

BankFinancial CORP  
Form 10-Q  
October 29, 2014

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

FORM 10-Q

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

For the Quarterly Period ended September 30, 2014

or

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

For transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 0-51331

BANKFINANCIAL CORPORATION  
(Exact Name of Registrant as Specified in Charter)

Maryland  
(State or Other Jurisdiction  
of Incorporation)

75-3199276  
(I.R.S. Employer  
Identification No.)

15W060 North Frontage Road, Burr Ridge, Illinois 60527  
(Address of Principal Executive Offices)  
Registrant's telephone number, including area code: (800) 894-6900  
Not Applicable  
(Former name or former address, if changed since last report)

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
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

Indicate the number of shares outstanding of each of the Issuer's classes of common stock as of the latest practicable date. At October 27, 2014, there were 21,101,966 shares of Common Stock, \$0.01 par value, outstanding.



BANKFINANCIAL CORPORATION

Form 10-Q

September 30, 2014

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BANKFINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(In thousands, except share and per share data) - Unaudited

	September 30, 2014	December 31, 2013
Assets		
Cash and due from other financial institutions	\$11,078	\$15,781
Interest-bearing deposits in other financial institutions	81,847	145,176
Cash and cash equivalents	92,925	160,957
Securities, at fair value	115,001	110,907
Loans receivable, net of allowance for loan losses: September 30, 2014, \$13,051 and December 31, 2013, \$14,154	1,134,442	1,098,077
Other real estate owned, net	5,990	6,306
Stock in Federal Home Loan Bank, at cost	6,257	6,068
Premises and equipment, net	34,030	35,328
Accrued interest receivable	3,590	3,933
Core deposit intangible	1,998	2,433
Bank owned life insurance	22,140	21,958
Other assets	4,560	7,627
Total assets	\$1,420,933	\$1,453,594
Liabilities		
Deposits		
Noninterest-bearing	\$128,498	\$126,680
Interest-bearing	1,089,804	1,126,028
Total deposits	1,218,302	1,252,708
Borrowings	2,834	3,055
Advance payments by borrowers for taxes and insurance	6,762	10,432
Accrued interest payable and other liabilities	11,759	11,772
Total liabilities	1,239,657	1,277,967
Stockholders' equity		
Preferred Stock, \$0.01 par value, 25,000,000 shares authorized, none issued or outstanding	—	—
Common Stock, \$0.01 par value, 100,000,000 shares authorized; 21,101,966 shares issued at September 30, 2014 and December 31, 2013	211	211
Additional paid-in capital	193,674	193,594
Retained earnings (deficit)	(2,461	) (7,342
Unearned Employee Stock Ownership Plan shares	(10,522	) (11,255
Accumulated other comprehensive income	374	419
Total stockholders' equity	181,276	175,627
Total liabilities and stockholders' equity	\$1,420,933	\$1,453,594

See accompanying notes to the consolidated financial statements.

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BANKFINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands, except share and per share data) - Unaudited

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest and dividend income				
Loans, including fees	\$ 11,983	\$ 11,680	\$ 35,767	\$ 35,812
Securities	283	241	866	710
Other	102	186	303	574
Total interest income	12,368	12,107	36,936	37,096
Interest expense				
Deposits	744	880	2,327	2,799
Borrowings	2	2	5	12
Total interest expense	746	882	2,332	2,811
Net interest income	11,622	11,225	34,604	34,285
Provision for (recovery of) loan losses	(1,413	) (437	) 20	491
Net interest income after provision for loan losses	13,035	11,662	34,584	33,794
Noninterest income				
Deposit service charges and fees	519	520	1,417	1,528
Other fee income	571	571	1,698	1,713
Insurance commissions and annuities income	106	106	279	301
Gain on sale of loans, net	39	32	107	1,445
Loss on sale of securities (includes \$7 accumulated other compre-hensive income reclassifications for unrealized net losses on available for sale securities for the nine months ended September 30, 2014)	—	—	(7	) —
Gain on disposition of premises and equipment, net	—	—	5	—
Loan servicing fees	102	112	310	349
Amortization and impairment of servicing assets	(32	) (43	) (112	) (152
Earnings on bank owned life insurance	57	84	182	236
Trust	171	172	505	536
Other	215	183	556	513
	1,748	1,737	4,940	6,469
Noninterest expense				
Compensation and benefits	5,492	6,143	17,046	19,581
Office occupancy and equipment	1,687	1,797	5,227	5,550
Advertising and public relations	271	195	737	609
Information technology	674	817	2,004	2,394
Supplies, telephone, and postage	394	382	1,169	1,234
Amortization of intangibles	143	149	435	455
Nonperforming asset management	418	682	619	2,031
Operations of other real estate owned	494	476	1,160	1,409
FDIC insurance premiums	208	476	1,157	1,445
Other	1,376	1,243	3,956	3,762
	11,157	12,360	33,510	38,470
Income before income taxes	3,626	1,039	6,014	1,793
Income tax expense	36	—	78	—

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Net income	\$3,590	\$1,039	\$5,936	\$1,793
Basic earnings per common share	\$0.17	\$0.05	\$0.29	\$0.09
Diluted earnings per common share	\$0.17	\$0.05	\$0.29	\$0.09
Weighted average common shares outstanding	20,218,951	20,048,058	20,154,912	20,002,381
Diluted weighted average common shares outstanding	20,235,407	20,054,092	20,170,964	20,005,197

See accompanying notes to the consolidated financial statements.

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BANKFINANCIAL CORPORATION  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (In thousands) - Unaudited

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$3,590	\$1,039	\$5,936	\$1,793
Unrealized holding loss arising during the period, net of tax	(26	) (215	) (52	) (659
Reclassification adjustment for losses included in net income	—	—	7	—
Net current period other comprehensive loss	(26	) (215	) (45	) (659
Comprehensive income	\$3,564	\$824	\$5,891	\$1,134

See accompanying notes to the consolidated financial statements.

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## BANKFINANCIAL CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(In thousands, except per share data) - Unaudited

	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Unearned Employee Stock Ownership Plan Shares	Accumulated Other Comprehen-sive Income	Total
Balance at January 1, 2013	\$211	\$193,590	\$(9,796 )	\$(12,233 )	\$ 1,118	\$172,890
Net income	—	—	1,793	—	—	1,793
Other comprehensive loss, net of tax effects	—	—	—	—	(659 )	(659 )
Nonvested stock awards-stock-based compensation expense	—	62	—	—	—	62
Cash dividends declared on common stock (\$0.02 per share)	—	—	(422 )	—	—	(422 )
ESOP shares earned	—	(85 )	—	732	—	647
Balance at September 30, 2013	\$211	\$193,567	\$(8,425 )	\$(11,501 )	\$ 459	\$174,311
Balance at January 1, 2014	\$211	\$193,594	\$(7,342 )	\$(11,255 )	\$ 419	\$175,627
Net income	—	—	5,936	—	—	5,936
Other comprehensive loss, net of tax effects	—	—	—	—	(45 )	(45 )
Nonvested stock awards-stock-based compensation expense	—	52	—	—	—	52
Cash dividends declared on common stock (\$0.05 per share)	—	—	(1,055 )	—	—	(1,055 )
ESOP shares earned	—	28	—	733	—	761
Balance at September 30, 2014	\$211	\$193,674	\$(2,461 )	\$(10,522 )	\$ 374	\$181,276

See accompanying notes to the consolidated financial statements.



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BANKFINANCIAL CORPORATION  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands) - Unaudited

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities		
Net income	\$5,936	\$1,793
Adjustments to reconcile to net income to net cash from operating activities		
Provision for loan losses	20	491
ESOP shares earned	761	647
Stock-based compensation expense	52	62
Depreciation and amortization	2,864	3,285
Amortization of premiums and discounts on securities and loans	(325)	(606)
Amortization of core deposit intangible	435	455
Amortization and impairment of servicing assets	112	152
Net change in net deferred loan origination costs	(99)	(157)
Net loss (gain) on sale of other real estate owned	(40)	182
Net gain on sale of loans	(107)	(1,445)
Net loss on sale of securities	7	—
Net gain on disposition of premises and equipment	(5)	—
Loans originated for sale	(3,492)	(9,876)
Proceeds from sale of loans	3,599	10,750
Other real estate owned valuation adjustments	392	471
Net change in:		
Accrued interest receivable	343	570
Earnings on bank owned life insurance	(182)	(236)
Other assets	3,638	3,749
Accrued interest payable and other liabilities	(13)	(583)
Net cash from operating activities	13,896	9,704
Cash flows from investing activities		
Securities		
Proceeds from maturities	43,924	25,422
Proceeds from principal repayments	5,259	10,571
Proceeds from sales of securities	3,663	—
Purchases of securities	(57,023)	(42,351)
Loans receivable		
Principal payments on loans receivable	322,271	345,906
Originated for investment	(363,909)	(353,764)
Proceeds from sale of loans	—	2,868
Proceeds of redemption of Federal Home Loan Bank of Chicago stock	—	2,344
Purchase of Federal Home Loan Bank of Chicago stock	(189)	—
Proceeds from sale of other real estate owned	3,790	7,542
Purchase of premises and equipment, net	(362)	(24)
Net cash used in investing activities	(42,576)	(1,486)

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BANKFINANCIAL CORPORATION  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands) - Unaudited

	Nine Months Ended September 30,	
Cash flows from financing activities		
Net change in deposits	\$(34,406	) \$(32,518
Net change in borrowings	(221	) (2,684
Net change in advance payments by borrowers for taxes and insurance	(3,670	) (4,880
Cash dividends paid on common stock	(1,055	) (422
Net cash used in financing activities	(39,352	) (40,504
Net change in cash and cash equivalents	(68,032	) (32,286
Beginning cash and cash equivalents	160,957	275,764
Ending cash and cash equivalents	\$92,925	\$243,478
Supplemental disclosures of cash flow information:		
Interest paid	\$2,344	\$2,849
Income taxes paid	114	—
Income taxes refunded	—	461
Loans transferred to other real estate owned	3,836	3,268

See accompanying notes to the consolidated financial statements.

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BANKFINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation:** BankFinancial Corporation, a Maryland corporation headquartered in Burr Ridge, Illinois, is the owner of all of the issued and outstanding capital stock of BankFinancial, F.S.B. (the “Bank”).

**Principles of Consolidation:** The interim unaudited consolidated financial statements include the accounts of and transactions of BankFinancial Corporation, the Bank, and the Bank’s wholly-owned subsidiaries, Financial Assurance Services, Inc. and BF Asset Recovery Corporation (collectively, “the Company”), and reflect all normal and recurring adjustments that are, in the opinion of management, considered necessary for a fair presentation of the financial condition and results of operations for the periods presented. All significant intercompany accounts and transactions have been eliminated. The results of operations for the three- and nine-month periods ended September 30, 2014 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2014. Certain information and note disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

**Use of Estimates:** To prepare financial statements in conformity with GAAP, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, mortgage servicing rights, deferred tax assets, other intangible assets, stock-based compensation, impairment of securities and fair value of financial instruments are particularly subject to change and the effect of such change could be material to the financial statements.

**Reclassifications:** Certain reclassifications have been made in the prior period’s financial statements to conform them to the current period’s presentation.

These unaudited consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission.

**Recent Accounting Pronouncements**

In January 2014, the FASB amended existing guidance to clarify when a creditor should derecognize a loan receivable and recognize a collateral asset. An in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendment requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. This amendment is effective for interim and annual reporting periods beginning after December 15, 2014. The adoption of this standard will not have a material impact on the Company’s results of operation or financial position but will require expansion of the Company’s disclosures.

**FASB ASC 606 -** In May 2014, the FASB issued an update (ASU No. 2014-09, Revenue from Contracts with Customers) creating FASB Topic 606, Revenue from Contracts with Customers. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Qualitative and quantitative information is required about contracts with customers, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. We are currently evaluating the impact of adopting the new guidance on the consolidated financial statements.

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 2 - EARNINGS PER SHARE

Amounts reported in earnings per share reflect earnings available to common stockholders for the period divided by the weighted average number of shares of common stock outstanding during the period, exclusive of unearned ESOP shares and unvested restricted stock shares. Stock options and restricted stock are regarded as potential common stock and are considered in the diluted earnings per share calculations to the extent that they would have a dilutive effect if converted to common stock.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Net income available to common stockholders	\$3,590	\$1,039	\$5,936	\$1,793
Average common shares outstanding	21,101,966	21,101,966	21,101,966	21,087,838
Less:				
Unearned ESOP shares	(866,193 )	(1,028,158 )	(926,705 )	(1,072,180 )
Unvested restricted stock shares	(16,822 )	(25,750 )	(20,349 )	(13,277 )
Weighted average common shares outstanding	20,218,951	20,048,058	20,154,912	20,002,381
Add - Net effect of dilutive stock options and unvested restricted stock	16,456	6,034	16,052	2,816
Diluted weighted average common shares outstanding	20,235,407	20,054,092	20,170,964	20,005,197
Basic earnings per common share	\$0.17	\$0.05	\$0.29	\$0.09
Diluted earnings per common share	\$0.17	\$0.05	\$0.29	\$0.09

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 3 - SECURITIES

The fair value of securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income are shown below.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2014				
Certificates of deposit	\$78,109	\$—	\$—	\$78,109
Municipal securities	180	1	—	181
Equity mutual fund	500	5	—	505
Mortgage-backed securities - residential	24,195	1,147	(80	) 25,262
Collateralized mortgage obligations - residential	10,929	41	(57	) 10,913
SBA-guaranteed loan participation certificates	31	—	—	31
	\$113,944	\$1,194	\$(137	) \$115,001
December 31, 2013				
Certificates of deposit	\$65,010	\$—	\$—	\$65,010
Municipal securities	180	7	—	187
Equity mutual fund	500	—	(3	) 497
Mortgage-backed securities - residential	27,229	1,295	(160	) 28,364
Collateralized mortgage obligations - residential	16,851	35	(72	) 16,814
SBA-guaranteed loan participation certificates	35	—	—	35
	\$109,805	\$1,337	\$(235	) \$110,907

Mortgage-backed securities and collateralized mortgage obligations reflected in the preceding table were issued by U.S. government-sponsored entities or agencies, Freddie Mac, Fannie Mae and Ginnie Mae, and are obligations which the government has affirmed its commitment to support. All securities reflected in the preceding table were classified as available-for-sale at September 30, 2014 and December 31, 2013.

The amortized cost and fair values of securities by contractual maturity are shown below. Securities not due at a single maturity date are shown separately. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	September 30, 2014	
	Amortized Cost	Fair Value
Due in one year or less	\$78,289	\$78,290
Equity mutual fund	500	505
Mortgage-backed securities - residential	24,195	25,262
Collateralized mortgage obligations - residential	10,929	10,913
SBA-guaranteed loan participation certificates	31	31
	\$113,944	\$115,001

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 3 - SECURITIES (continued)

Sales of securities were as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Proceeds	\$—	\$—	\$3,663	\$—
Gross gains	—	—	—	—
Gross losses	—	—	7	—

Securities with unrealized losses not recognized in income are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2014						
Mortgage-backed securities - residential	\$—	\$—	\$2,285	\$(80)	\$2,285	\$(80)
Collateralized mortgage obligations - residential	1,637	(2)	7,391	(55)	9,028	(57)
	\$1,637	\$(2)	\$9,676	\$(135)	\$11,313	\$(137)
December 31, 2013						
Equity mutual fund	\$497	\$(3)	\$—	\$—	\$497	\$(3)
Mortgage-backed securities - residential	2,806	(160)	—	—	2,806	(160)
Collateralized mortgage obligations - residential	11,233	(72)	—	—	11,233	(72)
	\$14,536	\$(235)	\$—	\$—	\$14,536	\$(235)

The Company evaluates marketable investment securities with significant declines in fair value on a quarterly basis to determine whether they should be considered other-than-temporarily impaired under current accounting guidance, which generally provides that if a marketable security is in an unrealized loss position, whether due to general market conditions or industry or issuer-specific factors, the holder of the securities must assess whether the impairment is other-than-temporary.

Certain residential mortgage-backed securities and certain collateralized mortgage obligations that the Company holds in its investment portfolio were in an unrealized loss position at September 30, 2014, but the unrealized losses were not considered significant under the Company's impairment testing methodology. In addition, the Company does not intend to sell these securities, and it is likely that the Company will not be required to sell these securities before their anticipated recovery occurs.



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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE

Loans receivable are as follows:

	September 30, 2014	December 31, 2013
One-to-four family residential real estate	\$ 187,318	\$ 201,382
Multi-family mortgage	453,720	396,058
Nonresidential real estate	243,047	263,567
Construction and land	2,356	6,570
Commercial loans	53,962	54,255
Commercial leases	203,563	187,112
Consumer	2,458	2,317
	1,146,424	1,111,261
Net deferred loan origination costs	1,069	970
Allowance for loan losses	(13,051	) (14,154
Loans, net	\$ 1,134,442	\$ 1,098,077

The following tables present the balance in the allowance for loan losses and the loans receivable by portfolio segment and based on impairment method:

	Allowance for loan losses				Loan Balances			
	Individually evaluated for impairment	Purchased impaired loans	Collectively evaluated for impairment	Total	Individually evaluated for impairment	Purchased impaired loans	Collectively evaluated for impairment	Total
September 30, 2014								
One-to-four family residential real estate	\$ 8	\$ —	\$ 2,548	\$ 2,556	\$ 3,901	\$ 51	\$ 183,366	\$ 187,318
Multi-family mortgage	457	—	4,782	5,239	6,772	—	446,948	453,720
Nonresidential real estate	243	—	3,180	3,423	6,103	161	236,783	243,047
Construction and land	12	—	188	200	120	—	2,236	2,356
Commercial loans	—	—	590	590	76	—	53,886	53,962
Commercial leases	—	—	956	956	—	—	203,563	203,563
Consumer	—	—	87	87	—	—	2,458	2,458
	\$ 720	\$ —	\$ 12,331	\$ 13,051	\$ 16,972	\$ 212	\$ 1,129,240	1,146,424
Net deferred loan origination costs								1,069
Allowance for loan losses								(13,051
Loans, net								) \$ 1,134,442

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

	Allowance for loan losses			Total	Loan Balances			Total
	Individually evaluated for impairment	Purchased impaired loans	Collectively evaluated for impairment		Individually evaluated for impairment	Purchased impaired loans	Collectively evaluated for impairment	
December 31, 2013								
One-to-four family residential real estate	\$26	\$5	\$ 3,817	\$3,848	\$3,692	\$100	\$197,590	\$201,382
Multi-family mortgage	255	—	4,189	4,444	7,031	—	389,027	396,058
Nonresidential real estate	77	—	3,658	3,735	4,381	1,633	257,553	263,567
Construction and land	12	—	381	393	383	—	6,187	6,570
Commercial loans	—	—	731	731	—	23	54,232	54,255
Commercial leases	—	—	946	946	—	—	187,112	187,112
Consumer	—	—	57	57	77	—	2,240	2,317
	\$370	\$5	\$ 13,779	\$14,154	\$15,564	\$1,756	\$1,093,941	1,111,261
Net deferred loan origination costs								970
Allowance for loan losses								(14,154 )
Loans, net								\$1,098,077

Activity in the allowance for loan losses is as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Beginning balance	\$14,452	\$17,097	\$14,154	\$18,035
Loans charged off:				
One-to-four family residential real estate	(298 )	(528 )	(644 )	(1,073 )
Multi-family mortgage	(97 )	(902 )	(781 )	(1,512 )
Nonresidential real estate	(695 )	(138 )	(1,461 )	(370 )
Construction and land	—	(16 )	(1 )	(943 )
Commercial loans	(78 )	(131 )	(100 )	(363 )
Commercial leases	(8 )	—	(8 )	—
Consumer	—	(38 )	(10 )	(50 )
	(1,176 )	(1,753 )	(3,005 )	(4,311 )
Recoveries:				
One-to-four family residential real estate	26	108	134	435
Multi-family mortgage	11	3	31	219
Nonresidential real estate	116	329	400	451
Construction and land	29	193	287	196
Commercial loans	1,005	335	1,027	356
Consumer	1	1	3	4
	1,188	969	1,882	1,661

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Net (charge-off) recoveries	12	(784	) (1,123	) (2,650	)
Provision for (recovery of) loan losses	(1,413	) (437	) 20	491	
Ending balance	\$13,051	\$15,876	\$13,051	\$15,876	

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

## Impaired loans

Several of the following disclosures are presented by “recorded investment,” which the FASB defines as “the amount of the investment in a loan, which is not net of a valuation allowance, but which does reflect any direct write-down of the investment.” The following represents the components of recorded investment:

Loan principal balance  
 Less unapplied payments  
 Plus negative unapplied balance  
 Less escrow balance  
 Plus negative escrow balance  
 Plus unamortized net deferred loan costs  
 Less unamortized net deferred loan fees  
 Plus unamortized premium  
 Less unamortized discount  
 Less previous charge-offs  
 Plus recorded accrued interest  
 Less reserve for uncollected interest  
 = Recorded investment

The following tables present loans individually evaluated for impairment by class of loans, excluding purchased impaired loans:

					Three months ended September 30, 2014	Interest Income Recognized	Nine months ended September 30, 2014	Interest Income Recognized
	Loan Balance	Recorded Investment	Partial Charge-off	Allowance for Loan Losses Allocated	Average Investment in Impaired Loans		Average Investment in Impaired Loans	
September 30, 2014								
With no related allowance recorded:								
One-to-four family residential real estate	\$4,306	\$ 3,211	\$ 1,088	\$ —	\$2,847	\$ 3	\$2,741	\$ 16
One-to-four family residential real estate - non-owner occupied	669	596	71	—	611	13	713	21
Multi-family mortgage	3,173	3,093	24	—	2,354	25	3,571	72
Wholesale commercial lending	521	519	—	—	521	9	366	26
Nonresidential real estate	2,825	2,715	66	—	4,376	21	4,566	92
Commercial loans - secured	76	76	—	—	129	1	99	3
	11,570	10,210	1,249	—	10,838	72	12,056	230
With an allowance recorded:								
One-to-four family residential real estate - non-owner occupied	115	84	32	8	119	—	239	—
Multi-family mortgage	4,202	3,130	1,068	457	2,504	18	2,208	67

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Nonresidential real estate	3,609	3,368	245	243	2,048	4	1,568	47
Land	180	120	61	12	119	—	119	—
	8,106	6,702	1,406	720	4,790	22	4,134	114
Total	\$19,676	\$ 16,912	\$ 2,655	\$ 720	\$15,628	\$ 94	\$16,190	\$ 344

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

	Loan Balance	Recorded Investment	Partial Charge-off	Allowance for Loan Losses Allocated	Average Investment in Impaired Loans	Interest Income Recognized
December 31, 2013						
With no related allowance recorded:						
One-to-four family residential real estate	\$3,656	\$ 2,540	\$ 1,102	\$ —	\$ 3,693	\$ 20
One-to-four family residential real estate - non-owner occupied	875	706	137	—	591	—
Multi-family mortgage	5,466	4,449	4	—	6,098	27
Wholesale commercial lending	—	—	—	—	306	—
Nonresidential real estate	4,062	3,313	253	—	4,054	33
Land	274	263	8	—	169	—
Commercial loans - secured	77	77	—	—	83	—
	14,410	11,348	1,504	—	14,994	80
With an allowance recorded:						
One-to-four family residential real estate - non-owner occupied	490	438	38	26	393	2
Multi-family mortgage	3,144	2,541	573	255	2,998	125
Nonresidential real estate	1,343	1,048	255	77	2,148	15
Land	180	119	60	12	1,265	—
	5,157	4,146	926	370	6,804	142
Total	\$19,567	\$ 15,494	\$ 2,430	\$ 370	\$ 21,798	\$ 222

## Purchased Impaired Loans

As a result of its acquisition of Downers Grove National Bank, the Company holds purchased loans for which there was evidence of deterioration of credit quality since origination and for which it was probable that all contractually required payments would not be collected as of the date of the acquisition. The carrying amounts of these purchased impaired loans are as follows:

	September 30, 2014	December 31, 2013
One-to-four family residential real estate	\$51	\$100
Nonresidential real estate	161	1,633
Commercial loans	—	23
Outstanding balance	\$212	\$1,756
Carrying amount, net of allowance (None at September 30, 2014 and \$5 at December 31, 2013)	\$212	\$1,751

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

Accretable yield, or income expected to be collected, related to purchased impaired loans are as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Beginning balance	\$11	\$100	\$37	\$196
Reclassifications from nonaccretable difference	—	(2	) (1	) 1
Accretion of income	6	48	31	147
Ending balance	\$5	\$50	\$5	\$50

For the above purchased impaired loans, there was a \$5,000 decrease to the allowance for loan losses for the three and nine months ended September 30, 2014. For the above purchased impaired loans, the allowance for loan losses was decreased by \$51,000 and \$109,000 for the three and nine months ended September 30, 2013, respectively.

Purchased impaired loans for which it was probable at the date of acquisition that all contractually required payments would not be collected are as follows:

	September 30, 2014	December 31, 2013
Contractually required payments receivable of loans purchased:		
One-to-four family residential real estate	\$82	\$832
Nonresidential real estate	203	1,999
Commercial loans	—	222
	\$285	\$3,053

At acquisition, cash flows expected to be collected were \$18.8 million, compared to the fair value of purchased impaired loans of \$15.4 million.

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

## Nonaccrual Loans

The following tables present the recorded investment in nonaccrual loans and loans past due over 90 days still on accrual by class of loans, excluding purchased impaired loans:

	Loan Balance	Recorded Investment	Loans Past Due Over 90 Days, Still Accruing
September 30, 2014			
One-to-four family residential real estate	\$4,797	\$4,036	\$—
One-to-four family residential real estate – non owner occupied	291	190	—
Multi-family mortgage	7,375	6,223	—
Nonresidential real estate	4,711	4,384	—
Land	180	120	—
Commercial loans – secured	286	82	—
Consumer	1	1	—
	\$17,641	\$15,036	\$—
December 31, 2013			
One-to-four family residential real estate	\$3,516	\$3,498	\$—
One-to-four family residential real estate – non owner occupied	1,190	1,143	—
Multi-family mortgage	8,142	7,098	228
Nonresidential real estate	4,748	4,214	—
Land	387	382	—
Commercial loans – secured	77	77	—
Consumer loans	12	12	—
	\$18,072	\$16,424	\$228

Nonaccrual loans and impaired loans are defined differently. Some loans may be included in both categories, and some may only be included in one category. Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The Company's reserve for uncollected loan interest was \$471,000 and \$1.3 million at September 30, 2014 and December 31, 2013, respectively. Except for purchased impaired loans, when a loan is on non-accrual status and the ultimate collectability of the total principal of an impaired loan is in doubt, all payments are applied to principal under the cost recovery method. Alternatively, when a loan is on non-accrual status but there is doubt concerning only the ultimate collectability of interest, contractual interest is credited to interest income only when received, under the cash basis method pursuant to the provisions of FASB ASC 310-10, as applicable. In all cases, the average balances are calculated based on the month-end balances of the financing receivables within the period reported pursuant to the provisions of FASB ASC 310-10, as applicable.



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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

## Past Due Loans

The following tables present the aging of the recorded investment of loans at September 30, 2014 by class of loans:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
One-to-four family residential real estate	\$1,900	\$609	\$3,278	\$5,787	\$130,829	\$136,616
One-to-four family residential real estate - non-owner occupied	87	—	152	239	50,518	50,757
Multi-family mortgage	—	1,873	3,787	5,660	331,470	337,130
Wholesale commercial lending	—	—	—	—	114,506	114,506
Nonresidential real estate	2,343	1,534	3,322	7,199	234,294	241,493
Construction	—	—	—	—	73	73
Land	128	—	120	248	2,035	2,283
Commercial loans:						
Secured	77	—	—	77	11,679	11,756
Unsecured	8	—	—	8	2,369	2,377
Municipal	—	—	—	—	2,228	2,228
Warehouse lines	—	180	—	180	5,111	5,291
Health care	—	—	—	—	20,654	20,654
Aviation	—	—	—	—	1,125	1,125
Other	—	—	—	—	10,649	10,649
Commercial leases:						
Investment rated commercial leases	124	488	—	612	157,107	157,719
Below investment grade	75	—	—	75	11,122	11,197
Non-rated	—	—	—	—	28,321	28,321
Lease pools	—	—	—	—	7,344	7,344
Consumer	—	3	1	4	2,463	2,467
	\$4,742	\$4,687	\$10,660	\$20,089	\$1,123,897	\$1,143,986
	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
Purchased impaired loans						
One-to-four family residential real estate - non-owner occupied	\$—	\$—	\$51	\$51	\$—	\$51
Nonresidential real estate	—	—	161	161	—	161
	\$—	\$—	\$212	\$212	\$—	\$212



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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

The following tables present the aging of the recorded investment of loans at December 31, 2013 by class of loans:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
One-to-four family residential real estate	\$751	\$424	\$2,876	\$4,051	\$142,058	\$146,109
One-to-four family residential real estate - non-owner occupied	905	—	960	1,865	52,676	54,541
Multi-family mortgage	2,193	1,716	6,354	10,263	303,903	314,166
Wholesale commercial lending	—	—	—	—	78,531	78,531
Nonresidential real estate	4,432	1,363	3,969	9,764	249,194	258,958
Construction	—	—	—	—	2,486	2,486
Land	—	—	382	382	3,684	4,066
Commercial loans:						
Secured	9	—	—	9	15,971	15,980
Unsecured	25	—	—	25	4,117	4,142
Municipal	—	—	—	—	2,849	2,849
Warehouse lines	—	—	—	—	1,927	1,927
Health care	—	—	—	—	19,381	19,381
Aviation	—	—	—	—	1,102	1,102
Other	—	—	—	—	9,006	9,006
Commercial leases:						
Investment rated commercial leases	—	—	—	—	147,374	147,374
Below investment grade	8	—	—	8	14,739	14,747
Non-rated	—	—	—	—	23,175	23,175
Lease pools	—	—	—	—	3,011	3,011
Consumer	3	4	4	11	2,317	2,328
	\$8,326	\$3,507	\$14,545	\$26,378	\$1,077,501	\$1,103,879
	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total
Purchased impaired loans						
One-to-four family residential real estate - non-owner occupied	\$—	\$—	\$100	\$100	\$—	\$100
Nonresidential real estate	—	—	1,631	1,631	—	1,631
Commercial loans – secured	—	—	23	23	—	23
	\$—	\$—	\$1,754	\$1,754	\$—	\$1,754

## Troubled Debt Restructurings

The Company evaluates loan extensions or modifications in accordance with FASB ASC 310-40 with respect to the classification of the loan as a TDR. In general, if the Company grants a loan extension or modification to a borrower for other than an insignificant period of time that includes a below-market interest rate, principal forgiveness, payment forbearance or other concession intended to minimize the economic loss to the Company, the loan extension or loan

modification is classified as a TDR. In cases where

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

borrowers are granted new terms that provide for a reduction of either interest or principal then due and payable, management measures any impairment on the restructured loan in the same manner as for impaired loans as noted above.

The Company had \$3.2 million of TDRs at September 30, 2014, compared to \$3.3 million at December 31, 2013, with \$50,000 and \$53,000 in specific valuation reserves allocated to those loans at September 30, 2014 and December 31, 2013, respectively. The Company had no outstanding commitments to borrowers whose loans were classified as TDRs at either date.

The following table presents loans classified as TDRs:

	September 30, 2014	December 31, 2013
One-to-four family residential real estate	\$1,965	\$2,093
Multi-family mortgage	516	518
Troubled debt restructured loans – accrual loans	2,481	2,611
One-to-four family residential real estate	404	342
Multi-family mortgage	353	384
Commercial loans - secured	5	—
Troubled debt restructured loans – nonaccrual loans	762	726
Total troubled debt restructured loans	\$3,243	\$3,337

Periodically, the Company will restructure a note into two separate notes (A/B structure), charging off the entire B portion of the note. The A note is structured with appropriate loan-to-value and cash flow coverage ratios that provide for a high likelihood of repayment. The A note is classified as a non-performing note until the borrower has displayed a historical payment performance for a reasonable time prior to and subsequent to the restructuring. A period of sustained repayment for at least six months generally is required to return the A note to accrual status provided that management has determined that the performance is reasonably expected to continue. The A note will be classified as a restructured note (either performing or nonperforming) through the calendar year of the restructuring that the historical payment performance has been established. These notes will be no longer included in the above tables as a TDR in the subsequent calendar year.

During the three and nine months ending September 30, 2014 and 2013, the terms of certain loans were modified and classified as TDRs. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. The following tables present TDR activity:

	Three Months Ended September 30, 2014		2013		Pre- Modification outstanding recorded investment	Post- Modification outstanding recorded investment
	Number of loans	Pre- Modification outstanding recorded investment	Post- Modification outstanding recorded investment	Number of loans		
One-to-four family residential real estate	1	\$ 345	\$ 345	—	\$ —	\$ —
Commercial loans - secured	1	210	5	—	—	—
Total	2	\$ 555	\$ 350	—	\$ —	\$ —



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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

	Due to reduction in interest rate	Due to extension of maturity date	Due to permanent reduction in recorded investment	Total
For the Three Months Ended September 30, 2014				
One-to-four family residential real estate	\$—	\$ 345	\$—	\$ 345
Commercial loans - secured	—	—	5	5
Total	\$—	\$ 345	\$ 5	\$ 350

The TDRs described above had no impact on interest income, resulted in no change to the allowance for loan losses allocated and resulted in \$205,000 of charge-offs for the three months ended September 30, 2014.

	Nine Months Ended September 30, 2014		2013			
	Number of loans	Pre- Modification outstanding recorded investment	Post- Modification outstanding recorded investment	Number of loans	Pre- Modification outstanding recorded investment	Post- Modification outstanding recorded investment
One-to-four family residential real estate	4	\$ 485	\$ 444	3	\$ 950	\$ 950
Commercial loans - secured	1	210	5	—	—	—
Total	5	\$ 695	\$ 449	3	\$ 950	\$ 950

	Due to reduction in interest rate	Due to extension of maturity date	Due to permanent reduction in recorded investment	Total
For the Nine Months Ended September 30, 2014				
One-to-four family residential real estate	\$ 19	\$ 373	\$ 52	\$ 444
Commercial loans - secured	—	—	5	5
	\$ 19	\$ 373	\$ 57	\$ 449

## For the Nine Months Ended September 30, 2013

One-to-four family residential real estate	\$—	\$ 950	\$—	\$ 950
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The TDRs described above decreased interest income by \$1,000, resulted in no change to the allowance for loan losses allocated and resulted in charge-offs of \$246,000 for the nine months ended September 30, 2014. The TDRs had no impact on interest income, resulted in no change to the allowance for loan losses allocated and resulted in no charge-offs for the nine months ended September 30, 2013.

The following table presents TDRs for which there was a payment default during the nine months ending September 30, 2014 and 2013 within twelve months following the modification.

	2014 Number of loans	Recorded investment	2013 Number of loans	Recorded investment
One-to-four family residential real estate	1	\$28	—	\$—

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

The one TDR for which there was a payment default had no effect on the allowance for loan losses during the nine months ending September 30, 2014.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

NOTE 4 - LOANS RECEIVABLE (continued)

There were certain other loan modifications during the three and nine months ending September 30, 2014 and 2013 that did not meet the definition of a TDR. These loans had a total recorded investment of \$1.6 million and \$1.1 million at September 30, 2014 and 2013, respectively. The modification of these loans involved either a modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company's internal underwriting policy.

Credit Quality Indicators

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt, including current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans based on credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a monthly basis. The Company uses the following definitions for risk ratings:

**Special Mention.** A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

**Substandard.** Loans categorized as Substandard continue to accrue interest, but exhibit a well-defined weakness or weaknesses that may jeopardize the liquidation of the debt. The loans continue to accrue interest because they are well secured and collection of principal and interest is expected within a reasonable time. The risk rating guidance published by the Office of the Comptroller of the Currency clarifies that a loan with a well-defined weakness does not have to present a probability of default for the loan to be rated Substandard, and that an individual loan's loss potential does not have to be distinct for the loan to be rated Substandard.

**Nonaccrual.** An asset classified Nonaccrual has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The loans were placed on nonaccrual status.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered "Pass" rated loans.

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

As of September 30, 2014, based on the most recent analysis performed, the risk categories of loans by class of loans are as follows:

	Pass	Special Mention	Substandard	Nonaccrual	Total
One-to-four family residential real estate	\$ 130,089	\$ 1,253	\$ 1,107	\$ 4,050	\$ 136,499
One-to-four family residential real estate - non-owner occupied	49,532	118	929	240	50,819
Multi-family mortgage	327,140	2,121	3,191	6,251	338,703
Wholesale commercial lending	113,862	—	1,155	—	115,017
Nonresidential real estate	228,757	2,933	6,805	4,552	243,047
Construction	70	—	—	—	70
Land	1,370	—	796	120	2,286
Commercial loans:					
Secured	11,656	5	8	76	11,745
Unsecured	1,494	45	837	—	2,376
Municipal	2,213	—	—	—	2,213
Warehouse lines	10,611	—	—	—	10,611
Health care	20,641	—	—	—	20,641
Aviation	1,122	—	—	—	1,122
Other	5,254	—	—	—	5,254
Commercial leases:					
Investment rated commercial leases	156,957	—	—	—	156,957
Below investment grade	11,141	—	—	—	11,141
Non-rated	28,148	—	—	—	28,148
Lease pools	7,317	—	—	—	7,317
Consumer	2,457	—	—	1	2,458
Total	\$ 1,109,831	\$ 6,475	\$ 14,828	\$ 15,290	\$ 1,146,424

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 4 - LOANS RECEIVABLE (continued)

As of December 31, 2013, based on the most recent analysis performed, the risk categories of loans by class of loans are as follows:

	Pass	Special Mention	Substandard	Nonaccrual	Total
One-to-four family residential real estate	\$140,716	\$269	\$1,941	\$3,508	\$146,434
One-to-four family residential real estate - non-owner occupied	53,010	—	693	1,245	54,948
Multi-family mortgage	300,230	6,471	3,890	7,031	317,622
Wholesale commercial lending	74,569	2,694	1,173	—	78,436
Nonresidential real estate	237,751	6,306	13,645	5,865	263,567
Construction	2,484	—	—	—	2,484
Land	2,871	—	832	383	4,086
Commercial loans:					
Secured	15,824	—	78	100	16,002
Unsecured	3,173	67	899	—	4,139
Municipal	2,812	—	—	—	2,812
Warehouse lines	1,904	—	—	—	1,904
Health care	19,330	—	—	—	19,330
Aviation	1,100	—	—	—	1,100
Other	8,968	—	—	—	8,968
Commercial leases:					
Investment rated commercial leases	146,471	—	—	—	146,471
Below investment grade	14,626	—	—	—	14,626
Non-rated	22,805	—	210	—	23,015
Lease pools	3,000	—	—	—	3,000
Consumer	2,316	—	1	—	2,317
Total	\$1,053,960	\$15,807	\$23,362	\$18,132	\$1,111,261

## NOTE 5 – FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Securities: The fair values of marketable equity securities are generally determined by quoted prices, in active markets, for each specific security (Level 1). If Level 1 measurement inputs are not available for a marketable equity security, we determine its fair value based on the quoted price of a similar security traded in an active market (Level 2). The fair values of debt securities are generally determined by matrix pricing, which is a mathematical technique

widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

NOTE 5 - FAIR VALUE (continued)

**Loans Held for Sale:** Loans held for sale are carried at the lower of cost or fair value, which is evaluated on a pool-level basis. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

**Impaired Loans:** At the time a loan is considered impaired, management measures impairment in accordance with ASC Topic 310. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Impaired loans carried at fair value generally require a partial charge-off and a specific valuation allowance for loan losses. For collateral dependent loans, fair value is commonly based on recent real estate appraisals. These real estate appraisals may include up to three approaches to value: the sales comparison approach, the income approach (for income-producing property) and the cost approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available, if applicable. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value. In addition, a discount is typically applied to account for sales and holding expenses. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. The method utilized to estimate the fair value of loans does not necessarily represent an exit price.

**Other Real Estate Owned:** Assets acquired through foreclosure or transfers in lieu of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Although the fair value of the property normally will be based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant will pay to purchase the property at the measurement date. Circumstances may exist that indicate that the appraised value is not an accurate measurement of the property's current fair value. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectivity in the appraisal process (i.e., actual sales for less than the appraised amount). Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

**Mortgage Servicing Rights:** On a quarterly basis, loan servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. The fair values of mortgage servicing rights are based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 3).

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 5 - FAIR VALUE (continued)

The following table sets forth the Company's financial assets that were accounted for at fair value and are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	Fair Value Measurements Using			Fair Value
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
September 30, 2014				
Securities:				
Certificates of deposit	\$—	\$78,109	\$—	\$78,109
Municipal securities	—	181	—	181
Equity mutual fund	505	—	—	505
Mortgage-backed securities – residential	—	25,262	—	25,262
Collateralized mortgage obligations – residential	—	10,913	—	10,913
SBA-guaranteed loan participation certificates	—	31	—	31
	\$505	\$114,496	\$—	\$115,001
December 31, 2013				
Securities:				
Certificates of deposit	\$—	\$65,010	\$—	\$65,010
Municipal securities	—	187	—	187
Equity mutual fund	497	—	—	497
Mortgage-backed securities - residential	—	28,364	—	28,364
Collateralized mortgage obligations – residential	—	16,814	—	16,814
SBA-guaranteed loan participation certificates	—	35	—	35
	\$497	\$110,410	\$—	\$110,907

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 5 - FAIR VALUE (continued)

The following table sets forth the Company's assets that were measured at fair value on a non-recurring basis:

	Fair Value Measurement Using			Fair Value
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
September 30, 2014				
Impaired loans:				
One-to-four family residential real estate	\$—	\$—	\$76	\$76
Multi-family mortgage	—	—	2,673	2,673
Nonresidential real estate	—	—	3,125	3,125
Construction and land	—	—	108	108
	\$—	\$—	\$5,982	\$5,982
Other real estate owned:				
One-to-four family residential real estate	\$—	\$—	\$174	\$174
Multi-family mortgage	—	—	1,265	1,265
Land	—	—	809	809
	\$—	\$—	\$2,248	\$2,248
Mortgage servicing rights	\$—	\$—	\$170	\$170
December 31, 2013				
Impaired loans:				
One-to-four family residential real estate	\$—	\$—	\$460	\$460
Multi-family mortgage	—	—	2,286	2,286
Nonresidential real estate	—	—	971	971
Construction and land	—	—	107	107
	\$—	\$—	\$3,824	\$3,824
Other real estate owned:				
One-to-four family residential real estate	\$—	\$—	\$297	\$297
Nonresidential real estate	—	—	460	460
Land	—	—	1,019	1,019
	\$—	\$—	\$1,776	\$1,776
Mortgage servicing rights	\$—	\$—	\$198	\$198

Impaired loans, including purchased impaired loans, which are measured for impairment using the fair value of the collateral for collateral-dependent loans, and have specific valuation allowances, had a carrying amount of \$6.7 million, with a valuation allowance of \$720,000 at September 30, 2014, compared to a carrying amount of \$4.2 million, and a valuation allowance of \$375,000 at December 31, 2013, resulting in an increase in the provision for loan losses of \$345,000 for the nine months ended September 30, 2014.

Other real estate owned ("OREO"), which is carried at the lower of cost or fair value less costs to sell, had a carrying value of \$3.0 million less a valuation allowance of \$788,000, or \$2.2 million at September 30, 2014, compared to a carrying value of \$2.7 million less a valuation allowance of \$902,000, or \$1.8 million at December 31, 2013. There were \$392,000 of valuation adjustments of OREO recorded for the nine months ended September 30, 2014.





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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 5 - FAIR VALUE (continued)

Mortgage servicing rights, which are carried at lower of cost or fair value, had a carrying amount of \$170,000 at September 30, 2014, and a carrying amount of \$198,000 at December 31, 2013. A pre-tax recovery of \$4,000 on our mortgage servicing rights portfolio was included in noninterest income for the three months ended September 30, 2014, compared to a recovery of \$6,000 for the same period in 2013.

The following table presents quantitative information, based on certain empirical data with respect to Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2014:

	Fair Value	Valuation Technique(s)	Significant Unobservable Input(s)	Range (Weighted Average)
Impaired loans:				
One-to-four family residential real estate loans	\$ 76	Sales comparison	Discount applied to valuation	4.8% (5%)
Multi-family mortgage loans	2,673	Sales comparison	Comparison between sales and income approaches	-10.9% to 51.1% (41%)
		Income approach	Cap Rate	9.6% to 13.8% (10%)
Nonresidential real estate loans	3,125	Sales comparison	Comparison between sales and income approaches	-2.1% to 33.9% (24%)
		Income approach	Cap Rate	10%
Construction and land loans	108	Sales comparison	Discount applied to valuation	21.8% (22%)
Impaired loans	\$ 5,982			
Other real estate owned:				
One-to-four family residential real estate	\$ 174	Sales comparison	Discount applied to valuation	7.7% to 29.2% (7%)
Multi-family mortgage	1,265	Sales comparison	Comparison between sales and income approaches	-6.6% to 16.4% (-%)
Land	809	Sales comparison	Discount applied to valuation	-21.9% to 11.2% (-8%)
Other real estate owned	\$ 2,248			
Mortgage servicing rights	\$ 170	Third party valuation	Present value of future servicing	11.5 % to 23.5% (15%)

Third party valuation	income based on prepayment speeds Present value of future servicing income based on default rates	12%
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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 5 - FAIR VALUE (continued)

The following table presents quantitative information, based on certain empirical data with respect to Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2013:

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans				
One-to-four family residential real estate	\$ 460	Sales comparison	Discount applied to valuation	7.5% to 12.8% (10%)
Multi-family mortgage	2,286	Sales comparison	Comparison between sales and income approaches	12.3% to 19.4% (17%)
		Income approach	Cap Rate	7.25% to 13.8% (9%)
Nonresidential real estate	971	Sales comparison	Comparison between sales and income approaches	-3.0% to 45.1% (11%)
		Income approach	Cap Rate	10% to 10.7% (10%)
Construction and land loans	107	Sales comparison	Discount applied to valuation	21.2%
Other real estate owned	\$ 3,824			
One-to-four family residential real estate	\$ 297	Sales comparison	Discount applied to valuation	5.0% to 9.4% (8%)
Nonresidential real estate	460	Sales comparison	Comparison between sales and income approaches	0% to 10.1% (7%)
Land	1,019	Sales comparison	Discount applied to valuation	0% to 10.2% (2%)
	\$ 1,776			
Mortgage servicing rights	\$ 198	Third party valuation	Present value of future servicing income based on prepayment speeds	11.4 % to 23.5% (15%)
				12%

Third party  
valuation

Present value  
of future  
servicing  
income based  
on default  
rates

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## BANKFINANCIAL CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

## NOTE 5 - FAIR VALUE (continued)

The carrying amount and estimated fair value of financial instruments are as follows:

	Carrying Amount	Fair Value Measurements at September 30, 2014 Using:			Total
		Level 1	Level 2	Level 3	
Financial assets					
Cash and cash equivalents	\$ 92,925	\$ 11,078	\$ 81,847	\$—	\$ 92,925
Securities	115,001	505	114,496	—	115,001
Loans held for sale	—	—	—	—	—
Loans receivable, net of allowance for loan losses	1,134,442	—	1,062,627	5,982	1,068,609
FHLBC stock	6,257	—	—	—	N/A
Accrued interest receivable	3,590	—	3,590	—	3,590
Financial liabilities					
Noninterest-bearing demand deposits	\$ 128,498	\$—	\$ 128,498	\$—	\$ 128,498
Savings deposits	152,545	—	152,545	—	152,545
NOW and money market accounts	693,624	—	693,624	—	693,624
Certificates of deposit	243,635	—	243,522	—	243,522
Borrowings	2,834	—	2,822	—	2,822
Accrued interest payable	101	—	101	—	101
		Fair Value Measurements at December 31, 2013 Using:			
	Carrying Amount	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	\$ 160,957	\$ 15,781	\$ 145,176	\$—	\$ 160,957
Securities	110,907	497	110,410	—	110,907
Loans held for sale	—	—	—	—	—
Loans receivable, net of allowance for loan losses	1,098,077	—	1,049,111	3,824	1,052,935
FHLBC stock	6,068	—	—	—	N/A
Accrued interest receivable	3,933	—	3,933	—	3,933
Financial liabilities					
Noninterest-bearing demand deposits	\$ 126,680	\$—	\$ 126,680	\$—	\$ 126,680
Savings deposits	149,602	—	149,602	—	149,602
NOW and money market accounts	700,804	—	700,804	—	700,804
Certificates of deposit	275,622	—	276,022	—	276,022
Borrowings	3,055	—	3,057	—	3,057
Accrued interest payable	113	—	113	—	113

For purposes of the above, the following assumptions were used:

Cash and Cash Equivalents: The estimated fair values for cash and cash equivalents are based on their carrying value due to the short-term nature of these assets.



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BANKFINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table amounts in thousands, except share and per share data)

NOTE 5 - FAIR VALUE (continued)

Loans: The estimated fair value for loans has been determined by calculating the present value of future cash flows based on the current rate the Company would charge for similar loans with similar maturities, applied for an estimated time period until the loan is assumed to be repriced or repaid. The estimated fair values of loans held for sale are based on quoted market prices.

FHLBC Stock: It is not practicable to determine the fair value of FHLBC stock due to the restrictions placed on its transferability.

Deposit Liabilities: The estimated fair value for certificates of deposit has been determined by calculating the present value of future cash flows based on estimates of rates the Company would pay on such deposits, applied for the time period until maturity. The estimated fair values of noninterest-bearing demand, NOW, money market, and savings deposits are assumed to approximate their carrying values as management establishes rates on these deposits at a level that approximates the local market area. Additionally, these deposits can be withdrawn on demand.

Borrowings: The estimated fair values of advances from the FHLBC and notes payable are based on current market rates for similar financing. The estimated fair value of securities sold under agreements to repurchase is assumed to equal its carrying value due to the short-term nature of the liability.

Accrued Interest: The estimated fair values of accrued interest receivable and payable are assumed to equal their carrying value.

Off-Balance-Sheet Instruments: Off-balance-sheet items consist principally of unfunded loan commitments, standby letters of credit, and unused lines of credit. The estimated fair values of unfunded loan commitments, standby letters of credit, and unused lines of credit are not material.

While the above estimates are based on management's judgment of the most appropriate factors, as of the balance sheet date, there is no assurance that the estimated fair values would have been realized if the assets were disposed of or the liabilities settled at that date, since market values may differ depending on the various circumstances. The estimated fair values would also not apply to subsequent dates.

In addition, other assets and liabilities that are not financial instruments, such as premises and equipment, are not included in the above disclosures.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement Regarding Forward-Looking Information

Forward Looking Statements

This Quarterly Report on Form 10-Q contains, and other periodic and current reports, press releases and other public stockholder communications of BankFinancial Corporation may contain, forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve significant risks and uncertainties. Forward-looking statements may include statements relating to our future plans, strategies and expectations, as well as our future revenues, earnings, losses, financial performance, financial condition, asset quality metrics and future prospects. Forward looking statements are generally identifiable by use of the words "believe," "may," "will," "should," "could," "expect," "estimate," "intend," "anticipate," "project," "plan," or similar expressions. Forward looking statements speak only as of the date made. They are frequently based on assumptions that may or may not materialize, and are subject to numerous uncertainties that could cause actual results to differ materially from those anticipated in the forward looking statements. We intend all forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and are including this statement for the purpose of invoking these safe harbor provisions.

Factors that could cause actual results to differ materially from the results anticipated or projected and which could materially and adversely affect our operating results, financial condition or future prospects include, but are not limited to: (i) the failure of the real estate market to recover or further declines in real estate values that adversely

impact the value of our loan collateral and OREO, asset dispositions and the level of borrower equity in their investments; (ii) the persistence or worsening of adverse economic conditions in general and in the Chicago metropolitan area in particular, including high or increasing unemployment levels, that could result in increased delinquencies in our loan portfolio or a decline in the value of our investment securities and the collateral for our loans; (iii) results of supervisory monitoring or examinations by regulatory authorities, including the possibility that a regulatory authority could, among other things, require us to increase our allowance for loan losses or adversely change our loan classifications, write-down assets, reduce credit concentrations or maintain specific capital levels; (iv) interest rate movements



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and their impact on customer behavior and our net interest margin; (v) less than anticipated loan growth due to a lack of demand for specific loan products, competitive pressures or a dearth of borrowers who meet our underwriting standards; (vi) changes, disruptions or illiquidity in national or global financial markets; (vii) the credit risks of lending activities, including risks that could cause changes in the level and direction of loan delinquencies and charge-offs or changes in estimates relating to the computation of our allowance for loan losses; (viii) monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and Federal Reserve Board; (ix) factors affecting our ability to access deposits or cost-effective funding, and the impact of competitors' pricing initiatives on our deposit products; (x) the impact of new legislation or regulatory changes, including the Dodd-Frank Act and Basel III, on our products, services, operations and operating expenses; (xi) higher federal deposit insurance premiums; (xii) higher than expected overhead, infrastructure and compliance costs; (xiii) changes in accounting principles, policies or guidelines; and (xiv) our failure to achieve expected synergies and cost savings from acquisitions. These risks and uncertainties, as well as the Risk Factors set forth in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. We do not undertake any obligation to update any forward-looking statement in the future, or to reflect circumstances and events that occur after the date on which the forward-looking statement was made.

Critical Accounting Policies

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that the most critical accounting policies upon which our financial condition and results of operation depend, and which involve the most complex subjective decisions or assessments, are included in the discussion entitled "Critical Accounting Policies" in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, and all amendments thereto, as filed with the Securities and Exchange Commission.

Overview

Loan origination volumes were slightly higher than expectations for the third quarter of 2014 within the multifamily real estate category and commercial loan categories, and otherwise were consistent with expectations for all other categories. Loan payoffs declined overall but continued consolidation of first-lien and second-lien residential loans accelerated and we experienced a somewhat higher rate of compensated prepayments on commercial leases during the quarter. Given current loan and lease pipeline activity, we expect that total loan origination volumes in the fourth quarter of 2014 could be at or near our expectations for the year ended December 31, 2014.

Core earnings per share increased due principally to increases in non-interest income and decreases in core operating expenses. Pre-provision net interest income was consistent with the previous quarter, as improvements in interest income from loan originations were offset by yield reductions in refinanced loans or loan payoffs. We believe that a resumption of net interest income expansion and continued non-interest income and non-interest expense improvement, particularly in non-core operating expenses, is feasible in future periods.

Our asset quality continued to improve in the third quarter of 2014. The provision for loan losses decreased primarily due to decline in historical loss rates and a reduction in performing classified assets. Absent currently unforeseen events, we expect to be at or near our expectations for asset quality at the end of 2014.

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## SELECTED FINANCIAL DATA

The following summary information is derived from the consolidated financial statements of the Company. For additional information, reference is made to the Consolidated Financial Statements of the Company and related notes included elsewhere in this Quarterly Report.

	September 30, 2014	December 31, 2013	Change
(Dollars in thousands)			
Selected Financial Condition Data:			
Total assets	\$1,420,933	\$1,453,594	\$(32,661 )
Loans, net	1,134,442	1,098,077	36,365
Securities, at fair value	115,001	110,907	4,094
Core deposit intangible	1,998	2,433	(435 )
Deposits	1,218,302	1,252,708	(34,406 )
Borrowings	2,834	3,055	(221 )
Equity	181,276	175,627	5,649

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	2014	2013	Change	2014	2013	Change
(Dollars in thousands)						
Selected Operating Data:						
Interest and dividend income	\$12,368	\$12,107	\$261	\$36,936	\$37,096	\$(160 )
Interest expense	746	882	(136 )	2,332	2,811	(479 )
Net interest income	11,622	11,225	397	34,604	34,285	319
Provision for (recovery of) loan losses	(1,413 )	(437 )	(976 )	20	491	(471 )
Net interest income after provision for loan losses	13,035	11,662	1,373	34,584	33,794	790
Noninterest income	1,748	1,737	11	4,940	6,469	(1,529 )
Noninterest expense	11,157	12,360	(1,203 )	33,510	38,470	(4,960 )
Income before income tax expense	3,626	1,039	2,587	6,014	1,793	4,221
Income tax expense	36	—	36	78	—	78
Net income	\$3,590	\$1,039	\$2,551	\$5,936	\$1,793	\$4,143

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	Three Months Ended September 30,		Nine Months Ended September 30,		
	2014	2013	2014	2013	
Selected Financial Ratios and Other Data:					
Performance Ratios:					
Return on assets (ratio of net income to average total assets) <sup>(1)</sup>	1.01	% 0.29	% 0.55	% 0.16	%
Return on equity (ratio of net income to average equity) <sup>(1)</sup>	7.98	2.38	4.43	1.37	
Average equity to average assets	12.60	12.13	12.42	12.03	
Net interest rate spread <sup>(1)(2)</sup>	3.35	3.21	3.34	3.28	
Net interest margin <sup>(1)(3)</sup>	3.40	3.26	3.39	3.34	
Efficiency ratio <sup>(4)</sup>	83.45	95.36	84.74	94.40	
Noninterest expense to average total assets <sup>(1)</sup>	3.13	3.43	3.11	3.53	
Average interest-earning assets to average interest-bearing liabilities	123.12	121.95	122.51	121.33	
Dividends declared per share	\$0.04	\$—	\$0.05	\$0.02	
Dividend payout ratio	23.50	% N.M.	17.78	% N.M.	
			At September 30, 2014	At December 31, 2013	
Asset Quality Ratios:					
Nonperforming assets to total assets <sup>(5)</sup>		1.49	% 1.70	%	
Nonperforming loans to total loans		1.33	1.66		
Allowance for loan losses to nonperforming loans		85.59	76.89		
Allowance for loan losses to total loans		1.14	1.27		
Capital Ratios:					
Equity to total assets at end of period		12.76	% 12.08	%	
Tier 1 leverage ratio (Bank only)		10.95	10.16		
Other Data:					
Number of full-service offices		19	20		
Employees (full-time equivalents)		270	301		

(1) Ratios annualized.

(2) The net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities for the period.

(3) The net interest margin represents net interest income divided by average total interest-earning assets for the period.

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

(5) Nonperforming assets include nonperforming loans and other real estate owned.

N.M. Not Meaningful

#### Comparison of Financial Condition at September 30, 2014 and December 31, 2013

Total assets decreased \$32.7 million, or 2.2%, to \$1.421 billion at September 30, 2014, from \$1.454 billion at December 31, 2013. The decrease in total assets was primarily due to a decrease in cash and cash equivalents, which was partially offset by an increase in loans. Cash and cash equivalents decreased by \$68.0 million, or 42.3%, to \$92.9 million at September 30, 2014, from \$161.0 million at December 31, 2013. Loans increased \$36.4 million, or 3.3%, to \$1.134 billion at September 30, 2014, from \$1.098 billion at December 31, 2013.

Total liabilities decreased by \$38.3 million, or 3.0%, to \$1.240 billion at September 30, 2014, from \$1.278 billion at December 31, 2013, primarily due to a decrease in certificates of deposits, which was partially offset by increases in non-interest bearing deposits and savings accounts. Total deposits decreased \$34.4 million, or 2.7%, to \$1.218 billion

at September 30, 2014, from \$1.253

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billion at December 31, 2013. Certificates of deposit decreased \$32.0 million, or 11.6%, to \$243.6 million at September 30, 2014, from \$275.6 million at December 31, 2013. Noninterest-bearing demand deposits increased \$1.8 million, or 1.4%, to \$128.5 million at September 30, 2014, from \$126.7 million at December 31, 2013. Savings accounts increased \$2.9 million, or 2.0%, to \$152.5 million at September 30, 2014, from \$149.6 million at December 31, 2013. Money market and interest-bearing NOW accounts decreased \$7.2 million, or 1.0%, to \$693.6 million at September 30, 2014, from \$700.8 million at December 31, 2013. Core deposits (savings, money market, noninterest-bearing demand and NOW accounts) increased to 80.0% of total deposits at September 30, 2014, from 78.0% of total deposits at December 31, 2013.

Total stockholders' equity was \$181.3 million at September 30, 2014, compared to \$175.6 million at December 31, 2013. The increase in total stockholders' equity was primarily due to the \$5.9 million of net income that we recorded for the nine months ended September 30, 2014. The unallocated shares of common stock that our ESOP owns were reflected as a \$10.5 million reduction to stockholders' equity at September 30, 2014, compared to an \$11.3 million reduction at December 31, 2013.

Operating results for the three months ended September 30, 2014 and 2013

**Net Income.** We had net income of \$3.6 million for the three months ended September 30, 2014, compared to \$1.0 million for the three months ended September 30, 2013. Earnings per basic and fully diluted share of common stock were \$0.17 for the three months ended September 30, 2014, compared to \$0.05 for the three months ended September 30, 2013.

**Net Interest Income.** Net interest income was \$11.6 million for the three months ended September 30, 2014, compared to \$11.2 million for the same period in 2013. The increase reflected a \$261,000, or 2.2%, increase in interest income and a \$136,000, or 15.4%, decrease in interest expense.

The increase in net interest income was primarily attributable to increases in the yield on interest-earning assets, which were partially offset by a decrease in net average interest-earning assets. Total average interest-earning assets decreased \$9.2 million, or 0.67%, to \$1.355 billion for the three months ended September 30, 2014, from \$1.365 billion for the same period in 2013. Our net interest rate spread increased by 14 basis points to 3.35% for the three months ended September 30, 2014, from 3.21% for the same period in 2013. Our net interest margin increased by 14 basis points to 3.40% for the three months ended September 30, 2014, from 3.26% for the same period in 2013. The increase in the net interest rate spread and net interest margin resulted from higher yields on interest-earning assets and decreases in the average balance and costs of our interest-bearing liabilities. The yield on interest-earning assets increased ten basis points to 3.62% for the three months ended September 30, 2014, from 3.52% for the same period in 2013, and the cost of interest-bearing liabilities decreased four basis points to 0.27% for the three months ended September 30, 2014, from 0.31% for the same period in 2013.

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## Average Balance Sheets

The following table sets forth average balance sheets, average yields and costs, and certain other information. No tax-equivalent yield adjustments were made, as the effect of these adjustments would not be material. Average balances are daily average balances. Nonaccrual loans are included in the computation of average balances, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees and expenses, discounts and premiums, purchase accounting adjustments that are amortized or accreted to interest income or expense.

	For the Three Months Ended September 30, 2014			2013			
	Average Outstanding Balance (Dollars in thousands)	Interest	Yield/Rate <sup>(1)</sup>	Average Outstanding Balance	Interest	Yield/Rate <sup>(1)</sup>	
Interest-earning assets:							
Loans	\$ 1,127,735	\$ 11,983	4.22	% \$ 1,019,402	\$ 11,680	4.55	%
Securities	114,805	283	0.98	68,109	241	1.40	
Stock in FHLBC	6,257	8	0.51	6,068	5	0.33	
Other	106,639	94	0.35	271,046	181	0.26	
Total interest-earning assets	1,355,436	12,368	3.62	1,364,625	12,107	3.52	
Noninterest-earning assets	72,114			75,936			
Total assets	\$ 1,427,550			\$ 1,440,561			
Interest-bearing liabilities:							
Savings deposits	\$ 153,256	40	0.10	\$ 147,230	38	0.10	
Money market accounts	348,556	281	0.32	340,578	280	0.33	
NOW accounts	348,278	89	0.10	344,571	88	0.10	
Certificates of deposit	247,672	334	0.54	283,775	474	0.66	
Total deposits	1,097,762	744	0.27	1,116,154	880	0.31	
Borrowings	3,185	2	0.25	2,813	2	0.28	
Total interest-bearing liabilities	1,100,947	746	0.27	1,118,967	882	0.31	
Noninterest-bearing deposits	129,406			132,120			
Noninterest-bearing liabilities	17,268			14,684			
Total liabilities	1,247,621			1,265,771			
Equity	179,929			174,790			
Total liabilities and equity	\$ 1,427,550			\$ 1,440,561			
Net interest income		\$ 11,622			\$ 11,225		
Net interest rate spread <sup>(2)</sup>			3.35	%		3.21	%
Net interest-earning assets <sup>(3)</sup>	\$ 254,489			\$ 245,658			
Net interest margin <sup>(4)</sup>			3.40	%		3.26	%
Ratio of interest-earning assets to interest-bearing liabilities	123.12	%		121.95	%		

(1) Annualized

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

(3) Net interest-earning assets represents total interest-earning assets less total interest-bearing liabilities.

(4) Net interest margin represents net interest income divided by average total interest-earning assets.

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## Provision for Loan Losses

We establish provisions for loan losses, which are charged to operations in order to maintain the allowance for loan losses at a level we consider necessary to absorb probable incurred credit losses in the loan portfolio. In determining the level of the allowance for loan losses, we consider past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower's ability to repay a loan and the levels of nonperforming and other classified loans. The amount of the allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or events change. We assess the allowance for loan losses on a quarterly basis and make provisions for loan losses in order to maintain the allowance.

We had a recovery of loan losses of \$1.4 million for the three months ended September 30, 2014, compared to a recovery of \$437,000 for the same period in 2013. The provision for or recovery of loan losses is a function of the allowance for loan loss methodology that we use to determine the appropriate level of the allowance for inherent loan losses after net charge-offs have been deducted. The portion of the allowance for loan losses attributable to loans collectively evaluated for impairment decreased \$1.5 million, or 10.6%, to \$12.3 million at September 30, 2014, compared to \$13.8 million at June 30, 2014. The primary reason for this decrease is that the growth that occurred in our loan portfolio focused on loan types that had lower loss ratios based on our historical loss experience. During the three months ended September 30, 2014 we recorded a recovery of \$1.0 million on a purchased impaired commercial loan from one borrower in connection with the final resolution of that loan. We also recorded a \$560,000 charge-off based on an updated valuation for a single tenant commercial real estate property. The reserve established for loans individually evaluated for impairment increased \$65,000, or 9.9%, for the three months ended September 30, 2014. Net recoveries were \$12,000 for the three months ended September 30, 2014. The allowance for loan losses as a percentage of nonperforming loans was 85.59% at September 30, 2014, compared to 97.21% at June 30, 2014.

A loan balance is classified as a loss and charged-off when it is confirmed that there is no readily apparent source of repayment for the portion of the loan that is classified as loss. Confirmation can occur upon the receipt of updated third-party appraisal valuation information indicating that there is a low probability of repayment upon sale of the collateral, the final disposition of collateral where the net proceeds are insufficient to pay the loan balance in full, our failure to obtain possession of certain consumer-loan collateral within certain time limits specified by applicable federal regulations, the conclusion of legal proceedings where the borrower's obligation to repay is legally discharged (such as a Chapter 7 bankruptcy proceeding), or when it appears that further formal collection procedures are not likely to result in net proceeds in excess of the costs to collect.

## Noninterest Income

	Three Months Ended		Change
	2014	2013	
	September 30,		
	(Dollars in thousands)		
Deposit service charges and fees	\$519	\$520	\$(1 )
Other fee income	571	571	—
Insurance commissions and annuities income	106	106	—
Gain on sale of loans, net	39	32	7
Loan servicing fees	102	112	(10 )
Amortization of servicing assets	(36 )	(49 )	13
Recovery of servicing assets	4	6	(2 )
Earnings on bank owned life insurance	57	84	(27 )
Trust income	171	172	(1 )
Other	215	183	32
Total noninterest income	\$1,748	\$1,737	\$11

Noninterest income remained stable, totaling \$1.7 million for the three months ended September 30, 2014 and the three months ended September 30, 2013. Noninterest income for the three months ended September 30, 2014 included



a \$39,000 gain on sale of loans, compared to a \$32,000 gain on sale of loans that was recorded for the same period in 2013. Earnings on bank owned life insurance decreased \$27,000 for the three months ended September 30, 2014 to \$57,000 from \$84,000 for the same period in 2013.

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## Noninterest Expense

	Three Months Ended		Change
	September 30,		
	2014	2013	
	(Dollars in thousands)		
Compensation and benefits	\$5,492	\$6,143	\$(651 )
Office occupancy and equipment	1,687	1,797	(110 )
Advertising and public relations	271	195	76
Information technology	674	817	(143 )
Supplies, telephone and postage	394	382	12
Amortization of intangibles	143	149	(6 )
Nonperforming asset management	418	682	(264 )
Loss on sale other real estate owned	52	64	(12 )
Valuation adjustments of other real estate owned	315	241	74
Operations of other real estate owned	127	171	(44 )
FDIC insurance premiums	208	476	(268 )
Other	1,376	1,243	133
Total noninterest expense	\$11,157	\$12,360	\$(1,203 )

Noninterest expense decreased by \$1.2 million, or 9.7%, to \$11.2 million for the three months ended September 30, 2014, from \$12.4 million for the same period in 2013, due in substantial part to decreases in compensation and benefits expense, nonperforming asset management expense and FDIC insurance premiums. Compensation and benefits expense decreased \$651,000, or 10.6%, primarily due to a reduction in full time equivalent employees to 270 at September 30, 2014 from 308 at September 30, 2013. Nonperforming asset management expenses decreased \$264,000, or 38.7%, to \$418,000 for the three months ended September 30, 2014, from \$682,000 for the same period in 2013, primarily due to a decline in nonperforming assets, a decline in expenses relating to resolutions and accelerated dispositions of nonperforming assets, and a \$21,000 reimbursement that we received from a borrower for legal expenses in connection with the final resolution of a loan. Valuation adjustments of OREO increased \$74,000, or 30.7%, to \$315,000 for the three months ended September 30, 2014, from \$241,000 for the same period in 2013. The increase in OREO valuation adjustments was a result of updated appraisals. OREO expenses decreased \$44,000, or 25.7%, to \$127,000 for the three months ended September 30, 2014, from \$171,000 for the same period in 2013.

## Income Taxes

For the three months ended September 30, 2014, we recorded \$36,000 of income tax expense relating to state and federal taxes currently due. For the three months ended September 30, 2013, we recorded no income tax expense or benefit due to the full valuation allowance we have established for deferred tax assets.

## Operating results for the nine months ended September 30, 2014 and 2013

**Net Income.** We had net income of \$5.9 million for the nine months ended September 30, 2014, compared to \$1.8 million for the nine months ended September 30, 2013. Our earnings per basic and fully diluted share of common stock was \$0.29 for the nine months ended September 30, 2014, compared to \$0.09 per basic and fully diluted share for the same period in 2013.

**Net Interest Income.** Net interest income was \$34.6 million for the nine months ended September 30, 2014, compared to \$34.3 million for the same period in 2013. The increase reflected a \$479,000 decrease in interest expense, which was partially offset by a \$160,000 decrease in interest income.

The increase in net interest income was primarily attributable to a lower level of average interest-earning assets and a stable yield on interest-earning assets. Total average interest-earning assets decreased \$8.2 million, or 0.6%, to \$1.364 billion for the nine months ended September 30, 2014, from \$1.372 billion for the same period in 2013. Our net interest rate spread increased by six basis points to 3.34% for the nine months ended September 30, 2014, from 3.28% for the same period in 2013. Our net interest margin increased by five basis point to 3.39% for the nine months ended September 30, 2014, from 3.34% for the same period in 2013. The increase in the net interest spread and net interest

margin was primarily a result of a lower cost of funds. The yield on interest-earning assets increased one basis point to 3.62% for the nine months ended September 30, 2014, from 3.61% for the same

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period in 2013, and the cost of interest-bearing liabilities decreased five basis points to 0.28% for the nine months ended September 30, 2014, from 0.33% for the same period in 2013.

## Average Balance Sheets

The following table sets forth average balance sheets, average yields and costs, and certain other information. No tax-equivalent yield adjustments were made, as the effect of these adjustments would not be material. Average balances are daily average balances. Nonaccrual loans are included in the computation of average balances, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees and expenses, discounts and premiums, purchase accounting adjustments that are amortized or accreted to interest income or expense.

	For the Nine Months Ended September 30,			2013			
	2014			Average	Interest	Yield/Rate <sup>(1)</sup>	
	Average	Interest	Yield/Rate <sup>(1)</sup>	Average	Interest	Yield/Rate <sup>(1)</sup>	
	Outstanding			Outstanding			
	Balance			Balance			
	(Dollars in thousands)						
Interest-earning assets:							
Loans	\$ 1,120,523	\$ 35,767	4.27	% \$ 1,020,932	\$ 35,812	4.69	%
Securities	114,194	866	1.01	66,119	710	1.44	
Stock in FHLBC	6,184	20	0.43	6,961	17	0.33	
Other	123,406	283	0.31	278,480	557	0.27	
Total interest-earning assets	1,364,307	36,936	3.62	1,372,492	37,096	3.61	
Noninterest-earning assets	73,946			79,460			
Total assets	\$ 1,438,253			\$ 1,451,952			
Interest-bearing liabilities:							
Savings deposits	\$ 153,818	118	0.10	\$ 147,248	113	0.10	
Money market accounts	349,196	842	0.32	343,104	886	0.35	
NOW accounts	349,989	265	0.10	345,834	289	0.11	
Certificates of deposit	257,799	1,102	0.57	292,028	1,511	0.69	
Total deposits	1,110,802	2,327	0.28	1,128,214	2,799	0.33	
Borrowings	2,808	5	0.24	2,954	12	0.54	
Total interest-bearing liabilities	1,113,610	2,332	0.28	1,131,168	2,811	0.33	
Noninterest-bearing deposits	127,499			129,563			
Noninterest-bearing liabilities	18,555			16,487			
Total liabilities	1,259,664			1,277,218			
Equity	178,589			174,734			
Total liabilities and equity	\$ 1,438,253			\$ 1,451,952			
Net interest income		\$ 34,604			\$ 34,285		
Net interest rate spread <sup>(2)</sup>			3.34	%		3.28	%
Net interest-earning assets <sup>(3)</sup>	\$ 250,697			\$ 241,324			
Net interest margin <sup>(4)</sup>			3.39	%		3.34	%
	122.51	%		121.33	%		

Ratio of interest-earning  
assets to interest-bearing  
liabilities

(1) Annualized

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

(3) Net interest-earning assets represents total interest-earning assets less total interest-bearing liabilities.

(4) Net interest margin represents net interest income divided by average total interest-earning assets.

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## Provision for Loan Losses

The provision for loan losses totaled \$20,000 for the nine months ended September 30, 2014, compared to \$491,000 for the same period in 2013. The portion of the allowance for loan losses attributable to loans collectively evaluated for impairment decreased \$1.4 million, or 10.5%, to \$12.3 million at September 30, 2014 compared to \$13.8 million at December 31, 2013. The reserve established for loans individually evaluated for impairment increased \$345,000 for the nine months ended September 30, 2014.

The increase in the reserve established for loans individually evaluated for impairment was primarily attributable to the establishment of a total of \$512,000 in specific reserves for four multifamily loans and two commercial real estate loans, which was partially offset by final charge-offs and to a lesser extent recoveries. Net charge-offs were \$1.1 million for the nine months ended September 30, 2014, compared to \$2.7 million for the same period in 2013. The allowance for loan losses as a percentage of nonperforming loans was 85.59% at September 30, 2014, compared to 76.89% at December 31, 2013.

## Noninterest Income

	Nine Months Ended September 30,		Change
	2014	2013	
	(Dollars in thousands)		
Deposit service charges and fees	\$1,417	\$1,528	\$(111 )
Other fee income	1,698	1,713	(15 )
Insurance commissions and annuities income	279	301	(22 )
Gain on sale of loans, net	107	1,445	(1,338 )
Loss on sales of securities	(7 )	—	(7 )
Gain on disposition of premises and equipment	5	—	5
Loan servicing fees	310	349	(39 )
Amortization of servicing assets	(106 )	(193 )	87
Recovery (impairment) of servicing assets	(6 )	41	(47 )
Earnings on bank owned life insurance	182	236	(54 )
Trust income	505	536	(31 )
Other	556	513	43
Total noninterest income	\$4,940	\$6,469	\$(1,529 )

Noninterest income decreased by \$1.5 million to \$4.9 million for the nine months ended September 30, 2014, from \$6.5 million for the same period in 2013. Noninterest income for the nine months ended September 30, 2013, included a \$1.4 million gain on sale of loans, which included recurring loan sale activity combined with the completion of the sale of the owner-occupied and investor-owned one-to-four family residential loans that we designated as held for sale at December 31, 2012. The completion of this sale represented approximately \$1.3 million of the \$1.4 million gain on sale of loans that we recorded for the nine months ended September 30, 2013.

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## Noninterest Expense

	Nine Months Ended September 30,		Change
	2014	2013	
	(Dollars in thousands)		
Compensation and benefits	\$17,046	\$19,581	\$(2,535 )
Office occupancy and equipment	5,227	5,550	(323 )
Advertising and public relations	737	609	128
Information technology	2,004	2,394	(390 )
Supplies, telephone and postage	1,169	1,234	(65 )
Amortization of intangibles	435	455	(20 )
Nonperforming asset management	619	2,031	(1,412 )
Loss (gain) on sale other real estate owned	(40 )	182	(222 )
Valuation adjustments of other real estate owned	392	471	(79 )
Operations of other real estate owned	808	756	52
FDIC insurance premiums	1,157	1,445	(288 )
Other	3,956	3,762	194
Total noninterest expense	\$33,510	\$38,470	\$(4,960 )

Noninterest expense decreased by \$5.0 million, or 12.9%, to \$33.5 million for the nine months ended September 30, 2014, from \$38.5 million for the same period in 2013. Compensation and benefits expense decreased \$2.5 million, or 12.9% primarily due to a reduction in full time equivalent employees to 270 at September 30, 2014 from 301 at December 31, 2013. Noninterest expense for the nine months ended September 30, 2014 included \$1.8 million of nonperforming asset management and OREO expenses, compared to \$3.4 million for the same period in 2013. Nonperforming asset management expenses decreased \$1.4 million, or 69.5%, to \$619,000 for the nine months ended September 30, 2014, compared to \$2.0 million for the same period in 2013, primarily due to a decline in nonperforming assets, a decline in expenses relating to resolutions and accelerated dispositions of nonperforming assets, and a \$174,000 reimbursement that we received from three borrowers for legal, receivership and other expenses in connection with the final resolution of their loans. The most significant decreases in nonperforming asset management expense related to legal expenses, receiver fees, and real estate taxes, which totaled \$514,000 for the nine months ended September 30, 2014, compared to \$1.9 million for the same period in 2013, combined with reduced rental income of \$123,000 for the nine months ended September 30, 2014. Noninterest expense for the nine months ended September 30, 2014 included a \$392,000 valuation adjustment to OREO properties, compared to a \$471,000 valuation adjustment to OREO properties for the same period in 2013. OREO expenses increased \$52,000, or 6.9%, to \$808,000 for the nine months ended September 30, 2014, compared to \$756,000 for the same period in 2013. Noninterest expense for the nine months ended September 30, 2013 also included the payment of \$203,000 of settlements concerning two sold mortgage loans. Noninterest expense for the nine months ended September 30, 2014 included a provision of \$73,000 for mortgage representation and warranty reserve for mortgage loans sold, compared to \$86,000 for the same period 2013 and \$53,000 in compensatory fees and final settlements of loans serviced for others. The amount of the warranty and representation reserve was calculated by applying published Fannie Mae data relating to the percentage of loans that it required to be repurchased due to breaches of warranties and representations to the Bank's outstanding sold loans.

## Income Taxes

For the nine months ended September 30, 2014, we recorded \$78,000 income tax expense relating to state and federal taxes currently due. For the nine months ended September 30, 2013, we recorded no income tax expense or benefit due to the full valuation allowance we established for deferred tax assets.

## Nonperforming Loans and Assets

We review loans on a regular basis, and generally place loans on nonaccrual status when either principal or interest is 90 days or more past due. In addition, the Company places loans on nonaccrual status when we do not expect to

receive full payment of interest or principal. Interest accrued and unpaid at the time a loan is placed on nonaccrual status is reversed from interest income. Interest payments received on nonaccrual loans are recognized in accordance with our significant accounting policies. Once a loan is placed on nonaccrual status, the borrower must generally demonstrate at least six months of payment performance before the



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loan is eligible to return to accrual status. We may have loans classified as 90 days or more delinquent and still accruing. Generally, we do not utilize this category of loan classification unless: (1) the loan is repaid in full shortly after the period end date; (2) the loan is well secured and there are no asserted or pending legal barriers to its collection; or (3) the borrower has remitted all scheduled payments and is otherwise in substantial compliance with the terms of the loan, but the processing of loan payments actually received or the renewal of the loan has not occurred for administrative reasons. At September 30, 2014, we had no loans in this category.

We typically obtain new third-party appraisals or collateral valuations when we place a loan on nonaccrual status, conduct impairment testing or conduct a TDR unless the existing valuation information for the collateral is sufficiently current to comply with the requirements of our Appraisal and Collateral Valuation Policy (“ACV Policy”). We also obtain new third-party appraisals or collateral valuations when the judicial foreclosure process concludes with respect to real estate collateral, and when we otherwise acquire actual or constructive title to real estate collateral. In addition to third-party appraisals, we use updated valuation information based on Multiple Listing Service data, broker opinions of value, actual sales prices of similar assets sold by us and approved sales prices in response to offers to purchase similar assets owned by us to provide interim valuation information for consolidated financial statement and management purposes. Our ACV Policy establishes the maximum useful life of a real estate appraisal at 18 months. Because appraisals and updated valuations utilize historical or “ask-side” data in reaching valuation conclusions, the appraised or updated valuation may or may not reflect the actual sales price that we will receive at the time of sale. Real estate appraisals may include up to three approaches to value: the sales comparison approach, the income approach (for income-producing property) and the cost approach. Not all appraisals utilize all three approaches. Depending on the nature of the collateral and market conditions, we may emphasize one approach over another in determining the fair value of real estate collateral. Appraisals may also contain different estimates of value based on the level of occupancy or planned future improvements. “As-is” valuations represent an estimate of value based on current market conditions with no changes to the use or condition of the real estate collateral. “As-stabilized” or “as-completed” valuations assume the real estate collateral will be improved to a stated standard or achieve its highest and best use in terms of occupancy. “As-stabilized” or “as-completed” valuations may be subject to a present value adjustment for market conditions or the schedule of improvements.

As part of the asset classification process, we develop an exit strategy for real estate collateral or OREO by assessing overall market conditions, the current use and condition of the asset, and its highest and best use. For most income-producing real estate, we believe that investors value most highly a stable income stream from the asset; consequently, we perform a comparative evaluation to determine whether conducting a sale on an “as-is”, “as-stabilized” or “as-improved” basis is most likely to produce the highest net realizable value. If we determine that the “as-stabilized” or “as-improved” basis is appropriate, we then complete the necessary improvements or tenant stabilization tasks, with the applicable time value discount and improvement expenses incorporated into our estimates of the expected costs to sell. As of September 30, 2014, substantially all impaired real estate loan collateral and OREO were valued on an “as-is basis.”

Estimates of the net realizable value of real estate collateral also include a deduction for the expected costs to sell the collateral or such other deductions from the cash flows resulting from the operation and liquidation of the asset as are appropriate. For most real estate collateral subject to the judicial foreclosure process, we generally apply a 10.0% deduction to the value of the asset to determine the expected costs to sell the asset. This estimate includes one year of real estate taxes, sales commissions and miscellaneous repair and closing costs. If we receive a purchase offer that requires unbudgeted repairs, or if the expected resolution period for the asset exceeds one year, we then include, on a case-by-case basis, the costs of the additional real estate taxes and repairs and any other material holding costs in the expected costs to sell the collateral. For OREO, we generally apply a 7.0% deduction to determine the expected costs to sell, as expenses for real estate taxes and repairs are expensed when incurred.



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## Nonperforming Assets Summary

The following table below sets forth the amounts and categories of our nonperforming loans and nonperforming assets.

	September 30, 2014	June 30, 2014	December 31, 2013	Quarter Change	Nine Months Change
(Dollars in thousands)					
Nonaccrual loans:					
One-to-four family residential	\$4,226	\$5,156	\$4,641	\$(930)	\$(415)
Multi-family mortgage	6,223	4,274	7,098	1,949	(875)
Nonresidential real estate	4,384	4,959	4,214	(575)	170
Construction and land	120	118	382	2	(262)
Commercial	82	77	77	5	5
Commercial leases	—	8	—	(8)	—
Consumer	1	—	12	1	(11)
	15,036	14,592	16,424	444	(1,388)
Loans Past Due Over 90 Days, still accruing	—	16	228	(16)	(228)
Other real estate owned:					
One-to-four family residential	945	979	901	(34)	44
Multi-family mortgage	1,502	2,572	1,921	(1,070)	(419)
Nonresidential real estate	1,448	1,887	1,181	(439)	267
Land	181	258	275	(77)	(94)
	4,076	5,696	4,278	(1,620)	(202)
Nonperforming assets (excluding purchased impaired loans and purchased other real estate owned)	19,112	20,304	20,930	(1,192)	(1,818)
Purchased impaired loans:					
One-to-four family residential	51	102	100	(51)	(49)
Nonresidential real estate	161	157	1,633	4	(1,472)
Commercial	—	—	23	—	(23)
	212	259	1,756	(47)	(1,544)
Purchased other real estate owned:					
One-to-four family residential	132	156	176	(24)	(44)
Land	1,782	1,852	1,852	(70)	(70)
	1,914	2,008	2,028	(94)	(114)
Purchased impaired loans and other real estate owned	2,126	2,267	3,784	(141)	(1,658)
Total nonperforming assets	\$21,238	\$22,571	\$24,714	\$(1,333)	\$(3,476)
Ratios:					
Nonperforming loans to total loans	1.33	% 1.31	% 1.66	%	
Nonperforming loans to total loans <sup>(1)</sup>	1.31	1.29	1.50		
Nonperforming assets to total assets	1.49	1.56	1.70		
Nonperforming assets to total assets <sup>(1)</sup>	1.35	1.41	1.44		

(1) These asset quality ratios exclude purchased impaired loans and purchased other real estate owned resulting from the Downers Grove National Bank acquisition.



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## Nonperforming Assets

Nonperforming assets decreased by \$1.3 million and \$3.5 million, respectively, for the three and nine months ended September 30, 2014. Nonperforming assets totaled \$21.2 million at September 30, 2014, \$22.6 million at June 30, 2014, and \$24.7 million at December 31, 2013. Although we experience occasional isolated instances of new non-accrual loans, we believe that continuing our aggressive resolution posture will maintain the trends favoring very strong asset quality.

Approximately \$3.8 million nonaccrual loans were transferred to OREO during the nine months ended September 30, 2014. These were primarily land, multifamily and nonresidential loans, comprising the majority of the decrease in nonaccrual loans for the period. We continue to experience modest quantities of defaults on residential loans principally due either to the borrower's personal financial condition or deteriorated collateral value.

## Other Real Estate Owned

Real estate that is acquired through foreclosure or a deed in lieu of foreclosure is classified as OREO until it is sold. When real estate is acquired through foreclosure or by deed in lieu of foreclosure, it is recorded at its fair value, less the estimated costs of disposal. If the fair value of the property is less than the loan balance, the difference is charged against the allowance for loan losses.

The following tables represent the roll-forward of OREO and the composition of OREO properties:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Beginning balance	\$7,704	\$6,262	\$6,306	\$10,358
New foreclosed properties	376	512	3,836	3,268
Payments received	—	(3	) (10	) (28
Valuation adjustments	(315	) (241	) (392	) (471
Gain (loss) on sale of other real estate owned	(52	) (64	) 40	(182
Proceeds from sales of other real estate owned	(1,723	) (1,063	) (3,790	) (7,542
Ending balance	\$5,990	\$5,403	\$5,990	\$5,403
			September 30,	December 31,
			2014	2013
	(Dollars in thousands)			
One-to-four family residential			\$945	\$901
Multi-family mortgage			1,502	1,921
Nonresidential real estate			1,448	1,181
Land			181	275
			4,076	4,278
Acquired other real estate owned:				
One-to-four family residential			132	176
Land			1,782	1,852
			1,914	2,028
Total other real estate owned			\$5,990	\$6,306

## Liquidity and Capital Resources

Liquidity. The overall objective of our liquidity management is to ensure the availability of sufficient cash funds to meet all financial commitments and to take advantage of investment opportunities. We manage liquidity in order to meet deposit withdrawals on demand or at contractual maturity, to repay borrowings as they mature, and to fund new loans and investments as opportunities arise.



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Our primary sources of funds are deposits, principal and interest payments on loans and securities, and, to a lesser extent, wholesale borrowings, the proceeds from maturing securities and short-term investments, and the proceeds from the sales of loans and securities. The scheduled amortization of loans and securities, as well as proceeds from borrowings, are predictable sources of funds. Other funding sources, however, such as deposit inflows, mortgage prepayments and mortgage loan sales are greatly influenced by market interest rates, economic conditions and competition. We anticipate that we will have sufficient funds available to meet current loan commitments and lines of credit and maturing certificates of deposit that are not renewed or extended. We generally remain fully invested and utilize additional sources of funds through FHLBC advances. We had no outstanding FHLBC advances at September 30, 2014.

As of September 30, 2014, we were not aware of any known trends, events or uncertainties that had or were reasonably likely to have a material impact on our liquidity. As of September 30, 2014, we had no other material commitments for capital expenditures.

Capital Management

Capital Management - Bank. The overall objectives of our capital management are to ensure the availability of sufficient capital to support loan, deposit and other asset and liability growth opportunities and to maintain capital to absorb unforeseen losses or write-downs that are inherent in the business risks associated with the banking industry. We seek to balance the need for higher capital levels to address such unforeseen risks and the goal to achieve an adequate return on the capital invested by our stockholders.

The Bank is subject to regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by the Office of the Comptroller of the Currency that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. Adequately capitalized institutions require regulatory approval to accept brokered deposits. If undercapitalized, a financial institution's capital distributions, asset growth and expansion are limited, and the submission of a capital restoration plan is required.

The Company and the Bank have adopted Capital Plans that require the Bank to maintain a Tier 1 leverage ratio of at least 8% and a total risk-based capital ratio of at least 12%. The minimum capital ratios set forth in the Capital Plans will be increased and other minimum capital requirements will be established if and as necessary to comply with the Basel III requirements as such requirements become applicable to the Company and the Bank. In accordance with the Capital Plans, neither the Company nor the Bank will pursue any acquisition or growth opportunity, declare any dividend or conduct any stock repurchase that would cause the Bank's total risk-based capital ratio and/or its Tier 1 leverage ratio to fall below the established minimum capital levels. In addition, the Company will continue to maintain its ability to serve as a source of financial strength to the Bank by holding at least \$5.0 million of cash or liquid assets for that purpose.

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Actual capital ratios and minimum required ratios for the Bank were:

	Actual Ratio	Minimum required to be Well Capitalized Under Prompt Corrective Action Provisions	Minimum Capital Ratios Established under Capital Plans
September 30, 2014			
Total capital (to risk-weighted assets)			
Consolidated	17.65	% 8.00	% N/A
BankFinancial, F.S.B.	15.48	8.00	12.00 %
Tier 1 (core) capital (to risk-weighted assets)			
Consolidated	16.45	4.00	N/A
BankFinancial, F.S.B.	14.28	4.00	8.00
Tier 1 (core) capital (to adjusted total assets)			
Consolidated	12.62	4.00	N/A
BankFinancial, F.S.B.	10.95	4.00	8.00
December 31, 2013			
Total capital (to risk-weighted assets)			
Consolidated	17.28	8.00	N/A
BankFinancial, F.S.B.	14.93	8.00	12.00
Tier 1 (core) capital (to risk-weighted assets)			
Consolidated	16.03	4.00	N/A
BankFinancial, F.S.B.	13.68	4.00	8.00
Tier 1 (core) capital (to adjusted total assets)			
Consolidated	11.92	4.00	N/A
BankFinancial, F.S.B.	10.16	4.00	8.00

The Bank was notified that, as of September 30, 2014 and December 31, 2013, it was considered well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since those notifications that management believes have changed the Bank's prompt corrective action capitalization category. In July 2013, the Federal Reserve Board, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain "available-for-sale" securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-in or opt-out is exercised. The rule limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule becomes effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. The final rule also implements consolidated capital requirements for savings and loan



holding companies, such as the Company, effective January 1, 2015. Management has evaluated the expected impact of these new capital requirements on the Company's and the Bank's regulatory capital position and expects to be in compliance at January 1, 2015.

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Capital Management - Company Total stockholders' equity was \$181.3 million at September 30, 2014, compared to \$175.6 million at December 31, 2013. The increase in total stockholders' equity was primarily due to the \$5.9 million net income that we recorded for the nine months ended September 30, 2014. The unallocated shares of common stock that our ESOP owns were reflected as a \$10.5 million reduction to stockholders' equity at September 30, 2014, compared to a \$11.3 million reduction at December 31, 2013.

Quarterly Cash Dividends. We declared \$0.05 of dividends per share for the nine months ended September 30, 2014, compared to \$0.02 of dividends per share for the nine months ended September 30, 2013. As a result of the regulatory restructuring occasioned by the Dodd-Frank Act, the Federal Reserve Board issued Supervisory Letter SR 09-4, which outlines the circumstances in which a holding company should, among other things, notify and make a submission to the Federal Reserve Bank prior to declaring a dividend. If and as required by Supervisory Letter SR 09-4, the Company will consult with, and seek the prior approval of, the Federal Reserve Bank prior to declaring any dividends. Stock Repurchase Program. Our Board of Directors had authorized the repurchase of up to 5,047,423 shares of our common stock. The repurchase authorization expired on November 15, 2012. As of September 30, 2014, the Company had repurchased 4,239,134 shares of its common stock out of the 5,047,423 shares that had been authorized for repurchase. Federal Reserve Board Supervisory Letter SR 09-4 outlines the circumstances in which a holding company should notify and make a submission to the Federal Reserve Bank before redeeming or repurchasing common stock. The Company has no plans to engage in stock repurchases at this time.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Qualitative Analysis. A significant form of market risk is interest rate risk. Interest rate risk results from timing differences in the maturity or repricing of our assets, liabilities and off balance sheet contracts (i.e., forward loan commitments), the effect of loan prepayments and deposit withdrawals, the difference in the behavior of lending and funding rates arising from the use of different indices and "yield curve risk" arising from changing rate relationships across the spectrum of maturities for constant or variable credit risk investments. In addition to directly affecting net interest income, changes in market interest rates can also affect the amount of new loan originations, the ability of borrowers to repay variable rate loans, the volume of loan prepayments and refinancings, the carrying value of investment securities classified as available-for-sale and the flow and mix of deposits.

The general objective of our interest rate risk management is to determine the appropriate level of risk given our business strategy and then manage that risk in a manner that is consistent with our policy to reduce, to the extent possible, the exposure of our net interest income to changes in market interest rates. Our Asset/Liability Management Committee ("ALCO"), which consists of certain members of senior management, evaluates the interest rate risk inherent in certain assets and liabilities, our operating environment and capital and liquidity requirements, and modifies our lending, investing and deposit gathering strategies accordingly. The Board of Directors' Asset/Liability Management Committee then reviews the ALCO's activities and strategies, the effect of those strategies on our net interest margin, and the effect that changes in market interest rates would have on the economic value of our loan and securities portfolios as well as the intrinsic value of our deposits and borrowings, and reports to the full Board of Directors.

We actively evaluate interest rate risk in connection with our lending, investing and deposit activities. In an effort to better manage interest-rate risk, we have de-emphasized the origination of residential mortgage loans, and have increased our emphasis on the origination of nonresidential real estate loans, multi-family mortgage loans, commercial loans and commercial leases. In addition, depending on market interest rates and our capital and liquidity position, we generally sell all or a portion of our longer-term, fixed-rate residential loans, usually on a servicing-retained basis.

Further, we primarily invest in shorter-duration securities, which generally have lower yields compared to longer-term investments. Shortening the average maturity of our interest-earning assets by increasing our investments in shorter-term loans and securities, as well as loans with variable rates of interest, helps to better match the maturities and interest rates of our assets and liabilities, thereby reducing the exposure of our net interest income to changes in market interest rates. Finally, we have classified all of our investment portfolio as available-for-sale so as to provide flexibility in liquidity management.

We utilize a combination of analyses to monitor the Bank's exposure to changes in interest rates. The economic value of equity analysis is a model that estimates the change in net portfolio value ("NPV") over a range of interest rate

scenarios. NPV is the discounted present value of expected cash flows from assets, liabilities and off-balance sheet contracts. In calculating changes in NPV, we assume estimated loan prepayment rates, reinvestment rates and deposit decay rates that seem most likely based on historical experience during prior interest rate changes.

Our net interest income analysis utilizes the data derived from the dynamic GAP analysis, described below, and applies several additional elements, including actual interest rate indices and margins, contractual limitations such as interest rate floors and caps

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and the U.S. Treasury yield curve as of the balance sheet date. In addition, we apply consistent parallel yield curve shifts (in both directions) to determine possible changes in net interest income if the theoretical yield curve shifts occurred instantaneously. Net interest income analysis also adjusts the dynamic GAP repricing analysis based on changes in prepayment rates resulting from the parallel yield curve shifts.

Our dynamic GAP analysis determines the relative balance between the repricing of assets and liabilities over multiple periods of time (ranging from overnight to five years). Dynamic GAP analysis includes expected cash flows from loans and mortgage-backed securities, applying prepayment rates based on the differential between the current interest rate and the market interest rate for each loan and security type. This analysis identifies mismatches in the timing of asset and liability repricing but does not necessarily provide an accurate indicator of interest rate risk because it omits the factors incorporated into the net interest income analysis.

Quantitative Analysis. The following table sets forth, as of September 30, 2014, the estimated changes in the Bank's NPV and net interest income that would result from the designated instantaneous parallel shift in the U.S. Treasury yield curve. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

Change in Interest Rates (basis points)	Estimated Increase (Decrease) in NPV		Decrease in Estimated Net Interest Income	
	Amount	Percent	Amount	Percent
	(dollars in thousands)			
+400	\$(18,573 )	(13.21 )%	\$(6,550 )	(14.82 )%
+300	(5,686 )	(4.05 )	(4,785 )	(10.83 )
+200	(2,068 )	(1.47 )	(2,945 )	(6.66 )
+100	(16 )	(0.01 )	(1,365 )	(3.09 )
0	—	—	—	—

The Company has opted not to include an estimate for a decrease in rates at September 30, 2014 as the results are not relevant given the current targeted fed funds rate of the Federal Open Market Committee. The table set forth above indicates that at September 30, 2014, in the event of an immediate 200 basis point increase in interest rates, the Bank would be expected to experience a 1.47% decrease in NPV and a \$2.9 million decrease in net interest income. This data does not reflect any actions that we may undertake in response to changes in interest rates, such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on NPV and net interest income, if any.

Certain shortcomings are inherent in the methodology used in the above interest rate risk measurements. Modeling changes in NPV and net interest income requires that we make certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. The NPV and net interest income table presented above assumes that the composition of our interest-rate-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and, accordingly, the data does not reflect any actions that we may undertake in response to changes in interest rates, such as changes in rates paid on certain deposit accounts based on local competitive factors. The table also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or the repricing characteristics of specific assets and liabilities. Because of the shortcomings mentioned above, management considers many additional factors such as projected changes in loan and deposit balances and various projected forward interest rate scenarios when evaluating strategies for managing interest rate risk. Accordingly, although the NPV and net interest income table provides an indication of our sensitivity to interest rate changes at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

**ITEM 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chairman, Chief Executive Officer and President and the Executive Vice President and Chief Financial

Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2014. Based on that evaluation, the Company's management, including the Chairman, President, and Chief Executive Officer and the Executive Vice President and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective.

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During the quarter ended September 30, 2014, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

The Company and its subsidiaries are subject to various legal actions arising in the normal course of business. In the opinion of management, based on currently available information, the resolution of these legal actions is not expected to have a material adverse effect on the Company's results of operations.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors disclosed in the Company's Annual Report in Form 10-K for the year ended December 31, 2013.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Unregistered Sale of Equity Securities. Not applicable.

(b) Use of Proceeds. Not applicable

(c) Repurchases of Equity Securities.

The Company's Board of Directors had authorized the repurchase of up to 5,047,423 shares of our common stock. The repurchase authorization expired on November 15, 2012. In accordance with this authorization, the Company had repurchased 4,239,134 shares of its common stock as of September 30, 2014. The Company has no plans to engage in stock repurchases at this time.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number Description

31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
101	The following financial statements from the BankFinancial Corporation Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, formatted in Extensive Business Reporting Language (XBRL): (i) consolidated statement of conditions, (ii) consolidated statements of operations, (iii) consolidated statements of cash flows and (iv) the notes to consolidated financial statements.

\* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BANKFINANCIAL CORPORATION

Dated: October 29, 2014

By: /s/ F. Morgan Gasior  
F. Morgan Gasior  
Chairman of the Board, Chief Executive Officer and President

/s/ Paul A. Cloutier  
Paul A. Cloutier  
Executive Vice President and Chief Financial Officer