%, increase in noninterest bearing demand deposit accounts to $882.1 million at December 31, 2016 from $770.9 million at December 31, 2015 and a $48.6 million, or 10.7%, increase in savings accounts to $502.5 million at December 31, 2016 from $453.8 million at December 31, 2015. The increases in these deposit categories were offset partially by a $62.9 million, or 15.0%, decrease in certificates of deposit to $357.4 million at December 31, 2016 from $420.3 million at December 31, 2015. As a result of this decrease, the percentage of CDs to total deposits decreased to 11.1% at December 31, 2016 from 13.5% at December 31, 2015.

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The following table provides the balances outstanding for each major category of deposits at the dates indicated:

	December 31, 2016		December 31, 2015		December 31, 2014	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)					
Noninterest demand deposits	$882,091	27.3 %	$770,927	24.8 %	$709,673	24.4 %
NOW accounts	963,821	29.8	917,859	29.5	793,362	27.3
Money market accounts	523,875	16.2	545,342	17.6	520,065	17.9
Savings accounts	502,460	15.6	453,826	14.6	357,834	12.3
Total non-maturity deposits	2,872,247	88.9	2,687,954	86.5	2,380,934	81.9
CDs	357,401	11.1	420,333	13.5	525,397	18.1
Total deposits	$3,229,648	100.0%	$3,108,287	100.0%	$2,906,331	100.0%

The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years indicated:

	Years Ended December 31,					
	2016		2015		2014	
	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate
	(Dollars in thousands)					
NOW accounts and money market accounts	$1,464,198	0.16 %	$1,374,757	0.17 %	$1,049,078	0.18 %
Savings accounts	485,482	0.16	405,633	0.11	282,150	0.09
CDs	388,286	0.50	464,277	0.51	494,948	0.60
Total interest bearing deposits	2,337,966	0.21	2,244,667	0.23	1,826,176	0.28
Noninterest demand deposits	829,912	—	740,718	—	574,692	—
Total deposits	$3,167,878	0.16 %	$2,985,385	0.18 %	$2,400,868	0.21 %

The following table shows the amount and maturity of CDs of $250,000 or more:

	December 31, 2016
	(In thousands)
Remaining maturity:	
Three months or less	$ 14,954
Over three months through twelve months	25,810
Over twelve months through three years	11,390
Over three years	2,670
Total	$ 54,824

Borrowings

Borrowed funds provide an additional source of funding for loan growth. Our borrowed funds consist primarily of borrowings from the FHLB of Des Moines as well as securities repurchase agreements. The FHLB advances are typically secured by first lien one-to-four family residential loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. Securities repurchase agreements are secured by investment securities.

At December 31, 2016, the Bank maintained a credit facility with the FHLB of Des Moines in the amount of $549.0 million, of which $79.6 million was advanced. At December 31, 2015 there were no FHLB advances outstanding. During the years ended December 31, 2016 and 2015, we had average balances of FHLB advances of $13.3 million and $1.8 million, respectively.

At December 31, 2016 and 2015, the Bank had securities sold under agreement to repurchase of $22.1 million and $23.2 million, respectively.

Stockholders' Equity and Capital

Total stockholders' equity increased $11.8 million, or 2.51%, to $481.8 million at December 31, 2016 from $470.0 million at December 31, 2015. This increase was primarily due to net income of $38.9 million, partially offset by cash dividends in the amount of $21.6 million, accumulated other comprehensive loss of $5.2 million and repurchase of common stock of $2.9 million.

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. The following table sets forth the dividends paid per common share and the dividend payout ratio:

	Year Ended December 31,		
	2016	2015	2014
	(In thousands		
Dividends paid per common share	$0.72	$0.53	$0.50
Dividend payout ratio (1)	55.4 %	42.4 %	61.0 %

(1) Dividends paid per common share as a percentage of earnings per diluted common share.

Subsequent to year end, on January 25, 2017, the Company's Board of Directors declared a dividend of $0.12 per share which was paid on February 23, 2017 to shareholders of record as of February 9, 2017.

See "Item 6. Selected Financial Data" for our return on average assets, return on average equity and average equity to average assets ratios for all reported periods.

The Company and the Bank are subject to various regulatory capital requirements as prescribed by the Federal Reserve and by the FDIC, respectively. As of December 31, 2016, the Company and the Bank were classified as "well capitalized" institutions under the criteria established by these banking regulators. For additional information regarding the Company's and the Bank's regulatory capital requirements, see "Supervision and Regulation-Capital Adequacy" in "Item 1. Business" and Note (22) Regulatory Capital Requirements included in "Item 8. Financial Statements and Supplementary Data."

Off-Balance Sheet Arrangements

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our Consolidated Financial Statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments. The Company had off-balance sheet loan commitments, including letters of credit, aggregating $626.0 million at December 31, 2016, an increase of $53.5 million, or 9.4%, from $572.5 million at December 31, 2015. For additional information, see Note (15) Commitments and Contingencies included in "Item 8. Financial Statements and Supplementary Data."

Average Balances, Yields and Rates Paid for the Years Ended December 31, 2016, 2015 and 2014

Our core profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment portfolios, and our cost of funds, which consists of interest paid on deposits and borrowed funds. Like most financial institutions, our interest income and cost of funds are affected significantly by

general economic conditions, particularly changes in market interest rates and government policies.
Changes in net interest income result from changes in volume, net interest spread, and net interest margin.

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Volume refers to the average dollar amounts of interest earning assets and interest bearing liabilities. Net interest spread refers to the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Net interest margin refers to net interest income divided by average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing and noninterest bearing liabilities.

The following table provides relevant net interest income information for selected periods. The average daily loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been presented on a tax-equivalent basis.

	Year Ended December 31,								
	2016			2015			2014		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Assets:									
Total loans receivable, net	$2,489,730	$122,147	4.91 %	$2,316,175	$121,687	5.25 %	$1,871,696	$110,437	5.90 %
Taxable securities	589,867	11,215	1.90	548,787	9,578	1.75	383,626	7,328	1.91
Nontaxable securities	221,708	4,870	2.20	204,443	4,196	2.05	145,113	2,886	1.99
Other interest earning assets	44,951	280	0.62	80,882	278	0.34	150,189	455	0.30
Total interest earning assets	3,346,256	138,512	4.14	3,150,287	135,739	4.31	2,550,624	121,106	4.75
Noninterest earning assets	399,279			377,228			295,666		
Total assets	$3,745,535			$3,527,515			$2,846,290		
Liabilities and Stockholders' Equity:									
Certificates of deposit	$388,286	$1,936	0.50 %	$464,277	$2,386	0.51 %	$494,948	$2,991	0.60 %
Savings accounts	485,482	756	0.16	405,633	445	0.11	282,150	252	0.09
Interest bearing demand and money market accounts	1,464,198	2,318	0.16	1,374,757	2,398	0.17	1,049,078	1,907	0.18
Total interest bearing deposits	2,337,966	5,010	0.21	2,244,667	5,229	0.23	1,826,176	5,150	0.28
Junior subordinated debentures	19,565	880	4.50	19,271	827	4.29	12,751	458	3.59
FHLB advances and other borrowings	13,349	74	0.55	1,777	6	0.34	111	—	—
Securities sold under agreement to repurchase	20,392	42	0.21	23,522	58	0.25	27,984	73	0.26

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	Year Ended December 31,								
	2016			2015			2014		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Total interest bearing liabilities	2,391,272	6,006	0.25	2,289,237	6,120	0.27	1,867,022	5,681	0.30
Demand and other noninterest bearing deposits	829,912			740,718			574,692		
Other noninterest bearing liabilities	38,474			33,458			29,669		
Stockholders' equity	485,877			464,102			374,907		
Total liabilities and stockholders' equity	$3,745,535			$3,527,515			$2,846,290		
Net interest income		$132,506			$129,619			$115,425	
Net interest spread			3.89 %			4.04 %			4.45 %
Net interest margin			3.96 %			4.11 %			4.53 %
Average interest earning assets to average interest bearing liabilities			139.94 %			137.61 %			136.61 %

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The following table provides the amount of change in our net interest income attributable to changes in volume and changes in interest rates. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately for changes due specifically to volume and interest rates.

	Year Ended December 31,					
	2016 Compared to 2015			2015 Compared to 2014		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$8,515	$(8,055)	$460	$23,352	$(12,102)	$11,250
Taxable securities	781	856	1,637	2,883	(633)	2,250
Nontaxable securities	379	295	674	1,218	92	1,310
Other interest earning assets	(224)	226	2	(238)	61	(177)
Interest income	$9,451	$(6,678)	$2,773	$27,215	$(12,582)	$14,633
Interest Bearing Liabilities:						
Certificates of deposit	$(379)	$(71)	$(450)	$(158)	$(447)	$(605)
Savings accounts	124	187	311	135	58	193
Interest bearing demand and money market accounts	142	(222)	(80)	568	(77)	491
Total interest bearing deposits	(113)	(106)	(219)	545	(466)	79
Junior subordinated debentures	13	40	53	280	89	369
FHLB advances and other borrowings	64	4	68	6	—	6
Securities sold under agreement to repurchase	(6)	(10)	(16)	(11)	(4)	(15)
Interest expense	$(42)	$(72)	$(114)	$820	$(381)	$439
Net Interest Income	$9,493	$(6,606)	$2,887	$26,395	$(12,201)	$14,194

Results of Operations for the Years Ended December 31, 2016 and 2015

Earnings Summary

Net income was $38.9 million, or $1.30 per diluted common share, for the year ended December 31, 2016 compared to $37.5 million, or $1.25 per diluted common share, for the year ended December 31, 2015. The $1.4 million, or 3.8% increase in net income for the year ended December 31, 2016 compared to the year ended December 31, 2015 was primarily the result of a $2.9 million, or 2.2%, increase in net interest income, primarily as a result of the increase in interest earning assets, offset partially by a decrease in the net interest margin. The net interest margin decreased 15 basis points to 3.96% for the year ended December 31, 2016 compared to 4.11% for the same period in 2015.

The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income. The Company’s efficiency ratio decreased to 64.9% for the year ended December 31, 2016 from 65.6% for the year ended December 31, 2015. The decrease in the efficiency ratio for the year ended December 31, 2016 compared to the year ended December 31, 2015 is attributable primarily to the above mentioned increase in net interest income.

Noninterest expense as a percentage of average assets (or overhead ratio) is a metric utilized by the Bank to monitor its performance exclusive of the impact of market conditions on net interest margin. The Company's noninterest expense ratio decreased to 2.84% for the year ended December 31, 2016 from 3.01% during the year ended December 31, 2015. The decrease reflects the Company's growth in average assets and its efforts to reduce discretionary operating costs.

Net Interest Income

One of the Company's key sources of earnings is net interest income. There are several factors that affect net interest income including, but not limited to, the volume, pricing, mix and maturity of interest earning assets and

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interest bearing liabilities; the volume of noninterest bearing deposits and other liabilities and stockholders' equity; the volume of noninterest earning assets; market interest rate fluctuations; and asset quality. Net interest income increased $2.9 million, or 2.2%, to $132.5 million for the year ended December 31, 2016 compared to $129.6 million for the year ended December 31, 2015. The increase in net interest income was primarily due to an increase in average interest earning assets, partially offset by a decrease in the yield on average interest earning assets during the year ended December 31, 2016.

Interest Income

Total interest income increased $2.8 million, or 2.0%, to $138.5 million for the year ended December 31, 2016 compared to $135.7 million for the year ended December 31, 2015. The balance of average interest earning assets increased $196.0 million, or 6.2%, to $3.35 billion for the year ended December 31, 2016 from $3.15 billion for the year ended December 31, 2015. The yield on total interest earning assets decreased 17 basis points to 4.14% for the year ended December 31, 2016 from 4.31% for the year ended December 31, 2015.

Total interest income increased primarily due to the $2.3 million, or 16.8%, increase in interest income on investment securities to $16.1 million during the year ended December 31, 2016 from $13.8 million for the year ended December 31, 2015 as a result of both an increase in average balances and an increase in investment yields for the for the year ended December 31, 2016 compared to the year ended December 31, 2015. The average balances of taxable and nontaxable securities increased $58.3 million, or 7.7%, to $811.6 million for the year ended December 31, 2016 from $753.2 million for the year ended December 31, 2015, primarily as a result of purchases of investment securities. The yields on taxable securities increased 15 basis points to 1.90% for the year ended December 31, 2016 from 1.75% for the same period in 2015 and the yields on nontaxable securities increased 15 basis points to 2.20% for the year ended December 31, 2016 from 2.05% for the same period in 2015. The Company is actively managing its investment securities portfolio to mitigate declining loan yields.

Interest income on loans increased $460,000, or 0.4%, to $122.1 million for the year ended December 31, 2016 from $121.7 million for the same period in 2015 due primarily to a $173.6 million, or 7.5%, increase in the average balance of loans receivable to $2.49 billion for the year ended December 31, 2016 compared to $2.32 billion for the year ended December 31, 2015 as a result of loan growth. The impact on interest income as a result of the increase in average loan balances was partially offset by a decrease in loan yields, which was the result of a decrease in the contractual loan note rates and a decrease in the effects of incremental accretion income. Loan yields decreased 34 basis points to 4.91% for the year ended December 31, 2016 compared to 5.25% for the year ended December 31, 2015.

The following table presents the loan yield and effects of the incremental accretion on purchased loans for the years ended December 31, 2016 and 2015:

	Year Ended December 31,	
	2016	2015
	(Dollars in thousands)	
Loan yield, excluding incremental accretion on purchased loans [(1)]	4.62 %	4.81 %
Impact on loan yield from incremental accretion on purchased loans [(1)]	0.29	0.44
Loan yield	4.91 %	5.25 %
Incremental accretion on purchased loans [(1)]	$7,155	$10,293

(1) As of the dates of the completion of each of the merger and acquisition transactions, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is modified quarterly as a result of cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.

The incremental accretion income was $7.2 million and $10.3 million for the years ended December 31, 2016 and 2015, respectively. The effect on loan yields from incremental accretion income decreased 15 basis points to 0.29% for the year ended December 31, 2016 from 0.44% for the year ended December 31, 2015 primarily a result of a decrease in the prepayments of purchased loans, consisting primarily of loans from the Washington Banking Merger, during the year ended December 31, 2016 compared to the same period in 2015, and a continued decline in the purchased loan balances.

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The decrease in loan yields is also the result of an increase in LIBOR-based lending during the year ended December 31, 2016. The Bank began entering into non-hedge interest rate swap contracts to accommodate the business needs of its lending customers during the third quarter of 2015. Under these derivative contract arrangements with the borrower and a third party, the Bank effectively earns a variable rate of interest while the customer pays a fixed rate of interest. These derivatives were all written using 1-month LIBOR as the variable indexed rate. At December 31, 2016, the Bank had 28 separate interest rate swap contracts with borrowers with a notional value of $102.7 million compared to four interest rate swap contracts with borrowers with notional value of $20.7 million at December 31, 2015. The $82.0 million, or 396.1%, increase in these LIBOR-based loans during 2016 resulted in a lower loan yield during the year ended December 31, 2016 as compared to the year ended December 31, 2015 as these variable rate loans earn less interest income than comparable fixed rate loans at the time of origination. These LIBOR-based loans, however, will improve overall loan performance in a rising rate environment.

Interest Expense

Total interest expense decreased by $114,000, or 1.9%, to $6.0 million for the year ended December 31, 2016 from $6.1 million for the year ended December 31, 2015. The average cost of interest bearing liabilities decreased two basis points to 0.25% for the year ended December 31, 2016 from 0.27% for the year ended December 31, 2015. Total average interest bearing liabilities increased by $102.0 million, or 4.5%, to $2.39 billion for the year ended December 31, 2016 from $2.29 billion for the year ended December 31, 2015.

Total interest expense on interest bearing deposits decreased $219,000, or 4.2%, to $5.0 million during the year ended December 31, 2016 from $5.2 million the same period in 2015. The average total cost of interest bearing deposits decreased two basis points to 0.21% for the year ended December 31, 2016 from 0.23% for the same period in 2015. The decrease in interest expense was primarily due to a $76.0 million, or 16.4%, decrease in the average balance of certificates of deposit to $388.3 million during the year ended December 31, 2016 from $464.3 million during the same period in 2015 and a one basis point decrease in the cost on certificates of deposit to 0.50% from 0.51% for the same respective periods. Based on the change in the average balance and cost of the certificates of deposit, the interest expense on certificates of deposit decreased $450,000, or 18.9%, to $1.9 million for the year ended December 31, 2016 from $2.4 million for the same period in 2015.

The decrease in interest expense on certificates of deposit was offset by a $311,000, or 69.9%, increase in the cost of savings accounts to $756,000 for the year ended December 31, 2016 from $445,000 for the same period in 2015. The increase in the cost of savings accounts during the year ended December 31, 2016 was due to the combination of a $79.8 million, or 19.7%, increase in the average balance of savings accounts to $485.5 million for the year ended December 31, 2016 from $405.6 million for the same period in 2015 and an increase of five basis points in the average cost of savings accounts to 0.16% for the year ended December 31, 2016 from 0.11% for the year ended December 31, 2015.

The average rate of the junior subordinated debentures, including the effects of accretion of the discount established as of the date of the Washington Banking Merger, for the year ended December 31, 2016 was 4.50%, an increase of 21 basis points from 4.29% for the same period in 2015.

Net Interest Margin

Net interest margin for the year ended December 31, 2016 decreased 15 basis points to 3.96% from 4.11% for the same period in 2015. The net interest spread for the year ended December 31, 2016 decreased 15 basis points to 3.89% from 4.04% for the same period in 2015. The decrease is primarily due to the above mentioned decrease in yields on total interest earning assets for the year ended December 31, 2016.

The following table presents the net interest margins and effects of the incremental accretion on purchased loans for the years ended December 31, 2016 and December 31, 2015:

	Year Ended December 31,	
	2016	2015
Net interest margin, excluding incremental accretion on purchased loans [1]	3.75 %	3.78 %
Impact on net interest margin from incremental accretion on purchased loans [1]	0.21	0.33

Net interest margin	3.96%	4.11%

(1) As of the dates of the completion of each of the merger and acquisition transactions, purchased loans were recorded at their estimated fair value, including our estimate of future expected cash flows until the ultimate resolution of these credits. The difference between the contractual loan balance and the fair value represents the purchased discount. The purchased discount is accreted into income over the estimated remaining life of

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the loan or pool of loans, based upon results of the quarterly cash flow re-estimation. The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes.

Provision for Loan Losses

The Bank has established a comprehensive methodology for determining its allowance for loan losses. The allowance for loan losses is increased by provisions for loan losses charged to expense, and is reduced by loans charged-off, net of loan recoveries or a recovery of previous provision. The amount of the provision expense recognized during the years ended December 31, 2016 and 2015 was calculated in accordance with the Bank's methodology. For additional information, see “Item 1. Business—Analysis of Allowance for Loan Losses.”

The provision for loan losses is dependent on the Company’s ability to manage asset quality and control the level of net charge-offs through prudent underwriting standards. In addition, a decline in general economic conditions could increase future provisions for loan losses and have a material effect on the Company’s net income.

The provision for loan losses increased $559,000, or 12.8%, to $4.9 million for the year ended December 31, 2016 from $4.4 million for the year ended December 31, 2015. The increase in provision expense was due primarily the result of a $1.2 million increase in net charge-offs during 2016 in addition to changes in the volume and mix of loans, offset by the decrease in certain historical loss factors. The Bank had net charge-offs on loans of $3.6 million for the year ended December 31, 2016 compared to $2.4 million for the year ended December 31, 2015. The ratio of net charge-offs to average total loans outstanding was 0.14% for the year ended December 31, 2016 and 0.10% for the year ended December 31, 2015. Total gross loans receivable at December 31, 2016 and 2015 were $2.64 billion and $2.40 billion, respectively. Based on a thorough review of the loan portfolio, the Bank determined that the provision for loan losses for the year ended December 31, 2016 was appropriate as it was calculated in accordance with the Bank's methodology for determining allowance for loan losses.

Noninterest Income

Total noninterest income decreased $649,000, or 2.0%, to $31.6 million for the year ended December 31, 2016 compared to $32.3 million for the year ended December 31, 2015. The components of noninterest income and the changes from prior year are as follows:

	Year Ended December 31,			
	2016	2015	Change 2016 vs. 2015	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$14,354	$14,179	$175	1.2 %
Gain on sale of investment securities, net	1,315	1,516	(201)	(13.3)
Gain on sale of loans, net	6,994	4,683	2,311	49.3
Gain on termination of FDIC shared-loss agreements	—	1,747	(1,747)	(100.0)
Gain on sale of Merchant Visa portfolio	—	2,198	(2,198)	(100.0)
Interest rate swap fees	1,854	452	1,402	310.2
Other income	7,102	7,493	(391)	(5.2)
Total noninterest income	$31,619	$32,268	$(649)	(2.0)%

Gain on the sale of loans, net increased $2.3 million, or 49.3%, to $7.0 million for the year ended December 31, 2016 compared to the same period in 2015. The following table details the components of the gain on sale of loans:

	Year Ended December 31,			
	2016	2015	Change 2016 vs.	Percentage Change

			2015		
	(Dollars in thousands)				
Gain on sale of mortgage loans, net	$3,723	$3,150	$573	18.2	%
Gain on sale of guaranteed portion of SBA loans, net	1,016	1,533	(517)	(33.7)	
Gain on sale of other loans, net	2,255	—	2,255	100.0	
Gain on sale of loans, net	$6,994	$4,683	$2,311	49.3	%

The increase in the net gain on the sale of mortgage loans was primarily due to an increase in the volume of loans sold to $141.1 million for the year ended December 31, 2016 from $130.8 million for the same period in 2015. The decrease of net gain on the sale of the government guaranteed portion of certain SBA loans is a result of a decrease in SBA guarantee sales activities due to competitive pressures. The net gain on sale of other loans was a result of the sale of two previously classified purchased credit impaired loans.

The Bank recorded a $1.7 million gain on termination of FDIC shared-loss agreements for the year ended December 31, 2015 as the Bank entered into an agreement terminating the shared-loss agreements for all three of the FDIC-assisted acquisitions during the year ended December 31, 2015. No similar gain was recorded by the Bank during the year ended December 31, 2016. For additional information see Note (6) FDIC Indemnification Asset of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

The Bank sold its Merchant Visa portfolio in January 2015, resulting in a gain on sale of Merchant VISA portfolio of $2.2 million for the year ended December 31, 2015. The effects of this sale resulted in lower Merchant Visa income and a decrease in total noninterest income.

Interest rate swap fees increased $1.4 million, or 310.2%, to $1.9 million for the year ended December 31, 2016 compared to $452,000 the same period in 2015, due primarily to an increase in the number of interest rate swap contracts executed during 2016. The Bank began executing these types of contracts during the third quarter of 2015. At December 31, 2016, the Bank had 28 contracts with borrowers with a notional value of $102.7 million compared to four contracts with borrowers with a notional value of $20.8 million at December 31, 2015.

Other income decreased $391,000, or 5.2%, to $7.1 million for year ended December 31, 2016 from $7.5 million for year ended December 31, 2015 due primarily to a decrease in cash payments received on purchased loans charged-off prior to commencement of the acquisition or merger dates of $1.1 million. The decrease in other income was offset partially an FDIC indemnification was not recorded during the year ended December 31, 2016 because of the above-mentioned termination of the FDIC shared-loss agreements as compared to a reduction of income of $497,000 recorded during the year ended December 31, 2015. The Bank also experienced an increase in fee income from annuities of $210,000 for the year ended December 31, 2016 compared to the same period in 2015.

Noninterest Expense

Noninterest expense increased $265,000, or 0.2%, to $106.5 million for the year ended December 31, 2016 compared to $106.2 million for the year ended December 31, 2015.

The following table presents the key components of noninterest expense and the changes from prior year:

	Year Ended December 31,			
	2016	2015	Change 2016 vs. 2015	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$61,405	$58,134	$3,271	5.6 %
Occupancy and equipment	15,763	15,846	(83)	(0.5)
Data processing	7,312	7,700	(388)	(5.0)
Marketing	2,835	3,066	(231)	(7.5)
Professional services	3,606	3,536	70	2.0
State and local taxes	2,616	2,378	238	10.0
Federal deposit insurance premium	1,620	2,046	(426)	(20.8)
Other real estate owned, net	334	1,007	(673)	(66.8)
Amortization of intangible assets	1,415	2,100	(685)	(32.6)
Other expense	9,567	10,395	(828)	(8.0)
Total noninterest expense	$106,473	$106,208	$265	0.2 %

Compensation and employee benefits increased $3.3 million, or 5.6%, to $61.4 million during the year ended December 31, 2016 compared to $58.1 million during the year ended December 31, 2015. The increase was primarily due to the results of increased staffing in the metro markets, including Seattle and Bellevue, Washington and standard salary increases.

Data processing decreased $388,000, or 5.0% to $7.3 million during the year ended December 31, 2016 from $7.7 million during the year ended December 31, 2015. The decrease was primarily a result of a $429,000 cancellation fee incurred during the year ended December 31, 2015 as a result of the early termination of a data processing contract.

Federal deposit insurance premium decreased $426,000, or 20.8% to $1.6 million during the year ended December 31, 2016 from $2.0 million during the year ended December 31, 2015. The decrease was primarily a result of the FDIC's new assessment rate schedule that became effective beginning in the third quarter of 2016 due to the levels achieved in the Deposit Insurance Fund reserve. Effective July 1, 2016, the range of initial base assessment rates for all insured institutions was reduced based on current reserve levels.

Other real estate owned, net decreased $673,000, or 66.8%, to $334,000 during the year ended December 31, 2016 compared to $1.0 million during the year ended December 31, 2015. The Bank had $754,000 other real estate owned at December 31, 2016 compared to $2.0 million at December 31, 2015. The decrease in other real estate owned, net was due to net gains on the sale of other real estate owned of $173,000 during the year ended December 31, 2016 compared to net losses on sale of other real estate owned of $97,000 during the year ended December 31, 2015 and a $146,000, or 27.6%, decrease in the valuation adjustment to $383,000 in fiscal year 2016 from $529,000 in fiscal year 2015.

Amortization of intangible assets decreased $685,000, or 32.6%, during the year ended December 31, 2016 as the useful life of core deposit intangibles for certain acquisitions was reached, resulting in either a decrease in amortization for fiscal year 2016 or no further amortization expense recorded during the year ended December 31, 2016.

Other expense decreased $828,000, or 8.0%, to $9.6 million for the year ended December 31, 2016 from $10.4 million for the same period in 2015. The decrease was primarily the result of a decrease in courier services as the Company discontinued its regular scheduled service during 2015. The Company also experienced decreases in other employee-related expenses such as travel expenses, office supplies, and other business expenses as a result of a concerted effort of the Company to reduce other discretionary expenses.

The ratio of noninterest expense to average assets was 2.84% for the year ended December 31, 2016, compared to 3.01% for the year ended December 31, 2015. The decrease was primarily a result of an increase in assets due to the Bank's organic growth in addition to a relatively constant noninterest expense year-over-year due to the above mentioned efforts by the Company to reduce noninterest expenses.

Income Tax Expense

Income tax expense remained constant at $13.8 million for both the years ended December 31, 2016 and 2015. The Company’s effective tax rate was 26.2% for the year ended December 31, 2016 compared to 26.9% for the same period in 2015. The decrease in the Company's effective tax rate during the year ended December 31, 2016 compared to the same period in 2015 is primarily due to an increase in tax exempt loans and investment securities as compared to the increase in pre-tax net income and an increase in bank-owned life insurance ("BOLI") income, offset partially by the effects of the resolution of certain Washington Banking tax liabilities during the year ended December 31, 2015. For additional information, see Note (21) Income Taxes of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

Results of Operations for the Years Ended December 31, 2015 and 2014

Earnings Summary

Net income of $1.25 per diluted common share was recorded for the year ended December 31, 2015 compared to $0.82 per diluted common share for the year ended December 31, 2014. Net income for the year ended December 31, 2015 was $37.5 million compared to net income of $21.0 million for the same period in 2014. The $16.5 million, or 78.4%, increase was primarily the result of a $14.6 million increase in interest income and a $15.8 million increase in noninterest income, partially offset by a $6.8 million increase in noninterest expense, a $6.9 million increase in income tax expense, and a $439,000 increase in interest expense. The Company’s efficiency ratio decreased to 65.6% for the year ended December 31, 2015 from 75.3% for the year ended December 31, 2014 primarily due to net interest income increases related to the mergers and acquisitions as well as increased operating efficiencies which did not increase noninterest expenses to the same extent.

Net Interest Income

Net interest income increased $14.2 million, or 12.3%, to $129.6 million for the year ended December 31, 2015 compared to $115.4 million for the previous year. The increase in net interest income was due primarily to a full fiscal year of operations attributable to the Washington Banking Merger, and the results of the positive effects of the discount accretion on the acquired loan portfolios for the year ended December 31, 2015. The increase in net interest income was also due to an increase in average interest earning assets, again substantially attributable to the Washington Banking Merger. The increase in net interest income was partially offset by the decrease in the net interest margins due primarily to lower contractual loan note rates in the current lending environment. Net interest income as a percentage of average interest earning assets (net interest margin) for the year ended December 31, 2015 decreased 42 basis points to 4.11% from 4.53% for the previous year. Our net interest spread for the year ended December 31, 2015 decreased 41 basis points to 4.04% from 4.45% for the prior year.

Total interest income increased $14.6 million, or 12.1%, to $135.7 million for the year ended December 31, 2015, from $121.1 million for the year ended December 31, 2014. The increase in interest income was due primarily to the effects of the Washington Banking Merger, offset partially by lower yields on interest earning assets and a decrease in accretion of discounts on acquired loans. During the years ended December 31, 2015 and 2014, the Company recorded approximately $10.3 million and $14.3 million, respectively, of discount accretion into interest income that related to the acquired loans. This income was incremental to the acquired loans' contractual interest income. The balance of average interest earning assets (including nonaccrual loans) increased $599.7 million, or 23.5%, to $3.15 billion for the year ended December 31, 2015 from $2.55 billion for the year ended December 31, 2014. The majority of this increase in interest earning assets was a result of the realization of the Washington Banking Merger for a full fiscal year. The Company acquired in the Washington Banking Merger fair values at the May 1, 2014 merger date of $458.3 million in investment securities, $1.00 billion in loans and $7.1 million of FHLB stock.

The yield on interest earning assets decreased 44 basis points to 4.31% for the year ended December 31, 2015 from 4.75% for the year ended December 31, 2014. The decrease in the yield on interest earning assets for the year ended December 31, 2015 reflects the decreased loan yields due primarily to lower contractual note rates as well as a decrease of the effects of the overall discount accretion on all the acquired loan portfolios.

The effect of discount accretion on net interest margin for the year ended December 31, 2015 and December 31, 2014 was as follows:

	Year Ended December 31,	
	2015	2014
Net interest margin, excluding incremental accretion on purchased loans (1)	3.78%	3.97%
Impact on net interest margin from incremental accretion on purchased loans (1)	0.33	0.56
Net interest margin	4.11%	4.53%

(1) The incremental accretion income represents the amount of income recorded on the purchased loans in excess of the contractual stated interest rate in the individual loan notes. This income results from the discount established at the time these loan portfolios were acquired and modified quarterly for PCI loans as a result of cash flow re-estimation.

The yield on interest earning assets was reduced by nonaccruing loans. Nonaccrual loans totaled $9.7 million at December 31, 2015 compared to $11.6 million at December 31, 2014.

Interest income on taxable and nontaxable investment securities increased $3.6 million, or 34.9%, to $13.8 million for the year ended December 31, 2015 from $10.2 million for the year ended December 31, 2014 due primarily to an increase in the average investment securities as a result of the Washington Banking Merger and an increase in yields on nontaxable investments securities, offset by lower yields earned on the taxable investment securities in 2015 as a result of declining interest rates. The changes in average balances and interest income on other interest earning assets had minimal impact on net interest margins for the years ended December 31, 2015 and 2014.

Total interest expense increased by $439,000, or 7.7%, to $6.1 million for the year ended December 31, 2015 from $5.7 million for the year ended December 31, 2014. The increase in interest expense was due to an increase in the average deposit balance, primarily as a result of the deposits acquired in the Washington Banking Merger which had a fair value at the acquisition date of $1.43 billion. The effects of the increase in the average deposit balance was offset by lower rates paid on interest bearing deposits, reflecting the relatively low interest rate environment. The average rate paid on interest bearing deposits decreased to 0.23% for the year ended December 31, 2015 from 0.28% for the year ended December 31, 2014. The Company also acquired junior subordinated debentures in the Washington Banking Merger with a fair value of $18.9 million at the merger date. The average rate paid on these liabilities, including accretion of discount from purchase accounting fair value adjustment, during 2015 was 4.29% compared to 3.59% during 2014. Total average interest bearing liabilities increased by $422.2 million, or 22.6%, to $2.29 billion for the year ended December 31, 2015 from $1.87 billion for the year ended December 31, 2014 and the average rate was 0.27% and 0.30%, respectively.

Provision for Loan Losses

The provision for loan losses decreased $222,000, or 4.8%, to $4.4 million for the year ended December 31, 2015 from $4.6 million for the year ended December 31, 2014. The decrease in provision expense was due primarily to the resolution of nonperforming loans and a decrease in net charge-offs during the year ended December 31, 2015 compared to the prior year, offset partially by an increase in the volume of loans. The Bank had net charge-offs on loans of $2.4 million for the year ended December 31, 2015 compared to $5.7 million for the year ended December 31, 2014. The ratio of net charge-offs to average total loans outstanding was 0.10% for the year ended December 31, 2015 and 0.30% for the year ended December 31, 2014. Total gross loans receivable at December 31, 2015 and 2014 were $2.40 billion and $2.25 billion, respectively.

As shown in the table below, the general allowance as a percentage of gross loans, excluding PCI and impaired loans, was 0.76% and 0.71% at December 31, 2015 and 2014, respectively. The increase in the percentage during the noted periods was due primarily to an increase in the volume of loans, a change in the historical loss factors and change in the mix of loans. The general allowance also increased during the year ended December 31, 2015 as a result of the mergers and acquisitions, since the acquired Non-PCI loans were recorded at a net discount at the merger date and, accordingly, no allowance for loan losses was initially recorded for the acquired loans. As the remaining discounts are accreted into income, the Company may determine a provision for loan losses is necessary which may increase the allowance for loan losses. The remaining discount for these acquired Non-PCI loans was $9.4 million and $14.2 million at December 31, 2015 and 2014, respectively.

The following table outlines the allowance for loan losses and related outstanding loan balances on loans at December 31, 2015 and 2014:

	December 31, 2015	December 31, 2014
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses	$17,354	$15,016
Gross loans, excluding PCI and impaired loans	2,283,832	2,102,512
Percentage	0.76 %	0.71 %
PCI Allowance:		
Allowance for loan losses	$9,084	$9,055
Gross PCI loans	86,919	119,271
Percentage	10.45 %	7.59 %
Specific Valuation Allowance:		
Allowance for loan losses	$3,308	$3,658
Gross impaired loans	30,362	30,231
Percentage	10.90 %	12.10 %
Total Allowance for Loan Losses:		
Allowance for loan losses	$29,746	$27,729
Gross loans receivable	2,401,113	2,252,014
Percentage	1.24 %	1.23 %

The allowance for loan losses increased by $2.0 million, or 7.3%, to $29.7 million at December 31, 2015 from $27.7 million at December 31, 2014. As of December 31, 2015, the Bank identified $9.7 million of nonperforming loans and $20.7 million of performing TDR loans for a total of $30.4 million of impaired loans. Of these impaired loans, $6.0 million had no allowances for loan losses as their estimated collateral value or discounted expected cash flow is equal to or exceeds their carrying costs. The remaining $24.3 million had related allowances for loan losses totaling $3.3 million. Based on the comprehensive methodology, management deemed the allowance for loan losses of $29.7 million at December 31, 2015 (1.24% of loans receivable, net and 307.67% of nonperforming loans) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

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Noninterest Income

Total noninterest income increased $15.8 million, or 96.0%, to $32.3 million for the year ended December 31, 2015 compared to $16.5 million for the prior year. The components of noninterest income and the changes from prior year are as follows:

	Year Ended December 31,			
	2015	2014	Change 2015 vs. 2014	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$14,179	$11,143	$3,036	27.2 %
Merchant Visa income, net	513	1,076	(563)	(52.3)
Change in FDIC indemnification asset	(497)	(2,543)	2,046	(80.5)
Gain on sale of investment securities, net	1,516	287	1,229	428.2
Gain on sale of loans, net	4,683	1,518	3,165	208.5
Gain on termination of FDIC shared-loss agreements	1,747	—	1,747	100.0
Gain on sale of Merchant Visa portfolio	2,198	—	2,198	100.0
Interest rate swap fees	452	—	452	100.0
Other income	7,477	4,986	2,491	50.0
Total noninterest income	$32,268			