HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 10, 2016
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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, 2015
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 (State or other jurisdiction of incorporation or organization)	91-1857900 (I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA (Address of principal executive offices)	98501 (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, 2015, based on the closing price of its common stock on such date, on the NASDAQ Global Select Market, of $17.87 per share, and 29,175,066 shares held by non-affiliates was $521,358,429.

The registrant had 29,965,708 shares of common stock outstanding as of February 19, 2016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2016 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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PART I. FINANCIAL INFORMATION

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the “Company” or "Heritage") is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from the mutual holding company form of organization to the stock holding company form of organization. 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 "Bank"). The Company acquired Central Valley Bank in March 1999 and changed its charter from a nationally chartered commercial bank to a state chartered commercial bank effective September 1, 2005. In 1998, the Company acquired North Pacific Bank. 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 Federal Deposit Insurance Corporation (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. In 2013, the Company consolidated three of these branches into existing Heritage Bank branches. 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. The Lakewood branch was subsequently consolidated with an existing Heritage Bank branch in 2013.

On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley" or "Valley Community Bancshares") 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. Subsequently, four of these branches were consolidated into existing Heritage Bank branches as of December 31, 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 "Central Valley Merger"). 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. The Washington Banking Merger was completed on May 1, 2014.

For additional information on the merger and acquisitions completed during the years ended December 31, 2014 and 2013, see Note (2) Business Combinations of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary, Heritage Bank. The deposits of the Bank are insured by the FDIC. Heritage Bank is headquartered in Olympia, Washington and conducts business in its 63 branch offices located in Washington and the greater Portland, Oregon area.

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

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residential loans on residential properties located primarily in western and central Washington State and the greater Portland, Oregon area.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and its 63 branch offices located along the I-5 corridor throughout Washington and the greater Portland, Oregon area. We additionally have offices located in eastern Washington, primarily in Yakima County.

Lending Activities

General. Lending activities are conducted through Heritage Bank. 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 check for credit quality, proper documentation and compliance with laws and regulations.

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 and industrial loans totaled $596.7 million, or 24.8% of total loans, as of December 31, 2015, and $570.5 million, or 25.3% of total loans, as of December 31, 2014. Owner-occupied commercial real estate loans totaled $629.2 million, or 26.2%, of total loan, as of December 31, 2015 and $595.0 million, or 26.4% of total loans, as of December 31, 2014, and non-owner occupied commercial real estate loans totaled $697.4 million, or 29.0% of total loans, as of December 31, 2015 and $643.6 million, or 28.6% of total loans, as of December 31, 2014. One-to-four family residential loans totaled $72.5 million, or 3.0% of total loans, at December 31, 2015, and $69.5 million, or 3.1% of total loans, at December 31, 2014. Real estate construction and land development loans totaled $107.1 million, or 4.5% of total loans, at December 31, 2015, and $114.1 million, or 5.1% of total loans, at December 31, 2014. Consumer loans totaled $298.2 million, or 12.4% of total loans, as of December 31, 2015, and $259.3 million, or 11.5% of total loans, as of December 31, 2014.

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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, 2015		2014		2013		2012		2011	
	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	$596,726	24.8 %	$570,453	25.3 %	$351,230	28.5 %	$327,784	31.9 %	$347,804	33.6
Owner-occupied commercial real estate	629,207	26.2	594,986	26.4	305,675	24.8	236,501	23.0	222,000	21.4
Non-owner occupied commercial real estate	697,388	29.0	643,636	28.6	414,604	33.7	289,882	28.2	279,635	27.0
Total commercial business	1,923,321	80.0 %	1,809,075	80.3	1,071,509	87.0	854,167	83.3	849,439	82.0
One-to-four family residential(1)	72,548	3.0	69,530	3.1	47,859	3.9	46,915	4.6	45,900	4.4
Real estate construction and land development:										
One-to-four family residential	51,752	2.2	49,195	2.2	21,280	1.7	30,121	2.8	29,536	2.9
Five or more family residential and commercial properties	55,325	2.3	64,920	2.9	48,655	3.9	52,939	5.2	56,032	5.4
Total real estate construction and land development (2)	107,077	4.5	114,115	5.1	69,935	5.6	83,060	8.1	85,568	8.3
Consumer	298,167	12.4	259,294	11.5	45,287	3.7	44,892	4.4	56,348	5.4
Gross loans receivable	2,401,113	99.9	2,252,014	100.0	1,234,590	100.2	1,029,034	100.2	1,037,255	100.2
Deferred loan costs (fees), net	929	0.1	(937)	—	(2,670)	(0.2)	(2,096)	(0.2)	(1,860)	(0.2
Loans receivable, net	$2,402,042	100.0 %	$2,251,077	100.0 %	$1,231,920	100.0 %	$1,026,938	100.0 %	$1,035,395	100.0

(1) Excludes loans held for sale of $7.7 million, $5.6 million, $1.7 million and $1.8 million as of December 31, 2015, 2014, 2012 and 2011, 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, 2015 (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 that mature after one year.

	Maturing Within 1 year (In thousands)	Over 1-5 years	After 5 years	Total
Commercial business	$230,851	$437,885	$1,254,585	$1,923,321
Real estate construction and land development	45,685	29,195	32,197	$107,077
Total	$276,536	$467,080	$1,286,782	$2,030,398
Fixed rate loans, due after 1 year		$259,411	$323,957	$583,368
Variable or adjustable rate loans, due after 1 year		207,669	962,825	$1,170,494
Total		$467,080	$1,286,782	$1,753,862

Commercial Business Lending

We offer different types of commercial business loans, including lines of credit, term equipment financing and term owner-occupied and non-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, 2015 we had $1.92 billion, or 80.0%, of our total loans receivable in commercial business loans with an average outstanding loan balance of approximately $374,000 at December 31, 2015, 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 coverage to debt servicing requirements is generally a minimum of 1.15 times for five or more family residential loans and 1.25 times for other commercial real estate loans. Cash flow coverage 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."

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

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.

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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. 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 typically sell the servicing of the sold one-to-four family residential loans, or the collection of principal and interest payments, to other financial institutions. We did not service any of these sold loans as of or for the years ended December 31, 2015 or 2014.

The following table presents summary information concerning the origination and sale of our one-to-four family residential loans and the gains from the sale of loans.

	Years Ended December 31,				
	2015	2014	2013	2012	2011
	(In thousands)				
One-to-four family residential loans:					
Originated (1)	$164,974	$75,500	$18,867	$35,730	$23,865
Sold	132,365	55,997	8,460	21,187	15,888
Gains on sales of loans, net (2)	3,150	1,080	142	295	285

(1) Includes loans originated for our loan portfolio or for sale in the secondary market.
(2) Excludes net gains on sales of SBA loans.

Real Estate Construction and Land Development

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 the related value associated with the completed project. These estimates may be inaccurate.”

Consumer

At December 31, 2015, we had $298.2 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.

Commitments and Contingent Liabilities

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.

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The following table presents outstanding commitments to extend credit, including letters of credit, at the dates indicated:

	December 31, 2015	December 31, 2014
	(In thousands)	
Commercial business:		
Commercial and industrial	$350,227	$288,930
Owner-occupied commercial real estate	2,220	2,648
Non-owner occupied commercial real estate	11,168	20,240
Total commercial business	363,615	311,818
Real estate construction and land development:		
One-to-four family residential	21,778	24,028
Five or more family residential and commercial properties	52,772	32,653
Total real estate construction and land development	74,550	56,681
Consumer	134,313	122,633
Total outstanding commitments	$572,478	$491,132

Delinquencies and Nonperforming Assets

Delinquency Procedures. Delinquencies in the commercial business loan portfolio are handled by the assigned loan officer. Loan officers are responsible for collecting loans they originate or which are assigned to them. We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the due date.

If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is generally sold at a public sale and we may bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan relative to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower’s ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us in partial or full satisfaction of a loan obligation is classified as other real estate owned until it is sold. When property is acquired, it is recorded at the estimated fair value (less costs to sell) at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property’s net realizable value. If the estimated realizable value of the other real estate owned property declines after the acquisition date, the adjustment to the value is charged to other real estate owned expense, net.

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. We also have loans we classify as Watch and Other Assets Especially Mentioned (“OAEM”). Loans classified as Watch are performing assets but have elements of risk that require more monitoring than other performing loans. Loans classified as OAEM are assets that continue to perform but have shown deterioration in credit quality and require closer monitoring.

The Bank routinely tests its problem loans for potential impairment. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Problem loans that may be impaired are identified using the Bank's normal loan review procedures, which include post-approval reviews, monthly reviews by credit administration of criticized loan reports, scheduled internal reviews, underwriting during extensions and renewals and the analysis of information routinely received on a borrower's financial performance.

Impairment is measured using the present value of expected future cash flows, discounted at the loan's effective interest rate, unless the loan is collateral dependent, in which case impairment is measured using the fair value of the collateral after deducting appropriate collateral disposition costs. Furthermore, when it is practically expedient, impairment is measured by the fair market price of the loan.

Subsequent to an initial measure of impairment, if there is a significant change in the amount or timing of a loan's expected future cash flows or a change in the value of collateral or market price of a loan, based on new information received, the impairment is recalculated. However, the net carrying value of a loan never exceeds the recorded investment in the loan.

Nonperforming Assets. Nonperforming assets consist of nonaccrual loans and other real estate owned. The following table provides information about our nonaccrual loans and other real estate owned for the indicated dates. The following table also includes information regarding our performing troubled-debt restructured ("TDR") loans for the indicated dates. The performing TDR loans are not considered nonperforming assets as they continue to accrue interest despite being considered impaired due to the restructured status.

	December 31,									
	2015		2014		2013		2012		2011	
	(Dollars in thousands)									
Nonaccrual loans:										
Commercial business	$7,122		$8,596		$5,675		$6,068		$8,266	
One-to-four family residential	38		—		340		450		—	
Real estate construction and land development	2,414		2,831		1,045		6,420		14,947	
Consumer	94		145		685		320		622	
Total nonaccrual loans(1)(2)	9,668		11,572		7,745		13,258		23,835	
Other real estate owned	2,019		3,355		4,559		5,666		4,484	
Total nonperforming assets	$11,687		$14,927		$12,304		$18,924		$28,319	
Accruing loans past due 90 days or more(3)	$—		$—		$6		$248		$1,342	
Potential problem loans(4)	110,357		162,930		67,662		31,900		32,417	
Allowance for loan losses	29,746		27,729		28,824		28,594		30,915	
Nonperforming loans to loans receivable, net	0.40	%	0.51	%	0.63	%	1.29	%	2.30	%
Allowance for loan losses to loans receivable, net	1.24	%	1.23	%	2.34	%	2.78	%	2.99	%
Allowance for loan losses to nonperforming loans	307.67	%	239.62	%	372.16	%	215.67	%	129.70	%
Nonperforming assets to total assets	0.32	%	0.43	%	0.74	%	1.41	%	2.07	%
Performing TDR loans:										
Commercial business	$17,345		$14,421		$19,496		$15,227		$12,606	
One-to-four family residential	236		245		702		888		835	
Real estate construction and land development	3,014		3,927		6,043		361		364	
Consumer	100		66		101		—		—	
Total performing TDR loans(5)	$20,695		$18,659		$26,342		$16,476		$13,805	

(1)

At December 31, 2015, 2014, 2013, 2012 and 2011, $6.3 million $7.3 million, $2.6 million, $9.3 million and $11.7 million of nonaccrual loans were considered TDR loans, respectively.

(2) At December 31, 2015, 2014, 2013, 2012 and 2011, $1.1 million, $1.6 million $1.7 million, $1.2 million and $1.8 million of nonaccrual loans were guaranteed by government agencies, respectively.

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(3) Excludes purchased credit impaired ("PCI") loans. There were no accruing loans past due 90 days or more that were guaranteed by government agencies at December 31, 2015, 2014, and 2013. There were accruing loans past due 90 days or more of $6,000 and $92,000 guaranteed by government agencies at December 31, 2012 and 2011, respectively.

(4) At December 31, 2015, 2014, 2013, 2012 and 2011, $1.2 million, $2.0 million, $1.8 million, $2.9 million and $2.8 million of potential problem loans were guaranteed by government agencies, respectively.

(5) At December 31, 2015, 2014, 2013 and 2012, $449,000, $751,000, $1.2 million and $965,000 of performing TDR loans were guaranteed by government agencies. There were no performing TDR loans guaranteed by government agencies at December 31, 2011.

Nonaccrual Loans. Our Consolidated Financial Statements are prepared on the accrual basis of accounting, including the recognition of interest income on our loan portfolio, unless a loan is placed on nonaccrual status. Loans are considered to be impaired and are placed on nonaccrual status when there are serious doubts about the collectability of principal or interest. Our policy is to place a loan on nonaccrual status when the loan becomes past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Payments received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.
Nonaccrual loans decreased $1.9 million to $9.7 million, or 0.40% of loans receivable, net, at December 31, 2015 from $11.6 million, or 0.51% of loans receivable, net, at December 31, 2014 due to the loan resolution efforts of our credit department. During the year ended December 31, 2015, approximately $5.6 million in net principal payments were received on nonaccrual loans and $236,000 of nonaccrual loans were transferred back to accrual status. We also recorded $1.1 million in net charge-offs of nonaccrual loans. The decrease in total nonaccrual loans at December 31, 2015 was partially offset by $5.0 million in additions to nonperforming loans, of which $1.1 million were previously performing TDR loans that were transferred to nonaccrual status.
Nonperforming assets decreased $3.2 million to $11.7 million, or 0.32% of total assets, at December 31, 2015 from $14.9 million, or 0.43% of total assets, at December 31, 2014 due to the decrease in nonperforming loans discussed above as well as an overall decrease in other real estate owned. Other real estate owned decreased $1.3 million, or 39.8%, to $2.0 million at December 31, 2015 from $3.4 million at December 31, 2014 due primarily to dispositions of $3.6 million, which were offset partially by additions of $2.8 million during the year ended December 31, 2015.
Performing TDR loans as of December 31, 2015 and December 31, 2014 were $20.7 million and $18.7 million, respectively. The $2.0 million increase in performing TDR loans during the year ended December 31, 2015 was primarily due to $6.1 million of loans restructured during the year ended December 31, 2015, offset partially by $3.0 million of net principal reductions and $1.1 million in TDR loans transferred to nonaccrual status.
Troubled Debt Restructured Loans. A TDR loan is a restructuring in which the Bank, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to a borrower that it would not otherwise consider. The majority of the Bank's TDR loans are a result of granting extensions to troubled credits which have already been adversely classified. We grant such extensions to reassess the borrower’s financial status and develop a plan for repayment. Certain modifications also include interest rate reductions, which is the second most prevalent concession. The interest rate reductions can be for a period of time or over the remainder of the life of the loan. We may also bifurcate troubled credits into a “good” loan and a “bad” loan, whereas the good loan continues to accrue under the modified terms. We perform bifurcations to limit potential losses. The remainder of the Bank's TDRs are the result of converting revolving lines of credits to amortizing loans, changing amortizing loans to interest-only loans with balloon payments, or re-amortizing the loan over a longer period of time. These modifications would all be considered a concession for a borrower that could not obtain financing outside of the Bank. We do not forgive principal for a majority of our TDRs, but in those situations where principal is forgiven, the entire amount of such principal forgiveness is immediately charged off to the extent not done so prior to the modification. We sometimes delay the timing on the repayment of a portion of principal (principal forbearance) and charge-off the amount of forbearance if that amount is not considered fully collectible. We also consider insignificant delays in payments when determining if a loan should be classified as a TDR.

TDRs are considered impaired and are separately measured for impairment under Financial Accounting Standards Board ("FASB") Accounting Standards Codification (“ASC”) 310-10-35, whether on accrual or nonaccrual status. At December 31, 2015 and December 31, 2014, the balance of performing TDR loans was $20.7 million and $18.7 million, respectively. The related allowance for loan losses on the performing TDR loans was $2.1 million as of December 31, 2015 and $1.9 million as of December 31, 2014. At December 31, 2015, nonperforming TDR loans were $6.3 million and had a related allowance for loan losses of $679,000. At December 31, 2014, nonperforming TDR loans of $7.3 million had a related allowance for loan losses of $1.0 million.

A loan may have the TDR classification removed if (a) the restructured interest rate was greater than or equal to the interest rate of a new loan with comparable risk at the time of the restructure, and (b) the loan is no longer impaired based on the terms of the restructured agreement. The Bank's policy is that the borrower must demonstrate six consecutive monthly payments in accordance with the modified loan terms before it can be reviewed for removal of TDR classification under the second criteria. However, the loan must be reported as a TDR in at least one of the Company’s Annual Reports on Form 10-K. Once a loan has been classified as a TDR, it will continue to be an impaired loan until paid off or charged-off, even if the loan subsequently is no longer a TDR.

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 considered potential problem loans if they are both well-secured and in the process of collection. Potential problem loans decreased $52.6 million, or 32.3%, to $110.4 million at December 31, 2015 from $162.9 million at December 31, 2014 primarily due to loan payments.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses (“ALL”) to provide for estimated probable credit losses inherent in the loan portfolio that have been incurred as of the reporting date. The adequacy of the ALL is monitored through our ongoing quarterly loan quality assessments.

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

- Historical loss experience in a number of homogeneous segments of the loan portfolio;
- Balance of potential problem loans in the loan portfolio;
- The 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 requirements;
  - Effects of changes in credit concentrations; and
  - Other factors

We calculate an appropriate ALL 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 TDR loans, after a careful analysis of each loan’s credit and collateral factors. Our analysis of an appropriate ALL 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, results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A decline in local and national 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 allocations based upon their judgment of information available to them at the time of their examination.

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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,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Allowance for loan losses at beginning of the year	$27,729	$28,824	$28,594	$30,915	$22,062
Provision for loan losses	4,372	4,594	3,672	2,016	14,430