ANHEUSER-BUSCH COMPANIES, LLC
Form 424B5
July 11, 2012
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**Filed pursuant to Rule 424(b)(5)**
**Registration Statement No. 333-169514**

**The Information in this preliminary prospectus is not complete and may be changed. We are not using this prospectus supplement or the attached prospectus to offer to sell these securities or to solicit offers to buy these securities in any jurisdiction where the offer or sale is not permitted.**

**Subject to Completion dated 11 July 2012**

**Preliminary Prospectus Supplement**

**(To prospectus dated 21 September 2010, as previously amended by the Prospectus Supplement dated 6 October 2011) (as so amended, the Prospectus )**

# Anheuser-Busch InBev Worldwide Inc.

**$ % Notes due**

**$ % Notes due**

**$ % Notes due**

**$ % Notes due**

**Fully and unconditionally guaranteed by**

***Anheuser-Busch InBev SA/NV***

***Brandbrew S.A.***

***Cobrew NV/SA***

***Anheuser-Busch Companies, LLC***

The fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at a rate of % per year, the fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at rate of % per year, the fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at a rate of % per year and the fixed rate notes due (the **Fixed Rate Note** and together with the **Fixed Rate Notes** , **Fixed Rate Notes** and **Fixed Rate Notes** , the **Fixed Rate Notes** or the **Notes** ) will bear interest at a rate of % Interest on the Fixed Rate Notes will be payable semi-annually in arrears on and of each year, commencing on 2013. The Fixed Rate Notes will mature on , the Fixed Rate Notes will mature on , the Fixed Rate Notes will mature on and the Fixed Rate Notes will mature on . The Notes will be issued by Anheuser-Busch InBev Worldwide Inc. (the **Issuer** ) and will be fully and unconditionally guaranteed by Anheuser-Busch InBev SA/NV (the **Parent Guarantor** ), Brandbrew S.A., Cobrew NV/SA, and Anheuser-Busch Companies, LLC (the **Subsidiary Guarantors** , together with the Parent Guarantor, the **Guarantors** ). Application will be made to list the Notes on the New York Stock Exchange. There can be no assurance that the Notes will be listed.

The Issuer may, at its option, redeem the Fixed Rate Notes in whole or in part, at any time as further provided in Description of the Notes Optional Redemption. The Issuer may also redeem each series of the Notes at the Issuer s (or, if applicable, the Parent Guarantor s) option, in whole but not in part, at 100% of their principal amount then outstanding plus accrued interest if certain tax events occur as described in Description of the Notes Optional Tax Redemption.

**Investing in the Notes involves risks. See Risk Factors on page S-9 and beginning on page 2 of the accompanying Prospectus. Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus supplement or the accompanying Prospectus. Any representation to the contrary is a criminal offense.**

| | **Public offering price(1)** | **Underwriting discount** | **Proceeds, before expenses, to the Issuer** |
|---|---|---|---|
| Per Fixed Rate Note | % | % | % |
| Total for Fixed Rate Notes | $ | $ | $ |
| Per Fixed Rate Note | % | % | % |
| Total for Fixed Rate Notes | $ | $ | $ |
| Per Fixed Rate Note | % | % | % |
| Total for Fixed Rate Notes | $ | $ | $ |
| Per Fixed Rate Note | % | % | % |
| Total for Fixed Rate Notes | $ | $ | $ |

(1) Plus accrued interest, if any, from and including

The underwriters expect to deliver the Notes to purchasers in book-entry form only through the facilities of The Depository Trust Company and its direct and indirect participants (including Euroclear S.A./N.V. and Clearstream Banking, *société anonyme*) on or about .

*Joint Bookrunners*

**BofA Merrill Lynch** **Barclays** **Deutsche Bank Securities** **J.P. Morgan**

**BNP PARIBAS** **Mitsubishi UFJ Securities** **Mizuho Securities** **RBS** **SOCIETE GENERALE**

*Senior Co-Managers*

*Co-Managers*

The date of this Prospectus Supplement is 2012.

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### PROSPECTUS SUPPLEMENT



### PROSPECTUS

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## THE OFFERING

*This section outlines the specific financial and legal terms of the Notes that are more generally described under Description of the Notes beginning on page S-15 of this prospectus supplement and under Description of Debt Securities and Guarantees beginning on page 18 of the accompanying Prospectus. If anything described in this section is inconsistent with the terms described under Description of the Notes in this prospectus supplement or in Description of Debt Securities and Guarantees in the accompanying Prospectus, the terms described below shall prevail. References to $ or USD in this prospectus supplement are to U.S. dollars, and references to or EUR are to euros. References to we , us and our are, as the context requires, to Anheuser-Busch InBev SA/NV or Anheuser-Busch InBev SA/NV and the group of companies owned and/or controlled by Anheuser-Busch InBev SA/NV as more fully described on page 1 of the accompanying Prospectus.*

| | |
|---|---|
| **Issuer** | Anheuser-Busch InBev Worldwide Inc., a Delaware corporation (the **Issuer** ). |
| **Parent Guarantor** | Anheuser-Busch InBev SA/NV, a Belgian public limited liability company (the **Parent Guarantor** ). |
| **Subsidiary Guarantors** | Brandbrew S.A., Cobrew NV/SA and Anheuser-Busch Companies, LLC (each a **Subsidiary Guarantor** and together with the Parent Guarantor, the **Guarantors** ), will, along with the Parent Guarantor, jointly and severally guarantee the Notes on an unconditional, full and irrevocable basis, subject to certain limitations described in Description of Debt Securities and Guarantees in the accompanying Prospectus. |
| **Securities Offered** | $ aggregate principal amount of % notes due (the **Fixed Rate Notes** ). The Fixed Rate Notes will mature on . |
| | $ aggregate principal amount of % notes due (the **Fixed Rate Notes** ). The Fixed Rate Notes will mature on . |
| | $ aggregate principal amount of % notes due (the **Fixed Rate Notes** ). The Fixed Rate Notes will mature on . |
| | $ aggregate principal amount of % notes due (the **Fixed Rate Notes** ). The Fixed Rate Notes will mature on . |
| | The Fixed Rate Notes are redeemable prior to maturity as described in Description of the Notes Optional Redemption and all of the Notes will be redeemable prior to maturity as described under Description of the Notes Optional Tax Redemption. |
| **Price to Public** | % of the principal amount of the Fixed Rate Notes, plus accrued interest, if any, from and including 2012. |

% of the principal amount of the Fixed Rate Notes, plus accrued interest, if any, from and including 2012.

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% of the principal amount of the Fixed Rate Notes, plus accrued interest, if any, from and including 2012.

% of the principal amount of the Fixed Rate Notes, plus accrued interest, if any, from and including 2012.

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| **Ranking of the Notes** | The Notes will be senior unsecured obligations of the Issuer and will rank equally with all other existing and future unsecured and unsubordinated debt obligations of the Issuer. |
| **Ranking of the Guarantees** | Subject to certain limitations described in Description of Debt Securities and Guarantees in the accompanying Prospectus, each Note will be jointly and severally guaranteed by each of the Guarantors, on an unconditional, full and irrevocable basis (each a **Guarantee** and collectively the **Guarantees** ). The Guarantees will be the direct, unconditional, unsecured and unsubordinated general obligations of the Guarantors. The Guarantees will rank *pari passu* among themselves, without any preference of one over the other by reason of priority of date of issue or otherwise, and equally with all other existing and future unsecured and unsubordinated general obligations of the Guarantors. Each of the Guarantors other than the Parent Guarantor shall be entitled to terminate its Guarantee in certain circumstances as further described under Description of Debt Securities and Guarantees in the accompanying Prospectus. |
| **Minimum Denomination** | The Notes will be issued in denominations of $1,000 and integral multiples of $1,000 in excess thereof. |
| **Payment of Principal and Interest on the Fixed Rate Notes** | The principal amount of the Fixed Rate Notes is and the Fixed Rate Notes will bear interest at the rate per annum of %. |
| | The principal amount of the Fixed Rate Notes is and the Fixed Rate Notes will bear interest at the rate per annum of %. |
| | The principal amount of the Fixed Rate Notes is and the Fixed Rate Notes will bear interest at the rate per annum of %. |
| | The principal amount of the Fixed Rate Notes is and the Fixed Rate Notes will bear interest at the rate per annum of %. |
| | Interest on the Fixed Rate Notes will be payable semi-annually in arrears on and of each year, commencing on 2013. Interest on the Fixed Rate Notes will accrue from . |
| | If the date of such interest payment is not a Business Day, then payment will be made on the next succeeding Business Day. Interest |

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will accrue on the Fixed Rate Notes until the principal of the applicable Fixed Rate Notes is paid or duly made available for payment. Interest on the Fixed Rate Notes will be calculated on the basis of a 360-day year consisting of twelve 30-day months.

Interest on the Fixed Rate Notes will be paid to the persons in whose names such Fixed Rate Notes (or one or more predecessor notes) are registered at the close of business on the and , immediately preceding the applicable interest payment date, whether or not such date is a Business Day.

If the date of maturity of principal of any Fixed Rate Note or the date fixed for redemption or payment in connection with an acceleration of any Fixed Rate Note is not a Business Day, then payment of interest or principal need not be made on such date, but may be made on the next succeeding Business Day with the same force and effect as if made on the date of maturity or the date fixed for redemption or payment in connection with an acceleration, and no interest shall accrue as a result of the delayed payment.

**Business Day**

A day on which commercial banks and exchange markets are open, or not authorized to close, in the City of New York, London and Brussels.

**Additional Amounts**

To the extent any Guarantor is required to make payments in respect of the Notes, such Guarantor will make all payments in respect of the Notes without withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by way of withholding or deduction at source by or on behalf of any jurisdiction in which such Guarantor is incorporated, organized, or otherwise tax resident or any political subdivision or any authority thereof or therein having power to tax (the **Relevant Taxing Jurisdiction** ) unless such withholding or deduction is required by law, in which event, such Guarantor will pay to the Holders such additional amounts (the **Additional Amounts** ) as shall be necessary in order that the net amounts received by the Holders, after such withholding or deduction, shall equal the respective amounts of principal and interest which would otherwise have been receivable in the absence of such withholding or deduction, except that no such Additional Amounts shall be payable on account of any taxes or duties only in the circumstances described under Description of Debt Securities and Guarantees Additional Amounts in the accompanying Prospectus.

References to principal or interest in respect of the Notes include any Additional Amounts, which may be payable as set forth in the Indenture (as defined herein).

The covenant regarding Additional Amounts will not apply to any Guarantor at any time when such Guarantor is incorporated in a jurisdiction in the United States, but shall apply to the Issuer at any time that the Issuer is incorporated in any jurisdiction outside the United States.

**Optional Redemption**

The Fixed Rate Notes may be redeemed at any time, at the Issuer s option, as a whole or in part, upon not less than 30 nor more than 60 days prior notice, at a redemption price equal to the greater of:

- 100% of the aggregate principal amount of the Fixed Rate Notes to be redeemed; and

- as determined by the Independent Investment Banker (as defined below), the sum of the present values of the remaining scheduled payments of principal and interest on the Fixed Rate Notes to be redeemed (not including any portion of such payments of interest accrued to the date of redemption) discounted to the redemption date on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months) at the Treasury Rate described herein plus basis points in the case of the Fixed Rate Notes, basis points in the case of the Fixed Rate Notes, basis points in the case of the Fixed Rate Notes and basis points in the case of the Fixed Rate Notes;

plus, in each case described above, accrued and unpaid interest on the principal amount being redeemed to (but excluding) the redemption date.

**Optional Tax Redemption**

Each series of Notes may be redeemed at any time, at the Issuer s or the Parent Guarantor s option, as a whole, but not in part, upon not less than 30 nor more than 60 days prior notice, at a redemption price equal to 100% of the principal amount of the Notes of such series then outstanding plus accrued and unpaid interest on the principal amount being redeemed (and all Additional Amounts (see Description of Debt Securities and Guarantees Additional Amounts in the accompanying Prospectus), if any) to (but excluding) the redemption date, if (i) as a result of any change in, or amendment to, the laws, treaties, regulations or rulings of a jurisdiction in which the Issuer or any Guarantor is incorporated, organized, or otherwise tax resident or any political subdivision or any authority thereof or therein having power to tax, or in the interpretation, application or administration of any such laws, treaties, regulations or rulings (including a holding, judgment or order by a court of competent jurisdiction) which becomes effective on or after (any such change or amendment, a **Change in Tax Law** ), the Issuer or (if a payment were then due under a Guarantee, the relevant Guarantor) would be required to pay Additional Amounts and (ii) such obligation cannot be avoided by the Issuer (or the relevant Guarantor) taking reasonable measures available to it, *provided*, *however*, that any series of Notes may not be redeemed to the extent such Additional Amounts arise solely as a result of the Issuer

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assigning its obligations under such Notes to a Substitute Issuer (as defined in Description of the Notes ), unless this assignment to a Substitute Issuer is undertaken as part of a plan of merger by the Parent Guarantor.

No notice of redemption may be given earlier than 90 days prior to the earliest date on which the Issuer or the Guarantor would be obligated to pay the Additional Amounts if a payment in respect of such series of Notes were then due.

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| **Use of Proceeds** | The Issuer intends to apply substantially all of the net proceeds (estimated to be $ million before expenses) from the sale of the Notes toward general corporate purposes and pre-funding of financing related to the announced combination with (or acquisition of shares of) Grupo Modelo. |
| **Listing and Trading** | Application will be made for the Notes to be admitted to listing on the New York Stock Exchange ( **NYSE** ). No assurance can be given that such application will be approved. |
| **Name of Depositary** | The Depository Trust Company ( **DTC** ). |
| **Book-Entry Form** | The Notes will initially be issued to investors in book-entry form only. Fully-registered global notes representing the total aggregate principal amount of the Notes of each series will be issued and registered in the name of a nominee for DTC, the securities depositary for the Notes, for credit to accounts of direct or indirect participants in DTC, including Euroclear S.A./N.V. ( **Euroclear** ) and Clearstream Banking, *société anonyme* ( **Clearstream** ). Unless and until Notes in definitive certificated form are issued, the only holder will be Cede & Co., as nominee of DTC, or the nominee of a successor depositary. Except as described in this prospectus supplement or accompanying Prospectus, a beneficial owner of any interest in a global note will not be entitled to receive physical delivery of definitive Notes. Accordingly, each beneficial owner of any interest in a global note must rely on the procedures of DTC, Euroclear, Clearstream, or their participants, as applicable, to exercise any rights under the Notes. |
| **Taxation** | For a discussion of the United States, Belgian and Luxembourg tax consequences associated with the Notes, see Taxation Supplemental Discussion of United States Taxation, Taxation Belgian Taxation and Taxation Luxembourg Taxation in this prospectus supplement and Tax Considerations in the accompanying Prospectus. Investors should consult their own tax advisors in determining the non-United States, United States federal, state, local and any other tax consequences to them of the purchase, ownership and disposition of the Notes. |

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| **Governing Law** | The Notes, the Guarantees and the Indenture related thereto, will be governed by, and construed in accordance with, the laws of the State of New York. |
| **Additional Notes** | The Issuer may, from time to time, without notice to or the consent of the Holders, create and issue, pursuant to the Indenture and in accordance with applicable laws and regulations, additional Notes of a series (the **Additional Notes** ) maturing on the same maturity date as the other Notes of that series and having the same terms and conditions under the Indenture (including with respect to the Guarantors and the Guarantees) as the previously outstanding Notes of that series in all respects (or in all respects except for the issue date and the amount and, in some cases, the date of the first payment of interest thereon) so that such Additional Notes shall be consolidated and form a single series with the previously outstanding Notes of that series. Without limiting the foregoing, the Issuer may, from time to time, without notice to or the consent of the Holders, create and issue, pursuant to the Indenture and in accordance with applicable laws and regulations, additional series of notes with additional or different terms and maturity dates than the Notes. |
| **Trustee, Principal Paying Agent, Transfer Agent, Calculation Agent and Registrar** | The Trustee, principal paying agent, transfer agent, calculation agent and registrar is The Bank of New York Mellon Trust Company, N.A. ( **Trustee** ). |
| **CUSIPs:**<br>Fixed Rate Notes:<br>Fixed Rate Notes:<br>Fixed Rate Notes: | Fixed Rate Notes: |
| **ISINs:**<br>Fixed Rate Notes:<br>Fixed Rate Notes:<br>Fixed Rate Notes: | Fixed Rate Notes: |

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## RECENT DEVELOPMENTS

We held our annual General Shareholders Meeting on 25 April 2012, which approved our annual accounts for the year ended 31 December 2011, as well as the gross dividend of EUR 1.20 per share proposed by our board of directors. The General Shareholders Meeting also marked the end of the mandate of Mr. Peter Harf, one of our Independent Directors. Mr. Kees Storm, already an Independent Director, was appointed the new Chairman of the Board of Directors effective as of the end of the meeting. Mr. Mark Winkelman, already an Independent Director, succeeded Mr. Peter Harf as a member of our Audit Committee.

On 11 May 2012, we announced the closing of the transaction between Companhia de Bebidas das Americas-Ambev ( **Ambev** ) and E. León Jimenes S.A. to form a strategic alliance creating the leading beverage company in the Caribbean. As a result, Ambev Brasil Bebidas S.A., a closely-held subsidiary of Ambev, owns an indirect 41.76% interest in Cervecería Nacional Dominicana S.A. ( CND ), and Ambev will consolidate CND s results going forward. The acquisition of the 9.3% stake in CND owned by Heineken N.V. closed in the second quarter of 2012.

On 29 June 2012, we and Grupo Modelo announced that we had entered into a Transaction Agreement dated 28 June 2012, among us, Grupo Modelo, Diblo, S.A. de C.V., Anheuser-Busch International Holdings, Inc. and Anheuser-Busch Mexico Holding, S. de R.L. de C.V (the **Transaction Agreement** ) under which we will acquire the remaining stake in Grupo Modelo that we do not already own for USD 9.15 per share in cash in a transaction valued at USD 20.1 billion. For further details, see the following documents that are incorporated by reference herein:

Report on Form 6-K filed with the U.S. Securities and Exchange Commission (the **SEC** ) on 29 June 2012, regarding the announcement of our proposed acquisition of the remaining stake in Grupo Modelo.

Report on Form 6-K filed with the SEC on 2 July 2012, describing and exhibiting the Transaction Agreement.

See Incorporation of Certain Information by Reference .

**2012 Facilities Agreement**

On 20 June 2012 we entered into a USD 14 billion Facilities Agreement with, amongst others, Banc of America Securities Limited, Banco Santander, S.A., Barclays Bank PLC, Deutsche Bank AG, London Branch, Fortis Bank SA/NV, ING Belgium SA/NV, JPMorgan Chase Bank, N.A., Mizuho Corporate Bank, Ltd, RBS Securities Inc., Société Générale, London Branch and The Bank of Tokyo-Mitsubishi UFJ, Ltd. as mandated lead arrangers and bookrunners, and Fortis Bank SA/NV, acting as Agent (the **2012 Facilities Agreement** ). The 2012 Facilities Agreement makes the following two facilities available to us, the Issuer and Cobrew NV/SA: (i) **Facility A** , a term facility with a maximum maturity of two years from the funding date for up to USD 6 billion principal amount available to be drawn in USD and (ii) **Facility B** , a three-year term facility for up to USD 8 billion principal amount available to be drawn in USD.

As of the date of this prospectus supplement, both Facility A and Facility B remain undrawn. Each facility is available to be drawn until 20 June 2013, subject to an extension up to 20 December 2013 at our option. In the event that we choose to extend the availability period, the tenor of Facility B will be reduced by the length of the period by which the availability period has been extended.

The 2012 Facilities Agreement contains customary representations, covenants and events of default. Among other things and subject to certain thresholds and limitations, an event of default is triggered if any of our or our subsidiaries financial indebtedness is accelerated following an event of default. The obligations of the

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borrowers under the 2012 Facilities Agreement will be jointly and severally guaranteed by the other borrowers and by Anheuser-Busch Companies, LLC and Brandbrew SA.

All proceeds from the drawdown under the 2012 Facilities Agreement must be applied, directly or indirectly, toward the acquisition of Grupo Modelo, refinancing of existing indebtedness of Grupo Modelo or any costs in connection therewith.

The availability of funds under the 2012 Facilities Agreement is subject to the satisfaction of customary conditions precedent. In addition to these conditions, the utilisations under the 2012 Facilities Agreement also require that certain events of default are not outstanding and would not result from the proposed utilisations, that all utilisations are made on the same day and that certain representations made by each borrower and guarantor remain true in all material respects.

We may borrow under the 2012 Facilities Agreement at an interest rate equal to LIBOR, plus mandatory costs (if any), plus a margin on each of Facility A and Facility B based on ratings assigned by rating agencies to our long-term debt. For Facility A, the margin ranges between 0.85% per annum and 2.15% per annum, which margin will increase in fixed increments from the date falling six months after the date of drawdown of Facility A and on the last day of each three month period ending thereafter. For Facility B, the margin ranges between 1.10% per annum and 2.40% per annum. Customary ticking fees are payable on any undrawn but available funds under the Facilities.

Mandatory prepayments are not required to be made under the 2012 Facilities Agreement, except in certain limited circumstances , including (i) for Facility A only (following the drawdown thereof), out of the net proceeds received by us or our subsidiaries from funds raised in the public international debt capital markets subject to specific exceptions and (ii) for both Facility A and Facility B, where a person or a group of persons acting in concert (other than our controlling shareholder, Stichting Anheuser-Busch InBev or any of its certificate holders (as described in Item 7. Major Shareholders and Related Party Transactions A. Major Shareholders of our 2011 Annual Report on Form 20-F) or any persons or group of persons acting in concert with such persons) acquires control of us.

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## RISK FACTORS

*Investing in the Notes offered using this prospectus supplement involves risk. We urge you to carefully review the risks described in the accompanying Prospectus and the documents incorporated by reference into this prospectus supplement and the accompanying Prospectus, before you decide to buy our Notes. You should consult your financial and legal advisors about the risk of investing in the Notes. We disclaim any responsibility for advising you on these matters.*

## ABOUT THIS PROSPECTUS SUPPLEMENT

Prospective investors should rely on the information provided in this prospectus supplement, the accompanying Prospectus and the documents incorporated by reference in this prospectus supplement and the accompanying Prospectus. No person is authorized to make any representation or give any information not contained in this prospectus supplement, the accompanying Prospectus or the documents incorporated by reference in this prospectus supplement and the accompanying Prospectus. Any such representation or information not contained in this prospectus supplement, the accompanying Prospectus or the documents incorporated by reference in this prospectus supplement and the accompanying Prospectus must not be relied upon as having been authorized by us or the underwriters. Please see Incorporation of Certain Information by Reference in this prospectus supplement and the accompanying Prospectus for information about the documents that are incorporated by reference.

We are not offering to sell or soliciting offers to buy, any securities other than the Notes offered under this prospectus supplement, nor are we offering to sell or soliciting offers to buy the Notes in places where such offers are not permitted by applicable law. You should not assume that the information in this prospectus supplement or the accompanying Prospectus, or the information we have previously filed with the SEC and incorporated by reference in this prospectus supplement and the accompanying Prospectus, is accurate as of any date other than their respective dates.

The Notes described in this prospectus supplement are the Issuer s debt securities being offered under registration statement no. 333-169514 filed with the SEC, as amended, under the U.S. Securities Act of 1933, as amended (the **Securities Act** ). The accompanying Prospectus is part of that registration statement. The accompanying Prospectus provides you with a general description of the securities that we may offer, and this prospectus supplement contains specific information about the terms of this offering and the Notes. This prospectus supplement also adds, updates or changes information provided or incorporated by reference in the accompanying Prospectus. Consequently, before you invest, you should read this prospectus supplement together with the accompanying Prospectus as well as the documents incorporated by reference in this prospectus supplement and the accompanying Prospectus. Those documents contain information about us, the Notes and other matters. Our shelf registration statement, any post-effective amendments thereto, the various exhibits thereto, and the documents incorporated therein and herein by reference, contain additional information about us and the Notes. All of those documents may be inspected at the office of the SEC. Our SEC filings are also available to the public on the SEC s website at http://www.sec.gov. Certain terms used but not defined in this prospectus supplement are defined in the Prospectus.

References to $ or USD in this prospectus supplement are to U.S. dollars, and references to or EUR are to euros.

The distribution of this prospectus supplement and the accompanying Prospectus and the offering of the Notes in certain jurisdictions may be restricted by law. Persons who receive copies of this prospectus supplement and the accompanying Prospectus should inform themselves about and observe those restrictions. See Underwriting in this prospectus supplement.

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## FORWARD-LOOKING STATEMENTS

This prospectus supplement, including documents that are filed with the SEC and incorporated by reference herein, and the accompanying Prospectus, may contain statements that include the words or phrases *will likely result*, *are expected to*, *will continue*, *is anticipated*, *estim* *project*, *may* or similar expressions that are forward-looking statements. These statements are subject to certain risks and uncertainties. Actual results may differ materially from those suggested by these statements due to, among others, the risks or uncertainties listed below. See also Risk Factors beginning on page 2 of the accompanying Prospectus for further discussion of risks and uncertainties that could impact our business.

These forward-looking statements are not guarantees of future performance. Rather, they are based on current views and assumptions and involve known and unknown risks, uncertainties and other factors, many of which are outside our control and are difficult to predict, that may cause actual results or developments to differ materially from any future results or developments expressed or implied by the forward-looking statements. Factors that could cause actual results to differ materially from those contemplated by the forward-looking statements include, among others:

- local, regional, national and international economic conditions, including the risks of a global recession or a recession in one or more of our key markets, and the impact they may have on us and our customers and our assessment of that impact;
- limitations on our ability to contain costs and expenses;
- our expectations with respect to expansion, premium growth, accretion to reported earnings, working capital improvements and investment income or cash flow projections;
- our ability to continue to introduce competitive new products and services on a timely, cost-effective basis;
- the effects of competition and consolidation in the markets in which we operate, which may be influenced by regulation, deregulation or enforcement policies;
- changes in consumer spending;
- changes in applicable laws, regulations and taxes in jurisdictions in which we operate, including the laws and regulations governing our operations, changes to tax benefit programs as well as actions or decisions of courts and regulators;
- changes in pricing environments;
- volatility in the prices of raw materials, commodities and energy;
- difficulties in maintaining relationships with employees;
- the monetary and interest rate policies of central banks, in particular the European Central Bank, the Board of Governors of the U.S. Federal Reserve System, the Bank of England, *Banco Central do Brasil* and other central banks;

continued availability of financing and our ability to achieve our targeted coverage and debt levels and terms, including the risk of constraints on financing in the event of a credit rating downgrade;

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financial risks, such as interest rate risk, foreign exchange rate risk, commodity risk, asset price risk, equity market risk, counterparty risk, sovereign risk, liquidity risk, inflation or deflation;

regional or general changes in asset valuations;

greater than expected costs (including taxes) and expenses;

the risk of unexpected consequences resulting from acquisitions;

tax consequences of restructuring and our ability to optimize our tax rate;

the outcome of pending and future litigation and governmental proceedings;

changes in government policies;

natural and other disasters;

any inability to economically hedge certain risks;

inadequate impairment provisions and loss reserves;

technological changes; and

our success in managing the risks involved in the foregoing.

Certain of the synergies information related to the announced combination with (or acquisition of shares of) Grupo Modelo set forth in Recent Developments and Incorporation of Certain Information by Reference constitute forward-looking statements and may not be representative of the actual synergies that will result from the announced combination with (or acquisition of shares of) Grupo Modelo because they are based on estimates and assumptions that are inherently subject to significant uncertainties which are difficult to predict, and accordingly, there can be no assurance that these synergies will be realized.

Our statements regarding financial risks, including interest rate risk, foreign exchange rate risk, commodity risk, asset price risk, equity market risk, counterparty risk, sovereign risk, inflation and deflation, are subject to uncertainty. For example, certain market and financial risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market or financial risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

We caution that the forward-looking statements in this prospectus supplement are further qualified by the risks described above in Risk Factors and beginning on page 2 of the accompanying Prospectus, elsewhere in this prospectus supplement or accompanying Prospectus, or in the 2011 Annual Report on Form 20-F incorporated by reference herein, that could cause actual results to differ materially from those in the forward-looking statements. Subject to our obligations under Belgian and U.S. law in relation to disclosure and ongoing information, we undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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## INCORPORATION OF CERTAIN INFORMATION BY REFERENCE

The SEC allows us to incorporate by reference in the prospectus supplement information contained in documents that we file with the SEC. The information that we incorporate by reference is an important part of this prospectus supplement and the accompanying Prospectus. We incorporate by reference in this prospectus supplement, after the date of this prospectus supplement and until we complete the offerings using this prospectus supplement and accompanying Prospectus, any future filings that we make with the SEC under Sections 13(a), 13(c), 14 and 15(d) of the Securities Exchange Act of 1934, as amended, and reports on Form 6-K we furnish to the SEC to the extent we designate therein.

We also incorporate by reference in this prospectus supplement the following documents:

- Annual Report on Form 20-F for the fiscal year ended 31 December 2011 filed with the SEC on 13 April 2012.
- Report on Form 6-K filed with the SEC on 16 April 2012, regarding our transaction with E. Leon Jimenes S.A. to acquire an indirect stake in Cerveceria Nacional Dominicana S.A.
- Report on Form 6-K filed with the SEC on 25 April 2012, regarding approval of our annual accounts and dividend payment by our General Shareholders Meeting.
- Report on Form 6-K filed with the SEC on 27 April 2012, regarding certain disclosures of share capital.
- Report on Form 6-K filed with the SEC on 30 April 2012, regarding our Unaudited Interim Report for the three-month period ended 31 March 2012.
- Report on Form 6-K filed with the SEC on 14 May 2012, regarding the closing of our transaction with E. Leon Jimenes S.A. to acquire an indirect stake in Cerveceria Nacional Dominicana S.A.
- Report on Form 6-K filed with the SEC on 14 June 2012, regarding certain disclosures of share capital.
- Report on Form 6-K filed with the SEC on 29 June 2012, regarding our proposed acquisition of all or part of the outstanding share capital of Grupo Modelo and any warrants and options in respect thereof.
- Report on Form 6-K filed with the SEC on 2 July 2012, regarding the Transaction Agreement dated 28 June 2012, among us, Grupo Modelo, Diblo, S.A. de C.V., Anheuser-Busch International Holdings, Inc. and Anheuser-Busch Mexico Holding, S. de R.L. de C.V.

The information that we file with the SEC, including future filings, automatically updates and supersedes information in documents filed at earlier dates. All information appearing in this prospectus supplement is qualified in its entirety by the information and financial statements, including the notes, contained in the documents that we incorporate by reference in this prospectus supplement.

You may request a copy of the filings referred to above, at no cost, upon written or oral request. You should direct your requests to Anheuser-Busch InBev SA/NV, Brouwerijplein 1, 3000 Leuven, Belgium (telephone: +32 (0)1 627 6111).

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## USE OF PROCEEDS

The Issuer intends to apply substantially all of the net proceeds (estimated to be $    million before expenses) from the sale of the Notes to general corporate purposes and pre-funding of financing related to the announced combination with (or acquisition of shares of) Grupo Modelo.

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## CAPITALIZATION

The following table shows our cash and cash equivalents and capitalization as of 31 December 2011 on an actual basis and on an as adjusted basis to give effect to (i) this offering, (ii) the application of the estimated net proceeds of this offering for general corporate purposes and pre-funding of financing related to the announced combination with (or acquisition of shares of) Grupo Modelo, (iii) the early redemption of $185 million and the repayment of $450 million Anheuser-Busch Notes maturing in March and April 2012 and (iv) the repayment of BRL 1.25 billion bonds maturing on 2 July 2012.

| | As of 31 December 2011 | |
|---|---|---|
| | Actual (audited) | As Adjusted (unaudited) |
| | ($ million) | |
| Cash and cash equivalents, less bank overdrafts(1)(2)(3) | 5,312 | |
| **Current interest-bearing liabilities** | | |
| Secured bank loans | 60 | 60 |
| Commercial papers | 2,287 | 2,287 |
| Unsecured bank loans | 580 | 580 |
| Unsecured bond issues(2)(3) | 2,624 | 1,557 |
| Unsecured other loans | 3 | 3 |
| Finance lease liabilities | 5 | 5 |
| **Non-current interest-bearing liabilities** | | |
| Secured bank loans | 95 | 95 |
| Unsecured bank loans | 4,022 | 4,022 |
| Unsecured bond issues(1)(2) | 30,278 | |
| Secured other loans | 6 | 6 |
| Unsecured other loans | 77 | 77 |
| Finance lease liabilities | 120 | 120 |
| **Total interest-bearing liabilities** | 40,157 | |
| Equity attributable to our equity holders | 37,492 | 37,492 |
| Non-controlling interests | 3,552 | 3,552 |
| **Total Capitalization:** | 81,201 | |

Notes:

(1) We intend to use the estimated net proceeds from this offering of $ million (see cover page of this prospectus supplement) for general corporate purposes and pre-funding of financing related to the announced combination with (or acquisition of shares of) Grupo Modelo. For illustrative purposes, this table has been prepared based on the assumption that this offering will increase our non-current unsecured bond issues by $ million and will increase our cash and cash equivalents, less bank overdrafts, by $ million.

(2) After 31 December 2011, we redeemed early $185 million and repaid at maturity $450 million of Anheuser-Busch Notes maturing in March and April 2012 (as described in Item 5. Operating and Financial Review G. Liquidity and Capital Resources of our 2011 Annual Report on Form 20-F). The early redemption and repayment described in the preceding sentence reduced our non-current unsecured bond issues, our current unsecured bond issues and our cash and cash equivalents, less bank overdrafts by $185 million, $450 million and $635 million, respectively.

(3) After 31 December 2011, we repaid at maturity BRL 1.25 billion of Ambev bonds maturing 2 July 2012. Such repayment decreased our current unsecured bond issues and our cash and cash equivalents, less bank overdrafts by $617 million.

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# DESCRIPTION OF THE NOTES

## General

The fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at a rate of % per year, the fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at a rate of % per year, the fixed rate notes due (the **Fixed Rate Notes** ) will bear interest at a rate of % per year and the fixed rate notes due (the **Fixed Rate Notes** , and together with the **Fixed Rate Notes** , **Fixed Rate Notes** and **Fixed Rate Notes** , the **Fixed Rate Notes** or the **Notes** ) will bear interest at a rate of % per year.

The Notes will be issued by Anheuser-Busch InBev Worldwide Inc. (the **Issuer** ) and will be fully and unconditionally guaranteed by Anheuser-Busch InBev SA/NV (the **Parent Guarantor** ), Brandbrew S.A., Cobrew NV/SA, and Anheuser-Busch Companies, LLC (the **Subsidiary Guarantors** , together with the Parent Guarantor, the **Guarantors** ). Application will be made to list the Notes on the New York Stock Exchange. There can be no assurance that the Notes will be listed.

Each series of the Notes will be issued under a supplemental indenture to the indenture, dated as of 16 October 2009, as amended by the supplemental indentures thereto (the **Indenture** ), among Anheuser-Busch InBev Worldwide Inc., Anheuser-Busch InBev SA/NV, each of the subsidiary guarantors listed under Description of Debt Securities and Guarantees Guarantees in the accompanying Prospectus and The Bank of New York Mellon Trust Company, N.A., as trustee, principal paying agent, transfer agent and registrar (the **Trustee** ). The information below on certain provisions of the Notes and the Indenture should be read together with Description of Debt Securities and Guarantees in the accompanying Prospectus. This information, however, does not purport to be complete and is subject to, and is qualified in its entirety by reference to, all the provisions of the Notes and the Indenture, including the definitions of certain terms contained therein. The Indenture is by its terms subject to and governed by the Trust Indenture Act of 1939, as amended. The following description of the particular terms of the Notes offered hereby supplements and replaces any inconsistent information set forth in the description of the general terms and provisions of the debt securities set forth in the accompanying prospectus.

The Notes will be senior unsecured obligations of the Issuer and will rank equally with all other existing and future unsecured and unsubordinated debt obligations of the Issuer. The Notes will be repaid at maturity in U.S. dollars at a price equal to 100% of the principal amount thereof. The Notes will be issued in denominations of $1,000 and integral multiples of $1,000 in excess thereof. The Notes do not provide for any sinking fund. The Notes will be recorded on, and transferred through, the records maintained by DTC and its direct and indirect participants, including Euroclear S.A./N.V. ( **Euroclear** ) and Clearstream Banking, *société anonyme* ( **Clearstream** ).

**Business Day** means a day on which commercial banks and exchange markets are open, or not authorized to close, in the City of New York, London and Brussels.

## Fixed Rate Notes

The Fixed Rate Notes will be initially limited to $ aggregate principal amount and will mature on . The Fixed Rate Notes will be initially limited to $ aggregate principal amount and will mature on . The Fixed Rate Notes will be initially limited to $ aggregate principal amount and will mature on . The Fixed Rate Notes will be initially limited to $ aggregate principal amount and will mature on . Interest on the Fixed Rate Notes will be payable semi-annually in arrears on and of each year, commencing on 2013. The Fixed Rate Notes will be senior unsecured obligations of the Issuer and will rank equally with all other existing and future unsecured and unsubordinated debt obligations of the Issuer.

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Interest will accrue on the Fixed Rate Notes until the principal of the Fixed Rate Notes is paid or duly made available for payment. Interest on the Fixed Rate Notes will be calculated on the basis of a 360-day year consisting of twelve 30-day months. If the date of maturity of interest on or principal of any Fixed Rate Note or the date fixed for redemption or payment in connection with an acceleration of any Fixed Rate Note is not a Business Day, then payment of interest or principal need not be made on such date, but may be made on the next succeeding Business Day with the same force and effect as if made on the date of maturity or the date fixed for redemption or payment in connection with an acceleration, and no interest shall accrue as a result of the delayed payment.

Interest on the Fixed Rate Notes will be paid to the persons in whose names the Fixed Rate Notes are registered at the close of business on the and , immediately preceding the applicable interest payment date, whether or not such date is a Business Day. The Fixed Rate Notes may be redeemed at any time prior to maturity in the circumstances described under Optional Redemption and Optional Tax Redemption.

**Regarding the Trustee, Paying Agent, Transfer Agent and Registrar**

For a description of the duties and the immunities and rights of the Trustee, paying agent, transfer agent or registrar under the Indenture, reference is made to the Indenture, and the obligations of the Trustee, paying agent, transfer agent and registrar to the Holders of the Notes are subject to such immunities and rights.

The Issuer may at any time appoint new paying agents or transfer agents without prior notice to Holders.

**Additional Notes**

The Notes will be issued in the initial aggregate principal amount set forth above. The Issuer may, from time to time, without notice to or the consent of the Holders, create and issue, pursuant to the Indenture and in accordance with applicable laws and regulations, additional Notes (the **Additional Notes** ) maturing on the same maturity date as the other Notes of a series and having the same terms and conditions under the Indenture (including with respect to the Guarantors and the Guarantees) as the previously outstanding Notes of that series in all respects (or in all respects except for the issue date and the amount and, in some cases, the date of the first payment of interest thereon) so that such Additional Notes shall be consolidated and form a single series with the previously outstanding Notes of that series. Without limiting the foregoing, the Issuer may, from time to time, without notice to or the consent of the Holders, create and issue, pursuant to the Indenture and in accordance with applicable laws and regulations, additional series of notes with additional or different terms and maturity dates than the Notes.

**Optional Redemption**

The Issuer may, at its option, redeem the Fixed Rate Notes as a whole or in part at any time upon not less than 30 nor more than 60 days prior notice, at a redemption price equal to the greater of:

- 100% of the aggregate principal amount of the Fixed Rate Notes to be redeemed; and

- as determined by the Independent Investment Banker (as defined below), the sum of the present values of the remaining scheduled payments of principal and interest on the Fixed Rate Notes to be redeemed (not including any portion of such payments of interest accrued to the date of redemption) discounted to the redemption date on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months) at the Treasury Rate plus basis points in the case of the Fixed Rate Notes, basis points in the case of the Fixed Rate Notes, basis points in the case of the Fixed Rate Notes and basis points in the case of the Fixed Rate Notes;

plus, in each case described above, accrued and unpaid interest on the principal amount being redeemed to (but excluding) such redemption date.

**Treasury Rate** means, with respect to any redemption date:

- the yield, under the heading which represents the average for the immediately preceding week, appearing in the most recently published statistical release designated H.15(519) or any successor publication which is published weekly by the Board of Governors of the Federal Reserve System and which establishes yields on actively traded U.S. treasury securities adjusted to constant maturity under the caption Treasury constant maturities Nominal, for the maturity corresponding to the Comparable Treasury Issue (if no maturity is within three months before or after the remaining term of the Fixed Rate Notes, yields for the two published maturities most closely corresponding to the Comparable Treasury Issue will be determined and the Treasury Rate will be interpolated or extrapolated from such yields on a straight-line basis, rounding to the nearest month); or

- if such release (or any successor release) is not published during the week preceding the calculation date or does not contain such yields, the rate per annum equal to the semi-annual equivalent yield to maturity of the Comparable Treasury Issue, calculated using a price for the Comparable Treasury Issue (expressed as a percentage of its principal amount) equal to the Comparable Treasury Price for such redemption date.

The Treasury Rate will be calculated on the third Business Day preceding such redemption date.

**Comparable Treasury Issue** means the U.S. Treasury security (not inflation-indexed) selected by an Independent Investment Banker as having a maturity comparable to the remaining term of the Fixed Rate Notes to be redeemed that would be utilized, at the time of selection and in accordance with customary financial practice, in pricing new issues of corporate debt securities of comparable maturity to the remaining term of such Fixed Rate Notes.

**Comparable Treasury Price** means, with respect to a redemption date, (i) the average of five Reference Treasury Dealer Quotations for such redemption date, after excluding the highest and lowest Reference Treasury Dealer Quotations, or (ii) if the Independent Investment Banker obtains fewer than five such Reference Treasury Dealer Quotations, the average of all such quotations.

**Independent Investment Banker** means Merrill Lynch, Pierce, Fenner & Smith Incorporated, Barclays Capital Inc., Deutsche Bank Securities Inc. or J.P. Morgan Securities LLC, as specified by the Issuer, or if all of these firms are unwilling or unable to serve in that capacity, an independent investment banking institution of national standing in the United States appointed by the Issuer.

**Reference Treasury Dealer** means (i) Merrill Lynch, Pierce, Fenner & Smith Incorporated, Barclays Capital Inc., Deutsche Bank Securities Inc. and J.P. Morgan Securities LLC, and their respective successors, *provided*, *however*, that if any of the foregoing shall cease to be a primary U.S. government securities dealer in the City of New York (a **Primary Treasury Dealer** ), the Issuer will substitute therefor another Primary Treasury Dealer and (ii) any three other Primary Treasury Dealers selected by the Issuer after consultation with an Independent Investment Banker.

**Reference Treasury Dealer Quotations** means, with respect to each Reference Treasury Dealer and any redemption date, the average, as determined by the Independent Investment Banker, of the bid and asked prices for the Comparable Treasury Issue (expressed in each case as a percentage of its principal amount) quoted in writing to the Independent Investment Banker at 5:00 p.m., New York City time, on the third Business Day preceding such redemption date.

Unless the Issuer (and/or the Guarantors) defaults on payment of the redemption price, from and after the redemption date interest will cease to accrue on the Notes or portions thereof called for redemption. On the redemption date, the Issuer will deposit with the Trustee or with one or more paying agents (or, if the Issuer is acting as its own paying agent, set aside, segregate and hold in trust as provided in the Indenture) money

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sufficient to pay the redemption price of and accrued interest on the Notes to be redeemed on such date. If fewer than all of the Notes of any series are to be redeemed, the Trustee will select, not more than 60 days prior to the redemption date, the particular Notes of such series or portions thereof for redemption from the outstanding Notes of that series not previously called for redemption, on a pro rata basis across such series, or by such method as the Trustee deems fair and appropriate.

**Optional Tax Redemption**

A series of Notes may be redeemed at any time, at the Issuer s or the Parent Guarantor s option, as a whole, but not in part, upon not less than 30 nor more than 60 days prior notice, at a redemption price equal to 100% of the principal amount of the Notes of such series then outstanding plus accrued and unpaid interest on the principal amount being redeemed (and all Additional Amounts (see Description of Debt Securities and Guarantees in the accompanying Prospectus), if any) to (but excluding) the redemption date, if (i) as a result of any change in, or amendment to, the laws, treaties, regulations or rulings of a jurisdiction in which the Issuer or any Guarantor is incorporated, organized, or otherwise tax resident or any political subdivision or any authority thereof or therein having power to tax, or in the interpretation, application or administration of any such laws, treaties, regulations or rulings (including a holding, judgment or order by a court of competent jurisdiction) which becomes effective on or after (any such change or amendment, a **Change in Tax Law** ), the Issuer (or if a payment were then due under a Guarantee, the relevant Guarantor) would be required to pay Additional Amounts, with respect to the Notes of such series and (ii) such obligation cannot be avoided by the Issuer (or the relevant Guarantor) taking reasonable measures available to it. Additional Amounts are payable by the Issuer under the circumstances described under Description of Debt Securities and Guarantees Additional Amounts in the accompanying Prospectus; *provided, however*, that the Notes of such series may not be redeemed to the extent such Additional Amounts arise solely as a result of the Issuer assigning its obligations under the Notes of such series to a Substitute Issuer, unless this assignment to a Substitute Issuer is undertaken as part of a plan of merger by Parent Guarantor.

Prior to the mailing of any notice of redemption pursuant to the foregoing, the Issuer or the relevant Guarantor will deliver to the Trustee an opinion of independent tax counsel of recognized standing to the effect that the Issuer or the relevant Guarantor is or would be obligated to pay such Additional Amounts as a result of a Change in Tax Law.

No notice of redemption may be given earlier than 90 days prior to the earliest date on which the Issuer or the relevant Guarantor would be obligated to pay Additional Amounts if a payment in respect of the Notes were then due.

The foregoing provisions shall apply *mutatis mutandis* to any successor person, after such successor person becomes a party to the Indenture.

**Events of Default**

The occurrence and continuance of one or more of the following events will constitute an Event of Default under the Indenture and under the Notes:

(a) *payment default* (i) the Issuer or a Guarantor fails to pay interest within 30 days from the relevant due date, or (ii) the Issuer or a Guarantor fails to pay the principal (or premium, if any) due on the Notes at maturity; *provided* that to the extent any such failure to pay principal or premium is caused by a technical or administrative error, delay in processing payments or events beyond the control of the Issuer or Guarantors, no Event of Default shall occur for three days following such failure to pay; *provided further* that, in the case of a redemption payment, no Event of Default shall occur for 30 days following a failure to make such payment;

(b) *breach of other material obligations* the Issuer or a Guarantor defaults in the performance or observance of any of its other material obligations under or in respect of the Notes or the Indenture and such default remains unremedied for 90 days after a written notice has been given to the Issuer and the Parent Guarantor by the Trustee or to the Issuer, the Parent Guarantor and the Trustee by the Holders of at least 25% in principal amount of the outstanding Notes of the applicable series affected thereby, specifying such default or breach and requiring it to be remedied and stating that such notice is a **Notice of Default** under the Notes;

(c) *cross-acceleration* any obligation for the payment or repayment of borrowed money having an aggregate outstanding principal amount of at least 100,000,000 (or its equivalent in any other currency) of the Issuer or a Guarantor becomes due and payable prior to its stated maturity by reason of a default and is not paid within 30 days;

(d) *bankruptcy or insolvency* a court of competent jurisdiction commences bankruptcy or other insolvency proceedings against the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary under the applicable laws of their respective jurisdictions of incorporation, or the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary applies for or institutes such proceedings or offers or makes an assignment for the benefit of its creditors generally, or a third party institutes bankruptcy or insolvency proceedings against the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary and such proceedings are not discharged or stayed within 90 days;

(e) *impossibility due to government action* any governmental order, decree or enactment shall be made in or by Belgium or the jurisdiction of incorporation of a Guarantor that is a Significant Subsidiary whereby the Issuer, the Parent Guarantor, or such Guarantor that is a Significant Subsidiary is prevented from observing and performing in full its obligations as set forth in the terms and conditions of the Notes and the Guarantees, respectively, and this situation is not cured within 90 days; or

(f) *invalidity of the Guarantees* the Guarantees provided by the Parent Guarantor or a Guarantor that is a Significant Subsidiary cease to be valid and legally binding for any reason whatsoever or the Parent Guarantor or a Guarantor that is a Significant Subsidiary seeks to deny or disaffirm its obligations under the Guarantee.

If an Event of Default occurs and is continuing with respect to the Notes, then, unless the principal of all of the Notes shall already have become due and payable (in which case no action is required for the acceleration of the Notes), the Holders of not less than 25% in aggregate principal amount of Notes then outstanding, by written notice to the Issuer, the Parent Guarantor and the Trustee as provided in the Indenture, may declare the entire principal of all the Notes of such series, and the interest accrued thereon, to be due and payable immediately, *provided*, *however*, that if an Event of Default specified in paragraph (d) above with respect to the Notes at the time outstanding occurs, the principal amount of that series shall automatically, and without any declaration or other action on the part of the Trustee or any Holder, become immediately due and payable. Under certain circumstances, the Holders of a majority in aggregate principal amount of the Notes then outstanding may, by written notice to the Issuer and the Trustee as provided in the Indenture, waive all defaults and rescind and annul such declaration and its consequences, but no such waiver or rescission and annulment shall extend to or shall affect any subsequent default or shall impair any right consequent thereon.

Except in cases of default, where the Trustee has some special duties, the Trustee is not required to take any action under the indenture at the request of any Holders unless the Holders offer the Trustee reasonable protection from costs, expenses and liability. This protection is called an indemnity. If reasonable indemnity is provided, the Holders of a majority in principal amount of the outstanding Notes may direct the time, method and place of conducting any proceeding seeking any remedy available to the Trustee. These majority Holders may also direct the Trustee in performing any other action under the Indenture, so long as such direction would not involve the Trustee in personal liability.

Before you bypass the Trustee and bring your own lawsuit or other formal legal action or take other steps to enforce your rights or protect your interests relating to the debt securities, the following must occur:

The Trustee must be given written notice that an event of default has occurred and remains uncured.

The Holders of not less than 25% in principal amount of all outstanding Notes of the relevant series must make a written request that the Trustee institute proceedings because of the default, and must offer indemnity and/or security satisfactory to the Trustee against the costs, expenses and liabilities of taking such request.

The Trustee must have not taken action for 60 days after receipt of the above notice, request and offer of indemnity.

No direction inconsistent with such written request has been given to the Trustee during such 60-day period by the holders of the majority in principal amount of the outstanding Notes of that series.

However, you are entitled at any time to bring a lawsuit for the payment of money due on your security on or after its due date.
We will furnish to the Trustee every year a written statement of certain of our officers and directors, certifying that, to their knowledge, we are in compliance with the Indenture and the Notes, or else specifying any default.

***Street name and other indirect holders should consult their banks or brokers for information on how to give notice or direction to or make a request of the Trustee and to make or cancel a declaration of acceleration.***

**Modifications and Amendment**

The Issuer, the Guarantors and the Trustee may execute agreements adding any provisions to or changing in any manner or eliminating any of the provisions of the Indenture or of any supplemental agreement or modifying in any manner the rights of the Holders under the Notes or the Guarantees only with the consent of the Holders of not less than a majority in aggregate principal amount of the notes then outstanding (irrespective of series) that would be affected by the proposed modification or amendment; *provided* that no such agreement shall (a) change the maturity of the principal of, or any installment of interest on, any Note, or reduce the principal amount or the interest thereof, or extend the time of payment of any installment of interest thereon, or change the currency of payment of principal of, or interest on, any Note, or change the Issuer s or a Guarantor s obligation to pay Additional Amounts, impair or affect the right of any Holder to institute suit for the enforcement of any such payment on or after the due date thereof (or in the case of redemption on or after the redemption date) or change in any manner adverse to the interests of the Holders the terms and provisions of the Guarantees in respect of the due and punctual payment of principal amount of the Notes then outstanding plus accrued and unpaid interest (and all Additional Amounts, if any) without the consent of the Holder of each Note so affected; or (b) reduce the aforesaid percentage of notes, the consent of the Holders of which is required for any such agreement, without the consent of all of the Holders of the affected series of the notes then outstanding. To the extent that any changes directly affect fewer than all the series of the notes issued under the Indenture, only the consent of the Holders of notes of the relevant series (in the respective percentages set forth above) will be required.

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The Issuer, the Guarantors and the Trustee may, without the consent of the Holders, from time to time execute agreements or amendments or enter into an indenture or indentures supplemental thereto (including in respect of one series of notes only) for one or more of the following purposes:

to convey, transfer, assign, mortgage or pledge any property or assets to the Trustee or another person as security for the Notes;

to evidence the succession of another person to the Issuer or any Guarantors, or successive successions, and the assumption by the successor person of the covenants of the Issuer or any of the Guarantors, pursuant to the Indenture and the Notes;

to evidence and provide for the acceptance of appointment of a successor or successors to the Trustee in any of its capacities and to add to or change any of the provisions of the Indenture to facilitate the administration of the trusts created thereunder by more than one trustee;

to add to the covenants of the Issuer or the Guarantors, for the benefit of the Holders of the Notes issued under the Indenture, or to surrender any rights or powers conferred on the Issuer or the Guarantors in the Indenture;

to add any additional events of default for the benefit of the Holders of the Notes;

to add to, change or eliminate any of the provisions of the Indenture in respect of the Notes, provided that any such addition, change or elimination (A) shall neither (i) apply to any Note created prior to the execution of such supplemental indenture and entitled to the benefit of such provision nor (ii) modify the rights of the Holder of any such Note with respect to such provision or (B) shall become effective only when there is no such Note outstanding;

to modify the restrictions on and procedures for, resale and other transfers of the Notes pursuant to law, regulation or practice relating to the resale or transfer of restricted securities generally;

to provide for the issues of securities in exchange for one or more series of outstanding debt securities;

to provide for the issuance and terms of any particular series of securities, the rights and obligations of the Guarantors and the holders of the securities of such series, the form or forms of the securities of such series and such other matters in connection therewith as the Issuer and the Guarantors shall consider appropriate, including, without limitation, provisions for (a) additional or different covenants, restrictions or conditions applicable to such series, (b) additional or different events of default in respect of such series, (c) a longer or shorter period of grace and/or notice in respect of any provision applicable to such series than is otherwise provided, (d) immediate enforcement of any event of default in respect of such series or (e) limitations upon the remedies available in respect of any events of default in respect of such series or upon the rights of the holders of securities of such series to waive any such event of default;

(a) to cure any ambiguity or to correct or supplement any provision contained in the Indenture, the Notes or the Guarantees, or in any supplemental agreement, which may be defective or inconsistent with any other provision contained therein or in any supplemental agreement, (b) to eliminate any conflict between the terms thereof and the Trust Indenture Act or (c) to make such other provision in regard to matters or questions arising under the Indenture or under any supplemental agreement as the Issuer may deem necessary or desirable and which will not adversely affect the interests of the Holders to which such provision relates in any material respect;

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- to reopen the Notes and create and issue additional Notes having identical terms and conditions as the Notes (or in all respects except for the issue date, issue price, first interest accrual date and first interest payment date) so that the additional notes are consolidated and form a single series with the outstanding Notes;

- to add any Subsidiary of the Parent Guarantor as a Guarantor with respect to any series of notes, subject to applicable regulatory or contractual limitations relating to such subsidiary s Guarantee;

- to provide for the release and termination of any Subsidiary Guarantor s Guarantee in the circumstances described under Description of the Debt Securities and Guarantees Guarantees in the Prospectus;

- to provide for any amendment, modification or alteration of any Subsidiary Guarantor s Guarantee and the limitations applicable thereto in the circumstances described under Description of the Debt Securities and Guarantees Guarantees in the Prospectus; or

- to make any other change that does not materially adversely affect the interests of the holders of the notes affected thereby.

***Street name and other indirect holders should consult their banks or brokers for information on how approval may be granted or denied if we seek to change the indenture or the debt securities or request a waiver.***

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## UNDERWRITING

Each underwriter named below has severally agreed, subject to the terms and conditions of the pricing agreement with us, dated the date of this prospectus supplement (the **Pricing Agreement** ), to purchase the principal amount of Notes set forth below opposite its name below.

| | Principal Amount of Notes | | | |
|---|---|---|---|---|
| **Underwriter** | **Fixed Rate Notes** | **Fixed Rate Notes** | **Fixed Rate Notes** | **Fixed Rate Notes** |
| Merrill Lynch, Pierce, Fenner & Smith Incorporated | $ | $ | $ | $ |
| Barclays Capital Inc. | $ | $ | $ | $ |
| Deutsche Bank Securities Inc. | $ | $ | $ | $ |
| J.P. Morgan Securities LLC | $ | $ | $ | $ |
| BNP Paribas Securities Corp. | $ | $ | $ | $ |
| Mitsubishi UFJ Securities (USA), Inc. | $ | $ | $ | $ |
| Mizuho Securities USA Inc. | $ | $ | $ | $ |
| RBS Securities Inc. | $ | $ | $ | $ |
| SG Americas Securities, LLC | $ | $ | $ | $ |
| **Total** | $ | $ | $ | $ |

The underwriters have agreed to purchase all of the Notes being sold pursuant to the Pricing Agreement if any of such Notes are purchased, subject to certain conditions. If an underwriter defaults, the Pricing Agreement provides that the underwriting commitments of the non-defaulting underwriters, depending on conditions specified in the Pricing Agreement, may be increased or the Pricing Agreement may be terminated.

The Notes are a new issue of securities with no established trading market. Application will be made to list the Notes on the New York Stock Exchange, although no assurance can be given that the Notes will be listed on the New York Stock Exchange, and if so listed, the listing does not assure that a trading market for the Notes will develop. We have been advised by the underwriters that the underwriters intend to make a market in the Notes but are not obligated to do so and may discontinue market making at any time without notice. No assurance can be given as to the liquidity of, or trading markets for, the Notes.

The Issuer and the Parent Guarantor have agreed to indemnify the several underwriters against certain liabilities, including liabilities under the Securities Act.

The underwriters propose to offer the Notes initially at the offering prices on the cover page of this prospectus supplement. The underwriters may sell Notes to securities dealers at a discount from the initial public offering price of up to: (i) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; (ii) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; (iii) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; and (iv) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes. These securities dealers may resell any Notes purchased from the underwriters to other brokers or dealers at a discount from the initial public offering price of up to: (i) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; (ii) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; (iii) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes; and (iv) in the case of the Fixed Rate Notes, % of the principal amount of the Fixed Rate Notes. The offering of the Notes by the underwriters is subject to receipt and acceptance and subject to each underwriter s right to withdraw, cancel, modify offers to investors and to reject any order in whole or in part. If the underwriters cannot sell all the Notes at the initial offering prices, they may change the offering prices and the other selling terms.

In order to facilitate the offering of the Notes, the underwriters may engage in transactions that stabilize, maintain or support the price of such Notes, as the case may be, for a limited period after the issue date.

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Specifically, the underwriters may over-allot in connection with the offering, creating a short position in the Notes for their own account. In addition, to cover over-allotments or to stabilize the price of the Notes, the underwriters may bid for, and purchase, Notes in the open market. Any of these activities may stabilize or maintain the market price of the Notes above independent market levels. The underwriters are not required to engage in these activities, and may end any of these activities at any time.

The underwriters and their respective affiliates have, from time to time, performed, and may in the future perform various financial advisory, commercial banking and investment banking services for us, for which they received or will receive customary fees and expenses. These transactions and services are carried out in the ordinary course of business.

In addition, in the ordinary course of their business activities, the underwriters and their affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of ours or our affiliates. If any of the underwriters or their affiliates have a lending relationship with us, certain of those underwriters or their affiliates routinely hedge, and certain other of those underwriters may hedge, their credit exposure to us consistent with their customary risk management policies. Typically, these underwriters and their affiliates would hedge such exposure by entering into transactions which consist of either the purchase of credit default swaps or the creation of short positions in our securities, including potentially the Notes offered hereby. Any such credit default swaps or short positions could adversely affect future trading prices of the Notes offered hereby. The underwriters and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

**Selling Restrictions**

***European Economic Area:***

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a **Relevant Member State** ), each of the underwriters has represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the **Relevant Implementation Date** ) it has not made and will not make an offer of the Notes to the public in that Relevant Member State prior to the publication of a prospectus in relation to the Notes which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive, except that it may, with effect from and including the Relevant Implementation Date, make an offer of the Notes to the public in that Relevant Member State at any time:

- to any legal entity which is a qualified investor as defined in the Prospectus Directive;

- to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 Prospectus Directive Amending Directive, 150, natural or legal persons (other than qualified investors as defined in the Prospectus Directive), subject to obtaining the prior consent of the underwriters for any such offer; or

- in any other circumstances which do not require the publication of a prospectus pursuant to Article 3(2) of the Prospectus Directive,

provided that no such offer of the Notes referred to above shall require the Issuer or the Guarantors or any underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive.

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For the purposes of this provision, the expression an **offer of the Notes to the public** in relation to any Notes in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Notes to be offered so as to enable an investor to decide to purchase or subscribe for the Notes, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression **Prospectus Directive** means Directive 2003/71/EC (and amendments thereto, including the 2010 Prospectus Directive Amending Directive, to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in the Relevant Member State. The expression **2010 Prospectus Directive Amending Directive** means Directive 2010/73/EU.

***United Kingdom:***

Each of the underwriters has represented and agreed that, it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000 (the **FSMA** )) received by it in connection with the issue or sale of any Notes in circumstances in which section 21(1) of the FSMA does not apply to the Issuer or the Guarantors and that it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Notes in, from or otherwise involving the United Kingdom.

***France:***

Each of the underwriters and the Issuer has represented and agreed that:

it has only made and will only make an offer of the Notes to the public in France in the period beginning (1) when a prospectus in relation to the Notes has been approved by the *Autorité des marchés financiers* ( **AMF** ) on the date of such publication, or (2) when a prospectus has been approved by the competent authority of another Member State of the European Economic Area which has implemented the EU Prospectus Directive 2003/71/EC, on the date of notification of such approval to the AMF, all in accordance with articles L.411-1, L.412-1 and L.621-8 to L.621-8-3 of the French *Code monétaire et financier* and the *Règlement général* of the AMF, and ending at the latest on the date which is 12 months after the date of such publication; or

it has only made and will only make an offer of the Notes to the public in France and/or it has only required and will only require the admission to trading on Euronext Paris S.A. in circumstances which do not require the publication by the Issuer or the Guarantors of a prospectus pursuant to articles L.411-2 and L.412-1 of the French *Code monétaire et financier*; and

otherwise, it has not offered or sold and will not offer or sell, directly or indirectly, the Notes to the public in France, and has not distributed or caused to be distributed and will not distribute or cause to be distributed to the public in France, the Prospectus, any prospectus supplement or any other offering material relating to the Notes (which has not been submitted to the *Autorité des marchés financier*), and that such offers, sales and distributions have been and shall only be made in France only to (1) providers of investment services relating to portfolio management for the account of third parties *(personnes fournissant le service d investissement de gestion de portefeuille pour le compte de tiers*), and/or (2) qualified investors (*investisseurs qualifiés*) other than individuals, all as defined in, and in accordance with, articles L.411-1, L.411-2, D.411-1 to D.411-3, D.754-1 and D.764-1 of the French *Code monétaire et financier*.

***Hong Kong:***

Each underwriter has represented and agreed that (i) it has not offered or sold and will not offer or sell in Hong Kong, by means of any document, any Notes (except for Notes which are a structured product as defined in the Securities and Futures Ordinance (Cap. 571) of Hong Kong) other than (a) to professional investors as defined in the Securities and Futures Ordinance and any rules made under that Ordinance; or (b) in other circumstances which do not result in the document being a prospectus as defined in the Companies Ordinance (Cap. 32) of Hong Kong or which do not constitute an offer to the public within the meaning of that Ordinance, and (ii) it has not issued or had in its possession for the purposes of issue, and will not issue or have in its possession for the purposes of issue, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the Notes, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to Notes which are or are intended to be disposed of only to persons outside Hong Kong or only to professional investors as defined in the Securities and Futures Ordinance and any rules made under that Ordinance.

***Japan:***

The Notes have not been and will not be registered under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the **FIEA** ) and each underwriter has represented and agreed that it has not offered or sold and will not offer or sell any Notes, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (as defined under Item 5, Paragraph 1, Article 6 of the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949, as amended)), or to others for re-offering or resale, directly or indirectly, in Japan or to, or for the benefit of, a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the FIEA and any other applicable laws, regulations and ministerial guidelines of Japan.

***Singapore:***

This prospectus supplement and the accompanying Prospectus have not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus supplement, the accompanying Prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Notes may not be circulated or distributed, nor may the Notes be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act (the **SFA** ), (ii) to a relevant person pursuant to Section 275(1), or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the Notes are subscribed or purchased under Section 275 of the SFA by a relevant person which is: (a) a corporation (which is not an accredited investor (as defined in Section 4A of the SFA)) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor, securities (as defined in Section 239(1) of the SFA) of that corporation or the beneficiaries rights and interest (howsoever described) in that trust shall not be transferred within 6 months after that corporation or that trust has acquired the Notes pursuant to an offer made under Section 275 of the SFA except: (1) to an institutional investor or to a relevant person defined in Section 275(2) of the SFA, or (in the case of a corporation) where the transfer arises from an offer referred to in Section 276(3)(i)(B) of the SFA or (in the case of a trust) where the transfer arises from an offer referred to in Section 276(4)(i)(B) of the SFA; (2) where no consideration is or will be given for the transfer; (3) where the transfer is by operation of law; or (4) as specified in Section 276(7) of the SFA.

***Brazil:***

The Notes may not be offered or sold to the public in Brazil. Accordingly, this prospectus supplement and the accompanying Prospectus have not been nor will they be registered with the Brazilian Securities Commission (*Comissão de Valores Mobiliários*) nor have they been submitted to the foregoing agency for approval. Each underwriter has represented and agreed that it has not offered or sold and will not offer or sell the notes publicly (as defined for purposes of the securities laws of Brazil) in Brazil, as the offering of the Notes pursuant to this prospectus supplement and Prospectus is not a public offering of securities in Brazil. Documents relating to the offer, as well as the information contained therein, may not be used in connection with any offer for subscription or sale of the Notes to the public in Brazil.

***Other jurisdictions outside the United States:***

Each underwriter has represented and agreed that with respect to any other jurisdiction outside the United States, it has not offered or sold and will not offer or sell any of the Notes in any jurisdiction, except under circumstances that resulted or will result in compliance with the applicable rules and regulations of such jurisdiction.

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## TAXATION

**Supplemental Discussion of United States Taxation**

*See Tax Considerations United States Taxation in the Prospectus dated 21 September 2010 for a description of material United States federal income tax consequences of owning the Notes.*

You should consult your own tax advisor concerning the United States federal income tax consequences to you of acquiring, owning, and disposing of the Notes, as well as any tax consequences arising under the laws of any state, local, foreign, or other tax jurisdiction and the possible effects of changes in United States federal or other tax laws.

**Belgian Taxation**

*The following is a general description of the principal Belgian tax consequences for investors receiving interest in respect of, or disposing of, the Notes and is of a general nature based on the issuers understanding of current law and practice.*

*This general description is based upon the law as in effect on the date of this Prospectus Supplement and is subject to change potentially with retroactive effect. Investors should appreciate that, as a result of changing law or practice, the tax consequences may be otherwise than as stated below. Investors should consult their professional advisers on the possible tax consequences of subscribing for, purchasing, holding or selling the Notes under the laws of their countries of citizenship, residence, ordinary residence or domicile.*

***Withholding Tax and Income Tax***

*Tax rules applicable to individuals resident in Belgium*

Individuals who are Belgian residents for tax purposes, i.e. who are subject to the Belgian personal income tax (*Personenbelasting/Impôt des personnes physiques*) and who hold the Notes as a private investment, are in Belgium subject to the following tax treatment with respect to the Notes.

Other tax rules apply to Belgian resident individuals who do not hold the Notes as a private investment.

In accordance with Belgian tax law, the following amounts are qualified and taxable as interest : (i) periodic interest income, (ii) amounts paid by the Issuer in excess of the issue price (whether or not on the maturity date), and (iii) in case of a realization of the Notes between two interest payment dates, the pro rata of accrued interest corresponding to the detention period.

Interest payments on the Notes received by Belgian resident individuals will be subject to a 21 per cent. Belgian withholding tax if such interest is collected through a financial intermediary established in Belgium. For Belgian resident individuals, an additional levy of 4% may apply to the interest on the Notes.

For Belgian resident individuals holding the Notes as a private investment and who opt to submit the interest on the Notes, in addition to the withholding tax of 21%, to an additional levy of 4% withheld at source, the taxes withheld fully discharges them from their personal income tax liability with respect to these interest payments. This means that they do not have to declare the interest obtained on the Notes in their personal income tax return.

For Belgian resident individuals holding the Notes as a private investment and who do not opt to submit the interest on the Notes, in addition to the withholding tax of 21%, to an additional levy of 4% withheld at source, the taxes withheld do not fully discharge them from their personal income tax liability with respect to these interest payments. In such case, the interest amount on the Notes will be communicated to a special contact centre operated by the competent service of the Belgian tax administration who may exchange certain information to the Belgian tax authorities, and the individual will need to declare the interest amount in its personal income tax return. The interest amount so declared will normally be taxed at the interest withholding tax rate of 21% or at the progressive personal income tax rates plus local surcharges taking into account the taxpayer s other declared income (whichever is lower).

If the gross amount of all interest and dividend income declared and/or communicated to the contact centre or otherwise known by the contact centre, exceeds EUR 20,020 on a yearly basis (threshold applicable for assessment year 2013, income year 2012), the interest declared on the Notes exceeding this threshold will be subject to an additional levy of 4% in the personal income tax declaration. Certain specific categories of interest and dividends are exempt and not taken into consideration in order to calculate whether the threshold is exceeded. Some other categories of interest and dividends are exempt, but are taken into consideration in order to calculate whether the threshold is exceeded.

With respect to the interest payments that are being declared in the personal income tax of the taxpayer (either voluntarily or mandatory), the retained withholding tax at 21 per cent, increased with the additional levy of 4 per cent if applicable, is credited against any personal income tax due based upon the tax return and is reimbursed for any remaining part that exceeds the total personal income tax due.

If the payment is not made through a Belgian intermediary and withholding tax is not withheld, the investors who are Belgian residents for tax purposes and who are holding the Securities as a private investment must report the interest income in their annual tax return and pay tax thereon at the rate of 21 per cent, possibly increased with the additional levy of 4%.

Capital gains realized on the sale of the Notes are in principle tax exempt, unless the capital gains are realized outside the scope of the normal management of one s private estate or unless the capital gains qualify as interest (as defined above). Capital losses are in principle not tax deductible.

*Belgian resident companies*

Corporations Noteholders who are Belgian residents for tax purposes, i.e. who are subject to Belgian Corporate Income Tax (*Vennootschapsbelasting/Impôt des sociétés*) are in Belgium subject to the following tax treatment with respect to the Notes.

Interest derived by Belgian corporate investors on the Notes and capital gains realized on the Notes will be subject to Belgian corporate income tax. The current normal corporate income tax rate in Belgium is 33.99 per cent. Capital losses are in principle tax deductible.

Interest payments on the Notes made through a paying agent in Belgium can under certain circumstances be exempt from withholding tax, provided a special certificate is delivered. The Belgian withholding tax that has been levied is creditable in accordance with the applicable legal provisions.

*Other Belgian legal entities*

Other legal entities Noteholders who are Belgian residents for tax purposes, i.e. who are subject to Belgian tax on legal entities (*Rechtspersonenbelasting/impôt des personnes morales*) are in Belgium subject to the following tax treatment with respect to the Notes.

Payments of interest (as defined above in the section Tax rules applicable to individuals resident in Belgium ) on the Notes made through a paying agent in Belgium will in principle be subject to a 21 per cent. withholding tax in Belgium and no further tax on legal entities will be due on the interest.

However, if the interest is paid outside Belgium without the intervention of a Belgian paying agent and without the deduction of Belgian withholding tax, the legal entity itself is responsible for the declaration and payment of the 21 per cent. withholding tax.

Capital gains realized on the sale of the Notes are in principle tax exempt, unless the capital gain qualifies as interest (as defined above in the section Tax rules applicable to individuals resident in Belgium ). Capital losses are in principle not tax deductible.

*Organizations for Financing Pensions*

Belgian pension fund entities that have the form of an OFP are subject to Belgian Corporate Income Tax (*Vennootschapsbelasting/Impôt des sociétés*). OFPs are in Belgium subject to the following tax treatment with respect to the Notes.

Interest derived by OFP Noteholders on the Notes and capital gains realized on the Notes will be exempt from Belgian Corporate Income Tax.

Any Belgian withholding tax that has been levied is creditable in accordance with the applicable legal provisions.

*Belgian non-residents*

The interest income on the Notes paid through a professional intermediary in Belgium will, in principle, be subject to a 21 per cent. withholding tax, unless the Noteholder is resident in a country with which Belgium has concluded a double taxation agreement and delivers the requested affidavit. If the income is not collected through a financial institution or other intermediary established in Belgium, no Belgian withholding tax is due.

Non-resident investors that do not hold the Notes through a Belgian establishment can also obtain an exemption of Belgian withholding tax on interest from the Notes paid through a Belgian credit institution, a Belgian stock market company or a Belgian-recognized clearing or settlement institution, provided that they deliver an affidavit from such institution or company confirming (i) that the investors are non-residents, (ii) that the Notes are held in full ownership or in usufruct and (iii) that the Notes are not held for professional purposes in Belgium.

The non-residents who use the Notes to exercise a professional activity in Belgium through a permanent establishment are subject to the same tax rules as the Belgian resident companies (see above). Non-resident Noteholders who do not allocate the Notes to a professional activity in Belgium and who do not hold the Notes through a Belgian establishment are not subject to Belgian income tax, save, as the case may be, in the form of withholding tax.

***Tax on stock exchange transactions***

A stock exchange tax (*Taxe sur les opérations de bourse/Taks op de beursverrichtingen*) will be levied on the purchase and sale in Belgium of the Notes on a secondary market through a professional intermediary. The rate applicable for secondary sales and purchases in Belgium through a professional intermediary is 0.09 per cent. with a maximum amount of 650 per transaction and per party. The tax is due separately from each party to any such transaction, i.e. the seller (transferor) and the purchaser (transferee), both collected by the professional intermediary.

However, the tax referred to above will not be payable by exempt persons acting for their own account, including investors who are Belgian non-residents provided they deliver an affidavit to the financial intermediary in Belgium confirming their non-resident status and certain Belgian institutional investors, as defined in Article 126/1, 2° of the Code of various duties and taxes (*Code des droits et taxes divers/Wetboek diverse rechten en taksen*).

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***European Directive on taxation of savings income in the form of interest payments***

The Savings Directive has been implemented in Belgium by the law of 17 May 2004. The Savings Directive entered into force on 1 July 2005.

*Individuals not resident in Belgium*

Interest paid or collected through Belgium on the Notes and falling under the scope of application of the Savings Directive will be subject to the Disclosure of Information Method (as defined in the section EU Savings Directive 2003/48/EC below).

*Individuals resident in Belgium*

An individual resident in Belgium will be subject to the provisions of the Savings Directive, if he receives interest payments from a paying agent (within the meaning of the Savings Directive) established in another EU Member State, Switzerland, Liechtenstein, Andorra, Monaco, San Marino, Bonaire, Curacao, Saba, Sint Eustatius, Sint Maarten (formerly the Netherlands Antilles), Aruba, Guernsey, Jersey, the Isle of Man, Montserrat, the British Virgin Islands, Anguilla, the Cayman Islands or the Turks and Caicos Islands.

If the interest received by an individual resident in Belgium has been subject to a Source Tax (as defined in the section EU Savings Directive below), such Source Tax does not liberate the Belgian individual from declaring the interest income in the personal income tax declaration. The Source Tax will be credited against the personal income tax. If the Source Tax withheld exceeds the personal income tax due, the excessive amount will be reimbursed, provided it reaches a minimum of 2.5.

**Luxembourg Taxation**

*The following is a general description of certain tax laws relating to the Notes as in effect and as applied by the relevant tax authorities as at the date hereof and does not purport to be a comprehensive discussion of the tax treatment of the Notes.*

*Prospective investors should consult their own professional advisers on the implications of making an investment in, holding or disposing of Notes and the receipt of interest with respect to such Notes under the laws of the countries in which they may be liable to taxation. Please be aware that the residence concept used under the respective headings below applies for Luxembourg income tax assessment purposes only. Any reference in the present section to a tax, duty, levy, impost or other charge or withholding of a similar nature refers to Luxembourg tax law and/or concepts only. Also, please note that a reference to Luxembourg income tax encompasses corporate income tax (impôt sur le revenu des collectivités), municipal business tax (impôt commercial communal), a solidarity surcharge (contribution au fonds pour l emploi) as well as personal income tax (impôt sur le revenu) generally. Investors may further be subject to net wealth tax (impôt sur la fortune) as well as other duties, levies or taxes. Corporate income tax, municipal business tax as well as the solidarity surcharge invariably apply to most corporate taxpayers resident of Luxembourg for tax purposes. Individual taxpayers are generally subject to personal income tax and the solidarity surcharge. Under certain circumstances, where an individual taxpayer acts in the course of the management of a professional or business undertaking, municipal business tax may apply as well.*

***Luxembourg tax residency of the Noteholders***

A Noteholder will not become resident, or be deemed to be resident, in Luxembourg by reason only of the holding of the Notes, or the execution, performance, delivery and/or enforcement of the Notes.

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***Withholding tax***

Under Luxembourg tax law currently in effect and with the possible exception of interest paid to certain individual Noteholders and to certain entities, there is no Luxembourg withholding tax on payments of interest (including accrued but unpaid interest). There is also no Luxembourg withholding tax, with the possible exception of payments made to certain individual Noteholders and to certain entities, upon repayment of principal in case of reimbursement, redemption, repurchase or exchange of the Notes.

*Taxation of Luxembourg non-residents*

Under the Luxembourg laws dated 21 June 2005 implementing the Savings Directive and several agreements concluded between Luxembourg and certain dependent or associated territories of the European Union ( **EU** ), a Luxembourg-based paying agent (within the meaning of the Savings Directive) is required to withhold tax on interest and other similar income paid by it to (or under certain circumstances, to the benefit of) an individual resident in another Member State or in certain EU dependent or associated territories, unless the beneficiary of the interest payments elects for the procedure of exchange of information or for the tax certificate procedure. The same treatment will apply to payments of interest and other similar income made to certain residual entities within the meaning of Article 4.2 of the Savings Directive, established in a Member State or in certain EU dependent or associated territories (i.e., entities which are not (i) legal persons (which include, inter alia, the Finnish and Swedish companies listed in Article 4.5 of the Savings Directive), (ii) whose profits are not taxed under the general provisions related to business taxation, or (iii) UCITS recognized in accordance with Council Directive 85/611/EEC or similar collective investment funds located in Jersey, Guernsey, the Isle of Man, the Turks and Caicos Islands, the Cayman Islands, Montserrat or the British Virgin Islands and have not opted to be treated as UCITS recognized in accordance with Council Directive 85/611/EEC).

The withholding tax rate is 35 per cent. as from 1 July 2011. Responsibility for the withholding of the tax will be assumed by the Luxembourg paying agent. The withholding tax system will only apply during a transitional period, the ending of which depends on the conclusion of certain agreements relating to information exchange with certain third countries.

*Taxation of Luxembourg residents*

Interest payments made by Luxembourg paying agents (defined in the same way as in the Savings Directive) to Luxembourg individual residents or to certain residual entities that secure interest payments on behalf of such individuals (unless such entities have opted either to be treated as UCITS recognized in accordance with the Council Directive 85/611/EC or for the exchange of information regime) are subject to a 10 per cent. withholding tax (the **10 per cent. Luxembourg Withholding Tax** ). Responsibility for the withholding of the tax will be assumed by the Luxembourg paying agent.

Interest which is accrued once a year on savings account (short and long term) and which does not exceed 250 per person and per paying agent is exempted from the withholding tax.

***Taxation of the Noteholders***

*Taxation of Luxembourg non-residents*

A non-resident holder of Notes, not having a permanent establishment or permanent representative in Luxembourg to which/whom such Notes are attributable, is not subject to Luxembourg income tax on interest accrued or received, redemption premiums or issue discounts, under the Notes. A gain realised by such non-resident holder of Notes on the sale or disposal, in any form whatsoever, of the Notes is further not subject to Luxembourg income tax.

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A non-resident corporate holder of Notes or an individual holder of Notes acting in the course of the management of a professional or business undertaking, who has a permanent establishment or permanent representative in Luxembourg to which or to whom such Notes are attributable, is subject to Luxembourg income tax on interest accrued or received, redemption premiums or issue discounts, under the Notes and on any gains realised upon the sale or disposal, in any form whatsoever, of the Notes.

*Taxation of Luxembourg residents*

Noteholders who are residents of Luxembourg will not be liable for any Luxembourg income tax on repayment of principal.

*Luxembourg resident individuals*

Pursuant to the Luxembourg law of 23 December 2005 as amended by the law of 17 July 2008, Luxembourg resident individuals, acting in the course of their private wealth, can opt to self-declare and pay a 10 per cent. tax (the **10 per cent. Tax** ) on interest payments made after 31 December 2007 by paying agents (defined in the same way as in the Savings Directive) located in an EU Member State other than Luxembourg, a Member State of the European Economic Area or in a State or territory which has concluded an international agreement with Luxembourg directly related to the Savings Directive. The 10 per cent. Luxembourg Withholding Tax or the 10 per cent. Tax represents the final tax liability on interest received for the Luxembourg resident individuals receiving the interest payment in the course of their private wealth and can be reduced in consideration of foreign withholding tax, based on double tax treaties concluded by Luxembourg. Individual Luxembourg resident Noteholders receiving the interest as business income must include this interest in their taxable basis; if applicable, the 10 per cent. Luxembourg Withholding Tax levied will be credited against their final income tax liability.

Luxembourg resident individual Noteholders are not subject to taxation on capital gains upon the disposal of the Notes, unless the disposal of the Notes precedes the acquisition of the Notes or the Notes are disposed of within six months of the date of acquisition of the Notes. Upon the sale, redemption or exchange of the Notes, accrued but unpaid interest will be subject to the 10 per cent. Luxembourg Withholding Tax or to the 10 per cent. Tax if the Luxembourg resident individuals opt for the 10 per cent. Tax. Individual Luxembourg resident Noteholders receiving the interest as business income must include the portion of the price corresponding to this interest in their taxable income; the 10 per cent. Luxembourg Withholding Tax levied will be credited against their final income tax liability.

*Luxembourg resident companies*

Luxembourg resident companies (*société de capitaux*) which are Noteholders and which are subject to corporate taxes in Luxembourg without the benefit of a special tax regime in Luxembourg or foreign entities of the same type which have a permanent establishment or a permanent representative in Luxembourg with which the holding of the Notes is connected, must include in their taxable income any interest (including accrued but unpaid interest) and in case of sale, repurchase, redemption or exchange, the difference between the sale, repurchase, redemption or exchange price (received or accrued) and the lower of the cost or book value of the Notes sold, repurchased, redeemed or exchanged.

*Luxembourg resident companies benefiting from a special tax regime*

A corporate holder of Notes that is governed by the law of 11 May 2007 on family estate management companies, or by the law of 17 December 2010 on undertakings for collective investment, or by the law of 13 February 2007 on specialised investment funds, as amended, is neither subject to Luxembourg income tax in respect of interest accrued or received, any redemption premium or issue discount, nor on gains realised on the sale or disposal, in any form whatsoever, of the Notes.

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***Net Wealth Tax***

A corporate holder of Notes, whether it is resident of Luxembourg for tax purposes or, if not, it maintains a permanent establishment or a permanent representative in Luxembourg to which/whom such Notes are attributable, is subject to Luxembourg wealth tax on such Notes, except if the holder of Notes is governed by the law of 11 May 2007 on family estate management companies, or by the law of 17 December 2010 on undertakings for collective investment, or by the law of 13 February 2007 on specialised investment funds, as amended, or is a securitisation company governed by the law of 22 March 2004 on securitisation, as amended, or is a capital company governed by the law of 15 June 2004 on venture capital vehicles, as amended.

An individual holder of Notes, whether he/she is resident of Luxembourg or not, is not subject to Luxembourg wealth tax on such Notes.

***Other Taxes***

There is no Luxembourg registration tax, stamp duty or any other similar tax or duty payable in Luxembourg by Noteholders as a consequence of the issuance of the Notes, nor will any of these taxes be payable as a consequence of a subsequent transfer, repurchase or redemption of the Notes unless the documents relating to the Notes are voluntarily registered in Luxembourg. Proceedings in a Luxembourg court or the presentation of documents relating to the Notes, other than the Notes themselves, to an *autorité constituée* may require registration of the documents, in which case the documents will be subject to registration duties depending on the nature of the documents.

There is no Luxembourg VAT payable in respect of payments in consideration for the issuance of the Notes or in respect of the payment of interest or principal under the Notes or the transfer of the Notes.

Luxembourg VAT may, however, be payable in respect of fees charged for certain services rendered to the relevant Issuer, if for Luxembourg VAT purposes such services are rendered or are deemed to be rendered in Luxembourg and an exemption from Luxembourg VAT does not apply with respect to such services.

No Luxembourg inheritance taxes are levied on the transfer of the Notes upon death of a Noteholder in cases where the deceased was not a resident of Luxembourg for inheritance tax purposes. No Luxembourg gift tax will be levied on the transfer of the Notes by way of gift unless the gift is registered in Luxembourg.

**EU Savings Directive 2003/48/EC**

*The following paragraphs are general summaries only and are not intended to constitute a complete analysis of all potential tax consequences relating to the ownership of Notes. Prospective investors should consult their own tax advisers concerning the consequences of an investment in the Notes in their particular circumstances.*

Under the Savings Directive on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a paying agent located within its jurisdiction to, or for the benefit of, an individual resident or certain entities called residual entities (as described on page S-30 of this Prospectus Supplement) established in that other Member State (hereinafter also referred to as the **Disclosure of Information Method** ). However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system (referred to as **Source Tax** ) in relation to such payments (the ending of such transitional period mentioned above being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

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If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the relevant Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Notes as a result of the imposition of such withholding tax. The Issuers are required to maintain a Paying Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Savings Directive.

Potential purchasers of Notes should note that the European Commission has announced proposals to amend the Savings Directive which may, if implemented, amend or broaden the scope of the requirement describe above. The proposed amendments would extend the scope of the Directive to (i) payments made through certain intermediate structures (whether or not established in a Member State) for the ultimate benefit of an EU resident individual, and (ii) a wider range of income similar to interest.

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## VALIDITY OF THE NOTES

The validity of the Notes and the Guarantees in connection with the offering of the Notes will be passed upon for the Issuer by Sullivan & Cromwell LLP, U.S. counsel to the Issuer and the Parent Guarantor and Anheuser-Busch Companies, LLC, and Clifford Chance LLP, Belgian counsel to the Parent Guarantor and Cobrew NV/SA and Luxembourg counsel to Brandbrew S.A. Certain legal matters will be passed upon for the Underwriters by Allen & Overy LLP, counsel to the Underwriters.

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**PROSPECTUS**

# *Anheuser-Busch InBev Worldwide Inc.*

**Guaranteed Debt Securities**

**Fully and unconditionally guaranteed by**

## *Anheuser-Busch InBev SA/NV*

## *BrandBrew S.A.*

## *Cobrew NV/SA*

## *Anheuser-Busch Companies, Inc.*

This prospectus describes some of the general terms that may apply to these securities and the general manner in which they may be offered.

We will give you the specific terms of the securities, and the manner in which they are offered, in supplements to this prospectus. You should read this prospectus and the prospectus supplements carefully before you invest. We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a delayed or continuous basis. We will indicate the names of any underwriters in the applicable prospectus supplement.

Anheuser-Busch InBev Worldwide Inc. may use this prospectus to offer from time to time guaranteed debt securities.

This prospectus may not be used to sell securities unless it is accompanied by a prospectus supplement.

We have not applied to list the debt securities on any securities exchange. However, we may apply to list any particular issue of debt securities on a securities exchange. If we choose to do so, we would disclose the listing of such debt securities in the applicable prospectus supplement. We are under no obligation to list any issued debt securities and may in fact not list any.

***Investing in our securities involves certain risks. See Risk Factors beginning on page 2.***

**Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

The date of this prospectus is 21 September 2010.

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**ABOUT THIS PROSPECTUS**

In this prospectus, references to:

- we, us and our are, as the context requires, to Anheuser-Busch InBev SA/NV or Anheuser-Busch InBev SA/NV and the group of companies owned and/or controlled by Anheuser-Busch InBev SA/NV (including Anheuser-Busch Companies, Inc., for all periods following the closing of the acquisition of Anheuser-Busch by InBev on 18 November 2008);

- Parent Guarantor are to Anheuser-Busch InBev SA/NV;

- Issuer are to Anheuser-Busch InBev Worldwide, Inc.;

- Guarantors are to the Parent Guarantor and Subsidiary Guarantors;

- Subsidiary Guarantors are to one or more of Anheuser-Busch Companies, Inc., BrandBrew S.A. and Cobrew NV/SA, which are providing additional guarantees of a particular series of debt securities, as indicated in the applicable prospectus supplement;

- AB InBev Group are to Anheuser-Busch InBev SA/NV and the group of companies owned and/or controlled by Anheuser-Busch InBev SA/NV;

- InBev or the InBev Group are to InBev SA/NV or InBev SA/NV and the group of companies owned and/or controlled by InBev SA/NV, as existing prior to the closing of the Anheuser-Busch acquisition;

- Anheuser-Busch are to Anheuser-Busch Companies, Inc. and the group of companies owned and/or controlled by Anheuser-Busch Companies, Inc., as the context requires; and

Anheuser-Busch InBev Worldwide Inc. will be the issuer in an offering of debt securities. Anheuser-Busch InBev SA/NV will be the guarantor in an offering of debt securities of Anheuser-Busch InBev Worldwide Inc., which are referred to as guaranteed debt securities. The guaranteed debt securities may also be guaranteed by one or more of Anheuser-Busch Companies, Inc., BrandBrew S.A. and Cobrew NV/SA, as indicated in the applicable prospectus supplement. We refer to the guaranteed debt securities issued by Anheuser-Busch InBev Worldwide Inc. collectively as the debt securities or as the securities.

This prospectus is part of a registration statement that we filed with the U.S. Securities and Exchange Commission (the SEC ), using a shelf registration process. Under this shelf process, the securities described by this prospectus may be sold in one or more offerings. Each time we offer securities under the registration statement, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Before you invest in any securities offered under this prospectus, you should read this prospectus and the applicable prospectus supplement together with the additional information described under the headings Incorporation of Certain Documents by Reference and Where You Can Find More Information.

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## RISK FACTORS

*Investing in the securities offered using this prospectus involves risk. We urge you to carefully review the risks described below, together with the risks described in the documents incorporated by reference into this prospectus and any risk factors included in the prospectus supplement, before you decide to buy our securities. If any of these risks actually occur, our business, financial condition and results of operations could suffer, and the trading price and liquidity of the securities offered using this prospectus could decline, in which case you may lose all or part of your investment.*

### Risks Relating to Our Business

You should read Risk Factors in our Annual Report on Form 20-F for the fiscal year ended 31 December 2009 (the Annual Report ), which is incorporated by reference in this prospectus, or similar sections in subsequent filings incorporated by reference in this prospectus, for information on risks relating to our business.

### Risks Relating to the Debt Securities

***Since the Issuer and the Parent Guarantor are holding companies that conduct operations through subsidiaries, your right to receive payments on the debt securities and the Guarantees will be subordinated to the other liabilities of the Issuer s subsidiaries and those of the Parent Guarantor who are not Subsidiary Guarantors.***

The Parent Guarantor is organized as a holding company for our operations, and the Issuer is the holding company for Anheuser-Busch. As a result, substantially all of the Issuer s and the Parent Guarantor s operations are carried on through subsidiaries. The Issuer s and the Parent Guarantor s principal sources of income are the dividends and distributions the Issuer and Parent Guarantor receive from their respective subsidiaries. Following the completion of the acquisition of Anheuser-Busch, the Parent Guarantor has guaranteed all of the outstanding capital markets debt issued or guaranteed by Anheuser-Busch, any outstanding debt under the 2008 Senior Facilities Agreement (as defined in the Annual Report), the 2010 Facilities Agreements (as defined in the Annual Report) and may guarantee certain indebtedness of certain of its subsidiaries. The Parent Guarantor had guaranteed a total of USD 44.6 billion of debt as of 30 June 2010.

The Issuer s and the Parent Guarantor s ability to meet their financial obligations is dependent upon the availability of cash flows from their domestic and foreign subsidiaries and affiliated companies through dividends, intercompany advances, management fees and other payments. The Issuer s and the Parent Guarantor s subsidiaries and affiliated companies are not required and may not be able to pay dividends to the Issuer or the Parent Guarantor. Only certain of the Parent Guarantor s subsidiaries may be guarantors of the debt securities. Unless specified in the applicable prospectus supplement for a particular series of debt securities, debt securities of that series will benefit from the guarantees of any of the Subsidiary Guarantors. Claims of the creditors of the Issuer s or the Parent Guarantor s subsidiaries who are not Subsidiary Guarantors have priority as to the assets of such subsidiaries over the claims of creditors of the Issuer or the Parent Guarantor. Consequently, holders will be structurally subordinated, on the Issuer s or the Parent Guarantor s insolvency, to the prior claims of the creditors of the Issuer s or the Parent Guarantor s subsidiaries who are not Subsidiary Guarantors.

***The Guarantees to be provided by the Parent Guarantor and any of the Subsidiary Guarantors, will be subject to certain limitations that may affect the validity or enforceability of the Guarantees.***

Enforcement of each Guarantee will be subject to certain generally available defenses. Local laws and defenses may vary, and may include those that relate to corporate benefit (*ultra vires*), fraudulent conveyance or transfer (*actio pauliana*), voidable preference, financial assistance, corporate purpose, subordination and capital maintenance or similar laws and concepts. They may also include regulations or defenses which affect the rights of creditors generally.

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If a court were to find a Guarantee given by a Guarantor, or a portion thereof, void or unenforceable as a result of such local laws or defenses, or to the extent that agreed limitations on Guarantees apply (see Description of Debt Securities and Guarantees Guarantee Limitations ), Holders would cease to have any claim in respect of that Guarantor and would be creditors solely of the Issuer and any remaining Guarantors and, if payment had already been made under the relevant Guarantee, the court could require that the recipient return the payment to the relevant Guarantor.

***Any Guarantee to be provided by BrandBrew S.A. is subject to certain limitations.***

For the purposes of any Guarantee to be provided by BrandBrew S.A. ( **BrandBrew** ), the maximum aggregate liability of BrandBrew, BrandBrew s Guarantee and as guarantor of the BrandBrew Guaranteed Facilities (as defined below) (excluding its Guarantee) shall not exceed an amount equal to the aggregate of (without double counting): (A) the aggregate amount of all moneys received by BrandBrew and its subsidiaries as a borrower or issuer under BrandBrew s Guaranteed Facilities (as defined below); (B) the aggregate amount of all outstanding intercompany loans made to BrandBrew and its Subsidiaries by other members of the AB InBev Group which have been directly or indirectly funded using the proceeds of borrowings under BrandBrew s Guaranteed Facilities; and (C) an amount equal to 100% of the greater of: (I) the sum of BrandBrew s own capital (*capitaux propres*) and its subordinated debt (*dettes subordonnées*) (other than any subordinated debt already accounted above) (both as referred to in the Law of 2002) as reflected in BrandBrew s then most recent annual accounts approved by the competent organ of BrandBrew (as audited by its *réviseur d entreprises* (external auditor), if required by law); and (II) the sum of BrandBrew s own capital (*capitaux propres*) and its subordinated debt (*dettes subordonnées*) (both as referred to in article 34 of the Law of 2002) as reflected in its filed annual accounts available as of the date of BrandBrew s Guarantee.

In addition, the obligations and liabilities of BrandBrew under its Guarantee and under any of its Guaranteed Facilities shall not include any obligation which, if incurred, would constitute a breach of the provisions on financial assistance as defined by article 49-6 of the Luxembourg Law on Commercial Companies dated 10 August 1915, as amended, to the extent such or an equivalent provision is applicable to the relevant Luxembourg Guarantor.

***Any Guarantees to be provided by the Subsidiary Guarantors (but not the Parent Guarantor) may be released in certain circumstances.***

Each of the Subsidiary Guarantors may terminate its Guarantee in the event that (i) the relevant Subsidiary Guarantor is released from its guarantee of the Issuer s 2010 Senior Facilities Agreement, or is no longer a guarantor thereunder and (ii) the aggregate amount of indebtedness for borrowed money for which the relevant Subsidiary Guarantor is an obligor (as a guarantor or borrower) does not exceed 10% of the consolidated gross assets of the Parent Guarantor as reflected in the balance sheet included in its most recent publicly released interim or annual consolidated financial statements. In addition, each Subsidiary Guarantor whose Guarantee is subject to the limitations described below under Description of Debt Securities and Guarantees Guarantee Limitations may terminate its Guarantee in the event that under the rules, regulations or interpretations of the SEC such Subsidiary Guarantor determines that it would be required to include its financial statements in any registration statement filed with the SEC with respect to any series of notes or guarantees issued under the Indenture or in periodic reports filed with or furnished to the SEC (by reason of such limitations or otherwise). For more information see Description of Debt Securities and Guarantees Guarantees.

In relation to any of our future periodic or other filings with the SEC, the rules and regulations of the SEC require that the Guarantees be full and unconditional obligations of each of the Subsidiary Guarantors; otherwise, in connection with such filing, separate financial statements of the Subsidiary Guarantors would be required to be filed as well. As discussed below under Description of Debt Securities and Guarantees Guarantee Limitations, any Guarantee that is subject to limitations may be terminated or amended or modified in order to ensure compliance with the SEC s rules and regulations and to ensure that separate financial

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statements of such Subsidiary Guarantor need not be provided. It may not be possible to amend the limitations on the Guarantees in a manner that would meet the SEC s requirements for full and unconditional guarantees and be consistent with local law requirements for guarantees. For more information see Description of Debt Securities and Guarantees Guarantees.

If the Guarantees by the Subsidiary Guarantors are released, the Issuer and the Parent Guarantor are not required to replace them, and the debt securities will have the benefit of fewer or no Subsidiary guarantees for the remaining maturity of the debt securities.

BrandBrew S.A., the Subsidiary Guarantor whose Guarantee is subject to limitations, accounted for less than 1% of the total consolidated EBITDA, as defined, of AB InBev Group for the six month period ended 30 June 2010 and approximately 5% of the total consolidated debt of AB InBev Group as of 30 June 2010.

***Since the debt securities are unsecured, your right to receive payments may be adversely affected.***

The debt securities that the Issuer is offering will be unsecured. The debt securities will not be subordinated to any of the Issuer s other debt obligations, and therefore, they will rank equally with all its other unsecured and unsubordinated indebtedness. If the Issuer defaults on the debt securities or the Guarantors default on the Guarantees, or after bankruptcy, examinership, liquidation or reorganization, then, to the extent that the Issuer or the Guarantors have granted security over their assets, the assets that secure their debts will be used to satisfy the obligations under that secured debt before the Issuer or the Guarantors can make payment on the debt securities or the Guarantees. There may only be limited assets available to make payments on the debt securities or the Guarantees in the event of an acceleration of the debt securities. If there is not enough collateral to satisfy the obligations of the secured debt, then the remaining amounts on the secured debt would share equally with all unsubordinated unsecured indebtedness.

***Your rights as a holder may be inferior to the rights of holders of debt securities issued under a different series pursuant to the indenture.***

The debt securities are governed by documents called indentures, which are described below under the heading Description of Debt Securities and Guarantees . The Issuer may issue as many distinct series of debt securities under the indentures as it wishes. The Issuer may also issue series of notes under the indentures that provide holders of those notes with rights superior to the rights already granted or that may be granted in the future to holders of another series. You should read carefully the specific terms of any particular series of debt securities we may offer contained in the prospectus supplement relating to such debt securities.

***Should the Guarantors default on their Guarantees, your right to receive payments on the Guarantees may be adversely affected by the insolvency laws of the jurisdiction of organization of the defaulting Guarantors.***

The Parent Guarantor and Subsidiary Guarantors are organized under the laws of various jurisdictions, and it is likely that any insolvency proceedings applicable to a Guarantor would be governed by the law of its jurisdiction of organization. The insolvency laws of the various jurisdictions of organization of the Guarantors may vary as to treatment of unsecured creditors and may contain prohibitions on the Guarantors ability to pay any debts existing at the time of the insolvency.

***Since the Parent Guarantor is a Belgian company, Belgian insolvency laws may adversely affect a recovery by the Holders of amounts payable under the debt securities.***

There are two types of insolvency procedures under Belgian law: (i) the judicial restructuring (*réorganisation judiciaire/gerechtelijke reorganisatie*) procedure and (ii) the bankruptcy (*faillite/faillissement*) procedure, each of which is described below.

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A proceeding for a judicial restructuring may be commenced if the continuation of the debtor s business is, either immediately or in the future, at risk. The continuation of the debtor s business is, in any event, deemed to be at risk if, as a result of losses, the debtor s net assets have declined to less than 50% of its stated capital.

A request for a judicial restructuring is filed on the initiative of the debtor by a petition. The court can consider a preliminary suspension of payments during an initial period of six months, which can be extended by up to a maximum period of six months at the request of the company. In exceptional circumstances and in the interest of the creditors, there may be an additional extension of six months. In principle, during the initial suspension period, the debtor cannot be dissolved or declared bankrupt. However, the initial suspension period can be terminated if it becomes manifestly clear that the debtor will not be able to continue its business. Following early termination of the initial suspension period, the debtor can be dissolved or declared bankrupt. As a rule, creditors cannot enforce their rights against the debtor s assets during the period of preliminary suspension of payments, except in the following circumstances: (i) failure by the debtor to pay interest or charges falling due in the course of the preliminary suspension period, (ii) failure by the debtor to pay any new debts (e.g., debts which have arisen after the date of the preliminary suspension of payments) or (iii) enforcement by a creditor of security (or certain netting arrangements and relating accelerated termination arrangements) pursuant to the Belgian Act of 15 December 2004 on financial collateral.

During the preliminary suspension period, the debtor must draw up a restructuring plan which must be approved by a majority of its creditors who were present at a meeting of creditors and whose aggregate claims represent over half of all outstanding claims of the debtor. The restructuring plan must have a maximum duration of five years. This plan will be approved by the court provided the plan does not violate the formalities required by the judicial restructuring legislation nor public policy. The plan will be binding on all creditors listed in the plan. Enforcement rights of creditors secured by certain types of *in rem* rights are not bound by the plan. Such creditors may, as a result, enforce their security from the beginning of the final suspension period. Under certain conditions, and subject to certain exceptions, enforcement by such creditors can be suspended for up to 24 months (as from the filing of the request for a judicial restructuring with the relevant court). Under further conditions, this period of 24 months may be extended by a further 12 months.

Any provision providing that an agreement would be terminated as the result of a debtor entering a judicial composition is ineffective, subject to exceptions set forth in the Belgian Act of 15 December 2004 on financial collateral.

The above essentially describes the so-called judicial restructuring by collective agreement of the creditors. The judicial restructuring legislation also provides for alternative judicial restructuring procedures, including (i) by amicable settlement between the debtor and two or more of its creditors and (ii) by court-ordered transfer of part or all of the debtor s business.

A company which, on a sustained basis, has ceased to make payments and whose credit is impaired will be deemed to be in a state of bankruptcy. Within one month after the cessation of payments, the company must file for bankruptcy. If the company is late in filing for bankruptcy, its directors could be held liable for damages to creditors as a result thereof. Bankruptcy procedures may also be initiated on the request of unpaid creditors or on the initiative of the public prosecutor.

Once the court decides that the requirements for bankruptcy are met, the court will establish a date before which claims for all unpaid debts must be filed by creditors. A bankruptcy trustee will be appointed to assume the operation of the business and to organize a sale of the debtor s assets, the distribution of the proceeds thereof to creditors and the liquidation of the debtor.

Payments or other transactions (as listed below) made by a company during a certain period of time prior to that company being declared bankrupt (the **suspect period** ) (*période suspecte/verdachte periode*) can be voided for the benefit of the creditors. The court will determine the date of commencement and the duration of

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the suspect period. This period starts on the date of sustained cessation of payment of debts by the debtor. The court can only determine the date of sustained cessation of payment of debts if it has been requested to do so by a creditor proceeding for a bankruptcy judgment or if proceedings are initiated to that effect by the bankruptcy trustee or by any other interested party. This date cannot be earlier than six months before the date of the bankruptcy judgment, unless a decision to dissolve the company was made more than six months before the date of the bankruptcy judgment, in which case the date could be the date of such decision to dissolve the company. The ruling determining the date of commencement of the suspect period or the bankruptcy judgment itself can be opposed by third parties, such as other creditors, within 15 days following the publication of that ruling in the Belgian Official Gazette. The transactions which can or must be voided under the bankruptcy rules for the benefit of the bankrupt estate include (i) any transaction entered into by a Belgian company during the suspect period if the value given to creditors significantly exceeded the value the company received in consideration, (ii) any transaction entered into by a company which has stopped making payments if the counterparty to the transaction was aware of the suspension of payments, (iii) security interests granted during the suspect period if they intend to secure a debt which existed prior to the date on which the security interest was granted, (iv) any payments (in whatever form, i.e. money or in kind or by way of set-off) made during the suspect period of any debt which was not yet due, as well as all payments made during the suspect period other than with money or monetary instruments (i.e. checks, promissory notes, etc.) and (v) any transaction or payment effected with fraudulent intent irrespective of its date.

Following a judgment commencing a bankruptcy proceeding, enforcement rights of individual creditors are suspended (subject to exceptions set forth in the Belgian Act of 15 December 2004 on financial collateral). Creditors secured by *in rem* rights, such as share pledges, will regain their ability to enforce their rights under the security after the bankruptcy trustee has verified the creditors claims.

***The debt securities lack a developed trading market, and such a market may never develop. The trading price for the debt securities may be adversely affected by credit market conditions.***

Unless specified in the applicable prospectus supplement, the Issuer does not intend to list the debt securities on any securities exchange. There can be no assurance that an active trading market will develop for the debt securities, nor any assurance regarding the ability of holders to sell their debt securities or the price at which such holders may be able to sell their debt securities, even if we were to list a particular issue of debt securities on a securities exchange. If a trading market were to develop, the debt securities could trade at prices that may be higher or lower than the initial offering price depending on many factors, including, among other things, prevailing interest rates, the Issuer s or the Parent Guarantor s financial results, any decline in the Issuer s or the Parent Guarantor s creditworthiness and the market for similar securities. The trading market for the debt securities will be affected by general credit market conditions, which in recent periods have been marked by significant volatility and price reductions, including for debt issued by investment-grade companies.

Any underwriters, broker-dealers or agents that participate in the distribution of the debt securities may make a market in the debt securities as permitted by applicable laws and regulations but will have no obligation to do so, and any such market-making activities may be discontinued at any time. Therefore, there can be no assurance as to the liquidity of any trading market for the debt securities or that an active public market for the debt securities will develop. See Plan of Distribution .

***As a foreign private issuer in the United States, we are exempt from a number of rules under the U.S. securities laws and are permitted to file less information with the SEC.***

As a foreign private issuer, we are exempt from certain rules under the U.S. Securities Exchange Act of 1934, as amended (the **Exchange Act** ), that impose certain disclosure obligations and procedural requirements for proxy solicitations under Section 14 of the Exchange Act. In addition, our officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions under Section 16 of the Exchange Act. Moreover, we are not required to file periodic reports and financial statements with the SEC as

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frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. Accordingly, there may be less publicly available information concerning us than there is for U.S. public companies.

**Risks Relating to Debt Securities Denominated or Payable in or Linked to a Non-U.S. Dollar Currency**

If you intend to invest in non-U.S. dollar debt securities e.g., debt securities whose principal and/or interest are payable in a currency other than U.S. dollars or that may be settled by delivery of or reference to a non-U.S. dollar currency or property denominated in or otherwise linked to a non-U.S. dollar currency you should consult your own financial and legal advisors as to the currency risks entailed by your investment. Securities of this kind may not be an appropriate investment for investors who are unsophisticated with respect to non-U.S. dollar currency transactions.

The information in this prospectus is directed primarily to investors who are U.S. residents. Investors who are not U.S. residents should consult their own financial and legal advisors about currency-related risks particular to their investment.

***An investment in non-U.S. dollar debt securities involves currency-related risks.***

An investment in non-U.S. dollar debt securities entails significant risks that are not associated with a similar investment in debt securities that are payable solely in U.S. dollars and where settlement value is not otherwise based on a non-U.S. dollar currency. These risks include the possibility of significant changes in rates of exchange between the U.S. dollar and the various non-U.S. dollar currencies or composite currencies and the possibility of the imposition or modification of foreign exchange controls or other conditions by either the United States or non-U.S. governments. These risks generally depend on factors over which we have no control, such as economic and political events and the supply of and demand for the relevant currencies in the global markets.

***Changes in currency exchange rates can be volatile and unpredictable***

Rates of exchange between the U.S. dollar and many other currencies have been highly volatile, and this volatility may continue and perhaps spread to other currencies in the future. Fluctuations in currency exchange rates could adversely affect an investment in debt securities denominated in, or whose value is otherwise linked to, a specified currency other than U.S. dollars. Depreciation of the specified currency against the U.S. dollar could result in a decrease in the U.S. dollar-equivalent value of payments on the debt securities, including the principal payable at maturity or settlement value payable upon exercise. That in turn could cause the market value of the debt securities to fall. Depreciation of the specified currency against the U.S. dollar could result in a loss to the investor on a U.S. dollar basis.

***Government policy can adversely affect currency exchange rates and an investment in non-U.S. dollar debt securities.***

Currency exchange rates can either float or be fixed by sovereign governments. From time to time, governments use a variety of techniques, such as intervention by a country s central bank or imposition of regulatory controls or taxes, to affect the exchange rate of their currencies. Governments may also issue a new currency to replace an existing currency or alter the exchange rate or exchange characteristics by devaluation or revaluation of a currency. Thus, a special risk in purchasing non-U.S. dollar debt securities is that their yields or payouts could be significantly and unpredictably affected by governmental actions. Even in the absence of governmental action directly affecting currency exchange rates, political or economic developments in the country issuing the specified currency for non-U.S. dollar debt securities or elsewhere could lead to significant and sudden changes in the exchange rate between the U.S. dollar and the specified currency. These changes could affect the value of the debt securities as participants in the global currency markets move to buy or sell the specified currency or U.S. dollars in reaction to these developments.

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Governments have imposed from time to time and may in the future impose exchange controls or other conditions, including taxes, with respect to the exchange or transfer of a specified currency that could affect exchange rates as well as the availability of a specified currency for a debt security at its maturity or on any other payment date. In addition, the ability of a holder to move currency freely out of the country in which payment in the currency is received or to convert the currency at a freely determined market rate could be limited by governmental actions.

***Non-U.S. dollar debt securities may permit us to make payments in U.S. dollars or delay payment if we are unable to obtain the specified currency.***

Debt securities payable in a currency other than U.S. dollars may provide that, if the other currency is subject to convertibility, transferability, market disruption or other conditions affecting its availability at or about the time when a payment on the debt securities comes due because of circumstances beyond our control, we will be entitled to make the payment in U.S. dollars or delay making the payment. These circumstances could include the imposition of exchange controls or our inability to obtain the other currency because of a disruption in the currency markets. If we made payment in U.S. dollars, the exchange rate we would use would be determined in the manner described under Description of Debt Securities and Guarantees . A determination of this kind may be based on limited information and would involve significant discretion on the part of our foreign exchange agent. As a result, the value of the payment in U.S. dollars an investor would receive on the payment date may be less than the value of the payment the investor would have received in the other currency if it had been available, or may be zero. In addition, a government may impose extraordinary taxes on transfers of a currency. If that happens, we will be entitled to deduct these taxes from any payment on debt securities payable in that currency.

***We will not adjust non-U.S. debt dollar securities to compensate for changes in currency exchange rates.***

Except as described above, we will not make any adjustment or change in the terms of non-U.S. dollar debt securities in the event of any change in exchange rates for the relevant currency, whether in the event of any devaluation, revaluation or imposition of exchange or other regulatory controls or taxes or in the event of other developments affecting that currency, the U.S. dollar or any other currency. Consequently investors in non-U.S. dollar debt securities will bear the risk that their investment may be adversely affected by these types of events.

***In a lawsuit for payment on non-U.S. dollar debt securities, an investor may bear currency exchange risk.***

Our debt securities will be governed by New York law. Under Section 27 of the New York Judiciary Law, a state court in the State of New York rendering a judgment on a security denominated in a currency other than U.S. dollars would be required to render the judgment in the specified currency; however, the judgment would be converted into U.S. dollars at the exchange rate prevailing on the date of entry of the judgment. Consequently, in a lawsuit for payment on a debt security denominated in a currency other than U.S. dollars, investors would bear currency exchange risk until judgment is entered, which could be a long time.

In courts outside New York, investors may not be able to obtain judgment in a specified currency other than U.S. dollars. For example, a judgment for money in an action based on a non-U.S. dollar debt security in many other U.S. federal or state courts ordinarily would be enforced in the United States only in U.S. dollars. The date used to determine the rate of conversion of the currency in which any particular security is denominated into U.S. dollars will depend upon various factors, including which court renders the judgment.

***Information about exchange rates may not be indicative of future exchange rates.***

If we issue non-U.S. dollar securities, we may include in the applicable prospectus supplement a currency supplement that provides information about historical exchange rates for the relevant non-U.S. dollar currency or currencies. Any information about exchange rates that we may provide will be furnished as a matter

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of information only, and you should not regard the information as indicative of the range of, or trends in, fluctuations in currency exchange rates that may occur in the future. That rate will likely differ from the exchange rate used under the terms that apply to a particular security.

***Determinations made by the exchange rate agent.***

All determinations made by the exchange rate agent will be made in its sole discretion (except to the extent expressly provided in this prospectus or in the applicable prospectus supplement that any determination is subject to approval by us). In the absence of manifest error, its determinations will be conclusive for all purposes and will bind all holders and us. The exchange rate agent will not have any liability for its determinations.

**Additional risks, if any, specific to particular debt securities issued under this prospectus will be detailed in the applicable prospectus supplements.**

## FORWARD-LOOKING STATEMENTS

This prospectus, including documents that are filed with the SEC and incorporated by reference herein, and the related prospectus supplement, may contain statements that include the words or phrases *will likely result*, *are expected to*, *will continue*, *is anticipated*, *estimate*, *projec* or similar expressions that are forward-looking statements. These statements are subject to certain risks and uncertainties. Actual results may differ materially from those suggested by these statements due to, among others, the risks or uncertainties listed below. See also Risk Factors for further discussion of risks and uncertainties that could impact our business.

These forward-looking statements are not guarantees of future performance. Rather, they are based on current views and assumptions and involve known and unknown risks, uncertainties and other factors, many of which are outside our control and are difficult to predict, that may cause actual results or developments to differ materially from any future results or developments expressed or implied by the forward-looking statements. Factors that could cause actual results to differ materially from those contemplated by the forward-looking statements include, among others:

- greater than expected costs (including taxes) and expenses, including in relation to the integration of acquisitions such as the Anheuser-Busch acquisition;
- the risk of unexpected consequences resulting from acquisitions, including the Anheuser-Busch acquisition;
- our expectations with respect to expansion, projected asset divestitures, premium growth, accretion to reported earnings, working capital improvements and investment income or cash flow projections;
- lower than expected revenue;
- greater than expected customer losses and business disruptions following the Anheuser-Busch acquisition;
- difficulties in maintaining relationships with employees;
- limitations on our ability to contain costs and expenses;

local, regional, national and international economic conditions, including the risks of a global recession or a recession in one or more of our key markets, and the impact they may have on us and our customers and our assessment of that impact;

the monetary and interest rate policies of central banks, in particular the European Central Bank, the Board of Governors of the U.S. Federal Reserve System, the Bank of England, and other central banks;

continued availability of financing and our ability to achieve our targeted coverage and debt levels and terms;

market risks, such as interest rate risk, foreign exchange rate risk, commodity risk, asset price risk, equity market risk, inflation or deflation;

our ability to continue to introduce competitive new products and services on a timely, cost-effective basis;

the effects of competition and consolidation in the markets in which we operate, which may be influenced by regulation, deregulation or enforcement policies;

changes in pricing environments;

volatility in commodity prices;

regional or general changes in asset valuations;

tax consequences of restructuring and our ability to optimize our tax rate;

changes in consumer spending;

the outcome of pending and future litigation and governmental proceedings;

changes in government policies;

changes in applicable laws, regulations and taxes in jurisdictions in which we operate including the laws and regulations governing our operations, as well as actions or decisions of courts and regulators;

natural and other disasters;

any inability to economically hedge certain risks;

inadequate impairment provisions and loss reserves;

- technological changes; and

- our success in managing the risks involved in the foregoing.

Certain of the cost savings and synergies information related to the Anheuser-Busch acquisition set forth in Item 4. Information on the Company B. Strengths and Strategy Strengths of the 2009 Annual Report on Form 20-F incorporated by reference herein constitute forward-looking statements and may not be representative of the actual cost savings and synergies that will result from the Anheuser-Busch acquisition. Such information included in this prospectus reflects potential opportunities for savings and synergies identified by us based on estimates and assumptions that are inherently subject to significant uncertainties which are difficult to predict, and accordingly there can be no assurance that these cost savings and synergies will be realized. The statements relating to the synergies, cost savings and business growth opportunities we expect to continue to achieve following the Anheuser-Busch acquisition are based on assumptions. However, these expected synergies, cost savings and business growth opportunities may not be achieved. There can be no assurance that we will be able to continue to implement successfully the strategic and operational initiatives that are intended.

Our statements regarding market risks, including interest rate risk, foreign exchange rate risk, commodity risk, asset price risk, equity market risk, inflation and deflation, are subject to uncertainty. For example, certain market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

We caution that the forward-looking statements in this prospectus are further qualified by the risks described above in Risk Factors , elsewhere in this prospectus, or in the 2009 Annual Report on Form 20-F incorporated by reference herein, that could cause actual results to differ materially from those in the forward-looking statements. Subject to our obligations under Belgian and U.S. law in relation to disclosure and ongoing information, we undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The SEC allows us to incorporate by reference the information we file with them, which means we can disclose important information to you by referring you to those documents. The most recent information that we file with the SEC automatically updates and supersedes earlier information.

We have filed with the SEC a registration statement on Form F-3 relating to the securities covered by this prospectus. This prospectus is a part of the registration statement and does not contain all the information in the registration statement. Whenever a reference is made in this prospectus to a contract or other document of the company, the reference is only a summary and you should refer to the exhibits that are a part of the registration statement for a copy of the contract or other document. You may review a copy of the registration statement at the SEC s public reference room in Washington, D.C., as well as through the SEC s internet site, as discussed below.

We filed our Annual Report on Form 20-F for the fiscal year ended 31 December 2009 (the Annual Report ) with the SEC on 15 April 2010. We are incorporating the Annual Report by reference into this prospectus. We are also incorporating by reference into this prospectus the information under the heading Anheuser-Busch Companies. Inc. Historical Financial Information contained in our Registration Statement on Form 20-F filed with the SEC on 14 September 2009. We are further incorporating by reference our Report on Form 6-K furnished to the SEC on 12 July 2010 regarding the arbitration panel s confirmation of Anheuser-Busch InBev s position in its arbitration with Grupo Modelo and our Report on Form 6-K furnished to the SEC on 8 September 2010, regarding AB InBev s Unaudited Interim Report for the six-month period ended 30 June 2010.

In addition, we will incorporate by reference into this prospectus all documents that we file with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Exchange Act and, to the extent, if any, we designate therein, reports on Form 6-K we furnish to the SEC after the date of this prospectus and prior to the termination of any offering contemplated in this prospectus.

We will provide to you, upon your written or oral request, without charge, a copy of any or all of the documents referred to above which we have incorporated in this prospectus by reference. You should direct your requests to Anheuser-Busch InBev SA/NV, Brouwerijplein 1, 3000 Leuven, Belgium (telephone: +32 (0)1 627 6111).

## ANHEUSER-BUSCH INBEV SA/NV

We are the world s largest brewing company by volume, and one of the world s five largest consumer products companies. As a consumer-centric, sales-driven company, we produce, market, distribute and sell a strong, balanced portfolio of well over 200 beer brands. These include global flagship brands Budweiser, Stella Artois and Beck s; multi-country brands such as Leffe and Hoegaarden; and many local champions such as Bud Light, Skol, Brahma, Quilmes, Michelob, Harbin, Sedrin, Klinskoye, Sibirskaya Korona, Chernigivske and Jupiler. We also produce and distribute soft drinks, particularly in Latin America.

Our brewing heritage and quality are rooted in brewing traditions that originate from the Den Hoorn brewery in Leuven, Belgium, dating back to 1366, and those of Anheuser & Co. brewery, established in 1852 in St. Louis, U.S.A. As of 31 December 2009, we employed approximately 116,000 people, with operations in 23 countries across the world. Given the breadth of our operations, we are organized along seven business zones or segments: North America, Latin America North, Latin America South, Western Europe, Central & Eastern Europe, Asia Pacific and Global Export & Holding Companies. The first six correspond to specific geographic regions in which our operations are based. As a result, we have a global footprint with a balanced exposure to developed and developing markets and production facilities spread across our six geographic regions.

On 18 November 2008, we completed our combination with Anheuser-Busch, the largest brewer of beer and other malt beverages in the United States. Following completion of the Anheuser-Busch acquisition, we have significant brewing operations within our North America business zone. The North America business zone accounted for 33.0% of our consolidated volumes for the year ended 31 December 2009 as compared to 9.3% of our actual consolidated volumes for the year ended 31 December 2008, and 4.8% of our actual consolidated volumes for the year ended 31 December 2007. Through the Anheuser-Busch acquisition, we acquired a number of subsidiaries that conduct various other business operations, including one of the largest theme park operators in the United States, a major manufacturer of aluminum cans and one of the largest recyclers of aluminum cans in the United States by weight. The theme park operations and a part of the beverage can and lid operations were sold during 2009.

We also have significant exposure to fast-growing emerging markets in Latin America North (which accounted for 26.9% of our consolidated volumes in the year ended 31 December 2009), Asia Pacific (which accounted for 12.8% of our consolidated volumes in the year ended 31 December 2009) and Latin America South (which accounted for 8.2% of our consolidated volumes in the year ended 31 December 2009).

Our 2009 volumes (beer and non-beer) were 409 million hectoliters and our revenue amounted to USD 36.8 billion.

## ANHEUSER-BUSCH INBEV WORLDWIDE INC., AND THE SUBSIDIARY GUARANTORS

The Issuer of the debt securities, under the name of InBev Worldwide S.à.r.l, was incorporated on 9 July 2008 as a private limited liability company (*société à responsabilité limitée*) under the Luxembourg act dated 10 August 1915 on commercial companies, as amended. On 19 November 2008, the Issuer was domesticated as a corporation in the State of Delaware in accordance with Section 388 of the Delaware General Corporation Law and, in connection with such domestication, changed its name to Anheuser-Busch InBev Worldwide Inc. The Issuer complies with the laws and regulations of the State of Delaware regarding corporate governance. The Issuer s registered office is located at 1209 Orange Street, Wilmington, Delaware 19801.

Anheuser-Busch InBev SA/NV will guarantee the debt securities, on an unconditional, full and irrevocable basis. In addition, one or more of BrandBrew S.A., Cobrew NV/SA and Anheuser-Busch Companies, Inc., which are direct or indirect subsidiaries of Anheuser-Busch InBev SA/NV, may, as specified in the applicable prospectus supplement, jointly and severally guarantee the debt securities of a particular series, on

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an unconditional, full and irrevocable basis, subject to certain limitations described in Description of the Debt Securities and Guarantees . In addition, such subsidiaries are guarantors of the Anheuser-Busch InBev Worldwide Inc. s $17.2 billion 2010 Senior Facilities Agreement and Anheuser-Busch InBev Worldwide Inc. s January 2009 Notes (the January Notes ), May 2009 Notes (the May Notes ), October 2009 Notes (the October Notes ), March 2010 Notes (the March Notes ) and Euro Medium-Term Notes, as each are described in the Annual Report under the heading Item 5. Operating and Financial Review G. Liquidity and Capital Resources .

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## USE OF PROCEEDS

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from any sales by us of the securities offered under this prospectus and an accompanying prospectus supplement to provide additional funds for general corporate purposes. We may set forth additional information on the use of net proceeds from the sale of securities we offer under this prospectus or in the prospectus supplemental relating to a specific offering.

## RATIOS OF EARNINGS TO FIXED CHARGES

The following table sets out our ratios of earnings to fixed charges for the six months ended 30 June 2010 and each of the five years ended 31 December 2009, 2008, 2007, 2006 and 2005 calculated in accordance with International Financial Reporting Standards ( IFRS ).

| | Six Months ended 30 June | Year ended 31 December | | | | |
|---|---|---|---|---|---|---|
| | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 |
| | | | *(USD million)* | | | |
| | (unaudited) | | (audited) | | | (unaudited) |
| *Earnings:* | | | | | | |
| Profit from operations before taxes and share of results of associates | 2,937 | 7,150 | 3,740 | 5,054 | 3,332 | 2,244 |
| Add: Fixed charges (below) | 2,421 | 5,014 | 1,965 | 1,035 | 860 | 941 |
| Less: Interest Capitalized (below) | 9 | 4 | - | - | - | - |
| **Total earnings** | **5,349** | **12,160** | **5,705** | **6,089** | **4,192** | **3,185** |
| *Fixed charges:* | | | | | | |
| Interest expense and similar charges | 2,105 | 4,394 | 1,761 | 926 | 771 | 849 |
| Accretion expense | 268 | 526 | 127 | 49 | 30 | 23 |
| Interest capitalized | 9 | 4 | - | - | - | - |
| Estimated interest portion of rental expense | 39 | 90 | 77 | 60 | 59 | 69 |
| **Total fixed charges** | **2,421** | **5,014** | **1,965** | **1,035** | **860** | **941** |
| **Ratio of earnings to fixed charges** | **2.21** | **2.43** | **2.90** | **5.88** | **4.87** | **3.38** |

The ratio of earnings to fixed charges represents the number of times fixed charges are covered by earnings. For the purposes of computing this ratio, earnings consist of profit from operations before taxes and share of results of associates, plus fixed charges, minus interest capitalized during the period. Fixed charges consist of interest and accretion expense, interest on finance lease obligations, interest capitalized, plus one-third of rent expense on operating leases, estimated by the company as representative of the interest factor attributable to such rent expense.

The Parent Guarantor did not have any preferred stock outstanding and did not pay or accrue any preferred stock dividends during the periods presented above.

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## CAPITALIZATION AND INDEBTEDNESS

The following table shows our cash and cash equivalents and capitalization as of 31 July 2010. You should read the information in this table in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations in the Annual Report and our audited consolidated financial statements and the accompanying notes included in the Annual Report.

| | **As of 31 July 2010** *(USD million, unaudited)* |
|---|---|
| Cash and cash equivalents, less bank overdrafts | 4,918 |
| **Current interest-bearing liabilities** | |
| Secured bank loans | 26 |
| Unsecured bank loans | 2,250 |
| Unsecured bond issues | 442 |
| Unsecured other loans | 106 |
| Finance lease liabilities | 6 |
| **Non-current interest-bearing liabilities** | |
| Secured bank loans | 61 |
| Unsecured bank loans | 12,724 |
| Unsecured bond issues | 31,757 |
| Secured other loans | 6 |
| Unsecured other loans | 89 |
| Finance lease liabilities | 112 |
| **Total interest-bearing liabilities** | **47,579** |
| Equity attributable to our equity holders | 32,294 |
| Non-controlling interests | 3,418 |
| **Total Capitalization:** | **83,291** |

## LEGAL OWNERSHIP

*Street Name and Other Indirect Holders.* Investors who hold debt securities in accounts at banks or brokers will generally not be recognized by us as legal holders of debt securities. This is called holding in street name .

Instead, we would recognize only the bank or broker, or the financial institution the bank or broker uses to hold its debt securities. These intermediary banks, brokers and other financial institutions pass along principal, interest and other payments on the debt securities, either because they agree to do so in their customer agreements or because they are legally required to do so. An investor who holds debt securities in street name should check with the investor s own intermediary institution to find out:

- how it handles debt securities payments and notices;
- whether it imposes fees or charges;
- how it would handle voting if it were ever required;
- whether and how the investor can instruct it to send the investor s debt securities registered in the investor s own name so the investor can be a direct holder as described below; and

how it would pursue rights under the debt securities if there were a default or other event triggering the need for holders to act to protect their interests.

*Direct Holders.* Our obligations, as well as the obligations of the trustee and those of any third parties employed by us or the trustee, run only to persons who are registered as holders of debt securities. As noted above, we do not have obligations to an investor who holds in street name or other indirect means, either because the investor chooses to hold debt securities in that manner or because the debt securities are issued in the form of global securities as described below. For example, once we make payment to the registered holder, we have no further responsibility for the payment even if that holder is legally required to pass the payment along to the investor as a street name customer but does not do so.

*Global Securities.* A global security is a special type of indirectly held security, as described above under Legal Ownership Street Name and Other Indirect Holders . If we issue debt securities in the form of global securities, the ultimate beneficial owners can only be indirect holders.

We require that the global security be registered in the name of a financial institution we select. In addition, we require that the debt securities included in the global security not be transferred to the name of any other direct holder unless the special circumstances described in the section Global Securities occur. The financial institution that acts as the sole direct holder of the global security is called the depositary. Any person wishing to own a security must do so indirectly by virtue of an account with a broker, bank or other financial institution that in turn has an account with the depositary. Unless the applicable prospectus supplement indicates otherwise, each series of debt securities will be issued only in the form of global securities.

***Global Securities***

*Special Investor Considerations for Global Securities*

As an indirect holder, an investor s rights relating to a global security will be governed by the account rules of the investor s financial institution and of the depositary, as well as general laws relating to securities transfers. We do not recognize this type of investor as a holder of securities and instead deal only with the depositary that holds the global security.

Investors in securities that are issued only in the form of global securities should be aware that:

- they cannot get securities registered in their own name;

- they cannot receive physical certificates for their interests in securities;

- they will be a street name holder and must look to their own bank or broker for payments on the securities and protection of their legal rights relating to the securities, as explained earlier under Legal Ownership Street Name and Other Indirect Holders ;

- they may not be able to sell interests in the securities to some insurance companies and other institutions that are required by law to own their securities in the form of physical certificates;

- the depositary s policies will govern payments, transfers, exchange and other matters relating to their interest in the global security. We and the trustee have no responsibility for any aspect of the depositary s actions or for its records of ownership interests in the global security. We and the trustee also do not supervise the depositary in any way; and

- the depositary will require that interests in a global security be purchased or sold within its system using same-day funds. By contrast, payment for purchases and sales in the market for corporate bonds and other securities is generally made in next-day funds. The difference could have some effect on how interests in global securities trade, but we do not know what that effect will be.

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*Special Situations When a Global Security Will Be Terminated*

In a few special situations described below, the global security will terminate and interests in it will be exchanged for physical certificates representing securities. After that exchange, the choice of whether to hold the securities directly or in street name will be up to the investor. Investors must consult their own bank or brokers to find out how to have their interests in a global security transferred to their own name so that they will be direct holders. The rights of street name investors and direct holders in the securities have been previously described in the sections entitled Legal Ownership Street Name and Other Indirect Holders; Direct Holders .

The special situations for termination of a global security are:

- when the depositary notifies us that it is unwilling, unable or no longer qualified to continue as depositary; and

- when an Event of Default has occurred and has not been cured. Defaults are discussed below under Description of Debt Securities and Guarantees Events of Default .

The prospectus supplement may also list additional situations for terminating a global security that would apply only to the particular series of securities covered by the prospectus supplement. When a global security terminates, the depositary (and not us or the trustee) is responsible for deciding the names of the institutions that will be the initial direct holders.

***In the remainder of this description, holders means direct holders and not street name or other indirect holders of debt securities. Indirect holders should read the sub-section entitled Legal Ownership Street Name and Other Indirect Holders .***

## DESCRIPTION OF DEBT SECURITIES AND GUARANTEES

*The following is a summary of the general terms of the debt securities. It sets forth possible terms and provisions for each series of debt securities. Each time that we offer debt securities, we will prepare and file a prospectus supplement with the SEC, which you should read carefully. The prospectus supplement may contain additional terms and provisions of those securities. If there is any inconsistency between the terms and provisions presented here and those in the prospectus supplement, those in the prospectus supplement will apply and will replace those presented here.*

*Because this section is a summary, it does not describe every aspect of the debt securities in detail. As required by U.S. federal law for all bonds and notes of companies that are publicly offered, the debt securities are governed by documents called indentures. This summary is subject to, and qualified by reference to, all of the definitions and provisions of the relevant indenture, any supplement to the relevant indenture and each series of debt securities. We may issue as many distinct series of debt securities under the indenture as we wish. We may also from time to time without the consent of the holders of the debt securities create and issue further debt securities having the same terms and conditions as debt securities of an already issued series so that the further issue is consolidated and forms a single series with that series. Certain terms, unless otherwise defined here, have the meaning given to them in the relevant indenture.*

### General

Anheuser-Busch InBev SA/NV will, and Anheuser-Busch Companies, Inc., BrandBrew S.A. and Cobrew NV/SA may, act as guarantors of the debt securities issued under the indentures. The guarantors of each series of debt securities will be, specified in the applicable prospectus supplement and pricing agreement relating to the series. The guarantee is described under Guarantee below. The indenture and its associated documents contain the full legal text of the matters described in this section. The indenture, the debt securities and the guarantees are governed by New York law. A copy of the indenture is filed with the SEC as an exhibit to our registration statement. See Incorporation of Certain Documents by Reference and Where You Can Find More Information for information on how to obtain a copy.

The indentures do not limit the amount of debt securities that we may issue. We may issue the debt securities in one or more series. We may issue the debt securities as original issue discount securities, which are debt securities that are offered and sold at a substantial discount to their stated principal amount. The debt securities may also be issued as indexed securities or securities denominated in foreign currencies or currency units, as described in more detail in the prospectus supplement relating to any such debt securities.

In addition, the specific financial, legal and other terms particular to a series of debt securities are described in the prospectus supplement and the pricing agreement relating to the series. Those terms may vary from the terms described here. Accordingly, this summary also is subject to and qualified by reference to the description of the terms of the series described in the prospectus supplement.

The prospectus supplement will indicate for each series of debt securities:

- the title of the debt securities;
- any guarantors of the debt securities (in addition to Anheuser-Busch InBev SA/NV);
- any limit on the aggregate principal amount of the series of debt securities;
- the person to whom any interest on a debt security of the series will be payable if other than the person in whose name the security is registered;
- the date or dates on which we will pay the principal of the series of debt securities;

the rate or rates at which any debt securities of the series will bear interest, the date or dates from which any such interest will accrue, the interest payment dates on which such interest will be payable, and the regular record date for any such interest payable;

the place or places where the principal of and any premium and interest on any debt securities of the series will be payable;

the period or periods within which, the price or prices at which and the terms and conditions upon which any of the debt securities of the series may be redeemed, in whole or in part, at the option of the Issuer;

any mandatory or optional sinking funds or analogous provisions or provisions for redemption at the option of the holder;

the denominations in which the series of debt securities will be issuable if in other than denominations of $1,000;

the manner in which the amount of principal of or any premium or interest on any debt securities will be determined if the such amount may be determined with reference to an index or other formula;

the currency of payment of principal, premium, if any, and interest on the series of debt securities if other than the currency of the United States of America and the manner of determining the equivalent amount in the currency of the United States of America;

if any payment on the debt securities of that series will be made, at our option or your option, in any currency other than in the currency in which the debt securities state that they will be payable, the terms and conditions regarding how that election shall be made;

if less than the entire principal amount is payable upon a declaration of acceleration of the maturity, that portion of the principal which is payable;

if the principal amount payable at the Stated Maturity of any debt securities is not determinable prior to such date, the amount which will be deemed to be the principal amount of such debt securities as of any such date;

the applicability of the provisions described below under Discharge and Defeasance ;

if the series of debt securities will be issuable in whole or part in the form of a global security as described later under Legal Ownership Global Securities , the form of any legends to be borne by such global security, the depositary or its nominee with respect to the series of debt securities, and any special circumstances under which the global security may be registered for transfer or exchange in the name of a person other than the depositary or its nominee;

any additions to or changes in the covenants and the events of default described later under Events of Default ; and any other terms of the series of debt securities that are not inconsistent with the provisions of the indenture.

Debt securities may bear interest at a fixed rate or a floating rate or we may sell debt securities that bear no interest or that bear interest at a rate below the prevailing market interest rate or at a discount to their stated principal amount ( Discount Securities ). The relevant prospectus supplement will describe special U.S. federal income tax considerations applicable to Discount Securities or to debt securities issued at par that are treated for U.S. federal income tax purposes as having been issued at a discount.

Holders of debt securities have no voting rights except as explained below under Modification and Amendment and Events of Default .

**Principal Amount, Stated Maturity and Maturity**

The principal amount of a series of debt securities means the principal amount payable at its stated maturity, unless that amount is not determinable, in which case the principal amount of a debt security is its face amount. Any debt securities owned by us or any of our affiliates are not deemed to be outstanding.

The term stated maturity with respect to any debt security means the day on which the principal amount of your debt securities is scheduled to become due. The principal may become due sooner, by reason of redemption or acceleration after a default or otherwise in accordance with the terms of your debt securities. The day on which the principal actually becomes due, whether at the stated maturity or earlier, is called the maturity of the principal.

We also use the terms stated maturity and maturity to refer to the days when other payments become due. For example, we may refer to a regular interest payment date when an installment of interest is scheduled to become due as the stated maturity of that installment. When we refer to the stated maturity or the maturity of a debt security without specifying a particular payment, we mean the stated maturity or maturity, as the case may be, of the principal.

**Currency of Debt Securities**

Amounts that become due and payable on your debt securities in cash will be payable in a currency, composite currency, basket of currencies or currency unit or units specified in the applicable prospectus supplement. We refer to this currency, composite currency, basket of currencies or currency unit or units as a specified currency . The specified currency for your debt securities will be U.S. dollars, unless the applicable prospectus supplement states otherwise. Some debt securities may have different specified currencies for principal and interest. You will have to pay for your debt securities by delivering the requisite amount of the specified currency for the principal to the trustee, unless other arrangements have been made between you and us. We will make payments on your debt securities in the specified currency, except as described below in Additional Mechanics Payment and Paying Agents . See Risk Factors Risks Relating to Debt Securities Denominated or Payable in or Linked to a Non-U.S. Dollar Currency above for more information about risks of investing in debt securities of this kind.

**Form of Debt Securities**

We will issue debt securities in global i.e., book-entry form only, unless we specify otherwise in the applicable prospectus supplement. Debt securities in book-entry form will be represented by a global security registered in the name of a depositary, which will be the holder of all the debt securities represented by the global security. Those who own beneficial interests in a global debt security will do so through participants in the depositary s securities clearance system, and the rights of these indirect owners will be governed solely by the applicable procedures of the depositary and its participants. We describe book-entry securities above under Legal Ownership .

In addition, we will generally issue each debt security in registered form, without coupons, unless we specify otherwise in the applicable prospectus supplement.

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**Type of Security**

We may issue any of the three types of debt securities described below. A debt security may have elements of each of the three types of debt securities described below. For example, a debt security may bear interest at a fixed rate for some periods and at a variable rate in others. Similarly, a debt security may provide for a payment of principal at maturity linked to an index and also bear interest at a fixed or variable rate.

**Fixed Rate Debt Securities**

A series of debt securities of this type will bear interest at a fixed rate described in the applicable prospectus supplement. This type includes zero coupon debt securities, which bear no interest and are instead issued at a price lower than the principal amount. The prospectus supplement relating to original issue discount securities will describe special considerations applicable to them.

Each series of fixed rate debt securities, except any zero coupon debt securities, will bear interest from their original issue date or from the most recent date to which interest on the debt securities have been paid or made available for payment. Interest will accrue on the principal of a series of fixed rate debt securities at the fixed yearly rate stated in the applicable prospectus supplement, until the principal is paid or made available for payment or the debt securities are converted or exchanged. Each payment of interest due on an interest payment date or the date of maturity will include interest accrued from and including the last date to which interest has been paid, or made available for payment, or from the issue date if none has been paid or made available for payment, to but excluding the interest payment date or the date of maturity. We will compute interest on a series of fixed rate debt securities on the basis of a 360-day year of twelve 30-day months, unless the applicable prospectus supplement provides that we will compute interest on a different basis. We will pay interest on each interest payment date and at maturity as described below under Additional Mechanics Payment and Paying Agents .

**Variable Rate Debt Securities**

A series of debt securities of this type will bear interest at rates that are determined by reference to an interest rate formula. In some cases, the rates may also be adjusted by adding or subtracting a spread or multiplying by a spread multiplier and may be subject to a minimum rate or a maximum rate. If your debt securities are variable rate debt securities, the formula and any adjustments that apply to the interest rate will be specified in the applicable prospectus supplement.

Each series of variable rate debt securities will bear interest from its original issue date or from the most recent date to which interest on the debt security has been paid or made available for payment. Interest will accrue on the principal of a series of variable rate debt securities at the yearly rate determined according to the interest rate formula stated in the applicable prospectus supplement, until the principal is paid or made available for payment. We will pay interest on each interest payment date and at maturity as described below under Additional Mechanics Payment and Paying Agents .

*Calculation of Interest*. Calculations relating to a series of variable rate debt securities will be made by the calculation agent, an institution that we appoint as our agent for this purpose. The prospectus supplement for a particular series of variable rate debt securities will name the institution that we have appointed to act as the calculation agent for that particular series as of its original issue date. We may appoint a different institution to serve as calculation agent from time to time after the original issue date of the debt security without your consent and without notifying you of the change. Absent manifest error, all determinations of the calculation agent will be final and binding on you and us, without any liability on the part of the calculation agent.

For a series of variable rate debt securities, the calculation agent will determine, on the corresponding interest calculation or determination date, as described in the applicable prospectus supplement, the interest rate that takes effect on each interest reset date. In addition, the calculation agent will calculate the amount of interest that has accrued during each interest period i.e., the period from and including the original issue date, or the last date to which interest has been paid or made available for payment, to but excluding the payment date. For each interest period, the calculation agent will calculate the amount of accrued interest by multiplying the face or other specified amount of the variable rate debt security by an accrued interest factor for the interest period. This factor will equal the sum of the interest factors calculated for each day during the interest period. The interest factor for each day will be expressed as a decimal and will be calculated by dividing the interest rate, also expressed as a decimal, applicable to that day by 360 or by the actual number of days in the year, as specified in the applicable prospectus supplement.

Upon the request of the holder of any variable rate debt security, the calculation agent will provide for that debt security the interest rate then in effect and, if determined, the interest rate that will become effective on the next interest reset date. The calculation agent s determination of any interest rate, and its calculation of the amount of interest for any interest period, will be final and binding in the absence of manifest error.

All percentages resulting from any calculation relating to a series of variable rate debt securities will be rounded upward or downward, as appropriate, to the next higher or lower one hundred-thousandth of a percentage point, e.g., 9.876541 percent (or .09876541) being rounded down to 9.87654 percent (or .0987654) and 9.876545 percent (or .09876545) being rounded up to 9.87655 percent (or .0987655). All amounts used in or resulting from any calculation relating to a series of variable rate debt securities will be rounded upward or downward, as appropriate, to the nearest cent, in the case of U.S. dollars, or to the nearest corresponding hundredth of a unit, in the case of a currency other than U.S. dollars, with one-half cent or one-half of a corresponding hundredth of a unit or more being rounded upward.

In determining the base rate that applies to a particular series of variable rate debt securities during a particular interest period, the calculation agent may obtain rate quotes from various banks or dealers active in the relevant market, as described in the applicable prospectus supplement. Those reference banks and dealers may include the calculation agent itself and its affiliates, as well as any underwriter, dealer or agent participating in the distribution of the relevant variable rate debt securities and its affiliates.

**Indexed Debt Securities**

A series of debt securities of this type provides that the principal amount payable at its maturity, and/or the amount of interest payable on an interest payment date, will be determined by reference to:

- securities of one or more issuers;
- one or more currencies;
- one or more commodities;
- any other financial, economic or other measure or instrument, including the occurrence or non-occurrence of any event or circumstance; and/or
- one or more indices or baskets of the items described above.

If you are a holder of indexed debt securities, you may receive an amount at maturity (including upon acceleration following an event of default) that is greater than or less than the face amount of your debt securities depending upon the formula used to determine the amount payable and the value of the applicable index at maturity. The value of the applicable index will fluctuate over time.

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A series of indexed debt securities may provide either for cash settlement or for physical settlement by delivery of the underlying property or another property of the type listed above. A series of indexed debt securities may also provide that the form of settlement may be determined at our option or at the holder s option.

If you purchase an indexed debt security, the applicable prospectus supplement will include information about the relevant index, about how amounts that are to become payable will be determined by reference to the price or value of that index and about the terms on which the security may be settled physically or in cash. The prospectus supplement will also identify the calculation agent that will calculate the amounts payable with respect to the indexed debt security and may exercise significant discretion in doing so. See Risk Factors Risks Relating to Indexed Debt Securities for more information about risks of investing in debt securities of this type.

**Original Issue Discount Debt Securities**

A fixed rate debt security, a variable rate debt security or an indexed debt security may be an original issue discount debt security. A series of debt securities of this type is issued at a price lower than its principal amount and provides that, upon redemption or acceleration of its maturity, an amount less than its principal amount will be payable. An original issue discount debt security may be a zero coupon debt security. A debt security issued at a discount to its principal may, for U.S. federal income tax purposes, be considered an original issue discount debt security, regardless of the amount payable upon redemption or acceleration of maturity. See Taxation United States Taxation of Debt Securities United States Holders Original Issue Discount for a brief description of the U.S. federal income tax consequences of owning an original issue discount debt security.

**Guarantee**

Each debt security will benefit from an unconditional, full and irrevocable guarantee by the Parent Guarantor. One or more of the following Subsidiary Guarantors, which are subsidiaries of the Parent Guarantor, may, along with the Parent Guarantor, jointly and severally guarantee the debt securities on a full, unconditional and irrevocable basis:

BrandBrew S.A.;

Cobrew NV/SA; and

Anheuser-Busch Companies, Inc.

The Subsidiary Guarantors, if any, for any particular series of debt securities will be specified in the applicable prospectus supplement.

Each guarantee to be provided is referred to as a **Guarantee** and collectively, the **Guarantees**; the subsidiaries of the Parent Guarantor providing Guarantees are referred to as the **Subsidiary Guarantors** and the Parent Guarantor and Subsidiary Guarantors collectively are referred to as the **Guarantors**.

All such Guarantees are set forth in the Indenture, or a supplement thereto. The Guarantees provided by several of the Guarantors will be subject to certain limitations set forth below under Guarantee Limitations.

Under the Guarantees, the Guarantors will guarantee to each Holder the due and punctual payment of any principal, accrued and unpaid interest (and all Additional Amounts, if any) due under the debt securities in accordance with the Indenture. Each Guarantor will also pay Additional Amounts (if any) in respect of payments under its Guarantee. The Guarantees will be the full, direct, unconditional, unsecured and unsubordinated general obligations of the Guarantors. The Guarantees will rank *pari passu* among themselves, without any preference of one over the other by reason of priority of date of issue or otherwise, and at least equally with all other unsecured and unsubordinated general obligations of the Guarantors from time to time outstanding.

Each of the Subsidiary Guarantors shall be entitled to terminate its Guarantee, and the Trustee shall execute a release and termination agreement effecting such termination, in the event that at the time its Guarantee of the debt securities is terminated, (i) the relevant Subsidiary Guarantor is released from its guarantee of the Issuer s 2008 Senior Facilities Agreement and the Issuer s 2010 Senior Facilities Agreement, or is no longer a guarantor under either facility and (ii) the aggregate amount of indebtedness for borrowed money for which the relevant Guarantor is an obligor (as a guarantor or borrower) does not exceed 10% of the consolidated gross assets of the Parent Guarantor as reflected in the balance sheet included in its most recent publicly released interim or annual consolidated financial statements. For purposes of this clause, the amount of a Guarantor s indebtedness for borrowed money shall not include (A) the debt securities (or the January Notes, the May Notes, October Notes or March Notes), (B) any other debt the terms of which permit the termination of the Guarantor s guarantee of such debt under similar circumstances, as long as such Guarantor s obligations in respect of such other debt are terminated at substantially the same time as its guarantee of the debt securities, and (C) any debt that is being refinanced at substantially the same time that the Guarantee of the debt securities is being released, *provided* that any obligations of the Guarantor in respect of the debt that is incurred in the refinancing shall be included in the calculation of the Guarantor s indebtedness for borrowed money.

In addition, BrandBrew, whose guarantee is subject to certain limitations described below shall be entitled to terminate its Guarantee, and the Trustee shall execute a release and termination agreement effecting such termination, with respect to any or all series of the notes issued under the Indenture, in the event that BrandBrew determines that under the rules, regulations or interpretations of the SEC it would be required to include its financial statements in any registration statement filed with the SEC with respect to any series of notes or guarantees issued under the Indenture or in periodic reports filed with or furnished to the SEC (by reason of such limitations or otherwise). Furthermore, BrandBrew will be entitled to amend or modify by execution of an indenture supplemental to the Indenture the terms of its Guarantee or the limitations applicable to its Guarantee, as set forth below, in any respect reasonably deemed necessary by BrandBrew to meet the requirements of Rule 3-10 under Regulation S-X under the Securities Act (or any successor or similar regulation or exemption) in order for financial statements of such Subsidiary Guarantor not to be required to be included in any registration statement or in periodic reports filed with or furnished to the SEC.

**Supplemental Information on Subsidiary Guarantors**

BrandBrew S.A., whose Guarantees are subject to the limitations described below under Guarantee Limitations, accounted for less than 1% of the total consolidated EBITDA, as defined, of AB InBev Group for the six month period ended 30 June 2010 and approximately 5% of the total consolidated debt of AB InBev Group as of 30 June 2010.

**Guarantee Limitations**

***BrandBrew S.A.***

Notwithstanding anything to the contrary in the Guarantee provided by BrandBrew S.A., the maximum aggregate liability of BrandBrew S.A. under its Guarantee and as a guarantor of the BrandBrew Guaranteed Facilities (excluding its Guarantee) shall not exceed an amount equal to the aggregate of (without double counting):

(1) the aggregate amount of all moneys received by BrandBrew S.A. and the BrandBrew Subsidiaries as a borrower or issuer under the BrandBrew Guaranteed Facilities;

(2) the aggregate amount of all outstanding intercompany loans made to BrandBrew S.A. and the BrandBrew Subsidiaries by other members of the AB InBev Group which have been directly or indirectly funded using the proceeds of borrowings under the BrandBrew Guaranteed Facilities; and

(3) an amount equal to 100% of the greater of:

a. the sum of BrandBrew S.A. s own capital (*capitaux propres*) and its subordinated debt (*dettes subordonnées*) (other than any subordinated debt already accounted for under (B) above) (both as referred to in article 34 of the Luxembourg law 19 December 2002 on the commercial register and annual accounts, as amended (the **Law of 2002** ) as reflected in BrandBrew S.A. s most recent annual accounts approved by the competent organ of BrandBrew S.A. (as audited by its *réviseur d entreprises* (external auditor), if required by law); and

b. the sum of BrandBrew S.A. s own capital (i) and its subordinated debt (*dettes subordonnées*) (both as referred to in article 34 of the Law of 2002) as reflected in its filed annual accounts available as of the date of its Guarantee.

For the avoidance of doubt, the limitation on the Guarantee provided by BrandBrew S.A. shall not apply to any Guarantee by BrandBrew S.A. of any obligations owed by the BrandBrew Subsidiaries under the BrandBrew Guaranteed Facilities.

In addition to the limitation referred to above in respect of the Guarantee provided by BrandBrew S.A., the obligations and liabilities of BrandBrew S.A. under the Guarantee provided by BrandBrew S.A. and under any of the BrandBrew Guaranteed Facilities shall not include any obligation which, if incurred, would constitute a breach of the provisions on financial assistance as defined by article 49-6 of the Luxembourg Law on Commercial Companies dated 10 August 1915, as amended, to the extent such or an equivalent provision is applicable to BrandBrew S.A.

**BrandBrew Guaranteed Facilities** means: (i) the 2,500,000,000 syndicated credit facility agreement dated 8 December 2005 among the Parent Guarantor, Fortis Bank and others; (ii) the 150,000,000 facility agreement dated 13 May 2008 between the Parent Guarantor, Cobrew NV/SA and BNP Paribas as lender; (iii) the 150,000,000 facility agreement dated 20 June 2008 between, among others, the Parent Guarantor, Cobrew and The Royal Bank of Scotland plc as lender; (iv) the Existing Target Debt; (v) the USD 850,000,000 note purchase and guarantee agreement dated 22 October 2003 and entered into between, among others, the Parent Guarantor as issuer, Cobrew and BrandBrew; (vi) any notes issued by BrandBrew S.A. or the Parent Guarantor under the Programme; (vii) the 2008 Senior Facilities Agreement; (viii) the January Notes; (ix) the May Notes; (x) the October Notes; (xi) the March Notes; (xii) the 2010 Facilities Agreement; and (xiii) the debt securities, or any refinancing (in whole or part) of any of the above items for the same or a lower amount.

**BrandBrew Subsidiaries** means each entity of which BrandBrew S.A. has direct or indirect control or owns directly or indirectly more than 50% of the voting share capital or similar right of ownership; and control for this purpose means the power to direct the management and the policies of the entity whether through the ownership of voting capital, by contract or otherwise.

**Existing Target Debt** means the following notes, debentures and bonds of Anheuser-Busch Companies, Inc.: (i) 6.450% Debentures due 1 September 2037; (ii) 5.50% Notes due 15 January 2018; (iii) 9.0% Debentures due 1 December 2009; (iv) 6.75% Debentures due 15 December 2027; (v) 6.50% Debentures due 1 January 2028; (vi) 5.75% Notes due 1 April 2010; (vii) 7.50% Notes due 15 March 2012; (viii) 7.55% Debentures due 1 October 2030; (ix) 6.80% Debentures due 15 January 2031; (x) 6.00% Notes due 15 April 2011; (xi) 6.80% Debentures due 20 August 2032; (xii) 5.625% Notes due 1 October 2010; (xiii) 6.00% Debentures due 1 November 2041; (xiv) 6.50% Debentures due 1 May 2042; (xv) 6.50% Debentures due 1 February 2043; (xvi) 4.375% Notes due 15 January 2013; (xvii) 5.95% Debentures due 15 January 2033; (xviii) 4.625% Notes due 1 February 2015; (xix) 4.50% Notes due 1 April 2018; (xx) 5.35% Notes due 15 May 2023; (xxi) 4.95% Notes due 15 January 2014; (xxii) 5.05% Notes due 15 October 2016; (xxiii) 5.00% Notes due 1 March 2019; (xxiv) 4.70% Notes due 15 April 2012; (xxv) 5.00% Notes due 15 January 2015; (xxvi) 5.491%

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Notes due 15 November 2017; (xxvii) 5.75% Debentures due 1 April 2036; (xxviii) 5.60% Notes due 1 March 2017; (xxix) Notes issued on 1 December 1989 by the Development Authority of Cartersville*; (xxx) Notes issued on 1 November 1990 by the Development Authority of Cartersville*; (xxxi) Notes issued on 1 May 1991 by The Industrial Development Authority of the City of St. Louis, Missouri*; (xxxii) Notes issued on 1 April 1997 by the Industrial Development Authority of the County of James City, Virginia*; (xxxiii) Notes issued on 1 April 1997 by the Development Authority of Cartersville*; (xxxiv) Notes issued on 1 August 1999 by the Ohio Water Development Agency*; (xxxv) Notes issued on 1 December 1999 by The Onondaga County Industrial Development Agency*; (xxxvi) Notes issued on 1 July 2000 by the Ohio Water Development Agency*; (xxxvii) Notes issued on 1 November 2001 by the Ohio Water Development Agency*; (xxxviii) Notes issued on 1 March 2002 by the Development Authority of Cartersville*; (xxxix) Notes issued on 1 April 2002 by the Gulf Coast Waste Disposal Authority*; (xl) Notes issued on 1 October 2002 by the City of Jonesboro, Arkansas*; (xli) Notes issued on 1 July 2006 by The Onondaga County Industrial Development Agency*; (xlii) Notes issued on 1 February 2007 by The Business Finance Authority of the State of New Hampshire*; (xliii) Notes issued on 1 February 2007 by the Jacksonville Economic Development Commission*; (xliv) Notes issued on 1 February 2007 by the City of Fort Collins, Colorado*; (xlv) Notes issued on 1 February 2007 by The Industrial Development Authority of the City of St. Louis, Missouri*; (xlvi) Notes issued on 1 February 2007 by the California Statewide Communities Development Authority*; (xlvii) Notes issued on 31 May 2007 by the New Jersey Economic Development Authority*; (xlviii) Notes issued on 1 August 2007 by the Development Authority of Cartersville*; and (xlix) Notes issued on 1 September 2007 by the California Enterprise Development Authority*.

* Anheuser-Busch Companies, Inc. has subsequently become the principal debtor in respect of the debt securities listed in sub-paragraphs (xxix) to (xlix).

**Programme** means the Euro Medium Term Note Programme established by BrandBrew S.A. and Anheuser-Busch InBev SA/NV, as issuers, in January 2009 and subsequently recommenced on 24 February 2010.

**Redemption**

*Optional Redemption.* The relevant prospectus supplement will specify whether we may redeem the debt securities of any series, in whole or in part, at our option, in any other circumstances. The prospectus supplement will also specify the notice we will be required to give, what prices and any premium we will pay, and the dates on which we may redeem the debt securities. Any notice of redemption of debt securities will state:

- the date fixed for redemption;
- the redemption price, or if not ascertainable, the manner of calculation thereof;
- the amount of debt securities to be redeemed if we are only redeeming a part of the series;
- that on the date fixed for redemption the redemption price will become due and payable on each debt security to be redeemed and, if applicable, that any interest will cease to accrue on or after the redemption date;
- the place or places at which each holder may obtain payment of the redemption price;
- the CUSIP number or numbers, if any, with respect to the debt securities; and
- that the redemption is for a sinking fund, if such is the case.

In the case of a partial redemption, the trustee shall select the debt securities that we will redeem in any manner it deems fair and appropriate.

If we exercise an option to redeem any debt securities, we will give to the holder written notice of the principal amount of the debt securities to be redeemed, not less than 30 days nor more than 60 days before the applicable redemption date.

**Additional Mechanics**

*Form, Exchange and Transfer*

You may have your debt securities broken into more debt securities of smaller denominations or combined into fewer debt securities of larger denominations, as long as the total principal amount is not changed. This is called an exchange.

Subject to certain restrictions outlined in the indenture, you may exchange or transfer registered debt securities at the office of the trustee. The trustee acts as our agent for registering debt securities in the names of holders and transferring registered debt securities. We may change this appointment to another entity or perform the service ourselves. The entity performing the role of maintaining the list of registered holders is called the security registrar. It will also register transfers of the registered debt securities.

You will not be required to pay a service charge for registering a transfer or exchange of debt securities, but you may be required to pay for any tax or other governmental charge associated with the registration of the exchange or transfer. The transfer or exchange of a registered debt security will only be made if the security registrar is satisfied with your proof of ownership.

If we have designated additional transfer agents, they will be named in the prospectus supplement. We may cancel the designation of any particular transfer agent. We may also approve a change in the office through which any transfer agent acts.

If the debt securities are redeemable and we redeem less than all of the debt securities of a particular series, we may block the transfer or exchange of debt securities during a specified period of time in order to freeze the list of holders to prepare the mailing. The period begins 15 days before the day we mail the notice of redemption and ends on the day of that mailing. We may also refuse to register transfers or exchanges of debt securities selected for redemption. However, we will continue to permit transfers and exchanges of the unredeemed portion of any security being partially redeemed.

*Payment and Paying Agents*

We will pay interest to you if you are a direct holder listed in the trustee s records at the close of business on a particular day in advance of each due date for interest, even if you no longer own the security on the interest due date. That particular day, usually about two weeks in advance of the interest due date, is called the regular record date and is stated in the applicable prospectus supplement.

Holders buying and selling debt securities must work out between them how to compensate for the fact that we will pay all the interest for an interest period to the one who is the registered holder on the regular record date. The most common manner is to adjust the sales price of the debt securities to prorate interest fairly between buyer and seller.

We will pay interest, principal and any other money due on the registered debt securities at the corporate trust office of the trustee in New York City. You must make arrangements to have your payments picked up at or wired from that office. We may also choose to pay interest by mailing checks. Interest on global securities will be paid to the holder thereof by wire transfer of same day funds.

***Street name and other indirect holders should consult their banks or brokers for information on how they will receive payments.***

We may also arrange for additional payment offices, and may cancel or change these offices, including our use of the trustee s corporate trust office. These offices are called paying agents. We may also choose to act as our own paying agent. We must notify the trustee of changes in the paying agent for any particular series of debt securities.

*Payments Due in Other Currencies*

We will make payments on a global debt security in the applicable specified currency in accordance with the applicable policies as in effect from time to time of the depositary, which will be DTC, Euroclear or Clearstream, Luxembourg. Unless we specify otherwise in the applicable prospectus supplement, The Depository Trust Company, New York, New York, known as DTC, will be the depositary for all debt securities in global form.

Unless otherwise indicated in the applicable prospectus supplement, holders are not entitled to receive payments in U.S. dollars of an amount due in another currency.

If the applicable prospectus supplement specifies that holders may request that we make payments in U.S. dollars of an amount due in another currency, the exchange rate agent described below will calculate the U.S. dollar amount the holder receives in the exchange rate agent s discretion. A holder that requests payment in U.S. dollars will bear all associated currency exchange costs, which will be deducted from the payment.

If we are obligated to make any payment in a specified currency other than U.S. dollars, and the specified currency or any successor currency is not available to us due to circumstances beyond our control such as the imposition of exchange controls or a disruption in the currency markets we will be entitled to satisfy our obligation to make the payment in that specified currency by making the payment in U.S. dollars, on the basis of the exchange rate determined by the exchange rate agent described below, in its discretion.

The foregoing will apply to any debt security and to any payment, including a payment at maturity. Any payment made under the circumstances and in a manner described above will not result in a default under any debt security or the applicable indenture.

If we issue a debt security in a specified currency other than U.S. dollars, we will appoint a financial institution to act as the exchange rate agent and will name the institution initially appointed when the debt security is originally issued in the applicable prospectus supplement. We may change the exchange rate agent from time to time after the original issue date of the debt security without your consent and without notifying you of the change.

All determinations made by the exchange rate agent will be in its sole discretion unless we state in the applicable prospectus supplement that any determination requires our approval. In the absence of manifest error, those determinations will be conclusive for all purposes and binding on you and us, without any liability on the part of the exchange rate agent.

*Notices*

We and the trustee will send notices only to direct holders, using their addresses as listed in the trustee s records. Notices regarding the debt securities will be valid if given in writing and mailed, first-class postage prepaid, to each holder affected by the relevant event, at such holder s address as it appears in the Security Register, not later than the latest date (if any), and not earlier than the earliest date (if any), prescribed for the giving of such notice.

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Regardless of who acts as paying agent, all money that we pay to a paying agent that remains unclaimed at the end of two years after the amount is due to direct holders will be repaid to us, as the case may be. After that two-year period, you may look only to the Issuer for payment and not to the trustee, any other paying agent or anyone else.

**The Trustee**

The Bank of New York Mellon Trust Company, N.A. will be the trustee under the indentures. The trustee has two principal functions:

- first, it can enforce a holder s rights against us if we default on debt securities issued under the indenture. There are some limitations on the extent to which the trustee acts on a holder s behalf, described under Events of Default ; and

- second, the trustee performs administrative duties for us, such as sending the holder s interest payments, transferring debt securities to a new buyer and sending notices to holders.

We and some of our subsidiaries maintain deposit accounts and conduct other banking transactions with the trustee and affiliates of the trustee in the ordinary course of our respective businesses. The address of The Bank of New York Mellon Trust Company, N.A. is 911 Washington Avenue, 3rd Floor; St. Louis, Missouri 63101.

If an event of default occurs, or an event occurs that would be an event of default if the requirements for giving us default notice or our default having to exist for a specific period of time were disregarded, the trustee may therefore be considered to have a conflicting interest with respect to the debt securities or the applicable indenture for purposes of the Trust Indenture Act of 1939. In that case, the trustee may be required to resign as trustee under the applicable indenture and we would be required to appoint a successor trustee.

*Regarding the Trustee, Paying Agent, Transfer Agent and Registrar*

For a description of the duties and the immunities and rights of any trustee, paying agent, transfer agent or registrar under the Indenture, reference is made to the Indenture, and the obligations of any Trustee, paying agent, transfer agent and registrar to the Holder are subject to such immunities and rights.

**Modifications and Amendment**

The Issuer, the Guarantors and the Trustee may execute agreements adding any provisions to or changing in any manner or eliminating any of the provisions of the Indenture or of any supplemental agreement or modifying in any manner the rights of the Holders under the debt securities or the Guarantees only with the consent of the Holders of not less than a majority in aggregate principal amount of the debt securities then outstanding (irrespective of series) that would be affected by the proposed modification or amendment; provided that no such agreement shall (a) change the maturity of the principal of, or any installment of interest on, any debt security, or reduce the principal amount or the interest thereof, or extend the time of payment of any installment of interest thereon, or change the currency of payment of principal of, or interest on, any debt security, or change the Issuer s or a Guarantor s obligation to pay Additional Amounts, impair or affect the right of any Holder to institute suit for the enforcement of any such payment on or after the due date thereof (or in the case of redemption on or after the redemption date) or change in any manner adverse to the interests of the Holders the terms and provisions of the Guarantees in respect of the due and punctual payment of principal amount of the debt securities then outstanding plus accrued and unpaid interest (and all Additional Amounts, if any) without the consent of the Holder of each debt securities so affected; or (b) reduce the aforesaid percentage of , the consent of the Holders of which is required for any such agreement, without the consent of the Holders of the affected series of the debt securities then outstanding. To the extent that any changes directly affect fewer than all the series of the debt securities, only the consent of the Holders of debt securities of the relevant series (in the respective percentages set forth above) will be required.

The Issuer, the Guarantors and the Trustee may, without the consent of the Holders, from time to time execute agreements or amendments or enter into an Indenture or Indentures supplemental thereto (including in respect of one series of debt securities only) for one or more of the following purposes:

- to convey, transfer, assign, mortgage or pledge any property or assets to the Trustee or another person as security for the debt securities;

- to evidence the succession of another person to the Issuer or any Guarantors, or successive successions, and the assumption by the successor person of the covenants of the Issuer or any of the Guarantors, pursuant to the Indenture and the debt securities;

- to evidence and provide for the acceptance of appointment of a successor or successors to the Trustee in any of its capacities and to add to or change any of the provisions of the Indenture to facilitate the administration of the trusts created thereunder by more than one trustee;

- to add to the covenants of the Issuer or the Guarantors, for the benefit of the holders of all or any series of the debt securities issued under the Indenture, or to surrender any rights or powers conferred on the Issuer or the Guarantors in the Indenture;

- to add any additional events of default for the benefit of the Holders of all or any series of debt securities (and if such additional events of default are to be for the benefit of less than all series of Holders, stating that such additional events of default are expressly being included solely for the benefit of such series);

- to add to, change or eliminate any of the provisions of the Indenture in respect of one or more series of debt securities, provided that any such addition, change or elimination (A) shall neither (i) apply to any debt security of any series created prior to the execution of such supplemental indenture and entitled to the benefit of such provision nor (ii) modify the rights of the Holder of any such debt security with respect to such provision or (B) shall become effective only when there is no such debt security outstanding;

- to modify the restrictions on and procedures for, resale and other transfers of the debt securities pursuant to law, regulation or practice relating to the resale or transfer of restricted securities generally;

- to provide for the issues of securities in exchange for one or more series of outstanding debt securities;

- to provide for the issuance and terms of any particular series of securities, the rights and obligations of the Guarantors and the holders of the securities of such series, the form or forms of the securities of such series and such other matters in connection therewith as the Issuer and the Guarantors shall consider appropriate, including, without limitation, provisions for (a) additional or different covenants, restrictions or conditions applicable to such series, (b) additional or different events of default in respect of such series, (c) a longer or shorter period of grace and/or notice in respect of any provision applicable to such series than is otherwise provided, (d) immediate enforcement of any event of default in respect of such series or (e) limitations upon the remedies available in respect of any events of default in respect of such series or upon the rights of the holders of securities of such series to waive any such event of default;

- (a) to cure any ambiguity or to correct or supplement any provision contained in the Indenture, any series of debt securities or the Guarantees, or in any supplemental agreement, which may be defective or inconsistent with any other provision contained therein or in any supplemental

agreement, (b) to eliminate any conflict between the terms hereof and the Trust Indenture Act or (c) to make such other provision in regard to matters or questions arising under the Indenture or under any supplemental agreement as the Issuer may deem necessary or desirable and which will not adversely affect the interests of the Holders to which such provision relates in any material respect;

to reopen the debt securities of any series and create and issue additional debt securities having identical terms and conditions as the debt securities of such series (or in all respects except for the issue date, issue price, first interest accrual date and first interest payment date) so that the additional notes are consolidated and form a single series with the outstanding debt securities;

to add any Subsidiary of the Parent Guarantor as a Guarantor with respect to any series of notes, subject to applicable regulatory or contractual limitations relating to such subsidiary s Guarantee;

to provide for the release and termination of any Subsidiary Guarantor s Guarantee in the circumstances described under Guarantees above;

to provide for any amendment, modification or alteration of any Subsidiary Guarantor s Guarantee and the limitations applicable thereto in the circumstances described under Guarantees above; or

to make any other change that does not materially adversely affect the interests of the holders of the series of notes affected thereby.

***Street name and other indirect holders should consult their banks or brokers for information on how approval may be granted or denied if we seek to change the indenture or the debt securities or request a waiver.***

**Certain Covenants**

***Limitation on Liens***

So long as any of the debt securities remains outstanding, the Parent Guarantor will not, nor will it permit any Restricted Subsidiary to, create, assume, guarantee or suffer to exist any mortgage, pledge, security interest or lien (an Encumbrance ) on any of its Principal Plants or on any capital stock of any Restricted Subsidiary without effectively providing that the debt securities (together with, if the Parent Guarantor shall so determine, any other indebtedness of the Parent Guarantor then existing or thereafter created ranking equally with the debt securities and any other indebtedness of such Restricted Subsidiary then existing or thereafter created) shall be secured by the security for such secured indebtedness equally and ratably therewith, provided, however, the above limitation does not apply to:

(a) purchase money liens, so long as such liens attach only to the assets so acquired and improvements thereon;

(b) Encumbrances existing at the time of acquisition of property (including through merger or consolidation) or securing indebtedness the proceeds of which are used to pay or reimburse the Parent Guarantor or a Restricted Subsidiary for the cost of such property (provided such indebtedness is incurred within 180 days after such acquisition);

(c) Encumbrances on property of a Restricted Subsidiary existing at the time it becomes a Restricted Subsidiary;

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(d) Encumbrances to secure the cost of development or construction of property, or improvements thereon, provided that the recourse of the creditors in respect of such indebtedness is limited to such property and improvements;

(e) Encumbrances in connection with the acquisition or construction of Principal Plants or additions thereto financed by tax-exempt securities;

(f) Encumbrances securing indebtedness owing to the Parent Guarantor or a Restricted Subsidiary by a Restricted Subsidiary;

(g) Encumbrances existing at the date of the Indenture;

(h) Encumbrances required in connection with state or local governmental programs which provide financial or tax benefits, provided the obligations secured are in lieu of or reduce an obligation that would have been secured by an Encumbrance permitted under the Indenture;

(i) any Encumbrance arising by operation of law and not securing amounts more than ninety (90) days overdue or otherwise being contested in good faith;

(j) judgment Encumbrances not giving rise to an event of default;

(k) any Encumbrance incurred or deposits made in the ordinary course of business, including, but not limited to, (i) any mechanics , materialmen s, carriers , workmen s, vendors or other like Encumbrances, (ii) any Encumbrances securing amounts in connection with workers compensation, unemployment insurance and other types of social security, and (iii) any easements, rights-of-way, restrictions and other similar charges;

(l) any Encumbrance upon specific items of inventory or other goods and proceeds of the Parent Guarantor or any Restricted Subsidiary securing the Parent Guarantor s or any such Restricted Subsidiary s obligations in respect of bankers acceptances issued or created for the account of such person to facilitate the purchase, shipment or storage of such inventory or other goods;

(m) any Encumbrance incurred or deposits made securing the performance of tenders, bids, leases, statutory obligations, surety and appeal bonds, government contracts, performance and return-of-money bonds and other obligations of like nature incurred in the ordinary course of business;

(n) any Encumbrance on any Principal Plant of the Parent Guarantor or any Restricted Subsidiary in favor of the Federal Government of the United States or the government of any State thereof, or the government of the United Kingdom, or any state in the European Union, or any instrumentality of any of them, securing the obligations of the Parent Guarantor or any Restricted Subsidiary pursuant to any contract or payments owed to such entity pursuant to applicable laws, rules, regulations or statutes;

(o) any Encumbrance securing taxes or assessments or other applicable governmental charges or levies;

(p) extensions, renewals or replacements of the Encumbrances referred to in clauses (a) through (o), provided that the amount of indebtedness secured by such extension, renewal or replacement shall not exceed the principal amount of indebtedness being extended, renewed or replaced, together with the amount of any premiums, fees, costs and expenses associated with such extension, renewal or replacement, nor shall the pledge, mortgage or lien be extended to any additional Principal Plant unless otherwise permitted under this covenant;

(q) as permitted under the provisions described in the following two paragraphs herein; and

(r) in connection with sale-leaseback transactions permitted under the Indenture.

Notwithstanding the provisions described in the immediately preceding paragraph, the Parent Guarantor or any Restricted Subsidiary may, without ratably securing the debt securities, create, assume, guarantee or suffer to exist any indebtedness which would otherwise be subject to such restrictions, and renew, extend or replace such indebtedness, provided that the aggregate amount of such indebtedness, when added to the fair market value of property transferred in certain sale and leaseback transactions permitted by the Indenture as described below under Sale-Leaseback Financings (computed without duplication of amount) does not at the time exceed 15% of Net Tangible Assets.

If the Parent Guarantor or any Restricted Subsidiary merges or consolidates with, or purchases all or substantially all of the assets of, another corporation, or the Parent Guarantor sells all or substantially all of its assets to another corporation, and if such other corporation has outstanding obligations secured by an Encumbrance which, by reason of an after-acquired property clause or similar provision, would extend to any Principal Plant owned by the Parent Guarantor or such Restricted Subsidiary immediately prior thereto, the Parent Guarantor or such Restricted Subsidiary, as the case may be, will in such event be deemed to have created an Encumbrance, within the prohibition of the covenant described above, unless (a) such merger or consolidation involving a Restricted Subsidiary constitutes a disposition by the Parent Guarantor of its interest in the Restricted Subsidiary or (b) (i) at or prior to the effective date of such merger, consolidation, sale or purchase, such Encumbrance shall be released of record or otherwise satisfied to the extent it would extend to such Principal Plant, (ii) prior thereto, the Parent Guarantor or such Restricted Subsidiary shall have created, as security for the debt securities (and, if the Parent Guarantor shall so determine, as security for any other indebtedness of the Parent Guarantor then existing or thereafter created ranking equally with the debt securities and any other indebtedness of such Restricted Subsidiary then existing or thereafter created), a valid Encumbrance which will rank equally and ratably with the Encumbrances of such other corporation on such Principal Plant of the Parent Guarantor or such Restricted Subsidiary, as the case may be, or (iii) such Encumbrance is otherwise permitted or complies with the Covenant described above.

In each instance referred to in the preceding paragraphs where the Parent Guarantor is obligated to provide security for the debt securities (except, for certain issues of indebtedness, in the case of transactions relating to stock of a Restricted Subsidiary), the Parent Guarantor would be required to provide comparable security for other outstanding indebtedness under the indentures and other agreements relating thereto.

***Sale-Leaseback Transactions Relating to Principal Plants***

a. Except to the extent permitted under paragraph (c) below, and except for any transaction involving a lease for a temporary period, not to exceed three years, by the end of which it is intended that the use of the leased property by the Parent Guarantor or any Restricted Subsidiary will be discontinued and except for any transaction with a state or local authority that is required in connection with any program, law, statute or regulation that provides financial or tax benefits not available without such transaction, the Parent Guarantor shall not sell any Principal Plant as an entirety, or any substantial portion thereof, with the intention of taking back a lease of such property and the Parent Guarantor will not permit any Restricted Subsidiary to sell to anyone other than the Parent Guarantor or a Restricted Subsidiary any Principal Plant as an entirety, or any substantial portion thereof, with the intention of taking back a lease of such property unless:

b. the net proceeds of such sale (including any purchase money mortgages received in connection with such sale) are at least equal to the fair market value (as determined by an officer of the Parent Guarantor) of such property and

c. subject to paragraph (d) below, the Parent Guarantor shall, within 120 days after the transfer of title to such property (or, if the Parent Guarantor holds the net proceeds described below in cash or cash equivalents, within two years)

(i) purchase, and surrender to the Trustee for retirement as provided in this covenant, a principal amount of debt securities equal to the net proceeds derived from such sale (including the amount of any such purchase money mortgages), or

(ii) repay other pari passu indebtedness of the Parent Guarantor or any Restricted Subsidiary in an amount equal to such net proceeds, or

(iii) expend an amount equal to such net proceeds for the expansion, construction or acquisition of a Principal Plant, or

(iv) effect a combination of such purchases, repayments and plant expenditures in an amount equal to such net proceeds.

d. At or prior to the date 120 days after a transfer of title to a Principal Plant which shall be subject to the requirements of this covenant, the Parent Guarantor shall furnish to the Trustee:

e. an Officers Certificate stating that paragraph (a) of this covenant has been complied with and setting forth in detail the manner of such compliance, which certificate shall contain information as to

(i) the amount of debt securities theretofore redeemed and the amount of debt securities theretofore purchased by the Parent Guarantor and cancelled by the Trustee and the amount of debt securities purchased by the Parent Guarantor and then being surrendered to the Trustee for cancellation,

(ii) the amount thereof previously credited under paragraph (d) below,

(iii) the amount thereof which it then elects to have credited on its obligation under paragraph (d) below, and

(iv) any amount of other indebtedness which the Parent Guarantor has repaid or will repay and of the expenditures which the Parent Guarantor has made or will make in compliance with its obligation under paragraph (a), and

f. a deposit with the Trustee for cancellation of the debt securities then being surrendered as set forth in such certificate.

g. Notwithstanding the restriction of paragraph (a) above, the Parent Guarantor and any one or more Restricted Subsidiaries may transfer property in sale-leaseback transactions which would otherwise be subject to such restriction if the aggregate amount of the fair market value of the property so transferred and not reacquired at such time, when added to the aggregate principal amount of indebtedness for borrowed money permitted by the last paragraph of the covenant described under Limitation on Liens which shall be outstanding at the time (computed without duplication of the value of property transferred as provided in this paragraph (c)), does not at the time exceed 15% of Net Tangible Assets.

h. The Parent Guarantor, at its option, shall be entitled to a credit, in respect of its obligation to purchase and retire debt securities under this covenant, for the principal amount of any debt securities deposited with the Trustee for the purpose and also for the principal amount of (i) any debt securities theretofore redeemed at the option of the Parent Guarantor and (ii) any debt securities previously purchased by the Parent Guarantor and cancelled by the Trustee, and in each case not theretofore applied as a credit under this paragraph (d) or as part of a sinking fund arrangement for the debt securities.

i. For purposes of this covenant, the amount or the principal amount of debt securities which are issued with original issue discount shall be the principal amount of such debt securities that on the date of the purchase or redemption of such debt securities referred to in this covenant could be declared to be due and payable pursuant to the Indenture.

**Ranking**

The debt securities are not secured by any of our property or assets. Accordingly, your ownership of debt securities means you are one of our unsecured creditors. The debt securities are not subordinated to any of our other debt obligations and therefore they rank equally with all our other unsecured and unsubordinated indebtedness.

**Events of Default**

The occurrence and continuance of one or more of the following events will constitute an Event of Default under the Indenture and the debt securities:

(a) Payment Default (i) The Issuer or a Guarantor fails to pay interest within 30 days from the relevant due date, or (ii) the Issuer or a Guarantor fails to pay the principal (or premium, if any) due on the debt securities at maturity; provided that to the extent any such failure to pay principal or premium is caused by a technical or administrative error, delay in processing payments or events beyond the control of the Issuer or Guarantors, no Event of Default shall occur for three days following such failure to pay; provided further that, in the case of a redemption payment, no Event of Default shall occur for 30 days following a failure to make such payment;

(b) Breach of Other Material Obligations The Issuer or a Guarantor defaults in the performance or observance of any of its other material obligations under or in respect of the debt securities or the Indenture and such default remains unremedied for 90 days after a written notice has been given to the Issuer and the Parent Guarantor by the Trustee or to the Issuer, the Parent Guarantor and the Trustee by the Holders of at least 25% in principal amount of the outstanding debt securities affected thereby, specifying such default or breach and requiring it to be remedied and stating that such notice is a Notice of Default under the debt securities;

(c) Cross-Acceleration Any obligation for the payment or repayment of borrowed money having an aggregate outstanding principal amount of at least 100,000,000 (or its equivalent in any other currency) of the Issuer or a Guarantor becomes due and payable prior to its stated maturity by reason of a default and is not paid within 30 days;

(d) Bankruptcy or Insolvency A court of competent jurisdiction commences bankruptcy or other insolvency proceedings against the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary under the applicable laws of their respective jurisdictions of incorporation, or the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary applies for or institutes such proceedings or offers or makes an assignment for the benefit of its creditors generally, or a third party institutes bankruptcy or insolvency proceedings against the Issuer, the Parent Guarantor or a Guarantor that is a Significant Subsidiary and such proceedings are not discharged or stayed within 90 days;

(e) Impossibility due to Government Action Any governmental order, decree or enactment shall be made in or by Belgium or the jurisdiction of incorporation of a Guarantor that is a Significant Subsidiary whereby the Issuer, the Parent Guarantor, or such Guarantor that is a Significant Subsidiary is prevented from observing and performing in full its obligations as set forth in the terms and conditions of the debt securities and the Guarantees, respectively, and this situation is not cured within 90 days; or

(f) Invalidity of the Guarantees The Guarantees provided by the Parent Guarantor or a Guarantor that is a Significant Subsidiary cease to be valid and legally binding for any reason whatsoever or the Parent Guarantor or a Guarantor that is a Significant Subsidiary seeks to deny or disaffirm its obligations under the Guarantee.

If an Event of Default occurs and is continuing with respect to the debt securities of any series, then in each and every case, unless the principal of all of the debt securities of such series shall already have become due and payable (in which case no action is required for the acceleration of the debt securities of such series), the Holders of not less than 25% in aggregate principal amount of debt securities of such series then outstanding, by written notice to the Issuer, the Parent Guarantor and the Trustee as provided in the Indenture, may declare the entire principal of all the debt securities of such series, and the interest accrued thereon, to be due and payable immediately, provided, however, that if an Event of Default specified in paragraph (d) above with respect to any series of the debt securities at the time outstanding occurs, the principal amount of that series shall automatically, and without any declaration or other action on the part of the Trustee or any Holder, become immediately due and payable. Under certain circumstances, the Holders of a majority in aggregate principal amount of a series of debt securities then outstanding may, by written notice to the Issuer and the Trustee as provided in the Indenture, waive all defaults and rescind and annul such declaration and its consequences, but no such waiver or rescission and annulment shall extend to or shall affect any subsequent default or shall impair any right consequent thereon.

Except in cases of default, where the trustee has some special duties, the trustee is not required to take any action under the indenture at the request of any holders unless the holders offer the trustee reasonable protection from costs, expenses and liability. This protection is called an indemnity. If reasonable indemnity is provided, the holders of a majority in principal amount of the outstanding debt securities of any series may direct the time, method and place of conducting any proceeding seeking any remedy available to the trustee. These majority holders may also direct the trustee in performing any other action under the indenture, so long as such direction would not involve the Trustee in personal liability.

Before you bypass the trustee and bring your own lawsuit or other formal legal action or take other steps to enforce your rights or protect your interests relating to the debt securities, the following must occur:

- The trustee must be given written notice that an event of default has occurred and remains uncured.

- The holders of not less than 25% in principal amount of all outstanding debt securities of the relevant series must make a written request that the trustee institute proceedings because of the default, and must offer indemnity and/or security satisfactory to the trustee against the costs, expenses and liabilities of taking such request.

- The trustee must have not taken action for 60 days after receipt of the above notice, request and offer of indemnity.

- No direction inconsistent with such written request has been given to the trustee during such 60-day period by the holders of the majority in principal amount of the outstanding securities of that series.

However, you are entitled at any time to bring a lawsuit for the payment of money due on your security on or after its due date.
We will furnish to the Trustee every year a written statement of certain of our officers and directors, certifying that, to their knowledge, we are in compliance with the indenture and the debt securities, or else specifying any default.

***Street name and other indirect holders should consult their banks or brokers for information on how to give notice or direction to or make a request of the trustee and to make or cancel a declaration of acceleration.***

**Substitution of the Issuer or Guarantor; Consolidation, Merger and Sale of Assets**

In all cases subject to any provisions contained in the applicable prospectus supplement describing the Holders option to require repayment upon a change in control, (i) the Issuer or a Guarantor, without the consent of the Holders of any of the debt securities, may consolidate with or merge into, or sell, transfer, lease or convey all or substantially all of their respective assets to, any corporation and (ii) the Issuer may at any time substitute for the Issuer either a Guarantor or any Affiliate (as defined below) of a Guarantor as principal debtor under the debt securities (a Substitute Issuer ); provided that:

(a) the Substitute Issuer or any other successor company shall expressly assume the Issuer s or such Guarantor s respective obligations under the debt securities or the Guarantees, as the case may be, and the Indenture;

(b) any other successor company is organized under the laws of a member country of the Organization for Economic Co-Operation and Development;

(c) the Issuer is not in default of any payments due under the debt securities and immediately before and after giving effect to such consolidation, merger, sale, transfer, lease or conveyance, no Event of Default shall have occurred and be continuing;

(d) in the case of a Substitute Issuer:

   (i) the obligations of the Substitute Issuer arising under or in connection with the debt securities and the Indenture are fully, irrevocably and unconditionally guaranteed by the Parent Guarantor and each Subsidiary Guarantor (if any) on the same terms as existed immediately prior to such substitution under the Guarantees given by such Guarantors;

   (ii) the Parent Guarantor, the Issuer and the Substitute Issuer jointly and severally indemnify each Holder for any income tax or other tax (if any) recognized by such Holder solely as a result of the substitution of the Substitute Issuer (and not as a result of any transfer by such Holder);

   (iii) each stock exchange on which the debt securities are listed shall have confirmed that, following the proposed substitution of the Substitute Issuer, such debt securities will continue to be listed on such stock exchange; and

   (iv) each rating agency that rates the debt securities shall have confirmed that, following the proposed substitution of the Substitute Issuer, such debt securities will continue to have the same or better rating as immediately prior to such substitution; and

(e) written notice of such transaction shall be promptly provided to the Holders.

For purposes of the foregoing, Affiliate shall mean, with respect to any specified person, any other person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified person.

Upon the effectiveness of any substitution, all of the foregoing provisions will apply mutatis mutandis, and references elsewhere herein to the Issuer or a Guarantor will, where the context so requires, be deemed to be or include references, to any successor company.

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**Discharge and Defeasance**

***Discharge of Indenture***

The Indenture provides that the Issuer and the Guarantors will be discharged from any and all obligations in respect of the Indenture (except for certain obligations to register the transfer of or exchange debt securities, replace stolen, lost or mutilated debt securities, make payments of principal and interest and maintain paying agencies) if:

- the Issuer or the Guarantors have paid or caused to be paid in full the principal of and interest on all debt securities outstanding thereunder;

- the Issuer or the Guarantors shall have delivered to the Trustee for cancellation all debt securities outstanding theretofore authenticated; or

- all debt securities not theretofore delivered to the Trustee for cancellation (i) have become due and payable, (ii) will become due and payable in accordance with their terms within one year or (iii) are to be, or have been, called for redemption as described under Optional Redemption within one year under arrangements satisfactory to the Trustee for the giving of notice of redemption, and, in any such case, the Issuer or the Guarantors shall have irrevocably deposited with the Trustee as trust funds in irrevocable trust, specifically pledged as security for, and dedicated solely to, the benefit of the Holders of such debt securities, (a) cash in U.S. dollars in an amount, or (b) U.S. Government Obligations (as defined below) which through the payment of interest thereon and principal thereof in accordance with their terms will provide not later than the due date of any payment, cash in U.S. dollars in an amount, or (c) any combination of (a) and (b), sufficient to pay all the principal of, and interest (and Additional Amounts, if any) on, all such debt securities not theretofore delivered to the Trustee for cancellation on the dates such payments are due in accordance with the terms of the debt securities and all other amounts payable under the Indenture by the Issuer.

**U.S. Government Obligations** means securities which are (i) direct obligations of the U.S. government or (ii) obligations of a person controlled or supervised by and acting as an agency or instrumentality of the U.S. government, the payment of which is unconditionally guaranteed by the U.S. government, which, in either case, are full faith and credit obligations of the U.S. government payable in U.S. dollars and are not callable or redeemable at the option of the issuer thereof.

***Covenant Defeasance***

The Indenture also provides that the Issuer and the Guarantors need not comply with certain covenants of the Indenture (including those described under Certain Covenants Limitation on Liens ), and the Guarantors shall be released from their obligations under the Guarantees, if:

- the Issuer (or the Guarantors) irrevocably deposit with the Trustee as trust funds in irrevocable trust, specifically pledged as security for, and dedicated solely to, the benefit of the holders of such debt securities, (i) cash in U.S. dollars in an amount, or (ii) U.S. government obligations which through the payment of interest thereon and principal thereof in accordance with their terms will provide not later than one day before the due date of any payment cash in U.S. dollars in an amount, or (iii) any combination of (i) and (ii), sufficient to pay all the principal of, and interest on, the debt securities then outstanding on the dates such payments are due in accordance with the terms of the debt securities;

- certain events of default, or events which with notice or lapse of time or both would become such an event of default, shall not have occurred and be continuing on the date of such deposit;

the Issuer, or the Guarantors, as the case may be, deliver to the Trustee an opinion of tax counsel of recognized standing with respect to U.S. federal income tax matters to the effect that the beneficial owners of the debt securities will not recognize income, gain or loss for U.S. federal income tax purposes as a result of the exercise of such Covenant Defeasance and will be subject to U.S. federal income tax on the same amounts, in the same manner and at the same times as would be the case if such Covenant Defeasance had not occurred;

the Issuer, or the Guarantors, as the case may be, deliver to the Trustee an opinion of tax counsel of recognized standing in its jurisdiction of incorporation to the effect that such deposit and related Covenant Defeasance will not cause the Holders, other than Holders who are or who are deemed to be residents of such jurisdiction of incorporation or use or hold or are deemed to use or hold their debt securities in carrying on a business in such jurisdiction of incorporation, to recognize income, gain or loss for income tax purposes in such jurisdiction of incorporation, and to the effect that payments out of the trust fund will be free and exempt from any and all withholding and other income taxes of whatever nature of such jurisdiction of incorporation or political subdivision thereof or therein having power to tax, except in the case of debt securities beneficially owned (i) by a person who is or is deemed to be a resident of such jurisdiction of incorporation or (ii) by a person who uses or holds or is deemed to use or hold such debt securities in carrying on a business in such jurisdiction of incorporation; and

the Issuer, or the Guarantors, as the case may be, deliver to the Trustee an officers certificate and an opinion of legal counsel of recognized standing, each stating that all conditions precedent provided for relating to such Covenant Defeasance have been complied with.

The effecting of these arrangements is also known as Covenant Defeasance.

**Additional Amounts**

To the extent that any Guarantor is required to make payments in respect of the debt securities, such Guarantor will make all payments in respect of the debt securities without withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by way of withholding or deduction at source by or on behalf of any jurisdiction in which such Guarantor is incorporated, organized or otherwise tax resident or any political subdivision or any authority thereof or therein having power to tax (the Relevant Taxing Jurisdiction ) unless such withholding or deduction is required by law. Where a Guarantor is a Luxembourg resident, please refer to the section entitled Tax Considerations Luxembourg Taxation for a description of tax consequences under Luxembourg law. In such event, such Guarantor will pay to the Holders such additional amounts (the Additional Amounts ) as shall be necessary in order that the net amounts received by the Holders, after such withholding or deduction, shall equal the respective amounts of principal and interest which would otherwise have been receivable in the absence of such withholding or deduction; except that no such Additional Amounts shall be payable on account of any taxes or duties which:

(a) are payable by any person acting as custodian bank or collecting agent on behalf of a Holder, or otherwise in any manner which does not constitute a deduction or withholding by the Guarantor from payment of principal or interest made by it;

(b) are payable by reason of the Holder or beneficial owner having, or having had, some personal or business connection with such Relevant Taxing Jurisdiction and not merely by reason of the fact that payments in respect of the debt securities or the Guarantees are, or for purposes of taxation are deemed to be, derived from sources in, or are secured in the Relevant Taxing Jurisdiction;

(c) are imposed or withheld by reason of the failure of the Holder or beneficial owner to provide certification, information, documents or other evidence concerning the nationality, residence or identity of the Holder and beneficial owner or to make any valid or timely declaration or similar claim or satisfy any other reporting requirements relating to such matters, whether required or imposed by statute, treaty, regulation or administrative practice, as a precondition to exemption from, or a reduction in the rate of withholding or deduction of, such taxes;

(d) consist of any estate, inheritance, gift, sales, excise, transfer, personal property or similar taxes;

(e) are imposed on or with respect to any payment by the applicable Guarantors to the registered Holder if such Holder is a fiduciary or partnership or any person other than the sole beneficial owner of such payment to the extent that taxes would not have been imposed on such payment had such registered Holder been the sole beneficial owner of such debt security;

(f) are deducted or withheld pursuant to (i) any European Union directive or regulation concerning the taxation of interest income; (ii) any international treaty or understanding relating to such taxation and to which the Relevant Taxing Jurisdiction or the European Union is a party, or (iii) any provision of law implementing, or complying with, or introduced to conform with, such directive, regulation, treaty or understanding;

(g) are payable by reason of a change in law or practice that becomes effective more than 30 days after the relevant payment of principal or interest becomes due, or is duly provided for and written notice thereof is provided to the Holders, whichever occurs later;

(h) are payable because any debt security was presented to a particular paying agent for payment if the debt security could have been presented to another paying agent without any such withholding or deduction; or

(i) are payable for any combination of (a) through (h) above.

References to principal or interest in respect of the debt securities shall be deemed to include any Additional Amounts, which may be payable as set forth in the Indenture.

The preceding covenant regarding Additional Amounts will not apply to any Guarantor at any time when such Guarantor is incorporated in a jurisdiction in the United States; provided, however, that such covenant will apply to the Issuer at any time when it is incorporated in a jurisdiction outside of the United States. The prospectus supplement relating to the debt securities may describe additional circumstances in which the Guarantors would not be required to pay additional amounts.

**Indemnification of Judgment Currency**

To the fullest extent permitted by applicable law, the Issuer and each of the Guarantors will indemnify each Holder against any loss incurred by such Holder as a result of any judgment or order being given or made for any amount due under any debt security or Guarantee and such judgment or order being expressed and paid in a currency (the Judgment Currency ), which is other than U.S. dollars and as a result of any variation between (i) the rate of exchange at which the U.S. dollar is converted into the Judgment Currency for the purposes of such judgment or order and (ii) the spot rate of exchange in The City of New York at which the Holder on the date of payment of such judgment is able to purchase U.S. dollars with the amount of the Judgment Currency actually received by such Holder. This indemnification will constitute a separate and independent obligation of the Issuer or each of the Guarantors, as the case may be, and will continue in full force and effect notwithstanding any such judgment or order as aforesaid. The term spot rate of exchange includes any premiums and costs of exchange payable in connection with the purchase of, or conversion into, U.S. dollars.

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**Governing Law; Submission to Jurisdiction**

The Indenture, the debt securities and the Guarantees will be governed by and construed in accordance with the laws of the State of New York.

The Issuer and the Guarantors have irrevocably submitted to the non-exclusive jurisdiction of the courts of any U.S. state or federal court in the Borough of Manhattan in The City of New York, New York with respect to any legal suit, action or proceeding arising out of or based upon the Indenture, the debt securities or the Guarantees.

**Definitions**

**Net Tangible Assets** means the total assets of the Parent Guarantor and its Restricted Subsidiaries (including, with respect to the Parent Guarantor, its net investment in subsidiaries that are not Restricted Subsidiaries) after deducting therefrom (a) all current liabilities (excluding any thereof constituting debt by reason of being renewable or extendable) and (b) all goodwill, trade names, trademarks, patents, unamortized debt discount and expense, organization and developmental expenses and other like segregated intangibles, all as computed by the Parent Guarantor in accordance with generally accepted accounting principles applied by the Parent Guarantor as of a date within 90 days of the date as of which the determination is being made; provided, that any items constituting deferred income taxes, deferred investment tax credit or other similar items shall not be taken into account as a liability or as a deduction from or adjustment to total assets.

**Principal Plant** means (a) any brewery, or any manufacturing, processing or packaging plant, now owned or hereafter acquired by the Parent Guarantor or any Subsidiary, but shall not include (i) any brewery or manufacturing, processing or packaging plant which the Parent Guarantor shall by board resolution have determined is not of material importance to the total business conducted by the Parent Guarantor and its Subsidiaries, (ii) any plant which the Parent Guarantor shall by board resolution have determined is used primarily for transportation, marketing or warehousing (any such determination to be effective as of the date specified in the applicable board resolution) or (iii) at the option of the Parent Guarantor, any plant that (A) does not constitute part of the brewing operations of the Parent Guarantor and its Subsidiaries and (B) has a net book value, as reflected on the balance sheet contained in the Parent Guarantor s financial statements of not more than $100,000,000, and (b) any other facility owned by the Parent Guarantor or any of its Subsidiaries that the Parent Guarantor shall, by board resolution, designate as a Principal Plant. Following any determination, designation or election referred to herein that a brewery or plant shall not be included as a Principal Plant, the Parent Guarantor may, at its option, by board resolution, elect that such facility subsequently be included as a Principal Plant.

**Restricted Subsidiary** means (a) any Subsidiary which owns or operates a Principal Plant, (b) any other subsidiary which the Parent Guarantor, by board resolution, shall elect to be treated as a Restricted Subsidiary, until such time as the Parent Guarantor may, by further board resolution, elect that such Subsidiary shall no longer be a Restricted Subsidiary, successive such elections being permitted without restriction, and (c) the Issuer and the Subsidiary Guarantors; provided that each of Companhia de Bebidas das Américas AmBev and Grupo Modelo S.A.B. de C.V. shall not be Restricted Subsidiaries until and unless the Parent Guarantor owns, directly or indirectly, 100% of the equity interests in such company. Any such election will be effective as of the date specified in the applicable board resolution.

**Significant Subsidiary** means any Subsidiary (i) the consolidated revenue of which represents 10% of more of the consolidated revenue of the Parent Guarantor, (ii) the consolidated earnings before interest, taxes, depreciation and amortization ( EBITDA ) of which represents 10% or more of the consolidated EBITDA of the Parent Guarantor or (iii) the consolidated gross assets of which represent 10% or more of the consolidated gross assets of the Parent Guarantor, in each case as reflected in the most recent annual audited financial statements of the Parent Guarantor, provided that (A) in the case of a Subsidiary acquired by the Parent Guarantor during or after the financial year shown in the most recent annual audited financial statements of the Parent Guarantor,

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such calculation shall be made on the basis of the contribution of the Subsidiary considered on a pro-forma basis as if it had been acquired at the beginning of the relevant period, with the pro-forma calculation (including any adjustments) being made by the Parent Guarantor acting in good faith and (B) EBITDA shall be calculated by the Parent Guarantor in substantially the same manner as it is calculated for the amounts shown in Item 5. Operating and Financial Review E. Results of Operations in the Annual Report incorporated in this prospectus.

**Subsidiary** means any corporation of which more than 50% of the issued and outstanding stock entitled to vote for the election of directors (otherwise than by reason of default in dividends) is at the time owned directly or indirectly by the Parent Guarantor or a Subsidiary or Subsidiaries or by the Parent Guarantor and a Subsidiary or Subsidiaries.

**Consent to Service**

The indentures provide that we irrevocably designate AB InBev Services LLC, 250 Park Avenue, 2nd Floor, New York, New York 10177 as our authorized agent for service of process in any proceeding arising out of or relating to the indentures or debt securities or Guarantees brought in any federal or state court in New York City and we irrevocably submit to the jurisdiction of these courts.

## CLEARANCE AND SETTLEMENT

The securities we issue may be held through one or more international and domestic clearing systems. The principal clearing systems we will use are the book-entry systems operated by The Depository Trust Company ( DTC ), in the United States, Clearstream Banking, société anonyme ( Clearstream, Luxembourg ), in Luxembourg and Euroclear Bank S.A./N.V. ( Euroclear ), in Brussels, Belgium. These systems have established electronic securities and payment transfer, processing, depositary and custodial links among themselves and others, either directly or through custodians and depositaries. These links allow securities to be issued, held and transferred among the clearing systems without the physical transfer of certificates.

Special procedures to facilitate clearance and settlement have been established among these clearing systems to trade securities across borders in the secondary market. Where payments for securities we issue in global form will be made in U.S. dollars, these procedures can be used for cross-market transfers and the securities will be cleared and settled on a delivery against payment basis.

Global securities will be registered in the name of a nominee for, and accepted for settlement and clearance by, one or more of Euroclear, Clearstream, Luxembourg, DTC and any other clearing system identified in the applicable prospectus supplement.

Cross-market transfers of securities that are not in global form may be cleared and settled in accordance with other procedures that may be established among the clearing systems for these securities.

Euroclear and Clearstream, Luxembourg hold interests on behalf of their participants through customers securities accounts in the names of Euroclear and Clearstream, Luxembourg on the books of their respective depositories, which, in the case of securities for which a global security in registered form is deposited with the DTC, in turn hold such interests in customers securities accounts in the depositories names on the books of the DTC.

The policies of DTC, Clearstream, Luxembourg and Euroclear will govern payments, transfers, exchange and other matters relating to the investor s interest in securities held by them. This is also true for any other clearance system that may be named in a prospectus supplement.

We have no responsibility for any aspect of the actions of DTC, Clearstream, Luxembourg or Euroclear or any of their direct or indirect participants. We have no responsibility for any aspect of the records kept by DTC, Clearstream, Luxembourg or Euroclear or any of their direct or indirect participants. We also do not supervise these systems in any way. This is also true for any other clearing system indicated in a prospectus supplement.

DTC, Clearstream, Luxembourg, Euroclear and their participants perform these clearance and settlement functions under agreements they have made with one another or with their customers. Investors should be aware that DTC, Clearstream, Luxembourg, Euroclear and their participants are not obligated to perform these procedures and may modify them or discontinue them at any time.

The description of the clearing systems in this section reflects our understanding of the rules and procedures of DTC, Clearstream, Luxembourg and Euroclear as they are currently in effect. Those systems could change their rules and procedures at any time.

### The Clearing Systems

*DTC*

DTC has advised us as follows:

DTC is:

(1) a limited purpose trust company organized under the laws of the State of New York;

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(2) a banking organization within the meaning of New York Banking Law;

(3) a member of the Federal Reserve System;

(4) a clearing corporation within the meaning of the New York Uniform Commercial Code; and

(5) a clearing agency registered pursuant to the provisions of Section 17A of the Exchange Act.

DTC was created to hold securities for its participants and to facilitate the clearance and settlement of securities transactions between participants through electronic book-entry changes to accounts of its participants. This eliminates the need for physical movement of securities.

Participants in DTC include securities brokers and dealers, banks, trust companies and clearing corporations and may include certain other organizations. DTC is partially owned by some of these participants or their representatives.

Indirect access to the DTC system is also available to banks, brokers and dealers and trust companies that have custodial relationships with participants.

The rules applicable to DTC and DTC participants are on file with the SEC.

*Clearstream, Luxembourg*

Clearstream, Luxembourg has advised us as follows:

Clearstream, Luxembourg is a duly licensed bank organized as a société anonyme incorporated under the laws of Luxembourg and is subject to regulation by the Luxembourg Commission for the Supervision of the Financial Sector (Commission de Surveillance du Secteur Financier).

Clearstream, Luxembourg holds securities for its customers and facilitates the clearance and settlement of securities transactions among them. It does so through electronic book-entry transfers between the accounts of its customers. This eliminates the need for physical movement of securities.

Clearstream, Luxembourg provides other services to its customers, including safekeeping, administration, clearance and settlement of internationally traded securities and lending and borrowing of securities. It interfaces with the domestic markets in over 30 countries through established depositary and custodial relationships.

Clearstream, Luxembourg s customers include worldwide securities brokers and dealers, banks, trust companies and clearing corporations and may include professional financial intermediaries. Its U.S. customers are limited to securities brokers and dealers and banks.

Indirect access to the Clearstream, Luxembourg system is also available to others that clear through Clearstream, Luxembourg customers or that have custodial relationships with its customers, such as banks, brokers, dealers and trust companies.

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*Euroclear*

Euroclear has advised us as follows:

Euroclear is incorporated under the laws of Belgium as a bank and is subject to regulation by the Belgian Banking, Finance and Insurance Commission (*La Commission Bancaire, Financière et des Assurances*) and the National Bank of Belgium (*Banque Nationale de Belgique*).

Euroclear holds securities for its customers and facilitates the clearance and settlement of securities transactions among them. It does so through simultaneous electronic book-entry delivery against payment, thereby eliminating the need for physical movement of certificates.

Euroclear provides other services to its customers, including credit, custody, lending and borrowing of securities and tri-party collateral management. It interfaces with the domestic markets of several countries.

Euroclear customers include banks, including central banks, securities brokers and dealers, trust companies and clearing corporations and may include certain other professional financial intermediaries.

Indirect access to the Euroclear system is also available to others that clear through Euroclear customers or that have custodial relationships with Euroclear customers.

All securities in Euroclear are held on a fungible basis. This means that specific certificates are not matched to specific securities clearance accounts.

*Other Clearing Systems*

We may choose any other clearing system for a particular series of debt securities. The clearance and settlement procedures for the clearing system we choose will be described in the applicable prospectus supplement.

**Primary Distribution**

The distribution of the debt securities will be cleared through one or more of the clearing systems that we have described above or any other clearing system that is specified in the applicable prospectus supplement. Payment for debt securities will be made on a delivery versus payment or free delivery basis. These payment procedures will be more fully described in the applicable prospectus supplement.

Clearance and settlement procedures may vary from one series of debt securities to another according to the currency that is chosen for the specific series of securities. Customary clearance and settlement procedures are described below.

We will submit applications to the relevant system or systems for the debt securities to be accepted for clearance. The clearance numbers that are applicable to each clearance system will be specified in the applicable prospectus supplement.

**Clearance and Settlement Procedures DTC**

DTC participants that hold debt securities through DTC on behalf of investors will follow the settlement practices applicable to United States corporate debt obligations in DTC s Same-Day Funds Settlement System, or such other procedures as are applicable for other securities.

Debt securities will be credited to the securities custody accounts of these DTC participants against payment in same-day funds, for payments in U.S. dollars, on the settlement date. For payments in a currency other than U.S. dollars, debt securities will be credited free of payment on the settlement date.

**Clearance and Settlement Procedures Euroclear and Clearstream, Luxembourg**

We understand that investors that hold their debt securities through Euroclear or Clearstream, Luxembourg accounts will follow the settlement procedures that are applicable to conventional Eurobonds in registered form for debt securities, or such other procedures as are applicable for other securities.

Debt securities will be credited to the securities custody accounts of Euroclear and Clearstream, Luxembourg participants on the business day following the settlement date, for value on the settlement date. They will be credited either free of payment or against payment for value on the settlement date.

**Secondary Market Trading**

*Trading Between DTC Participants*

Secondary market trading between DTC participants will occur in the ordinary way in accordance with DTC s rules. Secondary market trading will be settled using procedures applicable to United States corporate debt obligations in DTC s Same-Day Funds Settlement System for debt securities, or such other procedures as are applicable for other securities.

If payment is made in U.S. dollars, settlement will be in same-day funds. If payment is made in a currency other than U.S. dollars, settlement will be free of payment. If payment is made other than in U.S. dollars, separate payment arrangements outside of the DTC system must be made between the DTC participants involved.

*Trading Between Euroclear and/or Clearstream, Luxembourg Participants*

We understand that secondary market trading between Euroclear and/or Clearstream, Luxembourg participants will occur in the ordinary way following the applicable rules and operating procedures of Euroclear and Clearstream, Luxembourg. Secondary market trading will be settled using procedures applicable to conventional Eurobonds in registered form for debt securities, or such other procedures as are applicable for other securities.

*Trading Between a DTC Seller and a Euroclear or Clearstream, Luxembourg Purchaser*

A purchaser of debt securities that are held in the account of a DTC participant must send instructions to Euroclear or Clearstream, Luxembourg at least one business day prior to settlement. The instructions will provide for the transfer of the debt securities from the selling DTC participant s account to the account of the purchasing Euroclear or Clearstream, Luxembourg participant. Euroclear or Clearstream, Luxembourg, as the case may be, will then instruct the common depositary for Euroclear and Clearstream, Luxembourg to receive the debt securities either against payment or free of payment.

The interests in the debt securities will be credited to the respective clearing system. The clearing system will then credit the account of the participant, following its usual procedures. Credit for the debt securities will appear on the next day, European time. Cash debit will be back-valued to, and the interest on the debt securities will accrue from, the value date, which would be the preceding day, when settlement occurs in New York. If the trade fails and settlement is not completed on the intended date, the Euroclear or Clearstream, Luxembourg cash debit will be valued as of the actual settlement date instead.

Euroclear participants or Clearstream, Luxembourg participants will need the funds necessary to process same-day funds settlement. The most direct means of doing this is to pre-position funds for settlement, either from cash or from existing lines of credit, as for any settlement occurring within Euroclear or Clearstream, Luxembourg. Under this approach, participants may take on credit exposure to Euroclear or Clearstream, Luxembourg until the debt securities are credited to their accounts one business day later.

As an alternative, if Euroclear or Clearstream, Luxembourg has extended a line of credit to them, participants can choose not to pre-position funds and will instead allow that credit line to be drawn upon to finance settlement. Under this procedure, Euroclear participants or Clearstream, Luxembourg participants purchasing debt securities would incur overdraft charges for one business day (assuming they cleared the overdraft as soon as the debt securities were credited to their accounts). However, any interest on the debt securities would accrue from the value date. Therefore, in many cases, the investment income on debt securities that is earned during that one-business day period may substantially reduce or offset the amount of the overdraft charges. This result will, however, depend on each participant s particular cost of funds.

Because the settlement will take place during New York business hours, DTC participants will use their usual procedures to deliver debt securities to the depositary on behalf of Euroclear participants or Clearstream, Luxembourg participants. The sale proceeds will be available to the DTC seller on the settlement date. For the DTC participants, then, a cross-market transaction will settle no differently than a trade between two DTC participants.

**Special Timing Considerations**

Investors should be aware that they will only be able to make and receive deliveries, payments and other communications involving the debt securities through Clearstream, Luxembourg and Euroclear on days when those systems are open for business. Those systems may not be open for business on days when banks, brokers and other institutions are open for business in the United States.

In addition, because of time-zone differences, there may be problems with completing transactions involving Clearstream, Luxembourg and Euroclear on the same business day as in the United States. U.S. investors who wish to transfer their interests in the debt securities, or to receive or make a payment or delivery of the debt securities, on a particular day, may find that the transactions will not be performed until the next business day in Luxembourg or Brussels, depending on whether Clearstream, Luxembourg or Euroclear is used.

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## TAX CONSIDERATIONS

**United States Taxation**

This section describes the material United States federal income tax consequences of owning the debt securities we are offering. It applies to you only if you acquire debt securities in the offering and you hold your debt securities as capital assets for tax purposes. This section is the opinion of Sullivan & Cromwell LLP, U.S. counsel to the Issuer. This section does not apply to you if you are a member of a class of holders subject to special rules, such as:

- a dealer in securities or currencies,
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings,
- a bank,
- a life insurance company,
- a tax-exempt organization,
- a person that owns debt securities that are a hedge or that are hedged against interest rate or currency risks,
- a person that owns debt securities as part of a straddle or conversion transaction for tax purposes, or
- a United States holder (as defined below) whose functional currency for tax purposes is not the U.S. dollar.

This section deals only with debt securities that are issued in registered form and that are due to mature 30 years or less from the date on which they are issued. The United States federal income tax consequences of owning debt securities that are in bearer form or that are due to mature more than 30 years from their date of issue will be discussed in an applicable prospectus supplement. This section is based on the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations under the Internal Revenue Code, published rulings and court decisions, all as currently in effect. These laws are subject to change, possibly on a retroactive basis.

If a partnership holds the debt securities, the United States federal income tax treatment of a partner will generally depend on the status of the partner and the tax treatment of the partnership. A partner in a partnership holding the debt securities should consult its tax advisor with regard to the United States federal income tax treatment of an investment in the debt securities.

*Please consult your own tax advisor concerning the consequences of owning these debt securities in your particular circumstances under the Code and the laws of any other taxing jurisdiction.*

**United States Holders**

This subsection describes the tax consequences to a United States holder. You are a United States holder if you are a beneficial owner of a debt security and you are:

a citizen or resident of the United States,

- a domestic corporation,
- an estate whose income is subject to United States federal income tax regardless of its source, or
- a trust if a United States court can exercise primary supervision over the trust s administration and one or more United States persons are authorized to control all substantial decisions of the trust.

If you are not a United States holder, this subsection does not apply to you and you should refer to United States Alien Holders below.

**Payments of Interest**

Except as described below in the case of interest on a discount debt security that is not qualified stated interest, each as defined below under Original Issue Discount General , you will be taxed on any interest on your debt security (including any additional amounts paid with respect with withholding tax, as described in section ), whether payable in U.S. dollars or a foreign currency, including a composite currency or basket of currencies other than U.S. dollars, as ordinary income at the time you receive the interest or when it accrues, depending on your method of accounting for tax purposes.

Cash Basis Taxpayers. If you are a taxpayer that uses the cash receipts and disbursements method of accounting for tax purposes and you receive an interest payment that is denominated in, or determined by reference to, a foreign currency, you must recognize income equal to the U.S. dollar value of the interest payment, based on the exchange rate in effect on the date of receipt, regardless of whether you actually convert the payment into U.S. dollars.

Accrual Basis Taxpayers. If you are a taxpayer that uses an accrual method of accounting for tax purposes, you may determine the amount of income that you recognize with respect to an interest payment denominated in, or determined by reference to, a foreign currency by using one of two methods. Under the first method, you will determine the amount of income accrued based on the average exchange rate in effect during the interest accrual period or, with respect to an accrual period that spans two taxable years, that part of the period within the taxable year.

If you elect the second method, you would determine the amount of income accrued on the basis of the exchange rate in effect on the last day of the accrual period, or, in the case of an accrual period that spans two taxable years, the exchange rate in effect on the last day of the part of the period within the taxable year. Additionally, under this second method, if you receive a payment of interest within five business days of the last day of your accrual period or taxable year, you may instead translate the interest accrued into U.S. dollars at the exchange rate in effect on the day that you actually receive the interest payment. If you elect the second method it will apply to all debt instruments that you hold at the beginning of the first taxable year to which the election applies and to all debt instruments that you subsequently acquire. You may not revoke this election without the consent of the Internal Revenue Service.

When you actually receive an interest payment, including a payment attributable to accrued but unpaid interest upon the sale or retirement of your debt security, denominated in, or determined by reference to, a foreign currency for which you accrued an amount of income, you will recognize ordinary income or loss measured by the difference, if any, between the exchange rate that you used to accrue interest income and the exchange rate in effect on the date of receipt, regardless of whether you actually convert the payment into U.S. dollars.

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**Original Issue Discount**

General. If you own a debt security, other than a short-term debt security with a term of one year or less, it will be treated as a discount debt security issued at an original issue discount if the amount by which the debt security s stated redemption price at maturity exceeds its issue price is more than a de minimis amount. Generally, a debt security s issue price will be the first price at which a substantial amount of debt securities included in the issue of which the debt security is a part is sold to persons other than bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers. A debt security s stated redemption price at maturity is the total of all payments provided by the debt security that are not payments of qualified stated interest. Generally, an interest payment on a debt security is qualified stated interest if it is one of a series of stated interest payments on a debt security that are unconditionally payable at least annually at a single fixed rate, with certain exceptions for lower rates paid during some periods, applied to the outstanding principal amount of the debt security. There are special rules for variable rate debt securities that are discussed under Variable Rate Debt securities .

In general, your debt security is not a discount debt security if the amount by which its stated redemption price at maturity exceeds its issue price is less than the de minimis amount of $^{1}/4$ of 1 percent of its stated redemption price at maturity multiplied by the number of complete years to its maturity. Your debt security will have de minimis original issue discount if the amount of the excess is less than the de minimis amount. If your debt security has de minimis original issue discount, you must include the de minimis amount in income as stated principal payments are made on the debt security, unless you make the election described below under Election to Treat All Interest as Original Issue Discount . You can determine the includible amount with respect to each such payment by multiplying the total amount of your debt security s de minimis original issue discount by a fraction equal to:

the amount of the principal payment made

divided by:

the stated principal amount of the debt security.

Generally, if your discount debt security matures more than one year from its date of issue, you must include original issue discount, or OID, in income before you receive cash attributable to that income. The amount of OID that you must include in income is calculated using a constant-yield method, and generally you will include increasingly greater amounts of OID in income over the life of your debt security. More specifically, you can calculate the amount of OID that you must include in income by adding the daily portions of OID with respect to your discount debt security for each day during the taxable year or portion of the taxable year that you hold your discount debt security. You can determine the daily portion by allocating to each day in any accrual period a pro rata portion of the OID allocable to that accrual period. You may select an accrual period of any length with respect to your discount debt security and you may vary the length of each accrual period over the term of your discount debt security. However, no accrual period may be longer than one year and each scheduled payment of interest or principal on the discount debt security must occur on either the first or final day of an accrual period.

You can determine the amount of OID allocable to an accrual period by:

multiplying your discount debt security s adjusted issue price at the beginning of the accrual period by your debt security s yield to maturity, and then

subtracting from this figure the sum of the payments of qualified stated interest on your debt security allocable to the accrual period.

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You must determine the discount debt security s yield to maturity on the basis of compounding at the close of each accrual period and adjusting for the length of each accrual period. Further, you determine your discount debt security s adjusted issue price at the beginning of any accrual period by:

- adding your discount debt security s issue price and any accrued OID for each prior accrual period, and
- subtracting any payments previously made on your discount debt security that were not qualified stated interest payments.

If an interval between payments of qualified stated interest on your discount debt security contains more than one accrual period, then, when you determine the amount of OID allocable to an accrual period, you must allocate the amount of qualified stated interest payable at the end of the interval, including any qualified stated interest that is payable on the first day of the accrual period immediately following the interval, pro rata to each accrual period in the interval based on their relative lengths. In addition, you must increase the adjusted issue price at the beginning of each accrual period in the interval by the amount of any qualified stated interest that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. You may compute the amount of OID allocable to an initial short accrual period by using any reasonable method if all other accrual periods, other than a final short accrual period, are of equal length.

The amount of OID allocable to the final accrual period is equal to the difference between:

- the amount payable at the maturity of your debt security, other than any payment of qualified stated interest, and
- your debt security s adjusted issue price as of the beginning of the final accrual period.

Acquisition Premium. If you purchase your debt security for an amount that is less than or equal to the sum of all amounts, other than qualified stated interest, payable on your debt security after the purchase date but is greater than the amount of your debt security s adjusted issue price, as determined above under General , the excess is acquisition premium. If you do not make the election described below under Election to Treat All Interest as Original Issue Discount , then you must reduce the daily portions of OID by a fraction equal to:

- the excess of your adjusted basis in the debt security immediately after purchase over the adjusted issue price of the debt security

divided by:

- the excess of the sum of all amounts payable, other than qualified stated interest, on the debt security after the purchase date over the debt security s adjusted issue price.

Pre-Issuance Accrued Interest. An election may be made to decrease the issue price of your debt security by the amount of pre-issuance accrued interest if:

- a portion of the initial purchase price of your debt security is attributable to pre-issuance accrued interest,
- the first stated interest payment on your debt security is to be made within one year of your debt security s issue date, and
- the payment will equal or exceed the amount of pre-issuance accrued interest.

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If this election is made, a portion of the first stated interest payment will be treated as a return of the excluded pre-issuance accrued interest and not as an amount payable on your debt security.

Debt securities Subject to Contingencies Including Optional Redemption. Your debt security is subject to a contingency if it provides for an alternative payment schedule or schedules applicable upon the occurrence of a contingency or contingencies, other than a remote or incidental contingency, whether such contingency relates to payments of interest or of principal. In such a case, you must determine the yield and maturity of your debt security by assuming that the payments will be made according to the payment schedule most likely to occur if:

- the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and
- one of such schedules is significantly more likely than not to occur.

If there is no single payment schedule that is significantly more likely than not to occur, other than because of a mandatory sinking fund, you must include income on your debt security in accordance with the general rules that govern contingent payment obligations. These rules will be discussed in the applicable prospectus supplement.

Notwithstanding the general rules for determining yield and maturity, if your debt security is subject to contingencies, and either you or we have an unconditional option or options that, if exercised, would require payments to be made on the debt security under an alternative payment schedule or schedules, then:

- in the case of an option or options that we may exercise, we will be deemed to exercise or not exercise an option or combination of options in the manner that minimizes the yield on your debt security and
- in the case of an option or options that you may exercise, you will be deemed to exercise or not exercise an option or combination of options in the manner that maximizes the yield on your debt security.

If both you and we hold options described in the preceding sentence, those rules will apply to each option in the order in which they may be exercised. You may determine the yield on your debt security for the purposes of those calculations by using any date on which your debt security may be redeemed or repurchased as the maturity date and the amount payable on the date that you chose in accordance with the terms of your debt security as the principal amount payable at maturity.

If a contingency, including the exercise of an option, actually occurs or does not occur contrary to an assumption made according to the above rules then, except to the extent that a portion of your debt security is repaid as a result of this change in circumstances and solely to determine the amount and accrual of OID, you must redetermine the yield and maturity of your debt security by treating your debt security as having been retired and reissued on the date of the change in circumstances for an amount equal to your debt security s adjusted issue price on that date.

Election to Treat All Interest as Original Issue Discount. You may elect to include in gross income all interest that accrues on your debt security using the constant-yield method described above under General , with the modifications described below. For purposes of this election, interest will include stated interest, OID, de minimis original issue discount, market discount, de minimis market discount and unstated interest, as adjusted by any amortizable bond premium, described below under Debt securities Purchased at a Premium, or acquisition premium.

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If you make this election for your debt security, then, when you apply the constant-yield method:

- the issue price of your debt security will equal your cost,
- the issue date of your debt security will be the date you acquired it, and
- no payments on your debt security will be treated as payments of qualified stated interest.

Generally, this election will apply only to the debt security for which you make it; however, if the debt security has amortizable bond premium, you will be deemed to have made an election to apply amortizable bond premium against interest for all debt instruments with amortizable bond premium, other than debt instruments the interest on which is excludible from gross income, that you hold as of the beginning of the taxable year to which the election applies or any taxable year thereafter. Additionally, if you make this election for a market discount debt security, you will be treated as having made the election discussed below under Market Discount to include market discount in income currently over the life of all debt instruments having market discount that you acquire on or after the first day of the first taxable year to which the election applies. You may not revoke any election to apply the constant-yield method to all interest on a debt security or the deemed elections with respect to amortizable bond premium or market discount debt securities without the consent of the Internal Revenue Service.

Variable Rate Debt securities. Your debt security will be a variable rate debt security if:

- your debt security s issue price does not exceed the total noncontingent principal payments by more than the lesser of:
  1. .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date, or
  2. 15 percent of the total noncontingent principal payments; and
- your debt security provides for stated interest, compounded or paid at least annually, only at:
  1. one or more qualified floating rates,
  2. a single fixed rate and one or more qualified floating rates,
  3. a single objective rate, or
  4. a single fixed rate and a single objective rate that is a qualified inverse floating rate.

Your debt security will have a variable rate that is a qualified floating rate if:

variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which your debt security is denominated; or

the rate is equal to such a rate multiplied by either:

1. a fixed multiple that is greater than 0.65 but not more than 1.35 or

2. a fixed multiple greater than 0.65 but not more than 1.35, increased or decreased by a fixed rate; and

the value of the rate on any date during the term of your debt security is set no earlier than three months prior to the first day on which that value is in effect and no later than one year following that first day.

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If your debt security provides for two or more qualified floating rates that are within 0.25 percentage points of each other on the issue date or can reasonably be expected to have approximately the same values throughout the term of the debt security, the qualified floating rates together constitute a single qualified floating rate.

Your debt security will not have a qualified floating rate, however, if the rate is subject to certain restrictions (including caps, floors, governors, or other similar restrictions) unless such restrictions are fixed throughout the term of the debt security or are not reasonably expected to significantly affect the yield on the debt security.

Your debt security will have a variable rate that is a single objective rate if:

- the rate is not a qualified floating rate,
- the rate is determined using a single, fixed formula that is based on objective financial or economic information that is not within the control of or unique to the circumstances of the issuer or a related party, and
- the value of the rate on any date during the term of your debt security is set no earlier than three months prior to the first day on which that value is in effect and no later than one year following that first day.

Your debt security will not have a variable rate that is an objective rate, however, if it is reasonably expected that the average value of the rate during the first half of your debt security s term will be either significantly less than or significantly greater than the average value of the rate during the final half of your debt security s term.

An objective rate as described above is a qualified inverse floating rate if:

- the rate is equal to a fixed rate minus a qualified floating rate and
- the variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the cost of newly borrowed funds.

Your debt security will also have a single qualified floating rate or an objective rate if interest on your debt security is stated at a fixed rate for an initial period of one year or less followed by either a qualified floating rate or an objective rate for a subsequent period, and either:

- the fixed rate and the qualified floating rate or objective rate have values on the issue date of the debt security that do not differ by more than 0.25 percentage points or
- the value of the qualified floating rate or objective rate is intended to approximate the fixed rate.

In general, if your variable rate debt security provides for stated interest at a single qualified floating rate or objective rate, or one of those rates after a single fixed rate for an initial period, all stated interest on your debt security is qualified stated interest. In this case, the amount of OID, if any, is determined by using, in the case of a qualified floating rate or qualified inverse floating rate, the value as of the issue date of the qualified floating rate or qualified inverse floating rate, or, for any other objective rate, a fixed rate that reflects the yield reasonably expected for your debt security.

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If your variable rate debt security does not provide for stated interest at a single qualified floating rate or a single objective rate, and also does not provide for interest payable at a fixed rate other than a single fixed rate for an initial period, you generally must determine the interest and OID accruals on your debt security by:

- determining a fixed rate substitute for each variable rate provided under your variable rate debt security,
- constructing the equivalent fixed rate debt instrument, using the fixed rate substitute described above,
- determining the amount of qualified stated interest and OID with respect to the equivalent fixed rate debt instrument, and
- adjusting for actual variable rates during the applicable accrual period.

When you determine the fixed rate substitute for each variable rate provided under the variable rate debt security, you generally will use the value of each variable rate as of the issue date or, for an objective rate that is not a qualified inverse floating rate, a rate that reflects the reasonably expected yield on your debt security.

If your variable rate debt security provides for stated interest either at one or more qualified floating rates or at a qualified inverse floating rate, and also provides for stated interest at a single fixed rate other than at a single fixed rate for an initial period, you generally must determine interest and OID accruals by using the method described in the previous paragraph. However, your variable rate debt security will be treated, for purposes of the first three steps of the determination, as if your debt security had provided for a qualified floating rate, or a qualified inverse floating rate, rather than the fixed rate. The qualified floating rate, or qualified inverse floating rate, that replaces the fixed rate must be such that the fair market value of your variable rate debt security as of the issue date approximates the fair market value of an otherwise identical debt instrument that provides for the qualified floating rate, or qualified inverse floating rate, rather than the fixed rate.

Short-Term Debt securities. In general, if you are an individual or other cash basis United States holder of a short-term debt security, you are not required to accrue OID, as specially defined below for the purposes of this paragraph, for United States federal income tax purposes unless you elect to do so (although it is possible that you may be required to include any stated interest in income as you receive it). If you are an accrual basis taxpayer, a taxpayer in a special class, including, but not limited to, a regulated investment company, common trust fund, or a certain type of pass-through entity, or a cash basis taxpayer who so elects, you will be required to accrue OID on short-term debt securities on either a straight-line basis or under the constant-yield method, based on daily compounding. If you are not required and do not elect to include OID in income currently, any gain you realize on the sale or retirement of your short-term debt security will be ordinary income to the extent of the accrued OID, which will be determined on a straight-line basis unless you make an election to accrue the OID under the constant-yield method, through the date of sale or retirement. However, if you are not required and do not elect to accrue OID on your short-term debt securities, you will be required to defer deductions for interest on borrowings allocable to your short-term debt securities in an amount not exceeding the deferred income until the deferred income is realized.

When you determine the amount of OID subject to these rules, you must include all interest payments on your short-term debt security, including stated interest, in your short-term debt security s stated redemption price at maturity.

Foreign Currency Discount Debt securities. If your discount debt security is denominated in, or determined by reference to, a foreign currency, you must determine OID for any accrual period on your discount debt security in the foreign currency and then translate the amount of OID into U.S. dollars in the same manner as stated interest accrued by an accrual basis United States holder, as described under United States Holders

Payments of Interest . You may recognize ordinary income or loss when you receive an amount attributable to OID in connection with a payment of interest or the sale or retirement of your debt security.

**Market Discount**

You will be treated as if you purchased your debt security, other than a short-term debt security, at a market discount, and your debt security will be a market discount debt security if:

- you purchase your debt security for less than its issue price as determined above under Original Issue Discount General and

- the difference between the debt security s stated redemption price at maturity or, in the case of a discount debt security, the debt security s revised issue price, and the price you paid for your debt security is equal to or greater than $^1/4$ of 1 percent of your debt security s stated redemption price at maturity or revised issue price, respectively, multiplied by the number of complete years to the debt security s maturity. To determine the revised issue price of your debt security for these purposes, you generally add any OID that has accrued on your debt security to its issue price.

If your debt security s stated redemption price at maturity or, in the case of a discount debt security, its revised issue price, exceeds the price you paid for the debt security by less than $^1/4$ of 1 percent multiplied by the number of complete years to the debt security s maturity, the excess constitutes de minimis market discount, and the rules discussed below are not applicable to you.

You must treat any gain you recognize on the maturity or disposition of your market discount debt security as ordinary income to the extent of the accrued market discount on your debt security. Alternatively, you may elect to include market discount in income currently over the life of your debt security. If you make this election, it will apply to all debt instruments with market discount that you acquire on or after the first day of the first taxable year to which the election applies. You may not revoke this election without the consent of the Internal Revenue Service. If you own a market discount debt security and do not make this election, you will generally be required to defer deductions for interest on borrowings allocable to your debt security in an amount not exceeding the accrued market discount on your debt security until the maturity or disposition of your debt security.

You will accrue market discount on your market discount debt security on a straight-line basis unless you elect to accrue market discount using a constant-yield method. If you make this election, it will apply only to the debt security with respect to which it is made and you may not revoke it.

**Debt securities Purchased at a Premium**

If you purchase your debt security for an amount in excess of its principal amount, you may elect to treat the excess as amortizable bond premium. If you make this election, you will reduce the amount required to be included in your income each year with respect to interest on your debt security by the amount of amortizable bond premium allocable to that year, based on your debt security s yield to maturity. If your debt security is denominated in, or determined by reference to, a foreign currency, you will compute your amortizable bond premium in units of the foreign currency and your amortizable bond premium will reduce your interest income in units of the foreign currency. Gain or loss recognized that is attributable to changes in exchange rates between the time your amortized bond premium offsets interest income and the time of the acquisition of your debt security is generally taxable as ordinary income or loss. If you make an election to amortize bond premium, it will apply to all debt instruments, other than debt instruments the interest on which is excludible from gross income, that you hold at the beginning of the first taxable year to which the election applies or that you thereafter acquire, and you may not revoke it without the consent of the Internal Revenue Service. See also Original Issue Discount Election to Treat All Interest as Original Issue Discount .

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**Purchase, Sale and Retirement of the Debt securities**

Your tax basis in your debt security will generally be the U.S. dollar cost, as defined below, of your debt security, adjusted by:

- adding any OID or market discount previously included in income with respect to your debt security, and then
- subtracting any payments on your debt security that are not qualified stated interest payments and any amortizable bond premium applied to reduce interest on your debt security.

If you purchase your debt security with foreign currency, the U.S. dollar cost of your debt security will generally be the U.S. dollar value of the purchase price on the date of purchase. However, if you are a cash basis taxpayer, or an accrual basis taxpayer if you so elect, and your debt security is traded on an established securities market, as defined in the applicable Treasury regulations, the U.S. dollar cost of your debt security will be the U.S. dollar value of the purchase price on the settlement date of your purchase.

You will generally recognize gain or loss on the sale or retirement of your debt security equal to the difference between the amount you realize on the sale or retirement and your tax basis in your debt security. If your debt security is sold or retired for an amount in foreign currency, the amount you realize will be the U.S. dollar value of such amount on the date the debt security is disposed of or retired, except that in the case of a debt security that is traded on an established securities market, as defined in the applicable Treasury regulations, a cash basis taxpayer, or an accrual basis taxpayer that so elects, will determine the amount realized based on the U.S. dollar value of the foreign currency on the settlement date of the sale.

You will recognize capital gain or loss when you sell or retire your debt security, except to the extent:

- described above under Original Issue Discount Short-Term Debt securities or Market Discount ,
- attributable to accrued but unpaid interest,
- the rules governing contingent payment obligations apply, or
- attributable to changes in exchange rates as described below.

Capital gain of a noncorporate United States holder is generally taxed at preferential rates where the property is held for more than one year.

You must treat any portion of the gain or loss that you recognize on the sale or retirement of a debt security as ordinary income or loss to the extent attributable to changes in exchange rates. However, you take exchange gain or loss into account only to the extent of the total gain or loss you realize on the transaction.

**Substitution of the Issuer and Discharge of Indenture**

A Guarantor or certain of their subsidiaries, subject to certain restrictions, may assume the obligations of the Issuer under the debt securities without the consent of the holders. Also, under certain circumstances, the Issuer and the Guarantors will be discharged from any and all obligations in respect of the Indenture. Such events in some circumstances may be treated as taxable exchanges for United States federal income tax purposes (though in the case of a substitution of the Issuer, the Parent Guarantor, the Issuer and the Substitute Issuer will indemnify holders for any income tax or other tax (if any) recognized by such holder solely as a result of such substitution see Description of Debt securities and Guarantees Substitution of the Issuer or Guarantors; Consolidation, Merger and Sale of Assets ). Holders should consult their own tax advisors regarding the United States federal, state, and local tax consequences of such events.

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**Exchange of Amounts in Other Than U.S. Dollars**

If you receive foreign currency as interest on your debt security or on the sale or retirement of your debt security, your tax basis in the foreign currency will equal its U.S. dollar value when the interest is received or at the time of the sale or retirement. If you purchase foreign currency, you generally will have a tax basis equal to the U.S. dollar value of the foreign currency on the date of your purchase. If you sell or dispose of a foreign currency, including if you use it to purchase debt securities or exchange it for U.S. dollars, any gain or loss recognized generally will be ordinary income or loss.

**Medicare Tax**

For taxable years beginning after December 31, 2012, a United States holder that is an individual or estate, or a trust that does not fall into a special class of trusts that is exempt from such tax, will be subject to a 3.8% tax on the lesser of (1) the United States holder s net investment income for the relevant taxable year and (2) the excess of the United States holder s modified adjusted gross income for the taxable year over a certain threshold (which in the case of individuals will be between $125,000 and $250,000, depending on the individual s circumstances). A holder s net investment income will generally include its interest income and its net gains from the disposition of debt securities, unless such interest income or net gains are derived in the ordinary course of the conduct of a trade or business (other than a trade or business that consists of certain passive or trading activities). If you are a United States holder that is an individual, estate or trust, you are urged to consult your tax advisors regarding the applicability of the Medicare tax to your income and gains in respect of your investment in the debt securities.

**Indexed Debt securities**

The applicable prospectus supplement will discuss any special United States federal income tax rules with respect to debt securities the payments on which are determined by reference to any index and other debt securities that are subject to the rules governing contingent payment obligations which are not subject to the rules governing variable rate debt securities.

**United States Alien Holders**

This subsection describes the tax consequences to a United States alien holder. You are a United States alien holder if you are the beneficial owner of a debt security and are, for United States federal income tax purposes:

- a nonresident alien individual,
- a foreign corporation, or
- an estate or trust that in either case is not subject to United States federal income tax on a net income basis on income or gain from a debt security.

If you are a United States holder, this subsection does not apply to you.

This discussion assumes that the debt security is not subject to the rules of Section 871(h)(4)(A) of the Internal Revenue Code, relating to interest payments that are determined by reference to the income, profits, changes in the value of property or other attributes of the debtor or a related party.

Under United States federal income and estate tax law, and subject to the discussion of backup withholding below, if you are a United States alien holder of a debt security:

we and other U.S. payors generally will not be required to deduct United States withholding tax from payments of principal, premium, if any, and interest, including OID, to you if, in the case of payments of interest:

1. you do not actually or constructively own 10% or more of the total combined voting power of all classes of stock of the Company entitled to vote,

2. you are not a controlled foreign corporation that is related to the Company through stock ownership, and

3. the U.S. payor does not have actual knowledge or reason to know that you are a United States person and:

    a. you have furnished to the U.S. payor an Internal Revenue Service Form W-8BEN or an acceptable substitute form upon which you certify, under penalties of perjury, that you are a non-United States person,

    b. in the case of payments made outside the United States to you at an offshore account (generally, an account maintained by you at a bank or other financial institution at any location outside the United States), you have furnished to the U.S. payor documentation that establishes your identity and your status as the beneficial owner of the payment for United States federal income tax purposes and as a non-United States person,

    c. the U.S. payor has received a withholding certificate (furnished on an appropriate Internal Revenue Service Form W-8 or an acceptable substitute form) from a person claiming to be:

        i. a withholding foreign partnership (generally a foreign partnership that has entered into an agreement with the Internal Revenue Service to assume primary withholding responsibility with respect to distributions and guaranteed payments it makes to its partners),

        ii. a qualified intermediary (generally a non-United States financial institution or clearing organization or a non-United States branch or office of a United States financial institution or clearing organization that is a party to a withholding agreement with the Internal Revenue Service), or

        iii. a U.S. branch of a non-United States bank or of a non-United States insurance company,

        and the withholding foreign partnership, qualified intermediary or U.S. branch has received documentation upon which it may rely to treat the payment as made to a non-United States person that is, for United States federal income tax purposes, the beneficial owner of the payment on the debt securities in accordance with U.S. Treasury regulations (or, in the case of a qualified intermediary, in accordance with its agreement with the Internal Revenue Service),

d. the U.S. payor receives a statement from a securities clearing organization, bank or other financial institution that holds customers securities in the ordinary course of its trade or business,

i. certifying to the U.S. payor under penalties of perjury that an Internal Revenue Service Form W-8BEN or an acceptable substitute form has been received from you by it or by a similar financial institution between it and you, and

ii. to which is attached a copy of the Internal Revenue Service Form W-8BEN or acceptable substitute form, or

e. the U.S. payor otherwise possesses documentation upon which it may rely to treat the payment as made to a non-United States person that is, for United States federal income tax purposes, the beneficial owner of the payments on the debt securities in accordance with U.S. Treasury regulations; and

no deduction for any United States federal withholding tax will be made from any gain that you realize on the sale or exchange of your debt security.

Further, a debt security held by an individual who at death is not a citizen or resident of the United States will not be includible in the individual s gross estate for United States federal estate tax purposes if:

the decedent did not actually or constructively own 10% or more of the total combined voting power of all classes of stock of the Company entitled to vote at the time of death and

the income on the debt security would not have been effectively connected with a United States trade or business of the decedent at the same time.

**Treasury Regulations Requiring Disclosure of Reportable Transactions**

Treasury regulations require United States taxpayers to report certain transactions that give rise to a loss in excess of certain thresholds (a Reportable Transaction ). Under these regulations, if the debt securities are denominated in a foreign currency, a United States holder (or a United States alien holder that holds the debt securities in connection with a U.S. trade or business) that recognizes a loss with respect to the debt securities that is characterized as an ordinary loss due to changes in currency exchange rates (under any of the rules discussed above) would be required to report the loss on Internal Revenue Service Form 8886 (Reportable Transaction Statement) if the loss exceeds the thresholds set forth in the regulations. For individuals and trusts, this loss threshold is $50,000 in any single taxable year. For other types of taxpayers and other types of losses, the thresholds are higher. You should consult with your tax advisor regarding any tax filing and reporting obligations that may apply in connection with acquiring, owning and disposing of debt securities.

**Information with Respect to Foreign Financial Assets**

Under recently enacted legislation, individuals that own specified foreign financial assets with an aggregate value in excess of $50,000 in taxable years beginning after 18 March 2010 will generally be required to file an information report with respect to such assets with their tax returns. Specified foreign financial assets include any financial accounts maintained by foreign financial institutions, as well as any of the following, but only if they are not held in accounts maintained by financial institutions: (i) stocks and securities issued by non-United States persons, (ii) financial instruments and contracts held for investment that have non-United States issuers or counterparties, and (iii) interests in foreign entities. United States holders that are individuals are urged to consult their tax advisors regarding the application of this legislation to their ownership of the debt securities.

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**Backup Withholding and Information Reporting**

In general, if you are a noncorporate United States holder, we and other payors are required to report to the Internal Revenue Service all payments of principal, any premium and interest on your debt security, and the accrual of OID on a discount debt security. In addition, we and other payors are required to report to the Internal Revenue Service any payment of proceeds of the sale of your debt security before maturity within the United States. Additionally, backup withholding will apply to any payments, including payments of OID, if you fail to provide an accurate taxpayer identification number, or you are notified by the Internal Revenue Service that you have failed to report all interest and dividends required to be shown on your federal income tax returns.

Pursuant to recently enacted legislation, certain payments in respect of debt securities made to corporate United States holders after December 31, 2011 may be subject to information reporting and backup withholding.

In general, if you are a United States alien holder, payments of principal, premium or interest, including OID, made by us and other payors to you will not be subject to backup withholding and information reporting, provided that the certification requirements described above under United States Alien Holders are satisfied or you otherwise establish an exemption. However, we and other payors are required to report payments of interest on your debt securities on Internal Revenue Service Form 1042-S even if the payments are not otherwise subject to information reporting requirements. In addition, payment of the proceeds from the sale of debt securities effected at a United States office of a broker will not be subject to backup withholding and information reporting provided that:

- the broker does not have actual knowledge or reason to know that you are a United States person and you have furnished to the broker:
  - an appropriate Internal Revenue Service Form W-8 or an acceptable substitute form upon which you certify, under penalties of perjury, that you are not a United States person, or
  - other documentation upon which it may rely to treat the payment as made to a non-United States person in accordance with U.S. Treasury regulations, or
- you otherwise establish an exemption.

If you fail to establish an exemption and the broker does not possess adequate documentation of your status as a non-United States person, the payments may be subject to information reporting and backup withholding. However, backup withholding will not apply with respect to payments made to an offshore account maintained by you unless the broker has actual knowledge that you are a United States person.

In general, payment of the proceeds from the sale of debt securities effected at a foreign office of a broker will not be subject to information reporting or backup withholding. However, a sale effected at a foreign office of a broker will be subject to information reporting and backup withholding if:

- the proceeds are transferred to an account maintained by you in the United States,
- the payment of proceeds or the confirmation of the sale is mailed to you at a United States address, or
- the sale has some other specified connection with the United States as provided in U.S. Treasury regulations,

unless the broker does not have actual knowledge or reason to know that you are a United States person and the documentation requirements described above (relating to a sale of debt securities effected at a United States office of a broker) are met or you otherwise establish an exemption.

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In addition, payment of the proceeds from the sale of debt securities effected at a foreign office of a broker will be subject to information reporting if the broker is:

- a United States person,
- a controlled foreign corporation for United States tax purposes,
- a foreign person 50% or more of whose gross income is effectively connected with the conduct of a United States trade or business for a specified three-year period, or
- a foreign partnership, if at any time during its tax year:
  - one or more of its partners are United States persons , as defined in U.S. Treasury regulations, who in the aggregate hold more than 50% of the income or capital interest in the partnership, or
  - such foreign partnership is engaged in the conduct of a United States trade or business,

unless the broker does not have actual knowledge or reason to know that you are a United States person and the documentation requirements described above (relating to a sale of debt securities effected at a United States office of a broker) are met or you otherwise establish an exemption. Backup withholding will apply if the sale is subject to information reporting and the broker has actual knowledge that you are a United States person.

**Luxembourg Taxation**

The comments below are intended as a basic summary of certain tax consequences in relation to the purchase, ownership and disposal of the holders of the debt securities under Luxembourg law. Persons who are in any doubt as to their tax position should consult a professional tax adviser.

***Withholding tax***

Under Luxembourg tax law currently in effect and with the possible exception of interest paid to certain individual holders or so-called residual entities, there is no Luxembourg withholding tax on payments of interest (including accrued but unpaid interest). There is also no Luxembourg withholding tax, with the possible exception of payments made to certain individual holders or so-called residual entities, upon repayment of principal in case of reimbursement, redemption, repurchase or exchange of the Notes.

***Luxembourg non-resident individuals***

Under the Luxembourg law dated 21 June 2005 implementing the European Council Directive 2003/48/EC on the taxation of savings income (the Savings Directive ) and several agreements concluded between Luxembourg and certain dependent or associated territories of the European Union ( EU ), a Luxembourg based paying agent (within the meaning of the Savings Directive) is required since 1 July 2005 to withhold tax on interest and other similar income paid by it to (or under certain circumstances, to the benefit of) an individual resident in another Member State or in certain EU dependent or associated territories, unless the beneficiary of the interest payments elects for the exchange of information or the tax certificate procedure. The same regime applies to payments of interest and other similar income made to certain residual entities within the meaning of Article 4.2 of the Savings Directive established in a Member State or in certain EU dependent or associated territories (i.e., entities which are not legal persons (the Finnish and Swedish companies listed in Article 4.5 of the Savings Directive are not considered as legal persons for this purpose), whose profits are not taxed under the general arrangements for the business taxation, which are not UCITS recognised in accordance with the Council Directive 85/611/EEC or similar collective investment funds located in Jersey, Guernsey, the Isle of Man, the Turks and Caicos Islands, the Cayman Islands, Montserrat or the British Virgin Islands and which have not opted to be treated as UCITS recognised in accordance with the Council Directive 85/611/EEC).

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The current withholding tax rate is 20 per cent., increasing to 35 per cent. as from 1 July 2011. The withholding tax system will only apply during a transitional period, the ending of which depends on the conclusion of certain agreements relating to information exchange with certain third countries.

Investors should note that the European Commission adopted a new draft Savings Directive, which, among other changes, seeks to extend the application of the Savings Directive to (i) payments channeled through certain intermediate structures (whether or not established in a Member State) for the ultimate benefit of an EU resident individual, and (ii) a wider range of income similar to savings income. Further developments in this respect should be monitored on a continuing basis, since no certainty exists over whether and when the proposed amendments to the Savings Directive will be implemented. Investors who are in any doubt as to their position should consult their professional advisors.

***Luxembourg resident individuals***

In accordance with the law of 23 December 2005 as amended by the law of 17 July 2008 on the introduction of a withholding tax on certain interest payments on savings income, interest payments made by Luxembourg paying agents (defined in the same way as in the Savings Directive) to Luxembourg individual residents or to certain residual entities that secure interest payments on behalf of such individuals (unless such entities have opted either to be treated as UCITS recognised in accordance with the European Council Directive 85/611/EEC or for the exchange of information regime) are subject to a 10 per cent. withholding tax.

Pursuant to the Luxembourg law of 23 December 2005 as amended by the law of 17 July 2008, Luxembourg resident individuals, acting in the course of their private wealth, can opt to self-declare and pay a 10 per cent. tax on interest payments made after 31 December 2007 by paying agents (defined in the same way as in the Savings Directive) located in an EU Member State other than Luxembourg, a Member State of the European Economic Area other than an EU Member State or in a State or territory which has concluded an international agreement directly related to the Savings Directive.

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## PLAN OF DISTRIBUTION

### Initial Offering and Issue of Securities

We may issue all or part of the securities from time to time, in terms determined at that time, through underwriters, dealers and/or agents, directly to purchasers or through a combination of any of these methods. We will set forth in the applicable prospectus supplement:

- the terms of the offering of the securities;
- the names of any underwriters, dealers or agents involved in the sale of the securities;
- the principal amounts of securities any underwriters will subscribe for;
- any applicable underwriting commissions or discounts; and
- our net proceeds.

If we use underwriters in the issue, they will acquire the securities for their own account and they may effect the distribution of the securities from time to time in one or more transactions. These transactions may be at a fixed price or prices, which they may change, or at prevailing market prices, or at prices related to prevailing market prices, or at negotiated prices. The securities may be offered to the public either through underwriting syndicates represented by managing underwriters or underwriters without a syndicate. Unless the applicable prospectus supplement specifies otherwise, the underwriters obligations to subscribe for the securities will depend on certain conditions being satisfied. If the conditions are satisfied, the underwriters will be obligated to subscribe for all of the securities of the series, if they subscribe for any of them. The initial public offering price of any securities and any discounts or concessions allowed or reallowed or paid to dealers may change from time to time.

If we use dealers in the issue, unless the applicable prospectus supplement specifies otherwise, we will issue the securities to the dealers as principals. The dealers may then sell the securities to the public at varying prices that the dealers will determine at the time of sale.

We may also issue securities through agents we designate from time to time, or we may issue securities directly. The applicable prospectus supplement will name any agent involved in the offering and issue of the securities, and will also set forth any commissions that we will pay. Unless the applicable prospectus supplement indicates otherwise, any agent will be acting on a best efforts basis for the period of its appointment. Agents through whom we issue securities may enter into arrangements with other institutions with respect to the distribution of the securities, and those institutions may share in the commissions, discounts or other compensation received by our agents, may be compensated separately and may also receive commissions from the purchasers for whom they may act as agents.

In connection with the issue of securities, underwriters may receive compensation from us or from subscribers of securities for whom they may act as agents. Compensation may be in the form of discounts, concessions or commissions. Underwriters may sell securities to or through dealers, and these dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters. Dealers may also receive commissions from the subscribers for whom they may act as agents. Underwriters, dealers and agents that participate in the distribution of securities may be deemed to be underwriters, and any discounts or commissions received by them from us and any profit on the sale of securities by them may be deemed to be underwriting discounts and commissions under the Securities Act. The prospectus supplement will identify any underwriter or agent, and describe any compensation that we provide.

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If the applicable prospectus supplement so indicates, we will authorize underwriters, dealers or agents to solicit offers to subscribe the securities from institutional investors. In this case, the prospectus supplement will also indicate on what date payment and delivery will be made. There may be a minimum amount which an institutional investor may subscribe, or a minimum portion of the aggregate principal amount of the securities which may be issued by this type of arrangement. Institutional investors may include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and any other institutions we may approve. The subscribers obligations under delayed delivery and payment arrangements will not be subject to any conditions; however, the institutional investors subscription of particular securities must not at the time of delivery be prohibited under the laws of any relevant jurisdiction in respect, either of the validity of the arrangements, or the performance by us or the institutional investors under the arrangements.

We may enter into agreements with the underwriters, dealers and agents who participate in the distribution of the securities that may fully or partially indemnify them against some civil liabilities, including liabilities under the Securities Act. Underwriters, dealers and agents may be customers of, engage in transactions with, or perform services for, or be our affiliates in the ordinary course of business.

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## WHERE YOU CAN FIND MORE INFORMATION

We are subject to the information requirements of the Exchange Act, and accordingly we file reports and other information with the SEC.

We have filed with the SEC a registration statement on Form F-3 with respect to the securities offered with this prospectus. This prospectus is a part of that registration statement and it omits some information that is contained in the registration statement. The SEC maintains an internet site at http://www.sec.gov that contains reports and other information we file electronically with the SEC. You may read and copy any document that we file with or furnish to the SEC at the SEC s public reference room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the public reference room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports and other information regarding issuers that file electronically with the SEC at www.sec.gov. In addition, you may inspect and copy that material at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005, on which some of our securities are listed. We maintain an internet site at www.ab-inbev.com.

We will furnish to the Trustee referred to under Description of Debt Securities and Guarantees annual reports, which will include a description of operations and annual audited consolidated financial statements prepared in accordance with IFRS. We will also furnish to the Trustee certain interim reports that will include unaudited interim summary consolidated financial information prepared in accordance with IFRS. We will furnish to the Trustee all notices of meetings at which holders of securities are entitled to vote, and all other reports and communications that are made generally available to those holders.

## VALIDITY OF SECURITIES

If stated in the prospectus supplement applicable to a specific issuance of debt securities, the validity of such securities under New York law may be passed upon for us by our U.S. counsel, Sullivan & Cromwell LLP. If stated in the prospectus supplement applicable to a specific issuance of debt securities, the validity of such securities under Belgian law and Luxembourg law may be passed upon by our Belgian counsel, Linklaters LLP. Sullivan & Cromwell LLP may rely on the opinion of Linklaters LLP as to all matters of Belgian law and Luxembourg law and Linklaters LLP may rely on the opinion of Sullivan & Cromwell LLP as to all matters of New York law. If this prospectus is delivered in connection with an underwritten offering, the validity of the debt securities or warrants may be passed upon for the underwriters by United States, Belgian and Luxembourg counsel for the underwriters specified in the related prospectus supplement. If no Belgian or Luxembourg counsel is specified, such U.S. counsel to the underwriters may also rely on the opinion of Linklaters LLP as to certain matters of Belgian and Luxembourg law respectively.

## EXPERTS

Our financial statements as of 31 December 2009 and 2008 and for each of the three years in the period ended 31 December 2009 which are incorporated in this prospectus have been so included in reliance on the audit reports of Klynveld Peat Marwick Goerdeler ( KPMG ) Réviseurs d Entreprises SCCRL/Bedrijfsrevisoren BCVBA, independent registered public accounting firm, and PricewaterhouseCoopers LLP, independent registered public accounting firm, given on the authority of said firms as experts in auditing and accounting. KPMG (Avenue du Bourget/Bourgetlaan 40, 1130 Brussels, Belgium) is a member of the Institut des Réviseurs d Entreprises/Instituut der Bedrijfsrevisoren. PricewaterhouseCoopers LLP (800 Market Street, St. Louis, Missouri 63101) is a member of the American Institute of Certified Public Accountants.

The audited financial statements of the Anheuser-Busch U.S. Beer and Packaging reporting entities as of and for the year ended 31 December 2009 and the audited financial statement of Anheuser-Busch Companies Inc. as of 31 December 2008, which are not incorporated in this prospectus, have been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, whose reports thereon are incorporated into this prospectus. Such financial statements, to the extent they have been included in our financial statements, have been so included in reliance on the reports of such independent registered public accounting firm given on the authority of said firm as experts in auditing and accounting.

The audited financial statements of Anheuser-Busch Companies, Inc. as of 31 December 2007 and 2006 and for each of the three years in the period ended 31 December 2007 which are incorporated in this prospectus have been so included in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

Consents to the inclusion in this prospectus of such reports by KPMG and PricewaterhouseCoopers LLP have been filed as Exhibits 23.1 and 23.2 to the Form F-3, respectively.

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## EXPENSES

The following is a statement of the expenses (all of which are estimated) to be incurred by us in connection with a distribution of securities registered under this Registration Statement:

| | |
|---|---|
| Securities and Exchange Commission registration fee | $ [(1)] |
| Printing and engraving expenses | $ 40,000 |
| Legal fees and expenses | $ 600,000 |
| Accountants fees and expenses | $ 60,000 |
| Trustee fees and expenses | $ 15,000 |
| Total | $ 715,000 |

(1) The Registrants are registering an indeterminate amount of securities under the Registration Statement and in accordance with Rules 456(b) and 457(r), the Registrants are deferring payment of any additional registration fee until the time the securities are sold under the Registration Statement pursuant to a prospectus supplement.

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**PROSPECTUS SUPPLEMENT**

**(to Prospectus dated 21 September 2010)**

# *Anheuser-Busch InBev Worldwide Inc.*

**Guaranteed Debt Securities**

**Fully and unconditionally guaranteed by**

## *Anheuser-Busch InBev SA/NV*

## *BrandBrew S.A.*

## *Cobrew NV/SA*

## *Anheuser-Busch Companies, LLC*

This prospectus supplement supplements the prospectus, dated 21 September 2010, to reflect the change of name and business form of Anheuser-Busch Companies, Inc., a Delaware corporation, to Anheuser-Busch Companies, LLC, a Delaware limited liability company, by way of conversion pursuant to Section 266 of the Delaware General Corporation Law and Section 18-214 of the Delaware Limited Liability Company Act. Such conversion became effective at 3:00 p.m. (Eastern time) on October 1, 2011, which we refer to in this prospectus supplement as the Effective Time.

Anheuser-Busch InBev Worldwide Inc., Anheuser-Busch InBev SA/NV, Anheuser-Busch Companies, LLC, Brandbrew SA, Cobrew NV/SA and The Bank of New York Mellon Trust Company, N.A., as trustee, have entered into a supplemental indenture to the Indenture, dated as of October 16, 2009, among Anheuser-Busch InBev Worldwide Inc., Anheuser-Busch InBev SA/NV, the Subsidiary Guarantors party thereto from time to time and the Trustee for the purpose of clarifying that, from and after the Effective Time, Anheuser-Busch Companies, Inc. s obligations under its guarantee of securities outstanding under such Indenture remain obligations of Anheuser-Busch Companies, LLC by operation of law.

All references to Anheuser-Busch Companies, Inc. in the prospectus shall be deemed to refer to Anheuser-Busch Companies, LLC, except that the following references shall not be so modified:

- The reference to Anheuser-Busch Companies, Inc. Historical Financial Information under the heading Incorporation of Certain Documents by Reference in the prospectus;

- The two references to Anheuser-Busch Companies, Inc. audited financial statements under the heading Experts in the prospectus; and

- Any reference to Anheuser-Busch Companies, Inc. in a document incorporated by reference into the prospectus at or prior to the Effective Time.

**Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

The date of this prospectus supplement is 6 October 2011.

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**REGISTERED OFFICE OF THE ISSUER**

**Anheuser-Busch InBev Worldwide Inc.**

1209 Orange Street, Wilmington, DE 19801

United States

**REGISTERED OFFICE OF THE PARENT GUARANTOR**

**Anheuser-Busch InBev SA/NV**

Grand-Place/Grote Markt 1

1000 Brussels, Belgium

**LEGAL ADVISORS TO THE ISSUER AND THE PARENT GUARANTOR**

| | |
|---|---|
| *As to U.S. law* | *As to Belgian law* |
| **Sullivan & Cromwell LLP** | **Clifford Chance LLP** |
| 1 New Fetter Lane | 65 Avenue Louise |
| London EC4A 1AN | 1050 Brussels |
| United Kingdom | Belgium |

**LEGAL ADVISORS TO THE UNDERWRITERS**

| | |
|---|---|
| *As to U.S. law* | *As to Belgian law* |
| **Allen & Overy LLP** | **Allen & Overy LLP** |
| One Bishops Square | Avenue de Tervueren/Tervuerenlaan 268 A |
| London E1 6AD | B-1150 Brussels |
| United Kingdom | Belgium |

**TRUSTEE, PAYING AGENT, TRANSFER AGENT, CALCULATION AGENT AND REGISTRAR**

**The Bank of New York Mellon Trust Company, N.A.**

911 Washington Avenue, 3rd floor

St. Louis, MO 63101

United States

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# *Anheuser-Busch InBev Worldwide Inc.*

**$ % Notes due**

**$ % Notes due**

**$ % Notes due**

**$ % Notes due**

**Fully and unconditionally guaranteed by**

## *Anheuser-Busch InBev SA/NV*

## *Brandbrew S.A.*

## *Cobrew NV/SA*

## *Anheuser-Busch Companies, LLC*

**PROSPECTUS SUPPLEMENT**

2012

*Joint Bookrunners*

**BofA Merrill Lynch** **Barclays** **Deutsche Bank Securities** **J.P. Morgan**

**BNP PARIBAS** **Mitsubishi UFJ Securities** **Mizuho Securities** **RBS** **SOCIETE GENERALE**

*Senior Co-Managers*

*Co-Managers*

n style="font-family:inherit;font-size:9pt;">® mortgage servicing assets may require us to record impairment charges to the value of these assets, and significant impairment charges could be material and adversely affect our business.

In addition, our ability to generate income through mortgage sales to institutional investors depends in part on programs sponsored by Fannie Mae, Freddie Mac and Ginnie Mae, which facilitate the issuance of mortgage-backed securities in the secondary market. Any significant revision or reduction in the operation of those programs could have a material adverse effect on our loan origination and mortgage sales as well as our results of operations. Also, any significant adverse change in the level of activity in the secondary market or the underwriting criteria of these entities could negatively impact our results of business, operations and cash flows.

***Changes in accounting standards may require us to increase our Allowance for Loan Losses and could materially impact our financial statements.***

From time to time, the Financial Accounting Standards Board (the “FASB”) and the SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can materially impact how we record and report our financial condition and results of operations. For example, in June 2016, the FASB issued *ASU 2016-13*, *Financial Instruments - Credit Losses (Topic 326)* which changes, among other things, the way companies must record expected credit losses on financial instruments that are not accounted for at fair value through net income, including loans held for investment, available for sale and held-to-maturity debt securities, trade and other receivables, net investment in leases and other commitments to extend credit held by a reporting entity at each reporting date, and require that financial assets measured at amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis and eliminate the probable initial recognition in current GAAP and reflect the current estimate of all expected credit losses based upon historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the financial assets.

For purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (“PCD assets”) that are measured at amortized cost, an allowance for expected credit losses will be recorded as an adjustment to the cost basis of the asset. Subsequent changes in estimated cash flows would be recorded as an adjustment to the allowance and through the statement of income. Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses rather than as a direct write-down to the security's cost basis. The amendments in this ASU will be effective for us beginning on January 1, 2020. For most debt securities, the transition approach requires a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period the guidance is effective. For other-than-temporarily impaired debt securities and PCD assets, the guidance will be applied prospectively. We are currently evaluating the provisions of this ASU to determine the impact and developing appropriate systems to prepare for compliance with this new standard, however, we expect the new standard could have a material impact on the Company's consolidated financial statements.

***HomeStreet, Inc. primarily relies on dividends from the Bank, which may be limited by applicable laws and regulations.***

HomeStreet, Inc. is a separate legal entity from the Bank, and although we may receive some dividends from HomeStreet Capital Corporation, the primary source of our funds from which we service our debt, pay any dividends that we may declare to

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our shareholders and otherwise satisfy our obligations is dividends from the Bank. The availability of dividends from the Bank is limited by various statutes and regulations, capital rules regarding requirements to maintain a “well capitalized” ratio at the bank, as well as by our policy of retaining a significant portion of our earnings to support the Bank's operations. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations - *Capital Management*” as well as “Regulation and Supervision of HomeStreet Bank - *Capital and Prompt Corrective Action Requirements*” in this Form 10-K. If the Bank cannot pay dividends to us, we may be limited in our ability to service our debts, fund the Company's operations and acquisition plans and pay dividends to the Company's shareholders. While the Company has paid special dividends in some prior quarters, we have not adopted a policy to pay dividends and in recent years our Board of Directors has elected to retain capital for growth rather than to declare a dividend. While management has recently discussed the possibility of paying dividends in the near future, we have not declared dividends in any recent quarters, and the potential of future dividends is subject to board approval, cash flow limitations, capital requirements, capital and strategic needs and other factors.

***The financial services industry is highly competitive.***

We face pricing competition for loans and deposits. We also face competition with respect to customer convenience, product lines, accessibility of service and service capabilities. Our most direct competition comes from other banks, credit unions, mortgage companies and savings institutions, but more recently has also come from financial technology (or "fintech") companies that rely on technology to provide financial services. The significant competition in attracting and retaining deposits and making loans as well as in providing other financial services throughout our market area may impact future earnings and growth. Our success depends, in part, on the ability to adapt products and services to evolving industry standards and provide consistent customer service while keeping costs in line. There is increasing pressure to provide products and services at lower prices, which can reduce net interest income and non-interest income from fee-based products and services. New technology-driven products and services are often introduced and adopted, including innovative ways that customers can make payments, access products and manage accounts. We could be required to make substantial capital expenditures to modify or adapt existing products and services or develop new products and services. We may not be successful in introducing new products and services or those new products may not achieve market acceptance. We could lose business, be forced to price products and services on less advantageous terms to retain or attract clients, or be subject to cost increases if we do not effectively develop and implement new technology. In addition, advances in technology such as telephone, text, and on-line banking; e-commerce; and self-service automatic teller machines and other equipment, as well as changing customer preferences to access our products and services through digital channels, could decrease the value of our branch network and other assets. As a result of these competitive pressures, our business, financial condition or results of operations may be adversely affected.

***We will be subject to heightened regulatory requirements if we exceed $10 billion in assets.***

We anticipate that our total assets could exceed $10 billion in the next several years, based on our historic and projected growth rates. The Dodd-Frank Act and its implementing regulations impose various additional requirements on bank holding companies with $10 billion or more in total assets, including compliance with portions of the Federal Reserve’s enhanced prudential oversight requirements and annual stress testing requirements. In addition, banks with $10 billion or more in total assets are primarily examined by the CFPB with respect to various federal consumer financial protection laws and regulations. Currently, our bank is subject to regulations adopted by the CFPB, but the FDIC is primarily responsible for examining our bank’s compliance with consumer protection laws and those CFPB regulations. As a relatively new agency with evolving regulations and practices, there is uncertainty as to how the CFPB’s examination and regulatory authority might impact our business.

To ensure compliance with these heightened requirements when effective, our regulators may require us to fully comply with these requirements or take actions to prepare for compliance even before our or the Bank’s total assets equal or exceed $10 billion. In fact, we have already begun implementing measures to allow us to prepare for the heightened compliance that we expect will be required if we exceed $10 billion in assets, including hiring additional compliance personnel and designing and implementing additional compliance systems and internal controls. We may incur significant expenses in connection with these activities, any of which could have a material adverse effect on our business, financial condition or results of operations. We expect to incur these compliance-related costs even if they are not yet fully required, and may incur them even if we do not ultimately reach $10 billion in asset at the rate we expect or at all. We may also face heightened scrutiny by our regulators as we begin to implement these new compliance measures and grow toward the $10 billion asset threshold, and our regulators may consider our preparation for compliance with these regulatory requirements when examining our operations generally or considering any request for regulatory approval we may make, even requests for approvals on unrelated matters. In addition, compliance with the annual stress testing requirements, part of which must be publicly disclosed, may also be misinterpreted by the market generally or our customers and, as a result, may adversely affect our stock price or our ability to retain our customers or effectively compete for new business opportunities.

## Risks Related to Information Systems and Security

***A failure in or breach of our security systems or infrastructure, including breaches resulting from cyber-attacks, could disrupt our businesses, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses.***

Information security risks for financial institutions have increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists, activists, and other external parties. Those parties also may attempt to fraudulently induce employees, customers, or other users of our systems to disclose confidential information in order to gain access to our data or that of our customers. Our operations rely on the secure processing, transmission and storage of confidential information in our computer systems and networks, either managed directly by us or through our data processing vendors. In addition, to access our products and services, our customers may use personal computers, smartphones, tablet PCs, and other mobile devices that are beyond our control systems. Although we believe we have robust information security procedures and controls, we rely heavily on our third party vendors, technologies, systems, networks and our customers' devices all of which may become the target of cyber-attacks, computer viruses, malicious code, unauthorized access, hackers or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss, theft or destruction of our confidential, proprietary and other information or that of our customers, or disrupt our operations or those of our customers or third parties.

To date we are not aware of any material losses relating to cyber-attacks or other information security breaches, but there can be no assurance that we will not suffer such attacks, breaches and losses in the future. Our risk and exposure to these matters remains heightened because of, among other things, the evolving nature of these threats, our plans to continue to implement our Internet banking and mobile banking channel, our expanding operations and the outsourcing of a significant portion of our business operations. As a result, the continued development and enhancement of our information security controls, processes and practices designed to protect customer information, our systems, computers, software, data and networks from attack, damage or unauthorized access remain a priority for our management. As cyber threats continue to evolve, we may be required to expend significant additional resources to insure, modify or enhance our protective measures or to investigate and remediate important information security vulnerabilities or exposures; however, our measures may be insufficient to prevent physical and electronic break-ins, denial of service and other cyber-attacks or security breaches.

We maintain insurance coverage related to business interruptions and breaches of our security systems. However, disruptions or failures in the physical infrastructure or operating systems that support our businesses and customers, or cyber-attacks or security breaches of the networks, systems or devices that our customers use to access our products and services could result in customer attrition, uninsured financial losses, the inability of our customers to transact business with us, violations of applicable privacy and other laws, regulatory fines, penalties or intervention, additional regulatory scrutiny, reputational damage, litigation, reimbursement or other compensation costs, and/or additional compliance costs, any of which could materially and adversely affect our results of operations or financial condition.

***We rely on third party vendors and other service providers for certain critical business activities, which creates additional operational and information security risks for us.***

Third parties with which we do business or that facilitate our business activities, including exchanges, clearing houses, financial intermediaries or vendors that provide services or security solutions for our operations, could also be sources of operational and information security risk to us, including from breakdowns or failures of their own systems, capacity constraints or failures of their own internal controls. Specifically, we receive core systems processing, essential web hosting and other Internet systems and deposit and other processing services from third-party service providers. In late February 2018, one of our vendors provided notice to us that their independent auditors had determined their internal controls to be inadequate. While we do not believe this particular failure of internal controls would have an impact on us due to the strength of our own internal controls, future failures of internal controls of a vendor could have a significant impact on our operations if we do not have controls to cover those issues. To date none of our third party vendors or service providers has notified us of any security breach in their systems that has resulted in an increased vulnerability to us or breached the integrity of our confidential customer data. Such third parties may also be target of cyber-attacks, computer viruses, malicious code, unauthorized access, hackers or information security breaches that could compromise the confidential or proprietary information of HomeStreet and our customers.

In addition, if any third-party service providers experience difficulties or terminate their services and we are unable to replace them with other service providers, our operations could be interrupted and our operating expenses may be materially increased. If an interruption were to continue for a significant period of time, our business financial condition and results of operations could be materially adversely affected.

Some of our primary third party service providers are subject to examination by banking regulators and may be subject to enhanced regulatory scrutiny due to regulatory findings during examinations of such service providers conducted by federal regulators. While we subject such vendors to higher scrutiny and monitor any corrective measures that the vendors are taking or would undertake, we cannot fully anticipate and mitigate all risks that could result from a breach or other operational failure of a vendor’s system.

Others provide technology that we use in our own regulatory compliance, including our mortgage loan origination technology. If those providers fail to update their systems or services in a timely manner to reflect new or changing regulations, or if our personnel operate these systems in a non-compliant manner, our ability to meet regulatory requirements may be impacted and may expose us to heightened regulatory scrutiny and the potential for payment of monetary penalties.

In addition, in order to safeguard our online financial transactions, we must provide secure transmission of confidential information over public networks. Our Internet banking system relies on third party encryption and authentication technologies necessary to provide secure transmission of confidential information. Advances in computer capabilities, new discoveries in the field of cryptology or other developments could result in a compromise or breach of the algorithms our third-party service providers use to protect customer data. If any such compromise of security were to occur, it could have a material adverse effect on our business, financial condition and results of operations.

***The failure to protect our customers’ confidential information and privacy could adversely affect our business.***

We are subject to federal and state privacy regulations and confidentiality obligations that, among other things restrict the use and dissemination of, and access to, certain information that we produce, store or maintain in the course of our business. We also have contractual obligations to protect certain confidential information we obtain from our existing vendors and customers. These obligations generally include protecting such confidential information in the same manner and to the same extent as we protect our own confidential information, and in some instances may impose indemnity obligations on us relating to unlawful or unauthorized disclosure of any such information.

If we do not properly comply with privacy regulations and contractual obligations that require us to protect confidential information, or if we experience a security breach or network compromise, we could experience adverse consequences, including regulatory sanctions, penalties or fines, increased compliance costs, remedial costs such as providing credit monitoring or other services to affected customers, litigation and damage to our reputation, which in turn could result in decreased revenues and loss of customers, all of which would have a material adverse effect on our business, financial condition and results of operations.

***The network and computer systems on which we depend could fail for reasons not related to security breaches.***

Our computer systems could be vulnerable to unforeseen problems other than a cyber-attack or other security breach. Because we conduct a part of our business over the Internet and outsource several critical functions to third parties, operations will depend on our ability, as well as the ability of third-party service providers, to protect computer systems and network infrastructure against damage from fire, power loss, telecommunications failure, physical break-ins or similar catastrophic events. Any damage or failure that causes interruptions in operations may compromise our ability to perform critical functions in a timely manner (or may give rise to perceptions of such compromise) and could have a material adverse effect on our business, financial condition and results of operations as well as our reputation and customer or vendor relationships.

***We continually encounter technological change, and we may have fewer resources than many of our competitors to invest in technological improvements.***

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our clients by using technology to provide products and services that will satisfy client demands for convenience, as well as to create additional efficiencies in our operations. Many national vendors provide turn-key services to community banks, such as Internet banking and remote deposit capture that allow smaller banks to compete with institutions that have substantially greater resources to invest in technological improvements. We may not be able, however, to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

**Anti-Takeover Risk**

***Some provisions of our articles of incorporation and bylaws and certain provisions of Washington law may deter takeover attempts, which may limit the opportunity of our shareholders to sell their shares at a favorable price.***

Some provisions of our articles of incorporation and bylaws may have the effect of deterring or delaying attempts by our shareholders to remove or replace management, to commence proxy contests, or to effect changes in control. These provisions include:

- A classified Board of Directors so that only approximately one third of our board of directors is elected each year;
- Elimination of cumulative voting in the election of directors;
- Procedures for advance notification of shareholder nominations and proposals;
- The ability of our Board of Directors to amend our bylaws without shareholder approval; and
- The ability of our Board of Directors to issue shares of preferred stock without shareholder approval upon the terms and conditions and with the rights, privileges and preferences as the board of directors may determine.

In addition, as a Washington corporation, we are subject to Washington law which imposes restrictions on business combinations and similar transactions between a corporation and certain significant shareholders. These provisions, alone or together, could have the effect of deterring or delaying changes in incumbent management, proxy contests or changes in control. These restrictions may limit a shareholder’s ability to benefit from a change-in-control transaction that might otherwise result in a premium unless such a transaction is favored by our Board of Directors.

**ITEM 1B UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2 PROPERTIES**

We lease principal offices, which are located in downtown Seattle at 601 Union Street, Suite 2000, Seattle, WA 98101. This lease provides sufficient space to conduct the management of our business. The Company conducts Mortgage Lending as well as Commercial and Consumer Banking activities in locations in Washington, California, Oregon, Hawaii, Idaho, Arizona and Utah. As of December 31, 2017, we operated in 44 primary stand-alone home loan centers, six primary commercial lending centers, 59 retail deposit branches, and one insurance office. As of such date, we also operated three facilities for the purpose of administrative and other functions in addition to the principal offices: a loan fulfillment center and a call center and operations support facility, both located in Federal Way, Washington; and loan fulfillment centers in Pleasanton, California and Vancouver, Washington. Of these properties, we own five of the retail deposit branches, the loan fulfillment center and the call center and operations support facility in Federal Way and we own 50% of a retail branch through a joint venture. In addition, we own two parcels of land in Washington State. All facilities are in a good state of repair and appropriately designed for use as banking or administrative office facilities.

**ITEM 3 LEGAL PROCEEDINGS**

Because the nature of our business involves the collection of numerous accounts, the validity of liens and compliance with various state and federal lending laws, we are subject to various legal proceedings in the ordinary course of our business related to foreclosures, bankruptcies, condemnation and quiet title actions and alleged statutory and regulatory violations. We are also subject to legal proceedings in the ordinary course of business related to employment matters. We do not expect that these proceedings, taken as a whole, will have a material adverse effect on our business, financial position or our results of operations. There are currently no matters that, in the opinion of management, would have a material adverse effect on our consolidated financial position, results of operation or liquidity, or for which there would be a reasonable possibility of such a loss based on information known at this time.

**ITEM 4 MINE SAFETY DISCLOSURES**

Not applicable.

## PART II

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

Our common stock is traded on the NASDAQ Global Select Market under the symbol "HMST." The following table sets forth, for the periods indicated, the high and low reported sales prices per share of the common stock as reported on the NASDAQ Global Select Market, our principal trading market.

| | High | Low | Special Cash Dividends Declared |
|---|---|---|---|
| **For the Year Ended December 31, 2017** | | | |
| First quarter ended March 31 | $32.50 | $25.01 | $ — |
| Second quarter ended June 30 | 29.88 | 25.40 | — |
| Third quarter ended September 30 | 28.40 | 24.00 | — |
| Fourth quarter ended December 31 | 31.30 | 26.83 | — |
| **For the Year Ended December 31, 2016** | | | |
| First quarter ended March 31 | $22.79 | $18.58 | $ — |
| Second quarter ended June 30 | 22.97 | 18.74 | — |
| Third quarter ended September 30 | 27.21 | 19.07 | — |
| Fourth quarter ended December 31 | 33.70 | 24.03 | — |

As of March 2, 2018, there were 2,476 shareholders of record of our common stock.

### Dividend Policy

We have not adopted a formal dividend policy to pay dividends and did not pay any dividends in 2017 or 2016. The amount and timing of any future dividends have not been determined. The payment of dividends will depend upon a number of factors, including regulatory capital requirements, the Company's and the Bank's liquidity, financial condition and results of operations, strategic growth plans, tax considerations, statutory and regulatory limitations and general economic conditions. Our ability to pay dividends to shareholders is significantly dependent on the Bank's ability to pay dividends to the Company, which is limited to the extent necessary for the Bank to meet the regulatory requirements of a "well-capitalized" bank or other formal or informal guidance communicated by our principal regulators. Capital rules implemented beginning on January 1, 2015 have imposed more stringent requirements on the ability of the Bank to maintain "well-capitalized" status and to pay dividends to the Company. See "Regulation and Supervision of HomeStreet Bank - *Capital and Prompt Corrective Action Requirements - Capital Requirements*."

For the foregoing reasons, there can be no assurance that we will pay any further special dividends in any future period.

### Sales of Unregistered Securities

There were no sales of unregistered securities in the fourth quarter of 2017.

### Stock Repurchases in the Fourth Quarter

Not applicable.

**Stock Performance Graph**

*This performance graph shall not be deemed "soliciting material" or to be "filed" with the SEC for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (Exchange Act), or otherwise subject to the liabilities under that Section, and shall not be deemed to be incorporated by reference into any filing of HomeStreet, Inc. under the Securities Act of 1933, as amended, or the Exchange Act.*

The following graph shows a comparison from February 10, 2012 (the date our common stock commenced trading on the NASDAQ Global Select Market) through December 31, 2017 of the cumulative total return for our common stock, the KBW Bank Index (BKX), the Russell 2000 Index (RUT) and the KBW Regional Banking Index (KRX). The graph assumes that $100 was invested at the market close on February 10, 2012 in the common stock of HomeStreet, Inc., the KBW Bank Index, the Russell 2000 Index, the KBW Regional Banking Index and data for HomeStreet, Inc., the KBW Bank Index, the Russell 2000 Index and the KBW Regional Banking Index assumes reinvestments of dividends. The stock price performance of the following graph is not necessarily indicative of future stock price performance. We are adding in the KBW Regional Bank Index this year, to eventually replace KBW Bank Index, in our performance graph as the composition of the KBW Regional Bank index is more relevant to our size and market cap.

**ITEM 6 SELECTED FINANCIAL DATA**

The data set forth below should be read in conjunction with Item 7, “Management’s Discussion and Analysis of Consolidated Financial Condition and Results of Operations,” and the Consolidated Financial Statements and Notes thereto appearing at Item 8 of this report.

The following table sets forth selected historical consolidated financial and other data for us at and for each of the periods ended as described below. The selected historical consolidated financial data as of December 31, 2017 and 2016 and for each of the years ended December 31, 2017, 2016 and 2015 have been derived from, and should be read together with, our audited consolidated financial statements and related notes included elsewhere in this Form 10-K. The selected historical consolidated financial data as of December 31, 2015, 2014 and 2013 and for each of the years ended December 31, 2015, 2014 and 2013 have been derived from our audited consolidated financial statements for those years, which are not included in this Form10-K. You should read the summary selected historical consolidated financial and other data presented below in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our financial statements and the notes thereto, which are included elsewhere in this Form 10-K. We have prepared our unaudited information on the same basis as our audited consolidated financial statements and have included, in our opinion, all adjustments that we consider necessary for a fair presentation of the financial information set forth in that information.

| | At or for the Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (dollars in thousands, except share data) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Income statement data (for the period ended): | | | | | |
| Net interest income | $ 194,438 | $ 180,049 | $ 148,338 | $ 98,669 | $ 74,444 |
| Provision (reversal of provision) for credit losses | 750 | 4,100 | 6,100 | (1,000) | 900 |
| Noninterest income | 312,154 | 359,150 | 281,237 | 185,657 | 190,745 |
| Noninterest expense | 439,653 | 444,322 | 366,568 | 252,011 | 229,495 |
| Income before income taxes | 66,189 | 90,777 | 56,907 | 33,315 | 34,794 |
| Income tax (benefit) expense | (2,757) | 32,626 | 15,588 | 11,056 | 10,985 |
| Net income | $ 68,946 | $ 58,151 | $ 41,319 | $ 22,259 | $ 23,809 |
| Basic income per share | $ 2.57 | $ 2.36 | $ 1.98 | $ 1.50 | $ 1.65 |
| Diluted income per share | $ 2.54 | $ 2.34 | $ 1.96 | $ 1.49 | $ 1.61 |
| Common shares outstanding | 26,888,288 | 26,800,183 | 22,076,534 | 14,856,611 | 14,799,991 |
| Weighted average number of shares outstanding: | | | | | |
| Basic | 26,864,657 | 24,615,990 | 20,818,045 | 14,800,689 | 14,412,059 |
| Diluted | 27,092,019 | 24,843,683 | 21,059,201 | 14,961,081 | 14,798,168 |
| Book value per share | $ 26.20 | $ 23.48 | $ 21.08 | $ 20.34 | $ 17.97 |
| Dividends per share | $ — | $ — | $ — | $ 0.11 | $ 0.33 |
| Financial position (at year end): | | | | | |
| Cash and cash equivalents | $ 72,718 | $ 53,932 | $ 32,684 | $ 30,502 | $ 33,908 |
| Investment securities | 904,304 | 1,043,851 | 572,164 | 455,332 | 498,816 |
| Loans held for sale | 610,902 | 714,559 | 650,163 | 621,235 | 279,941 |
| Loans held for investment, net | 4,506,466 | 3,819,027 | 3,192,720 | 2,099,129 | 1,871,813 |
| Mortgage servicing rights | 284,653 | 245,860 | 171,255 | 123,324 | 162,463 |
| Other real estate owned | 664 | 5,243 | 7,531 | 9,448 | 12,911 |
| Total assets | 6,742,041 | 6,243,700 | 4,894,495 | 3,535,090 | 3,066,054 |
| Deposits | 4,760,952 | 4,429,701 | 3,231,953 | 2,445,430 | 2,210,821 |
| Federal Home Loan Bank advances | 979,201 | 868,379 | 1,018,159 | 597,590 | 446,590 |

| | | | | | |
|---|---|---|---|---|---|
| Federal funds purchased and securities sold under agreements to repurchase | — | — | — | 50,000 | — |
| Total shareholders' equity | $ 704,380 | $ 629,284 | $ 465,275 | $ 302,238 | $ 265,926 |

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Summary Financial Data (continued)

| (dollars in thousands, except share data) | At or for the Years Ended December 31, 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Financial position (averages): | | | | | |
| Investment securities | $1,023,702 | $834,671 | $523,756 | $459,060 | $515,000 |
| Loans held for investment | 4,178,326 | 3,668,263 | 2,834,511 | 1,890,537 | 1,496,146 |
| Total interest-earning assets | 5,998,521 | 5,307,118 | 4,150,089 | 2,869,414 | 2,422,136 |
| Total interest-bearing deposits | 3,588,515 | 3,145,137 | 2,499,538 | 1,883,622 | 1,661,568 |
| Federal Home Loan Bank advances | 1,037,650 | 942,593 | 795,368 | 431,623 | 293,871 |
| Total interest-bearing liabilities | 4,755,221 | 4,189,582 | 3,368,160 | 2,386,537 | 2,020,613 |
| Shareholders' equity | 675,877 | 566,148 | 442,105 | 289,420 | 249,081 |
| Financial performance: | | | | | |
| Return on average shareholders' equity (1) | 10.20 % | 10.27 % | 9.35 % | 7.69 % | 9.56 % |
| Return on average total assets | 1.05 % | 1.01 % | 0.91 % | 0.69 % | 0.88 % |
| Net interest margin (2) | 3.31 % | 3.45 % | 3.63 % | 3.51 % | 3.17 % (3) |
| Efficiency ratio (4) | 86.79 % | 82.40 % | 85.33 % | 88.63 % | 86.54 % |
| Asset quality: | | | | | |
| Allowance for credit losses | $39,116 | $35,264 | $30,659 | $22,524 | $24,089 |
| Allowance for loan losses/total loans (5) | 0.83 % | 0.88 % | 0.91 % | 1.04 % | 1.26 % |
| Allowance for loan losses/nonaccrual loans | 251.63 % | 165.52 % | 170.54 % | 137.51 % | 93.00 % |
| Total nonaccrual loans (6)/(7) | $15,041 | $20,542 | $17,168 | $16,014 | $25,707 |
| Nonaccrual loans/total loans | 0.33 % | 0.53 % | 0.53 % | 0.75 % | 1.36 % |
| Other real estate owned | $664 | $5,243 | $7,531 | $9,448 | $12,911 |
| Total nonperforming assets | $15,705 | $25,785 | $24,699 | $25,462 | $38,618 |
| Nonperforming assets/total assets | 0.23 % | 0.41 % | 0.50 % | 0.72 % | 1.26 % |
| Net (recoveries) charge-offs | $(3,102 ) | $(505 ) | $(2,035 ) | $565 | $4,562 |
| Regulatory capital ratios for the Bank: | | | | | |
| Basel III - Tier 1 leverage capital (to average assets) | 9.67 % | 10.26 % | 9.46 % | NA | NA |
| Basel III - Tier 1 common equity risk-based capital (to risk-weighted assets) | 13.22 % | 13.92 % | 13.04 % | NA | NA |
| Basel III - Tier 1 risk-based capital (to risk-weighted assets) | 13.22 % | 13.92 % | 13.04 % | NA | NA |
| Basel III - Total risk-based capital (to risk-weighted assets) | 14.02 % | 14.69 % | 13.92 % | NA | NA |
| Basel I - Tier 1 leverage capital (to average assets) | NA | NA | NA | 9.38 % | 9.96 % |
| Basel I - Tier 1 risk-based capital (to risk-weighted assets) | NA | NA | NA | 13.10 % | 14.12 % |
| Basel I - Total risk-based capital (to risk-weighted assets) | NA | NA | NA | 14.03 % | 15.28 % |
| Regulatory capital ratios for the Company: | | | | | |
| Basel III - Tier 1 leverage capital (to average assets) | 9.12 % | 9.78 % | 9.95 % | NA | NA |
| Basel III - Tier 1 common equity risk-based capital (to risk-weighted assets) | 9.86 % | 10.54 % | 10.52 % | NA | NA |
| Basel III - Tier 1 risk-based capital (to risk-weighted assets) | 10.92 % | 11.66 % | 11.94 % | NA | NA |
| Basel III - Total risk-based capital (to risk-weighted assets) | 11.61 % | 12.34 % | 12.70 % | NA | NA |

| | At or for the Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 | 2014 | 2013 |
| SUPPLEMENTAL DATA: | | | | | |
| Loans serviced for others | | | | | |
| Single family | $22,631,147 | $19,488,456 | $15,347,811 | $11,216,208 | $11,795,621 |
| Multifamily | 1,311,399 | 1,108,040 | 924,367 | 752,640 | 720,429 |
| Other | 79,797 | 69,323 | 79,513 | 82,354 | 95,673 |
| Total loans serviced for others | $24,022,343 | $20,665,819 | $16,351,691 | $12,051,202 | $12,611,723 |
| Loan origination activity | | | | | |
| Single family | $8,091,400 | $9,214,463 | $7,440,612 | $4,697,767 | $4,852,879 |
| Other | 2,749,291 | 2,560,549 | 1,540,455 | 967,500 | 603,271 |
| Total loan origination activity | $10,840,691 | $11,775,012 | $8,981,067 | $5,665,267 | $5,456,150 |

(1) Net earnings available to common shareholders divided by average shareholders' equity.

(2) Net interest income divided by total average interest-earning assets on a tax equivalent basis.

(3) Net interest margin for the year ended December 31, 2013 included $1.4 million in interest expense related to the correction of the cumulative effect of an error in prior years, resulting from the under accrual of interest due on the trust preferred securities for which the Company had deferred the payment of interest. Excluding the impact of the prior period interest expense correction, the net interest margin was 3.23% for the year ended December 31, 2013.

(4) Noninterest expense divided by total revenue (net interest income and noninterest income).

(5) Includes loans acquired with bank acquisitions. Excluding acquired loans, allowance for loan losses /total loans was 0.90%, 1.00%, 1.10%, 1.10% and 1.40% at December 31, 2017, 2016, 2015, 2014 and 2013, respectively.

(6) Generally, loans are placed on nonaccrual status when they are 90 or more days past due, unless payment is insured by the FHA or guaranteed by the VA.

(7) Includes $1.9 million and $1.9 million of nonperforming loans at December 31, 2017 and 2016, respectively, which are guaranteed by the Small Business Administration ("SBA").

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

*NOTICE REGARDING FORWARD LOOKING STATEMENTS*

The following discussion contains certain forward-looking statements, which are statements of expectations and not statements of historical fact. Many forward-looking statements can be identified as using words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "potential," "should," "will" and "would" and similar expres negative of these terms). Such statements involve inherent risks and uncertainties, many of which are difficult to predict and are generally beyond the control of the Company and are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-K, particularly in Item 1A "Risk Factors," that could cause actual results to differ significantly from those projected. Although we believe that expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to, and expressly disclaim any such obligation to update, or clarify any of the forward-looking statements after the date of this Form 10-K to reflect changed assumptions, the occurrence of anticipated or unanticipated events, new information or changes to future results over time of otherwise, except as required by law. Readers are cautioned not to place undue reliance on these forward-looking statements, which apply only as of the date of this Form 10-K.

*Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with "Selected Consolidated Financial Data" and the Consolidated Financial Statements and Notes included in Items 6 and 8 of this Form 10-K.*

**Executive Summary**

HomeStreet is a diversified financial services company founded in 1921, headquartered in Seattle, Washington, serving customers primarily in the western United States, including Hawaii. We are principally engaged in commercial and consumer banking and real estate lending, including commercial real estate and single family mortgage banking operations.

HomeStreet, Inc. is a bank holding company that has elected to be treated as a financial holding company. Our primary subsidiaries are HomeStreet Bank and HomeStreet Capital Corporation. We also sell insurance products and services for consumer clients under the name HomeStreet Insurance.
HomeStreet Bank is a Washington state-chartered commercial bank providing commercial and consumer loans, mortgage loans, deposit products, other banking services, non-deposit investment products, private banking and cash management services. Our loan products include commercial business loans and agriculture loans, consumer loans, single family residential mortgages, loans secured by commercial real estate and construction loans for residential and commercial real estate projects. We also have partial ownership in WMS Series LLC, an affiliated business arrangement with various owners of Windermere Real Estate Company franchises which operates a home loan business from select Windermere Real Estate Offices that is known as Penrith Home Loans (some of which were formerly known as Windermere Mortgage Services).
HomeStreet Capital Corporation, a Washington corporation, originates, sells and services multifamily mortgage loans under the Fannie Mae Delegated Underwriting and Servicing Program ("DUS®")[1] in conjunction with HomeStreet Bank.

We generate revenue by earning net interest income and noninterest income. Net interest income is primarily the difference between interest income earned on loans and investment securities less the interest we pay on deposits and other borrowings. We also earn noninterest income from the origination, sale and servicing of loans and from fees earned on deposit services and investment and insurance sales.

In 2017, we focused on measured growth and increased efficiency in our operations overall. In our Commercial and Consumer Banking Segment, we continued to execute our strategy of diversifying earnings by expanding the business, growing and improving the quality of our deposits, and bolstering our processing, compliance and risk management capabilities. We continued to expand our retail deposit branch network during the year, primarily focusing on high-growth areas of Puget Sound and Southern California, in order to build convenience and market share. As of December 31, 2017 we had 27 retail branches in the Puget Sound region, including two de novo branches added in 2017, and 16 retail branches in Southern California, including one de novo branch and one acquired branch added in 2017. Meanwhile, in our Mortgage Banking Segment, faced with reduced expectations for single family loan origination volume due to the current interest rate environment and, more importantly, a lack of housing inventory in our primary markets, we implemented a restructuring plan that included a reduction in staffing, production office closures and the streamlining of our single family leadership team.

[1] DUS® is a registered trademark of Fannie Mae

As part of our organic growth in commercial real estate lending, in 2015 we launched a new division of the Bank called HomeStreet Commercial Capital, which originates permanent commercial real estate loans, primarily up to $10 million in size, a portion of which we intend to sell into the secondary market.

**Management’s Overview of2017 Financial Performance**

Results for 2017 reflect the continued expansion of our commercial and consumer business as well as the restructuring of our mortgage banking business. During 2017, in our Commercial and Consumer Banking Segment we added three de novo branches and acquired one branch in El Cajon, California. We also added a new stand-alone commercial lending center in Northern California. In response to adverse market conditions, we reduced headcount in the Mortgage Banking Segment by 13.1% during the year, closed three stand-alone home loan centers and consolidated a further six offices down to three, and streamlined our leadership team by eliminating some positions and reducing overall compensation. At December 31, 2017, we had total home loan centers of 44, total commercial lending centers of six and total retail deposit branches of 59. We also have one stand-alone insurance office.

**Recent Developments**

On December 22, 2017, President Trump signed into law major tax legislation commonly referred to as the Tax Cuts and Jobs Act ("Tax Reform Act"). The Tax Reform Act reduces the U.S. federal corporate income tax rate from 35 percent to 21 percent and makes many other sweeping changes to the U.S. tax code. We were required to revalue our deferred tax assets and liabilities at the new statutory tax rate upon enactment. As a result of this revaluation, in 2017, we recognized a one-time, non-cash, $23.3 million income tax benefit. Additionally, we expect our estimated effective tax rate to fall to between 21% and 22% for 2018.

**Known Trends**

***Trends Impacting Mortgage Origination Volume***

Since the second half of 2016, the volume of loan origination for our single family mortgage business has been significantly adversely impacted by a combination of rising interest rates, which lowers the demand for refinancing, and a significant disparity between an increasing demand for housing and a decreasing supply of houses for sale in our primary markets, especially the Puget Sound region and Northern California. The Federal Reserve is expected to raise interest rates again in the near future, decreasing the likelihood that refinancing will regain popularity in the near term. At the same time, populations in many of our major markets are predicted to continue to grow faster than available housing inventory. While we have been focused on optimizing our mortgage banking operations in response to these pressures, management continues to monitor these trends and may implement further measures in an effort to keep the Company’s cost structure in line with the expectations of growth or contraction in our business.

***Regulatory Compliance Costs***

Federally insured financial institutions like the Bank become subject to heightened standards for regulatory compliance as they reach an asset size of $10 billion. As we grow toward that size, we have begun to implement additional compliance systems, procedures and processes to be able to meet these heightened standards. At the same time, we are already subject to additional review by our regulators who have an interest in making sure the Bank’s compliance systems are implemented and tested prior to crossing the $10 billion threshold for assets size, and the work of designing systems to meet heightened requirements coupled with additional regulatory scrutiny meant to test those systems may result in additional regulatory challenges for the Bank. As was disclosed in our most recent Community Reinvestment Act rating, we have faced some regulatory challenges including a finding of RESPA violations that have require additional resources and attention from management to remediate. As a result of both of the build out of our compliance management system and the growth in regulatory activity impacting the Bank, we expect our costs for compliance will grow in the near future, that we will continue to be subject to more regulatory scrutiny, and that compliance matters will require more attention from management and the Board.

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*Consolidated Financial Performance*

| | At or for the Years Ended December 31, | | |
|---|---|---|---|
| (in thousands, except per share data and ratios) | 2017 | 2016 | 2015 |
| Selected statement of operations data | | | |
| Total net revenue [(1)] | $506,592 | $539,199 | $429,575 |
| Total noninterest expense | 439,653 | 444,322 | 366,568 |
| Provision for credit losses | 750 | 4,100 | 6,100 |
| Income tax (benefit) expense | (2,757) | 32,626 | 15,588 |
| Net income | $68,946 | $58,151 | $41,319 |
| Financial performance | | | |
| Diluted income per share | $2.54 | $2.34 | $1.96 |
| Return on average common shareholders' equity | 10.20% | 10.27% | 9.35% |
| Return on average assets | 1.05% | 1.01% | 0.91% |
| Net interest margin | 3.31% | 3.45% | 3.63% |

(1) Total net revenue is net interest income and noninterest income.

*Commercial and Consumer Banking Segment Results*

Commercial and Consumer Banking Segment net income increased 36.6% to $42.1 million for the year ended December 31, 2017 from $30.8 million in 2016, primarily due to higher net interest income from higher average balances of interest-earning assets, partially offset by higher noninterest expense, primarily the result of organic growth. Included in net income for the years ended December 31, 2017 and 2016 were acquisition related expenses, net of tax of $391 thousand and $4.6 million, respectively. Net income in the year ended December 31, 2017, also includes a one-time, non-cash, $4.2 million tax expense related to the Tax Reform Act, with no similar expenses in 2016.

Commercial and Consumer Banking Segment net interest income was $174.5 million for the year ended December 31, 2017, an increase of $20.5 million, or 13.3%, from $154.0 million for the year ended December 31, 2016, reflecting higher average balances of loans held for investment primarily as a result of organic growth.

The Company recorded a $750 thousand provision for credit losses for the year ended December 31, 2017 compared to a $4.1 million provision for credit losses for the year ended December 31, 2016. The reduction in credit loss provision in the year was due primarily to continued improvements in credit quality reflected in the qualitative reserves and historical loss rates, combined with an increase of $2.6 million in net recoveries over the comparable period.

Net recoveries were $3.1 million in 2017 compared to net recoveries of $505 thousand in 2016. Overall, the allowance for loan losses (which excludes the allowance for unfunded commitments) represented 0.83% of loans held for investment at December 31, 2017 compared to 0.88% at December 31, 2016, which primarily reflected the improved credit quality of the Company's loan portfolio. Excluding acquired loans, the allowance for loan losses was 0.90% of loans held for investment at December 31, 2017 compared to 1.00% at December 31, 2016. Nonperforming assets were $15.7 million, or 0.23% of total assets at December 31, 2017, compared to $25.8 million, or 0.41% of total assets at December 31, 2016.

Commercial and Consumer Banking Segment noninterest expense of $149.0 million for the year ended December 31, 2017 an increase of $10.6 million, or 7.7%, from $138.4 million for the year ended December 31, 2016, primarily due to increased costs related to organic growth of our commercial real estate and commercial business lending units and the expansion of our branch banking network. During 2017, we added four retail deposit branches, three de novo and one through the acquisition in El Cajon, California, and increased the segment's headcount by 7.0%.

*Mortgage Banking Segment Results*

Mortgage Banking Segment net income was $26.9 million for the year ended December 31, 2017, compared to net income of $27.4 million for the year ended December 31, 2016. The 1.7% decrease in net income is primarily due to a $1.64 billion reduction in rate locks and restructuring related items, net of tax, of $2.4 million, substantially offset by a one-time, non-cash, $27.5 million tax benefit related to the Tax Reform Act. In 2017, due to reduced expectations in our single family loan origination volume, we implemented a restructuring plan to better align our cost structure with market conditions, including a reduction in staffing, production office closures and a streamlining of the single family leadership team.

Mortgage Banking noninterest income of $269.8 million for the year ended December 31, 2017 decreased $53.7 million, or 16.6%, from $323.5 million for the year ended December 31, 2016, primarily due to a 19.0% decrease in single family mortgage interest rate lock commitments. Decreased interest rate lock commitments were the result of both higher mortgage interest rates, which reduced the volume of refinance activity in the period and to a lesser extent the limited supply of housing in our markets, which reduced the volume of purchase mortgage activity in the period. We decreased our mortgage production personnel by 5.2% at December 31, 2017 compared to December 31, 2016, primarily due to our 2017 restructuring in our Mortgage Banking Segment.

Mortgage Banking noninterest expense of $290.7 million for the year ended December 31, 2017 decreased $15.3 million, or 5.0%, from $305.9 million for the year ended December 31, 2016, primarily due to decreased commissions, salary, and related costs on lower closed loan volume, partially offset by a $3.7 million restructuring charge related to our Mortgage Banking Segment. In 2017, we reduced home loan centers by a net of three and decreased the segment's headcount by 13.1% during 2017 primarily the result of our restructuring event.

*Regulatory Matters*

On January 1, 2015, the Company and the Bank became subject to new capital standards commonly referred to as “Basel III” which raised our minimum capital requirements. The Company and the Bank remain above current “well-capitalized” regulatory minimums since the Company’s initial public offering in 2012, even with the implementation of more stringent capital requirements implemented beginning in 2015 under the capital standards commonly referred to as “Basel III”.

Under the Basel III standards, the Bank's Tier 1 leverage and total risk-based capital ratios at December 31, 2017 were 9.67% and 14.02% and at December 31, 2016 were 10.26% and 14.69%, respectively. The Company's Tier 1 leverage and total risk-based capital ratios were 9.12% and 11.61% at December 31, 2017, and 9.78% and 12.34% at December 31, 2016, respectively.

In September 2017, federal banking regulators issued a proposed rule intended to simplify and limit the impact of the Basel III regulatory capital requirements for certain banks. We believe that these proposed changes, if implemented, would significantly benefit our Mortgage Banking business model by reducing the amount of regulatory capital that we would be required to maintain in relation to our mortgage servicing assets. Other proposed changes to the Basel III capital requirements would require a small increase in capital related to commercial and residential acquisition, development, and construction lending activity which would partially offset some portion of the benefit we would expect to receive with respect to our mortgage servicing assets. The final rules have yet to be published following the comment period, but if they are adopted without any material changes to the current proposal, we would expect to benefit from a significant reduction in the regulatory capital requirements related to our mortgage servicing rights beginning in 2018. Although it is too early to predict the form, if any, in which the final regulations are adopted, certain alternatives we believe to be under consideration would potentially allow us to allocate that capital to other aspects of our operations, including as capital to support our commercial lending operations.

For more on the Basel III requirements as they apply to us, please see “*Capital Management*" within the Liquidity and Capital Resources section and “Business - Regulation and Supervision” of this Form 10-K.

**Critical Accounting Policies and Estimates**

The preparation of financial statements in accordance with the accounting principles generally accepted in the United States ("U.S. GAAP") requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expense in the financial statements. Various elements of our accounting policies, by their nature, involve the application of highly sensitive and judgmental estimates and assumptions. Some of these policies and estimates relate to matters that are highly complex and contain inherent uncertainties. It is possible that, in some instances, different estimates and assumptions could reasonably have been made and used by management, instead of those we applied, which might have produced different results that could have had a material effect on the financial statements.

We have identified the following accounting policies and estimates that, due to the inherent judgments and assumptions and the potential sensitivity of the financial statements to those judgments and assumptions, are critical to an understanding of our financial statements. We believe that the judgments, estimates and assumptions used in the preparation of the Company's financial statements are appropriate. For a further description of our accounting policies, see Note 1–*Summary of Significant Accounting Policies* in the financial statements included in this Form 10-K.

***Allowance for Loan Losses***

The allowance for loan losses represents management's estimate of incurred credit losses inherent within our loan portfolio. Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in those future periods.

We employ a disciplined process and methodology to establish our allowance for loan losses that has two basic components: first, an asset-specific component involving the identification of impaired loans and the measurement of impairment for each individual loan identified; and second, a formula-based component for estimating probable principal losses for all other loans.

Based upon this methodology, management establishes an asset-specific allowance for impaired loans based on the amount of impairment calculated on those loans and charging off amounts determined to be uncollectible. A loan is considered impaired when it is probable that all contractual principal and interest payments due will not be collected substantially in accordance with the terms of the loan agreement. Factors we consider in determining whether a loan is impaired include payment status, collateral value, borrower financial condition, guarantor support and the probability of collecting scheduled principal and interest payments when due.

When a loan is identified as impaired, we measure impairment as the difference between the recorded investment in the loan and the present value of expected future cash flows discounted at the loan's effective interest rate or based on the loan's observable market price. For impaired collateral-dependent loans, impairment is measured as the difference between the recorded investment in the loan and the fair value of the underlying collateral. The fair value of the collateral is adjusted for the estimated cost to sell if repayment or satisfaction of a loan is dependent on the sale (rather than only on the operation) of the collateral. In accordance with our appraisal policy, the fair value of impaired collateral-dependent loans is based upon independent third-party appraisals or on collateral valuations prepared by in-house appraisers, which generally are updated every twelve months. We require an independent third-party appraisal at least annually for substandard loans and other real estate owned ("OREO"). Once a third-party appraisal is six months old, or if our chief appraiser determines that market conditions, changes to the property, changes in intended use of the property or other factors indicate that an appraisal is no longer reliable, we perform an internal collateral valuation to assess whether a change in collateral value requires an additional adjustment to carrying value. A collateral valuation is a restricted-use report prepared by our internal appraisal staff in accordance with our appraisal policy. When we receive an updated appraisal or collateral valuation, management reassesses the need for adjustments to loan impairment measurements and, where appropriate, records an adjustment. If the calculated impairment is determined to be permanent, fixed or nonrecoverable, the impairment will be charged off. See "*Credit Risk Management – Asset Quality and Nonperforming Assets*" discussions within Management's Discussion and Analysis of this Form 10-K.

In estimating the formula-based component of the allowance for loan losses, loans are segregated into loan classes. Loans are designated into loan classes based on loans pooled by product types and similar risk characteristics or areas of risk concentration. Credit loss assumptions are estimated using a model that categorizes loan pools based on loan type and asset quality rating ("AQR") or delinquency bucket. This model calculates an expected loss percentage for each loan category by considering the probability of default, based on the migration of loans from performing to loss by AQR or delinquency buckets using two-year analysis periods for commercial segments and one-year analysis periods for consumer segments, and the potential severity of loss, based on the aggregate net lifetime losses incurred per loan class.

The formula-based component of the allowance for loan losses also considers qualitative factors for each loan class, including changes in:

- lending policies and procedures;
- international, national, regional and local economic business conditions and developments that affect the collectability of the portfolio, including the condition of various markets;
- the nature of the loan portfolio, including the terms of the loans;
- the experience, ability and depth of the lending management and other relevant staff;
- the volume and severity of past due and adversely classified or graded loans and the volume of nonaccrual loans;
- the quality of our loan review and process;

- the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio.

Qualitative factors are expressed in basis points and are adjusted downward or upward based on statistical analysis of economic drivers and management’s judgment as to the potential loss impact of each qualitative factor to a particular loan pool at the date of the analysis.

The provision for loan losses recorded through earnings is based on management’s assessment of the amount necessary to maintain the allowance for loan losses at a level appropriate to cover probable incurred losses inherent within the loans held for investment portfolio. The amount of provision and the corresponding level of allowance for loan losses are based on our evaluation of the collectability of the loan portfolio based on historical loss experience and other significant qualitative factors.

The allowance for loan losses, as reported in our consolidated statements of financial condition, is adjusted by a provision for loan losses, which is recognized in earnings, and reduced by the charge-off of loan amounts, net of recoveries. For further information on the allowance for loan losses, see Note 5–*Loans and Credit Quality* in the notes to the financial statements of this Form 10-K.

***Fair Value of Financial Instruments, Single Family MSRs and OREO***

A portion of our assets are carried at fair value, including single family mortgage servicing rights ("MSRs"), single family loans held for sale, interest rate lock commitments, investment securities available for sale and derivatives used in our hedging programs. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value is based on quoted market prices, when available. If a quoted price for an asset or liability is not available, the Company uses valuation models to estimate its fair value. These models incorporate inputs such as forward yield curves, loan prepayment assumptions, expected loss assumptions, market volatilities, and pricing spreads utilizing market-based inputs where readily available. We believe our valuation methods are appropriate and consistent with those that would be used by other market participants. However, imprecision in estimating unobservable inputs and other factors may result in these fair value measurements not reflecting the amount realized in an actual sale or transfer of the asset or liability in a current market exchange.

A three-level valuation hierarchy has been established under the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820 for disclosure of fair value measurements. The valuation hierarchy is based on the observability of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument’s categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement. The levels are defined as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. This includes quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability for substantially the full term of the financial instrument.
- Level 3 – Unobservable inputs for the asset or liability. These inputs reflect the Company’s assumptions of what market participants would use in pricing the asset or liability.

Significant judgment is required to determine whether certain assets and liabilities measured at fair value are included in Level 2 or Level 3. When making this judgment, we consider all available information, including observable market data, indications of market liquidity and orderliness, and our understanding of the valuation techniques and significant inputs used. The classification of Level 2 or Level 3 is based upon the specific facts and circumstances of each instrument or instrument category and judgments are made regarding the significance of the Level 3 inputs to an instrument's fair value measurement in its entirety. If Level 3 inputs are considered significant, the instrument is classified as Level 3.

As of December 31, 2017, our Level 3 recurring fair value measurements consisted of single family MSRs, single family loans held for investment where fair value option was elected, certain single family loans held for sale and interest rate lock and purchase loan commitments.

On a quarterly basis, our Asset/Liability Management Committee ("ALCO") and the Finance Committee of the Board review significant modeling variables used to measure the fair value of the Company's financial instruments, including the significant inputs used in the valuation of single family MSRs. Additionally, ALCO periodically obtains an independent review of the MSR valuation process and procedures, including a review of the model architecture and the valuation assumptions. We obtain an MSR valuation from an independent valuation firm monthly to assist with the validation of our fair value estimate and the reasonableness of the assumptions used in measuring fair value.

In addition to the recurring fair value measurements, from time to time the Company may have certain nonrecurring fair value measurements. These fair value measurements usually result from the application of lower of cost or fair value accounting or impairment of individual assets. As of December 31, 2017 and 2016, the Company's Level 3 nonrecurring fair value measurements were based on the appraised value of collateral used as the basis for the valuation of collateral dependent loans held for investment and OREO.

Real estate valuations are overseen by our appraisal department, which is independent of our lending and credit administration functions. The appraisal department maintains the appraisal policy and recommends changes to the policy subject to approval by the Credit Committee of the Company's Board of Directors and Company's Loan Committee (the "Loan Committee"), established by the Credit Committee of the Company's Board of Directors and comprised of certain of the Company's management. Appraisals are prepared by independent third-party appraisers and our internal appraisers. Appraisals are reviewed either by our in-house appraisal staff or by independent and qualified third-party appraisers.

For further information on the fair value of financial instruments, single family MSRs and OREO, see Note 1–*Summary of Significant Accounting Policies,* Note 12–*Mortgage Banking Operations* and Note 17–*Fair Value Measurements* in the notes to the financial statements of this Form 10-K.

***Income Taxes***

In establishing an income tax provision, we must make judgments and interpretations about the application of inherently complex tax laws. We must also make estimates about when in the future certain items will affect taxable income. Our interpretations may be subject to review during examination by taxing authorities and disputes may arise over the respective tax positions. We monitor tax authorities and revise our estimates of accrued income taxes due to changes in income tax laws and their interpretation by the courts and regulatory authorities on a quarterly basis. Revisions of our estimate of accrued income taxes also may result from our own income tax planning and strategies and from the resolution of income tax controversies. Such revisions in our estimates may be material to our operating results for any given reporting period.

Income taxes are accounted for using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, a deferred tax asset or liability is determined based on the differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

The Company records net deferred tax assets to the extent it is believed that these assets will more likely than not be realized. In making such determination, management considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies and recent financial operations. After reviewing and weighing all of the positive and negative evidence, if the positive evidence outweighs the negative evidence, then management does not record a valuation allowance for deferred tax assets. If the negative evidence outweighs the positive evidence, then a valuation allowance for all or a portion of the deferred tax assets is recorded.

The Company recognizes potential interest and penalties related to unrecognized tax benefits as income tax expense in the consolidated statements of operations. Accrued interest and penalties are included within the related tax liability line in the consolidated statements of financial condition. For further information regarding income taxes, see Note 14–*Income Taxes* to the financial statements of this Form 10-K.

***Business Combinations***

The Simplicity and Orange County Business Bank acquisitions, as well as the branch acquisitions were accounted for under the acquisition method of accounting pursuant to ASC 805, *Business Combinations*. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of acquisition date. Management made significant estimates and exercised significant judgment in estimating the fair values and accounting for such acquired assets and assumed liabilities, and in certain instances received "bargain purchase gains" or "goodwill" in these transactions.

The valuation of acquired loans, mortgage servicing rights, premises and equipment, core deposit intangibles, deferred taxes, deposits, Federal Home Loan Bank advances and any contingent liabilities that arise as a result of the transaction may be preliminary for a period of time following completion of the acquisition. As such, fair value estimates are subject to adjustment when additional information relative to the closing date fair values becomes available and such information is considered final or up to one year after the acquisition date, or, whichever is earlier.

Management used valuation models to estimate the fair value for certain assets and liabilities. These models incorporate inputs such as forward yield curves, loan prepayment expectations, expected credit loss assumptions, market volatilities, and pricing spreads utilizing market-based inputs where available. We believe our valuation methods are appropriate and consistent with those that would be used by other market participants. However, imprecision in estimating unobservable inputs and other factors may result in these fair value measurements not reflecting the amount that could be realized in an actual sale or transfer of the asset or liability in a current market exchange.

## Results of Operations

### *Average Balances and Rates*

Average balances, together with the total dollar amounts of interest income and expense, on a tax equivalent basis related to such balances and the weighted average rates, were as follows.

| | Years Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2017 | | | 2016 | | | 2015 | | |
| (in thousands) | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost |
| Assets: | | | | | | | | | |
| Interest-earning assets: (1) | | | | | | | | | |
| Cash and cash equivalents | $85,430 | $567 | 0.67 % | $39,962 | $254 | 0.63 % | $36,134 | $67 | 0.18 % |
| Investment securities | 1,023,702 | 25,810 | 2.54 | 834,671 | 21,611 | 2.57 | 523,756 | 14,270 | 2.72 |
| Loans held for sale | 711,063 | 28,732 | 4.05 | 764,222 | 28,581 | 3.76 | 755,688 | 29,165 | 3.86 |
| Loans held for investment | 4,178,326 | 187,281 | 4.46 | 3,668,263 | 162,219 | 4.40 | 2,834,511 | 123,680 | 4.36 |
| Total interest-earning assets | 5,998,521 | 242,390 | 4.03 | 5,307,118 | 212,665 | 4.00 | 4,150,089 | 167,182 | 4.03 |
| Noninterest-earning assets (2) | 591,561 | | | 470,021 | | | 410,404 | | |
| Total assets | $6,590,082 | | | $5,777,139 | | | $4,560,493 | | |
| Liabilities and shareholders' equity: | | | | | | | | | |
| Deposits: | | | | | | | | | |
| Interest-bearing demand accounts | $477,635 | 1,964 | 0.41 % | $450,838 | $1,950 | 0.43 % | $317,510 | $1,492 | 0.46 % |
| Savings accounts | 306,151 | 1,013 | 0.33 | 299,502 | 1,029 | 0.34 | 284,309 | 1,053 | 0.38 |
| Money market accounts | 1,579,115 | 8,533 | 0.54 | 1,370,256 | 7,344 | 0.53 | 1,122,321 | 4,930 | 0.44 |
| Certificate accounts | 1,225,614 | 13,028 | 1.06 | 1,024,541 | 9,086 | 0.88 | 775,398 | 4,501 | 0.58 |
| Total interest-bearing deposits | 3,588,515 | 24,538 | 0.68 | 3,145,137 | 19,409 | 0.61 | 2,499,538 | 11,976 | 0.48 |
| Federal Home Loan Bank advances | 1,037,650 | 12,589 | 1.19 | 942,593 | 6,030 | 0.64 | 795,368 | 3,669 | 0.46 |
| Federal funds purchased and securities sold under agreements to repurchase | 3,732 | 48 | 1.20 | 803 | 6 | 0.40 | 11,397 | 29 | 0.31 |
| Long-term debt | 125,228 | 6,067 | 4.83 | 101,049 | 4,043 | 3.73 | 61,857 | 1,104 | 1.78 |
| Other borrowings | 96 | 3 | 0.89 | — | — | — | — | — | — |
| Total interest-bearing liabilities | 4,755,221 | 43,245 | 0.91 | 4,189,582 | 29,488 | 0.70 | 3,368,160 | 16,778 | 0.50 |
| Noninterest-bearing liabilities | 1,158,984 | | | 1,021,409 | | | 750,228 | | |
| Total liabilities | 5,914,205 | | | 5,210,991 | | | 4,118,388 | | |
| Shareholders' equity | 675,877 | | | 566,148 | | | 442,105 | | |
| Total liabilities and shareholders' equity | $6,590,082 | | | $5,777,139 | | | $4,560,493 | | |
| Net interest income (3) | | $199,145 | | | $183,177 | | | $150,404 | |
| Net interest spread | | | 3.12 % | | | 3.30 % | | | 3.53 % |
| Impact of noninterest-bearing sources | | | 0.19 % | | | 0.15 % | | | 0.10 % |
| Net interest margin | | | 3.31 % | | | 3.45 % | | | 3.63 % |

(1) The average balances of nonaccrual assets and related income, if any, are included in their respective categories.

(2) Includes former loan balances that have been foreclosed and are now reclassified to OREO.

(3) Includes taxable-equivalent adjustments primarily related to tax-exempt income on certain loans and securities of $4.7 million, $3.1 million and $2.1 million for the years ended December 31, 2017, 2016 and 2015, respectively. The estimated federal statutory tax rate was 35% for the periods presented.

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*Interest on Nonaccrual Loans*

We do not include interest collected on nonaccrual loans in interest income. When we place a loan on nonaccrual status, we reverse the accrued but unpaid interest, reducing interest income, and we stop amortizing any net deferred fees. Additionally, if interest is received on nonaccrual loans, the interest collected on the loan is recognized as an adjustment to the cost basis of the loan. The net decrease to interest income due to adjustments made for nonaccrual loans, including the effect of additional interest income that would have been recorded during the period if the loans had been accruing, was $1.5 million, $2.2 million and $2.5 million for the years ended December 31, 2017, 2016 and 2015, respectively.

***Rate and Volume Analysis***

The following table presents the extent to which changes in interest rates and changes in the volume of our interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense, excluding interest income from nonaccrual loans. Information is provided in each category with respect to: (1) changes attributable to changes in volume (changes in volume multiplied by prior rate), (2) changes attributable to changes in rate (changes in rate multiplied by prior volume), (3) changes attributable to changes in rate and volume (change in rate multiplied by change in volume), which were allocated in proportion to the percentage change in average volume and average rate and included in the relevant column and (4) the net change.

| | Years Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2017 vs. 2016 | | | 2016 vs. 2015 | | |
| | Increase (Decrease) Due to | | Total Change | Increase (Decrease) Due to | | Total Change |
| (in thousands) | Rate | Volume | | Rate | Volume | |
| Assets: | | | | | | |
| Interest-earning assets | | | | | | |
| Cash and cash equivalents | $27 | $287 | $314 | $180 | $7 | $187 |
| Investment securities | (656) | 4,855 | 4,199 | (1,128) | 8,469 | 7,341 |
| Loans held for sale | 2,149 | (1,998) | 151 | (914) | 329 | (585) |
| Loans held for investment | 2,597 | 22,464 | 25,061 | 2,191 | 36,348 | 38,539 |
| Total interest-earning assets | 4,117 | 25,608 | 29,725 | 329 | 45,153 | 45,482 |
| Liabilities: | | | | | | |
| Deposits | | | | | | |
| Interest-bearing demand accounts | (103) | 116 | 13 | (161) | 619 | 458 |
| Savings accounts | (39) | 23 | (16) | (81) | 57 | (24) |
| Money market accounts | 81 | 1,108 | 1,189 | 1,325 | 1,089 | 2,414 |
| Certificate accounts | 2,179 | 1,763 | 3,942 | 3,130 | 1,454 | 4,584 |
| Total interest-bearing deposits | 2,118 | 3,010 | 5,128 | 4,213 | 3,219 | 7,432 |
| Federal Home Loan Bank advances | 5,952 | 608 | 6,560 | 1,682 | 679 | 2,361 |
| Securities sold under agreements to repurchase | 30 | 11 | 41 | 10 | (32) | (22) |
| Long-term debt | 1,124 | 901 | 2,025 | 2,242 | 697 | 2,939 |
| Other borrowings | 3 | — | 3 | — | — | — |
| Total interest-bearing liabilities | 9,227 | 4,530 | 13,757 | 8,147 | 4,563 | 12,710 |
| Total changes in net interest income | $(5,110) | $21,078 | $15,968 | $(7,818) | $40,590 | $32,772 |

**Net Income**

*Comparison of 2017 to 2016*

For the year ended December 31, 2017, net income was $68.9 million, an increase of $10.8 million, or 18.6%, from $58.2 million for the year ended December 31, 2016. Included in net income for the year ended December 31, 2017 was a one-time, non-cash, tax reform benefit of $23.3 million and restructuring as well as merger-related costs (net of tax) of $2.4 million and $391 thousand, respectively. Such merger-related costs (net of tax) relating to prior acquisitions totaled $4.6 million in 2016. There were no similar tax reform benefits or restructuring costs in 2016.

*Comparison of 2016 to 2015*

For the year ended December 31, 2016, net income was $58.2 million, an increase of $16.8 million, or 40.7%, compared to net income of $41.3 million in 2015. Included in net income for the year ended December 31, 2016 were acquisition-related costs (net of tax) of $4.6 million. Such acquisition-related costs (net of tax) relating to prior acquisitions totaled $10.7 million which were offset by bargain purchase gains of $7.7 million during 2015.

**Net Interest Income**

Our profitability depends significantly on net interest income, which is the difference between income earned on our interest-earning assets, primarily loans and investment securities, and interest paid on interest-bearing liabilities. Our interest-bearing liabilities consist primarily of deposits and borrowed funds, including our outstanding trust preferred securities, senior unsecured notes and advances from the Federal Home Loan Bank ("FHLB").

*Comparison of 2017 to 2016*

Net interest income on a tax equivalent basis for the year ended December 31, 2017 increased $16.0 million, or 8.7%, from December 31, 2016 as a result of growth in average interest earning assets, partially offset by a lower net interest margin. The net interest margin decreased to 3.31% for the year ended December 31, 2017 from 3.45% for the year ended December 31, 2016. The decrease in the net interest margin from the year ended December 31, 2016 was due primarily to higher costs of funds related to our long term debt issuance in the second quarter of 2016 and higher FHLB borrowing costs due to higher short-term rates.

Total average interest-earning assets increased by $691.4 million, or 13%, in 2017 compared to 2016 primarily as a result of growth in average loans held for investment from organic growth. Additionally, our average balance of investment securities grew from prior periods as part of the strategic growth of the Company.

Total interest income on a tax equivalent basis in 2017 increased $29.7 million, or 14.0%, from 2016 resulting from higher average balances of loans held for investment, which increased $510.1 million, or 13.9%, from 2016.

Total interest expense in 2017 increased $13.8 million, or 46.7%, from 2016 primarily resulting from higher average balances of interest-bearing deposits and FHLB advances and interest paid on our $65.0 million in senior debt issued in May 2016.

*Comparison of 2016 to 2015*

Net interest income on a tax equivalent basis for the year ended December 31, 2016 increased $32.8 million, or 21.8%, from December 31, 2015 as a result of growth in average interest earning assets, partially offset by a lower net interest margin. The net interest margin decreased to 3.45% for the year ended December 31, 2016 from 3.63% for the year ended December 31, 2015. The decrease in the net interest margin from the year ended December 31, 2015 was due primarily to shifts in asset mix from growth in lower yielding investment securities and loans held for sale and to higher costs of funds primarily related to our long-term debt issuance in 2016, money market products and FHLB borrowings.

Total average interest-earning assets increased by $1.16 billion, or 28% in 2016 compared to 2015 primarily as a result of growth in average loans held for investment, both organically and through acquisition activity. Additionally, our average balance of investment securities grew from prior periods as part of the strategic growth of the Company.

Total interest income on a tax equivalent basis in 2016 increased $45.5 million, or 27.2%, from 2015 resulting from higher average balances of loans held for investment, which increased $833.8 million, or 29.4%, from 2015.

Total interest expense in 2016 increased $12.7 million, or 75.8%, from 2015 primarily resulting from higher average balances of interest-bearing deposits and FHLB advances, and interest paid on our $65.0 million in senior debt issued in May 2016.

**Provision for Credit Losses**

Management believes that our allowance for loan losses is at a level appropriate to cover estimated incurred losses inherent within the loans held for investment portfolio. Our credit risk profile has continued to improve since our initial public offering in 2012, including year over year improvements from December 31, 2016 and December 31, 2015.

*Comparison of 2017 to 2016*

The Company recorded a $750 thousand provision for credit losses for the year ended December 31, 2017 compared to a $4.1 million provision for credit losses for the year ended December 31, 2016. The reduction in credit loss provision in the year was due in part to continued improvements in credit quality reflected in the qualitative reserves and historical loss rates, combined with an increase of $2.6 million in net recoveries over the comparable period.

Nonaccrual loans were $15.0 million at December 31, 2017, a decrease of $5.5 million, or 26.8%, from $20.5 million at December 31, 2016. Nonaccrual loans as a percentage of total loans decreased to 0.33% at December 31, 2017 compared to 0.53% at December 31, 2016. Net loan loss recoveries were $3.1 million in 2017 compared to net loan loss recoveries of $505 thousand in 2016. Overall, the allowance for credit losses, which includes the reserve for unfunded commitments, was $39.1 million, or 0.86% of loans held for investment at December 31, 2017, compared to $35.3 million, or 0.92% of loans held for investment at December 31, 2016.

*Comparison of 2016 to 2015*

The Company recorded a $4.1 million provision for credit losses for the year ended December 31, 2016 compared to a $6.1 million provision for credit losses for the year ended December 31, 2015. The reduction in credit loss provision in the year was due in part to a continuing decline in historical loss rates as a result of net recoveries for the past two years and continued improvements in portfolio performance which was reflected in the qualitative reserves. In 2015, one-time model adjustments contributed to an increase in provision expense.

Nonaccrual loans were $20.5 million at December 31, 2016, an increase of $3.4 million, or 19.7%, from $17.2 million at December 31, 2015. Nonaccrual loans as a percentage of total loans remained steady at 0.53% at both December 31, 2016 and December 31, 2015. Net loan loss recoveries were $505 thousand in 2016 compared to net loan loss recoveries of $2.0 million in 2015. Overall, the allowance for credit losses, which includes the reserve for unfunded commitments, was $35.3 million, or 0.92% of loans held for investment at December 31, 2016, compared to $30.7 million, or 0.95% of loans held for investment at December 31, 2015.

For a more detailed discussion on our allowance for loan losses and related provision for loan losses, see "*Credit Risk Management - Asset Quality and Nonperforming Assets"* in this Form 10-K.

### Noninterest Income

*Noninterest income* consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Noninterest income | | | | | | | |
| Gain on loan origination and sale activities [1] | $255,876 | $(51,437) | (17)% | $307,313 | $70,925 | 30 % | $236,388 |
| Loan servicing income | 35,384 | 2,325 | 7 | 33,059 | 8,809 | 36 | 24,250 |
| Income from WMS Series LLC | 598 | (1,735) | (74) | 2,333 | 709 | 44 | 1,624 |
| Depositor and other retail banking fees | 7,221 | 431 | 6 | 6,790 | 909 | 15 | 5,881 |
| Insurance agency commissions | 1,904 | 285 | 18 | 1,619 | (63) | (4) | 1,682 |
| Gain on sale of investment securities available for sale | 489 | (2,050) | (81) | 2,539 | 133 | 6 | 2,406 |
| Bargain purchase gain | — | — | NM | — | (7,726) | NM | 7,726 |
| Other | 10,682 | 5,185 | 94 | 5,497 | 4,217 | 329 | 1,280 |
| Total noninterest income | $312,154 | $(46,996) | (13)% | $359,150 | $77,913 | 28 % | $281,237 |

NM = not meaningful

(1) Single family and multifamily mortgage banking activities.

*Comparison of 2017 to 2016*

Our noninterest income is heavily dependent upon our single family mortgage banking activities, which are comprised of mortgage origination and sale as well as mortgage servicing activities. The level of our mortgage banking activity fluctuates and is highly sensitive to changes in mortgage interest rates, as well as to general economic conditions such as employment trends and housing supply and affordability. The decrease in noninterest income in 2017 compared to 2016 was primarily due to a decrease in gain on loan origination and sale activities resulting from a 19% decrease in single family rate lock volume.

*Comparison of 2016 to 2015*

The increase in noninterest income in 2016 compared to 2015 was primarily the result of higher gain on loan origination and sale activities mostly due to increased single family mortgage interest rate lock commitments and higher mortgage servicing income. Included in noninterest income for 2015 was a bargain purchase gain of $7.7 million from the Simplicity merger and our acquisition of a branch in Dayton, Washington. No similar bargain purchase gains occurred in 2016.

The significant components of our noninterest income are described in greater detail, as follows.

***Gain on loan origination and sale activities*** consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Single family held for sale: | | | | | | | |
| Servicing value and secondary market gains[1] | $209,027 | $(51,450) | (20)% | $260,477 | $54,964 | 27 % | $205,513 |
| Loan origination and administrative fees | 26,822 | (3,144) | (10) | 29,966 | 7,745 | 35 | 22,221 |
| Total single family held for sale | 235,849 | (54,594) | (19) | 290,443 | 62,709 | 28 | 227,734 |
| Multifamily DUS® | 13,210 | 1,813 | 16 | 11,397 | 4,272 | 60 | 7,125 |
| SBA | 2,439 | 1,025 | 72 | 1,414 | 344 | 32 | 1,070 |
| CRE Non-DUS® | 4,378 | 319 | 8 | 4,059 | 3,600 | 784 | 459 |
| Gain on loan origination and sale activities | $255,876 | $(51,437) | (17)% | $307,313 | $70,925 | 30 % | $236,388 |

(1) Comprised of gains and losses on interest rate lock commitments (which considers the value of servicing), single family loans held for sale, forward sale commitments used to economically hedge secondary market activities, and changes in the Company's repurchase liability for loans that have been sold.

***Single family production volumes*** related to loans designated for sale consisted of the following.

| (in thousands) | For The Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Single family mortgage closed loan volume [1] | $7,554,185 | $(1,443,162) | (16)% | $8,997,347 | $1,784,912 | 25 % | $7,212,435 |
| Single family mortgage interest rate lock commitments [1] | $6,980,477 | $(1,640,499) | (19)% | $8,620,976 | $1,689,868 | 24 % | $6,931,108 |

(1) Includes loans originated by WMS Series LLC and purchased by HomeStreet Bank.

*Comparison of 2017 to 2016*

The decrease in gain on loan origination and sale activities in 2017 compared to 2016 predominantly reflected lower single family mortgage interest rate lock commitments as a result of higher market interest rates in the period and a limited supply of available housing in our primary markets. In 2017, we reduced the number of employees in the mortgage segment by 13.1% at December 31, 2017 compared to December 31, 2016, primarily due to our Mortgage Banking Segment restructuring. Mortgage production personnel was reduced by 5.2% at December 31, 2017 compared to December 31, 2016.

*Comparison of 2016 to 2015*

The increase in gain on loan origination and sale activities in 2016 compared to 2015 predominantly reflected higher single family mortgage interest rate lock commitments as a result of the expansion of our mortgage lending network, higher loan production per loan producer and higher refinance volumes. Mortgage production personnel grew by 12.7% during 2016 compared to 2015.

Management records a liability for estimated mortgage repurchase losses, which has the effect of reducing gain on mortgage loan origination and sale activities. The following table presents the effect of changes in our mortgage repurchase liability within the respective line of gain on mortgage loan origination and sale activities. For further information on the Company's mortgage repurchase liability, see Note 13, *Commitments, Guarantees and Contingencies* to the financial statements in this Form 10-K.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Effect of changes to the mortgage repurchase liability recorded in gain on loan origination and sale activities: | | | |
| New loan sales [1] | $(2,528) | $(3,574) | $(2,764) |
| Other changes in estimated repurchase losses[2] | 2,354 | 2,032 | — |
| | $(174) | $(1,542) | $(2,764) |

(1) Represents the estimated fair value of the repurchase or indemnity obligation recognized as a reduction of proceeds on new loan sales.
(2) Represents changes in estimated probable future repurchase losses on previously sold loans.

***Loan servicing income*** consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Servicing income, net: | | | | | | | |
| Servicing fees and other | $66,192 | $12,538 | 23 % | $53,654 | $11,638 | 28 % | $42,016 |
| Changes in fair value of single family MSRs due to amortization [1] | (35,451) | (2,146) | 6 | (33,305) | 733 | (2) | (34,038) |
| Amortization of multifamily and SBA MSRs | (3,932) | (1,297) | 49 | (2,635) | (643) | 32 | (1,992) |
| | 26,809 | 9,095 | 51 | 17,714 | 11,728 | 196 | 5,986 |
| Risk management: | | | | | | | |
| Changes in fair value of MSRs due to changes in model inputs and/or assumptions | (1,157) | (21,182) | (106) | 20,025 | 13,470 | 205 | 6,555 |
| Net gain (loss) from derivatives economically hedging MSRs | 9,732 | 14,412 | (308) | (4,680) | (16,389) | (140) | 11,709 |
| | 8,575 | (6,770) | (44) | 15,345 | (2,919) | (16) | 18,264 |
| Loan servicing income | $35,384 | $2,325 | 7 % | $33,059 | $8,809 | 36 % | $24,250 |

(1) Represents changes due to collection/realization of expected cash flows and curtailments.
(2) Principally reflects changes in market inputs, which include current market interest rates and prepayment model updates, both of which affect future prepayment speed and cash flow projections.

*Comparison of 2017 to 2016*

The increase in mortgage servicing income in 2017 compared to 2016 was primarily due to higher servicing income, net, offset by lower risk management results. The higher servicing income was primarily attributed to higher servicing fees on higher average balances of loans serviced for others. The lower risk management results were due in part to gains from prepayment model refinements in 2016 to align borrower prepayment behavior with observed borrower prepayment behavior. Mortgage servicing fees collected in 2017 increased compared to 2016 primarily as a result of higher average balances of loans serviced for others during the year. Our loans serviced for others portfolio was $24.02 billion at December 31, 2017 compared to $20.67 billion at December 31, 2016.

MSR risk management results represent changes in the fair value of single family MSRs due to changes in model inputs and assumptions net of the gain/(loss) from derivatives economically hedging MSRs. The fair value of MSRs is sensitive to changes in interest rates, primarily due to the effect on prepayment speeds. MSRs typically decrease in value when interest rates decline because declining interest rates tend to increase mortgage prepayment speeds and therefore reduce the expected life of the net servicing cash flows of the MSR asset. Certain other changes in MSR fair value relate to factors other than interest rate changes and are generally not within the scope of the Company's MSR economic hedging strategy. These factors may include but are not limited to the impact of changes to the housing price index, prepayment model assumptions, the level of home sales activity, changes to mortgage spreads, valuation discount rates, costs to service and policy changes by U.S. government agencies.

*Comparison of 2016 to 2015*

The increase in mortgage servicing income in 2016 compared to 2015 was primarily due to higher servicing income, net, offset by lower risk management results. The higher servicing income was primarily attributed to higher servicing fees on higher average balances of loans serviced for others and lower modeled amortization. Mortgage servicing fees collected in 2016 increased compared to 2015 primarily as a result of higher average balances of loans serviced for others during the year. Our loans serviced for others portfolio was $20.67 billion at December 31, 2016 compared to $16.35 billion at December 31, 2015.

The lower risk management results in 2016 compared to 2015 were mainly due to adverse results during the fourth quarter driven by the unexpected and significant increases in long-term Treasury rates beginning in November 2016 following the U.S. presidential election, coinciding with an increase in short-term interest rates by the Federal Reserve in December 2016. The unexpected and sustained increase in interest rates during the quarter resulted in asymmetrical changes in valuation between hedging derivatives and servicing valuations. This market dislocation in the fourth quarter reduced the value of our hedging derivatives to a greater extent than value of our mortgage servicing rights increased, resulting in lower risk management results.

***Income from WMS Series LLC***

*Comparison of 2017 to 2016*

Income from WMS Series LLC decreased by $1.7 million in 2017 to $598 thousand compared to $2.3 million in 2016, primarily due to a 15.6% decrease in interest rate lock commitments and a 7.7% decrease in closed loan volume, which were $546.5 million and $631.4 million, respectively, in 2017 compared to $647.3 million and $684.1 million, respectively, for the same period in 2016.

*Comparison of 2016 to 2015*

Income from WMS Series LLC increased by $709 thousand in 2016 to $2.3 million compared to $1.6 million in 2015 primarily due to a 15.1% increase in interest rate lock commitments and a 10.9% increase in closed loan volume, which were $647.3 million and $684.1 million, respectively, in 2016 compared to $562.2 million and $616.9 million, respectively, for the same period in 2015.

***Depositor and other retail banking fees*** for 2017 increased from 2016 primarily due to an increase in the number of transaction accounts in both existing branches and new retail deposit branches. The following table presents the composition of depositor and other retail banking fees for the periods indicated.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Fees: | | | | | | | |
| Monthly maintenance and deposit-related fees | $3,085 | $ 133 | 5 % | $2,952 | $ 295 | 11 % | $2,657 |
| Debit Card/ATM fees | 3,912 | 291 | 8 | 3,621 | 476 | 15 | 3,145 |
| Other fees | 224 | 7 | 3 | 217 | 138 | 175 | 79 |
| Total depositor and other retail banking fees | $7,221 | $ 431 | 6 % | $6,790 | $ 909 | 15 % | $5,881 |

## Noninterest Expense

***Noninterest expense*** consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Noninterest expense | | | | | | | |
| Salaries and related costs | $293,870 | $(9,484) | (3 )% | $303,354 | $62,767 | 26 % | $240,587 |
| General and administrative | 65,036 | 1,830 | 3 | 63,206 | 6,385 | 11 | 56,821 |
| Amortization of core deposit intangibles | 1,710 | (456 ) | (21 ) | 2,166 | 242 | 13 | 1,924 |
| Legal | 1,410 | (457 ) | (24 ) | 1,867 | (940 ) | (33 ) | 2,807 |
| Consulting | 3,467 | (1,491 ) | (30 ) | 4,958 | (2,257 ) | (31 ) | 7,215 |
| Federal Deposit Insurance Corporation assessments | 3,279 | (135 ) | (4 ) | 3,414 | 841 | 33 | 2,573 |
| Occupancy | 38,268 | 7,738 | 25 | 30,530 | 5,603 | 22 | 24,927 |
| Information services | 33,143 | 80 | — | 33,063 | 4,009 | 14 | 29,054 |
| Net (benefit) cost of operation and sale of other real estate owned | (530 ) | (2,294 ) | (130) | 1,764 | 1,104 | 167 | 660 |
| Total noninterest expense | $439,653 | $(4,669) | (1 )% | $444,322 | $77,754 | 21 % | $366,568 |

The following table shows the acquisition-related expenses impacting the components of noninterest expense.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Noninterest expense | | | |
| Salaries and related costs | $— | $4,128 | $7,672 |
| General and administrative | 79 | 633 | 1,463 |
| Legal | 64 | 132 | 830 |
| Consulting | 366 | 1,500 | 5,703 |
| Occupancy | 72 | 180 | 382 |
| Information services | 21 | 563 | 514 |
| Total noninterest expense | $602 | $7,136 | $16,564 |

The following table shows the restructuring-related expenses impacting the components of noninterest expense.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Noninterest expense | | | |
| Salaries and related costs | $648 | $ — | $ — |
| Occupancy | 3,072 | — | — |
| Total noninterest expense | $3,720 | $ — | $ — |

*Comparison of 2017 to 2016*

The decrease in noninterest expense in 2017 compared to 2016 was primarily due to decreased commissions on lower closed loan volume, partially offset by other costs related to the growth in offices and personnel in connection with our organic expansion of our commercial and consumer banking businesses and restructuring-related costs in our Mortgage Banking Segment.

Included in noninterest expense in 2017 was $602 thousand and $3.7 million of acquisition-related and restructuring-related costs, respectively, compared to $7.1 million in acquisition-related costs in 2016. There were no similar restructuring-related costs in 2016.

***Salaries and related costs*** decreased primarily due to lower commission and incentive expense, as single family mortgage closed loan volumes decreased 16.0%, from 2016 and a 5.2% decrease in full-time equivalent employees at December 31, 2017 compared to December 31, 2016, primarily due to our 2017 restructuring in our Mortgage Banking Segment.

***General and administrative and Information services costs*** increased primarily due to our expansion of our commercial and consumer business.

*Comparison of 2016 to 2015*

The increase in noninterest expense in 2016 compared to 2015 was primarily due to increased commissions on higher closed
loan volume, as well as other costs related to the growth in offices and personnel in connection with our expansion of our
commercial and consumer and mortgage banking businesses, both organically and through acquisition-related activities.

Included in noninterest expense in 2016 was $7.1 million of acquisition-related costs compared to $16.6 million in 2015 primarily related to Simplicity merger.

***Salaries and related costs*** increased primarily due to a 19.3% increase in full-time equivalent employees at December 31, 2016 compared to December 31, 2015 and higher commission and incentive expense, as single family mortgage closed loan volumes increased 24.7%, from 2015.

***General and administrative and Information services costs increased*** primarily due to increased headcount and continued growth of our mortgage banking business and expansion of our commercial and consumer business.

**Income Tax Expense**

*Comparison of 2017 to 2016*

The Tax Reform Act was signed into law in December 2017. We expect that our 2018 effective tax rate will be between 21% and 22%, before discrete items, as a result of this legislation. We also recognized a one-time, non-cash, benefit of $23.3 million from this legislation in 2017 as we revalued our December 31, 2017 net deferred tax liability position at the new federal corporate income tax rate.

For the year ended December 31, 2017, income tax benefit was $2.8 million with an effective tax rate of (4.2)% (inclusive of discrete items) compared to income tax expense of $32.6 million and an effective tax rate of 35.9% (inclusive of discrete items) for the year ended December 31, 2016.

The Company's effective income tax rate for the year ended December 31, 2017 differs from the Federal statutory tax rate of 35% primarily due to the impact of the newly enacted tax law, state income taxes, tax-exempt income and low income housing tax credit investments.

*Comparison of 2016 to 2015*

The Company’s income tax expense for 2016 was $32.6 million, representing an effective tax rate of 35.9% (inclusive of discrete items). In 2015, the Company’s tax expense was $15.6 million, representing an effective tax rate of 27.4% (inclusive of discrete items). The Company's effective income tax rate for the year ended December 31, 2015 was significantly less than the Federal statutory tax rate of 35% primarily due to the impact of state income taxes, tax-exempt interest income and low income housing tax credit investments.

**Capital Expenditures**

*Comparison of 2017 to 2016*

During 2017, our net expenditures for property and equipment were $42.3 million, compared to net expenditures of $24.5 million during 2016, primarily due to the continued expansion of our commercial and consumer businesses.

*Comparison of 2016 to 2015*

During 2016, our net expenditures for property and equipment were $24.5 million, compared to net expenditures of $20.6 million during 2015, as we continued the expansion of our commercial and consumer and mortgage banking businesses.

**Review of Financial Condition – Comparison of December 31, 2017 to December 31, 2016**

Total assets were $6.74 billion at December 31, 2017 and $6.24 billion at December 31, 2016, an increase of $498.3 million.

Cash and cash equivalents were $72.7 million at December 31, 2017 compared to $53.9 million at December 31, 2016, an increase of $18.8 million, or 34.8%.

Investment securities were $904.3 million at December 31, 2017 compared to $1.04 billion at December 31, 2016, a decrease of $139.5 million, or 13.4%, primarily due to sales and principal repayments of securities purchased with temporary excess capital from the 2016 debt and equity issuances.

We primarily hold investment securities for liquidity purposes, while also creating a relatively stable source of interest income. We designated the vast majority of these securities as available for sale. We held securities having a carrying value of $58.0 million at December 31, 2017, which were designated as held to maturity.

The following table sets forth certain information regarding the amortized cost and fair values of our investment securities available for sale.

| | At December 31, | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| (in thousands) | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Investment securities available for sale: | | | | |
| Mortgage-backed securities: | | | | |
| Residential | $133,654 | $130,090 | $181,158 | $177,074 |
| Commercial | 24,024 | 23,694 | 25,896 | 25,536 |
| Municipal bonds | 389,117 | 388,452 | 473,153 | 467,673 |
| Collateralized mortgage obligations: | | | | |
| Residential | 164,502 | 160,424 | 194,982 | 191,201 |
| Commercial | 100,001 | 98,569 | 71,870 | 70,764 |
| Corporate debt securities | 25,146 | 24,737 | 52,045 | 51,122 |
| U.S. Treasury securities | 10,899 | 10,652 | 10,882 | 10,620 |
| Agency debentures | 9,861 | 9,650 | — | — |
| Total investment securities available for sale | $857,204 | $846,268 | $1,009,986 | $993,990 |

Mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMO") represent securities issued by government sponsored enterprises ("GSEs"). Each of the MBS and CMO securities in our investment portfolio are guaranteed by Fannie Mae, Ginnie Mae or Freddie Mac. Municipal bonds are comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by either collateral or revenues from the specific project being financed) issued by various municipal corporations. As of December 31, 2017 and 2016, substantially all securities held were either agency quality or rated investment grade by at least one Nationally Recognized Statistical Rating Organization ("NRSRO").

For information regarding the fair value of investment securities available for sale by contractual maturity along with the associated contractual yield for the periods, see Note 4, *Investment Securities* to the financial statements of this Form 10-K.

Each of the MBS and CMO securities in our investment portfolio are guaranteed by Fannie Mae, Ginnie Mae or Freddie Mac. Investments in these instruments involve a risk that actual prepayments will vary from the estimated prepayments over the life of the security. This may require adjustments to the amortization of premium or accretion of discount relating to such instruments, thereby changing the net yield on such securities. At December 31, 2017, the aggregate net premium associated with our MBS portfolio was $8.0 million, or 4.4%, of the aggregate unpaid principal balance, compared with $10.1 million or 4.5% at December 31, 2016. The aggregate net premium associated with our CMO portfolio as of December 31, 2017 and 2016 was $4.8 million, or 1.8%, of the aggregate unpaid principal balance. There is also reinvestment risk associated with the cash flows from such securities and the market value of such securities may be adversely affected by changes in interest rates.

Management monitors the portfolio of securities classified as available for sale for impairment, which may result from credit deterioration of the issuer, changes in market interest rates relative to the rate of the instrument or changes in prepayment speeds. We evaluate each investment security on a quarterly basis to assess if impairment is considered other than temporary. In conducting this evaluation, management considers many factors, including but not limited to whether we expect to recover the entire amortized cost basis of the security in light of adverse changes in expected future cash flows, the length of time the security has been impaired and the severity of the unrealized loss. We also consider whether we intend to sell the security (or whether we will be required to sell the security) prior to recovery of its amortized cost basis, which may be at maturity.

Based on this evaluation, management concluded that unrealized losses as of December 31, 2017 were the result of changes in interest rates. Management does not intend to sell such securities nor is it likely it will be required to sell such securities prior to recovery of the securities' amortized cost basis. Accordingly, none of the unrealized losses as of December 31, 2017 were considered other than temporary.

*Loans held for sale* were $610.9 million at December 31, 2017 compared to $714.6 million at December 31, 2016, a decrease of $103.7 million, or 14.5%. Loans held for sale include single family and multifamily residential loans, typically sold within 30 days of closing the loan.

*Loans held for investment, net* increased $687.4 million, or 18.0%, from December 31, 2016. Our single family loan portfolio increased $297.5 million from 2016. Our commercial and industrial loan portfolio increased $149.8 million from 2016, primarily as a result of the organic growth of our Commercial and Consumer Banking Segment. Our construction loans, including commercial construction and residential construction, increased $51.3 million from 2016, primarily from new originations in our commercial real estate and residential construction lending business.

The following table details the composition of our loans held for investment portfolio by dollar amount and as a percentage of our total loan portfolio.

| | At December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | | 2016 | | 2015 | | 2014 | | 2013 | |
| (in thousands) | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| Consumer loans: | | | | | | | | | | |
| Single family | $1,381,366 (1) | 30.5 % | $1,083,822 (1) | 28.2 % | $1,203,180 | 37.3 % | $896,665 | 42.2 % | $904,913 | 47.7 % |
| Home equity and other | 453,489 | 10.0 | 359,874 | 9.3 | 256,373 | 8.0 | 135,598 | 6.4 | 135,650 | 7.1 |
| | 1,834,855 | 40.5 | 1,443,696 | 37.5 | 1,459,553 | 45.3 | 1,032,263 | 48.6 | 1,040,563 | 54.8 |
| Commercial real estate loans: | | | | | | | | | | |
| Non-owner occupied commercial real estate | 622,782 | 13.8 | 588,672 | 15.4 | 445,903 | 13.8 | 379,664 | 17.8 | 320,942 | 16.8 |
| Multifamily | 728,037 | 16.1 | 674,219 | 17.5 | 426,557 | 13.2 | 55,088 | 2.6 | 79,216 | 4.2 |
| Construction/ land development | 687,631 | 15.2 | 636,320 | 16.5 | 583,160 | 18.1 | 367,934 | 17.3 | 130,465 | 6.9 |
| | 2,038,450 | 45.1 | 1,899,211 | 49.4 | 1,455,620 | 45.1 | 802,686 | 37.7 | 530,623 | 27.9 |
| Commercial and industrial loans: | | | | | | | | | | |
| Owner occupied commercial real estate | 391,613 | 8.6 | 282,891 | 7.3 | 154,800 | 4.8 | 143,800 | 6.8 | 156,700 | 8.3 |
| Commercial business | 264,709 | 5.8 | 223,653 | 5.8 | 154,262 | 4.8 | 147,449 | 6.9 | 171,054 | 9.0 |
| | 656,322 | 14.4 | 506,544 | 13.1 | 309,062 | 9.6 | 291,249 | 13.7 | 327,754 | 17.3 |
| Total loans before allowance, net deferred loan fees and costs | 4,529,627 | 100.0% | 3,849,451 | 100.0% | 3,224,235 | 100.0% | 2,126,198 | 100.0% | 1,898,940 | 100.0% |
| Net deferred loan fees and costs | 14,686 | | 3,577 | | (2,237) | | (5,048) | | (3,219) | |
| | 4,544,313 | | 3,853,028 | | 3,221,998 | | 2,121,150 | | 1,895,721 | |
| Allowance for loan losses | (37,847) | | (34,001) | | (29,278) | | (22,021) | | (23,908) | |
| | $4,506,466 | | $3,819,027 | | $3,192,720 | | $2,099,129 | | $1,871,813 | |

(1) Includes $5.5 million and $18.0 million of loans at December 31, 2017 and 2016 respectively, where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.

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The following table shows the composition of the loan portfolio by fixed-rate and adjustable-rate loans.

| | At December 31, | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| (in thousands) | Amount | Percent | Amount | Percent |
| Adjustable-rate loans: | | | | |
| Single family | $998,237 | 22.0 % | $657,837 | 17.1 % |
| Non-owner occupied commercial real estate | 545,076 | 12.0 | 512,005 | 13.3 |
| Multifamily | 696,267 | 15.4 | 655,271 | 17.0 |
| Construction/land development, net [1] | 596,913 | 13.2 | 497,175 | 12.9 |
| Owner occupied commercial real estate | 259,207 | 5.7 | 189,689 | 4.9 |
| Commercial business | 189,163 | 4.2 | 143,960 | 3.7 |
| Home equity and other | 415,441 | 9.2 | 303,565 | 7.9 |
| Total adjustable-rate loans | 3,700,304 | 81.7 | 2,959,502 | 76.8 |
| Fixed-rate loans: | | | | |
| Single family | 383,129 | 8.5 | 425,985 | 11.1 |
| Non-owner occupied commercial real estate | 77,706 | 1.7 | 76,667 | 2.0 |
| Multifamily | 31,770 | 0.7 | 18,949 | 0.5 |
| Construction/land development, net [1] | 90,718 | 2.0 | 139,145 | 3.6 |
| Owner occupied commercial real estate | 132,406 | 2.9 | 93,201 | 2.4 |
| Commercial business | 75,546 | 1.7 | 79,693 | 2.1 |
| Home equity and other | 38,048 | 0.8 | 56,309 | 1.5 |
| Total fixed-rate loans | 829,323 | 18.3 | 889,949 | 23.2 |
| Total loans held for investment | 4,529,627 | 100.0% | 3,849,451 | 100.0% |
| Less: | | | | |
| Net deferred loan fees and costs | 14,686 | | 3,577 | |
| Allowance for loan losses | (37,847) | | (34,001) | |
| Loans held for investment, net | $4,506,466 | | $3,819,027 | |

(1) Construction/land development is presented net of the undisbursed portion of the loan commitment.

The following tables show the contractual maturity of our loan portfolio by loan type.

| | December 31, 2017 | | | | Loans due after one year by rate characteristic | |
|---|---|---|---|---|---|---|
| (in thousands) | Within one year | After one year through five years | After five years | Total | Fixed-rate | Adjustable-rate |
| Consumer: | | | | | | |
| Single family | $1,854 | $4,532 | $1,374,980 | $1,381,366 | $381,275 | $998,237 |
| Home equity and other | 1 | 80 | 453,408 | 453,489 | 38,047 | 415,441 |
| Total consumer | 1,855 | 4,612 | 1,828,388 | 1,834,855 | 419,322 | 1,413,678 |
| Commercial real estate loans: | | | | | | |
| Non-owner occupied commercial real estate | 28,363 | 65,470 | 528,949 | 622,782 | 66,565 | 527,854 |
| Multifamily | 11,197 | 74,237 | 642,603 | 728,037 | 30,046 | 686,794 |
| Construction/land development | 528,813 | 144,824 | 13,994 | 687,631 | 62,810 | 96,008 |
| Total commercial real estate | 568,373 | 284,531 | 1,185,546 | 2,038,450 | 159,421 | 1,310,656 |
| Commercial and industrial loans: | | | | | | |
| Owner occupied commercial real estate | 9,137 | 41,416 | 341,060 | 391,613 | 126,316 | 256,160 |
| Commercial business | 60,274 | 90,704 | 113,731 | 264,709 | 67,061 | 137,374 |
| Total commercial and industrial | 69,411 | 132,120 | 454,791 | 656,322 | 193,377 | 393,534 |
| Total loans held for investment | $639,639 | $421,263 | $3,468,725 | $4,529,627 | $772,120 | $3,117,868 |

| | December 31, 2016 | | | | Loans due after one year by rate characteristic | |
|---|---|---|---|---|---|---|
| (in thousands) | Within one year | After one year through five years | After five years | Total | Fixed-rate | Adjustable-rate |
| Consumer: | | | | | | |
| Single family | $7,327 | $4,878 | $1,071,618 | $1,083,823 | $418,923 | $657,573 |
| Home equity and other | 7,156 | 27,879 | 324,838 | 359,873 | 52,922 | 299,795 |
| Total consumer | 14,483 | 32,757 | 1,396,456 | 1,443,696 | 471,845 | 957,368 |
| Commercial real estate: | | | | | | |
| Non-owner occupied commercial real estate | 22,887 | 75,403 | 490,382 | 588,672 | 69,668 | 496,117 |
| Multifamily | 1,658 | 51,766 | 620,796 | 674,220 | 17,664 | 654,898 |
| Construction/land development | 483,211 | 151,785 | 1,324 | 636,320 | 74,003 | 79,106 |
| Total commercial real estate | 507,756 | 278,954 | 1,112,502 | 1,899,212 | 161,335 | 1,230,121 |
| Commercial and industrial: | | | | | | |
| Owner occupied commercial real estate | 25,232 | 32,164 | 225,495 | 282,891 | 78,300 | 179,359 |
| Commercial business | 55,820 | 72,985 | 94,847 | 223,652 | 76,060 | 91,772 |
| Total commercial and industrial | 81,052 | 105,149 | 320,342 | 506,543 | 154,360 | 271,131 |
| Total loans held for investment | $603,291 | $416,860 | $2,829,300 | $3,849,451 | $787,540 | $2,458,620 |

The following table presents loan origination and loan sale volumes.

| (in thousands) | Years Ended December 31, 2017 | 2016 | | 2015 |
|---|---|---|---|---|
| Loans originated | | | | |
| Real estate | | | | |
| Single family | | | | |
| Originated by HomeStreet | $7,525,248 | $8,637,631 | | $6,834,296 |
| Originated by WMS Series LLC | 566,152 | 576,832 | | 606,316 |
| Total single family | 8,091,400 | 9,214,463 | | 7,440,612 |
| Multifamily | 746,748 | 640,142 | | 322,637 |
| Non-owner occupied commercial real estate | 208,130 | 271,701 | | 134,068 |
| Owner occupied commercial real estate | 121,398 | 173,017 | | 35,236 |
| Construction/land development | 1,084,092 | 1,079,243 | | 767,063 |
| Total real estate | 10,251,768 | 11,378,566 | | 8,699,616 |
| Commercial business | 227,880 | 116,595 | | 105,021 |
| Home equity and other | 361,043 | 279,851 | | 176,430 |
| Total loans originated | $10,840,691 | $11,775,012 | | $8,981,067 |
| Loans sold | | | | |
| Single family | $7,508,949 | $8,785,412 | | $7,038,635 |
| Multifamily DUS ® (1) | 347,084 | 301,442 | | 204,744 |
| SBA | 26,841 | 17,308 | | 14,275 |
| CRE Non-DUS® (2) | 321,699 | 150,903 | (3) | 15,038 |
| Total loans sold | $8,204,573 | $9,255,065 | | $7,272,692 |

(1) Fannie Mae Multifamily Delegated Underwriting and Servicing Program (“DUS®”) is a registered trademark of Fannie Mae.
(2) Loans originated as Held for Investment.
(3) Includes $63.2 million of single family portfolio loan sales in 2016.

*Mortgage servicing rights* were $284.7 million at December 31, 2017 compared to $245.9 million at December 31, 2016, an increase of $38.8 million, or 15.8%, as a result of growth in the loans serviced for others portfolio and changes in market inputs, including current market interest rates and prepayment model updates.

*Federal Home Loan Bank stock* was $46.6 million at December 31, 2017 compared to $40.3 million at December 31, 2016, an increase of $6.3 million, or 15.6%. FHLB stock is carried at par value and can only be purchased or redeemed at par value in transactions between the FHLB and its member institutions. Both cash and stock dividends received on FHLB stock are reported in earnings.

*Other assets* were $188.5 million at December 31, 2017, compared to $221.1 million at December 31, 2016, a decrease of $32.6 million, or 14.7%.

**Deposits**

Deposit balances were as follows for the periods indicated:

| | At December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Noninterest-bearing accounts - checking and savings | $579,504 | $537,651 | $370,523 |
| Interest-bearing transaction and savings deposits: | | | |
| NOW accounts | 461,349 | 468,812 | 408,477 |
| Statement savings accounts due on demand | 293,858 | 301,361 | 292,092 |
| Money market accounts due on demand | 1,834,154 | 1,603,141 | 1,155,464 |
| Total interest-bearing transaction and savings deposits | 2,589,361 | 2,373,314 | 1,856,033 |
| Total transaction and savings deposits | 3,168,865 | 2,910,965 | 2,226,556 |
| Certificates of deposit | 1,190,689 | 1,091,558 | 732,892 |
| Noninterest-bearing accounts - other | 401,398 | 427,178 | 272,505 |
| Total deposits | $4,760,952 | $4,429,701 | $3,231,953 |

Deposits at December 31, 2017 increased $331.3 million, or 7.5%, from December 31, 2016. During 2017, the Company increased the balances of transaction and savings deposits by $257.9 million, or 8.9%. The $99.1 million, or 9.1%, increase in certificates of deposit since December 31, 2016 was due in part to increases in business and personal CDs, institutional CDs and brokered deposits.

At December 31, 2016, deposits increased $1.20 billion, or 37.1%, from December 31, 2015 primarily due to the acquisition related activities and growth of our deposit branch network. During 2016, the Company increased the balances of transaction and savings deposits by $684.4 million, or 30.7%, reflecting the growth and expansion of our branch banking network. The $358.7 million, or 48.9%, increase in certificates of deposit since December 31, 2015 was primarily due in part to increases in business and personal CDs, institutional CDs and brokered deposits.

**Borrowings**

FHLB advances were $979.2 million at December 31, 2017 compared to $868.4 million at December 31, 2016. FHLB advances may be collateralized by stock in the FHLB, cash, pledged mortgage-backed securities, real estate-secured commercial loans and unencumbered qualifying mortgage loans. As of December 31, 2017, 2016 and 2015, FHLB borrowings had weighted average interest rates of 1.58%, 0.91% and 0.64%, respectively. Of the total FHLB borrowings outstanding as of December 31, 2017, $963.6 million mature prior to December 31, 2018. We had $579.2 million and $282.8 million of additional borrowing capacity with the FHLB as of December 31, 2017 and 2016, respectively. We use short term funding to lower the cost of funds and manage the sensitivity of our net portfolio value and net interest income which mitigated the impact of changes in interest rates.

We may also borrow, on a collateralized basis, from the Federal Reserve Bank of San Francisco ("FRBSF" or "Federal Reserve Bank"). At December 31, 2017 and 2016, we did not have any outstanding borrowings from the FRBSF. Based on the amount of qualifying collateral available, borrowing capacity from the FRBSF was $331.5 million and $292.1 million at December 31, 2017 and 2016, respectively. The FRBSF is not contractually bound to offer credit to us, and our access to this source for future borrowings may be discontinued at any time.

Long-term debt was $125.3 million and $125.1 million at December 31, 2017 and 2016, respectively. The balance at December 31, 2017 represents $63.4 million of senior notes issued during 2016 and $61.9 million of junior subordinated debentures issued in prior years. Such debentures were issued in connection with the sale of trust preferred securities by HomeStreet Statutory Trusts, subsidiaries of HomeStreet, Inc. Trust preferred securities allow investors to buy subordinated debt through a variable interest entity trust that issues preferred securities to third-party investors and uses the cash received to purchase subordinated debt from the issuer. That debt is the sole asset of the trust and the coupon rate on the debt mirrors the dividend rate on the preferred securities. These securities are nonvoting and are not convertible into capital stock, and the variable interest entity trust is not consolidated in our financial statements.

**Shareholders' Equity**

Shareholders' equity was $704.4 million at December 31, 2017 compared to $629.3 million at December 31, 2016. This increase was primarily due to net income of $68.9 million and by other comprehensive income of $3.3 million recognized during the year ended December 31, 2017. Other comprehensive income (loss) represents unrealized gains and losses in the valuation of our available for sale investment securities portfolio at December 31, 2017.

Shareholders' equity, on a per share basis, was $26.20 per share at December 31, 2017, compared to $23.48 per share at December 31, 2016.

**Return on Equity and Assets**

The following table presents certain information regarding our returns on average equity and average total assets.

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Return on assets [1] | 1.05 % | 1.01 % | 0.91 % |
| Return on equity [2] | 10.20 % | 10.27 % | 9.35 % |
| Equity to assets ratio [3] | 10.26 % | 9.80 % | 9.69 % |

(1) Net income divided by average total assets.
(2) Net earnings available to common shareholders divided by average common shareholders' equity.
(3) Average equity divided by average total assets.

**Business Segments**

Our business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is evaluated by management.

This process is dynamic and is based on management's view of the Company's operations and is not necessarily comparable with similar information for other financial institutions. We define our business segments by product type and customer segment. If the management structure or the allocation process changes, allocations, transfers and assignments may change.

We use various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

- a funds transfer pricing system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets;
- an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on each segment's consumption patterns; and
- an allocation of the Company's consolidated income taxes which are based on the effective tax rate applied to the segment's pretax income or loss.

**Commercial and Consumer Banking Segment**

Commercial and Consumer Banking provides diversified financial products and services to our commercial and consumer customers through bank branches and through ATMs, online, mobile and telephone banking. These products and services include deposit products; residential, consumer, business and agricultural portfolio loans; non-deposit investment products; insurance products and cash management services. We originate construction loans, bridge loans and permanent loans for our portfolio primarily on single family residences, and on office, retail, industrial and multifamily property types. We originate multifamily real estate loans through our Fannie Mae DUS® business, whereby loans are sold to or securitized by Fannie Mae, while the Company generally retains the servicing rights. In addition, through HomeStreet Commercial Capital, a division of HomeStreet Bank based in Orange County, California, we originate permanent commercial real estate loans primarily up to $10 million in size, a portion of which we pool and sell into the secondary market. We have a team specializing in U.S. Small Business Administration ("SBA") lending. As of December 31, 2017, our retail deposit branch network consists of 59 branches in the Pacific Northwest, California and Hawaii. At December 31, 2017 and December 31, 2016, our transaction and savings deposits totaled $3.17 billion and $2.91 billion, respectively, and our loan portfolio totaled $4.51 billion and $3.82 billion, respectively. This segment also reflects the results for the management of the Company's portfolio of investment securities.

Commercial and Consumer Banking segment results are detailed below.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Net interest income | $174,542 | $20,527 | 13 % | $154,015 | $33,995 | 28 % | $120,020 |
| Provision for credit losses | 750 | (3,350) | (82) | 4,100 | (2,000) | (33) | 6,100 |
| Noninterest income | 42,360 | 6,678 | 19 | 35,682 | 6,315 | 22 | 29,367 |
| Noninterest expense | 148,977 | 10,592 | 8 | 138,385 | 15,787 | 13 | 122,598 |
| Income before income tax expense | 67,175 | 19,963 | 42 | 47,212 | 26,523 | 128 | 20,689 |
| Income tax expense | 25,114 | 8,702 | 53 | 16,412 | 13,740 | 514 | 2,672 |
| Net income | $42,061 | $11,261 | 37 % | $30,800 | $12,783 | 71 % | $18,017 |
| | | | | | | | |
| Total assets | $5,875,329 | $605,877 | 11 % | $5,269,452 | $1,223,402 | 30 % | $4,046,050 |
| Efficiency ratio [1] | 68.68 % | | | 72.95 % | | | 82.07 % |
| Full-time equivalent employees (ending) | 1,068 | 70 | 7 % | 998 | 170 | 21 % | 828 |
| Production volumes for sale to the secondary market: | | | | | | | |
| Loan originations | | | | | | | |
| Multifamily DUS ® [2] | $341,308 | $15,457 | 5 % | $325,851 | $121,013 | 59 % | $204,838 |
| SBA | 39,009 | 25,279 | 184 % | 13,730 | 13,730 | NM | $— |
| Loans sold | | | | | | | |
| Multifamily DUS ® [2] | $347,084 | $45,642 | 15 % | $301,442 | $96,698 | 47 % | $204,744 |
| SBA | 26,841 | 9,533 | 55 % | 17,308 | 3,033 | 21 % | 14,275 |
| CRE Non-DUS [3] | 321,699 | 170,796 | 113 % | 150,903 [4] | 135,865 | 903 % | 15,038 |
| Net gain on mortgage loan origination and sale activities: | | | | | | | |
| Multifamily DUS ® [2] | $13,210 | $1,813 | 16 % | $11,397 | $4,272 | 60 % | $7,125 |
| SBA | 2,439 | 1,025 | 72 % | 1,414 | 344 | 32 % | 1,070 |
| CRE Non-DUS [3] | 4,378 | 319 | 8 % | 4,059 [5] | 3,600 | 784 % | 459 [5] |
| | $20,027 | $3,157 | 19 % | $16,870 | $8,216 | 95 % | $8,654 |

(1) Noninterest expense divided by total net revenue (net interest income and noninterest income).
(2) Fannie Mae Multifamily Delegated Underwriting and Servicing Program ("DUS®) is a registered trademark of Fannie Mae.
(3) Loans originated as Held for Investment.
(4) Includes $63.2 million of single family portfolio loan sales in 2016.
(5) Includes $2.8 million net gain on sale of single family portfolio loan during fourth quarter of 2016 and $27 thousand during fourth quarter of 2015.

*Comparison of 2017 to 2016*

Commercial and Consumer Banking net income increased in 2017 primarily due to increased net interest income resulting from higher average balances of interest-earning assets, partially offset by increased noninterest expense. These increases were primarily due to organic growth. Included in net income for the year ended December 31, 2017 and 2016 were $391 thousand and $4.6 million, respectively, in acquisition related expenses, net of tax. Additionally, the year ended December 31, 2017 included a $4.2 million, one-time, non-cash, income tax expense related to the Tax Reform Act.

The segment recorded a provision for credit losses of $750 thousand for the year ended December 31, 2017 compared to a $4.1 million provision for credit losses for the year ended December 31, 2016. The reduction in credit loss provision in the year was due in part to continued improvements in credit quality reflected in the qualitative reserves and historical loss rates combined with an increase of $2.6 million in net recoveries over the comparable period.

Resulting from the growth of this segment, noninterest income increased for the year ended December 31, 2017 due primarily to an increase in gain on sale income driven by higher commercial real estate loan sales volume.

Noninterest expense increased primarily due to the growth of our commercial real estate and commercial business lending units and the expansion of our retail deposit banking network. In 2017, we added four retail deposit branches, three de novo and one acquired retail branch. Full-time equivalent employees increased by 70, or 7.0%, from 2016. Included in noninterest expense for 2017 and 2016 was $602 thousand and $7.1 million, respectively, of acquisition-related costs.

*Comparison of 2016 to 2015*

Commercial and Consumer Banking net income was $30.8 million for the year ended December 31, 2016, an increase of $12.8 million from $18.0 million for the year ended December 31, 2015. The increase in 2016 was primarily due to increased net interest income resulting from higher average balances of interest-earning assets and higher commercial net gain on loan origination and sale activities, partially offset by increased noninterest expense primarily resulting from the expansion of this segment.

The segment recorded a provision for credit losses of $4.1 million for the year ended December 31, 2016 compared to a $6.1 million provision for credit losses for the year ended December 31, 2015. The reduction in credit loss provision in the year was due in part to a continuing decline in historical loss rates as a result of net recoveries for the past two years and continued improvements in portfolio performance which was reflected in the qualitative reserves. In 2015, one-time model adjustments contributed to an increase in provision expense.

Resulting from the growth of this segment, noninterest income increased for the year ended December 31, 2016 due primarily to increases in net gain on loan origination and sale activities, mortgage servicing income and depositor and other retail banking fees. Included in noninterest income for the year ended December 31, 2015 was a bargain purchase gain of $7.7 million from the merger with Simplicity and the Dayton, Washington branch acquisition. There were no similar bargain purchase gains in 2016.

Noninterest expense increased primarily due to the growth of our commercial real estate and commercial business lending units and the expansion of our retail deposit banking network. In 2016, we added 11 retail deposit branches, six de novo and five from acquisitions. Full-time equivalent employees increased by 170, or 20.5%, from 2015. Included in noninterest expense for 2016 was $7.1 million of acquisition-related costs. In 2015, such acquisition-related expenses related to prior acquisitions were $16.6 million.

*Commercial and Consumer Banking segment loans serviced for others* consisted of the following.

| | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Commercial | | |
| Multifamily DUS® | $1,311,399 | $1,108,040 |
| Other | 79,797 | 69,323 |
| Total commercial loans serviced for others | $1,391,196 | $1,177,363 |

*Commercial and Consumer Banking segment servicing income* consisted of the following.

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |

| | | Dollar Change | Percent Change | | Dollar Change | Percent Change | |
|---|---|---|---|---|---|---|---|
| Servicing income, net: | | | | | | | |
| Servicing fees and other | $7,263 | $1,649 | 29 % | $5,614 | $1,335 | 31 % | $4,279 |
| Amortization of multifamily and SBA MSRs | (3,932 ) | (1,297 ) | 49 | (2,635 ) | (643 ) | 32 | (1,992 ) |
| Commercial mortgage servicing income | $3,331 | $352 | 12 % | $2,979 | $692 | 30 % | $2,287 |

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**Mortgage Banking Segment**

Mortgage Banking originates single family residential mortgage loans primarily for sale in the secondary markets and performs mortgage servicing on a substantial portion of such loans. The majority of our mortgage loans are sold to or securitized by Fannie Mae, Freddie Mac or Ginnie Mae, while we retain the right to service these loans. We have become a rated originator and servicer of jumbo loans, allowing us to sell these loans to other securitizers. Additionally, we purchase loans from WMS Series LLC through a correspondent arrangement with that company. We also sell loans on a servicing-released and servicing-retained basis to securitizers and correspondent lenders. A small percentage of our loans are brokered to other lenders. On occasion, we may sell a portion of our MSR portfolio. We manage the loan funding and the interest rate risk associated with the secondary market loan sales and the retained single family mortgage servicing rights within this business segment.

Mortgage Banking segment results are detailed below.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Net interest income | $19,896 | $(6,138) | (24)% | $26,034 | $(2,284) | (8)% | $28,318 |
| Noninterest income | 269,794 | (53,674) | (17) | 323,468 | 71,598 | 28 | 251,870 |
| Noninterest expense | 290,676 | (15,261) | (5) | 305,937 | 61,967 | 25 | 243,970 |
| Income (loss) before income tax (benefit) expense | (986) | (44,551) | (102) | 43,565 | 7,347 | 20 | 36,218 |
| Income tax (benefit) expense | (27,871) | (44,085) | (272) | 16,214 | 3,298 | 26 | 12,916 |
| Net income | $26,885 | $(466) | (2)% | $27,351 | $4,049 | 17 % | $23,302 |
| | | | | | | | |
| Total assets | $866,712 | $(107,536) | (11)% | $974,248 | $125,803 | 15 % | $848,445 |
| Efficiency ratio [(1)] | 100.34 % | | | 87.54 % | | | 87.07 % |
| Full-time equivalent employees (ending) | 1,351 | (203) | (13)% | 1,554 | 243 | 19 % | 1,311 |
| Production volumes for sale to the secondary market: | | | | | | | |
| Single family mortgage closed loan volume [(2)(3)] | $7,554,185 | $(1,443,162) | (16)% | $8,997,347 | $1,784,912 | 25 % | $7,212,435 |
| Single family mortgage interest rate lock commitments[(2)] | 6,980,477 | (1,640,499) | (19) | 8,620,976 | 1,689,868 | 24 | 6,931,108 |
| Single family mortgage loans sold[(2)] | $7,508,949 | $(1,276,463) | (15)% | $8,785,412 | $1,778,075 | 25 % | $7,007,337 |

(1) Noninterest expense divided by total net revenue (net interest income and noninterest income).
(2) Includes loans originated by WMS Series LLC and purchased by HomeStreet Bank and brokered loans where HomeStreet receives fee income but does not fund the loan on its balance sheet or sell it into the secondary market.
(3) Represents single family mortgage production volume designated for sale to the secondary market during each respective period.

*Comparison of 2017 to 2016*

The decrease in Mortgage Banking net income for 2017 compared to 2016 was primarily due to $1.64 billion of lower rate lock and purchase loan commitments and related lower noninterest expense resulting from lower commission expense from the decreased closed loan volume, partially offset by the recognition of a one-time, non-cash, tax benefit of $27.9 million from the revaluation of our net deferred tax liability position at December 31, 2017 related to the Tax-Reform Act. In 2017, we implemented a restructuring plan to better align our costs structure with market conditions, including a reduction in staffing, production office closures and a streamlining of the single family leadership team. Included in net income for the year ended December 31, 2017, was restructuring-related items, net of tax, of $2.4 million. There were no similar charges in 2016.

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*Comparison of 2016 to 2015*

The increase in Mortgage Banking net income for 2016 compared to 2015 was primarily due to the higher gain on single family mortgage loan origination and sale activities resulting from higher interest rate lock commitments and higher servicing fee income, partially offset by higher noninterest expense resulting from higher commission expense from increased closed loan volume, as well as continued growth and expansion of our mortgage banking segment, increased costs resulting from new regulatory disclosure requirements for the mortgage industry and lower risk management results.

***Mortgage Banking gain on sale to the secondary market*** is detailed in the following table.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Single family: (1) | | | | | | | |
| Servicing value and secondary market gains(2) | $209,027 | $(51,450) | (20)% | $260,477 | $54,964 | 27 % | $205,513 |
| Loan origination and funding fees | 26,822 | (3,144) | (10) | 29,966 | 7,745 | 35 | 22,221 |
| Total mortgage banking gain on mortgage loan origination and sale activities(1) | $235,849 | $(54,594) | (19)% | $290,443 | $62,709 | 28 % | $227,734 |

(1) Excludes inter-segment activities.

(2) Comprised of gains and losses on interest rate lock commitments (which considers the value of servicing), single family loans held for sale, forward sale commitments used to economically hedge secondary market activities, and the estimated fair value of the repurchase or indemnity obligation recognized on new loan sales.

*Comparison of 2017 to 2016*

The decrease in gain on mortgage loan origination and sale activities in 2017 compared to 2016 is primarily the result of a 19.0% decrease in interest rate lock commitments primarily due to the impact of higher interest rates, which reduced the volume of refinance activity in 2017. During 2017, as a result of our restructuring, we have decreased our lending footprint by a net of three home loan centers to bring our total primary home loan centers to 44 as of December 31, 2017.

*Comparison of 2016 to 2015*

The increase in gain on mortgage loan origination and sale activities in 2016 compared to 2015 is primarily the result of a 24.4% increase in interest rate lock commitments, which was mainly driven by the expansion of our mortgage production offices and personnel. During 2016, we increased our lending footprint to bring our total primary home loan centers to 48 as of December 31, 2016.

*Mortgage Banking servicing income* consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | Dollar Change | Percent Change | 2016 | Dollar Change | Percent Change | 2015 |
|---|---|---|---|---|---|---|---|
| Servicing income, net: | | | | | | | |
| Servicing fees and other | $58,929 | $10,889 | 23 % | $48,040 | $10,303 | 27 % | $37,737 |
| Changes in fair value of MSRs due to amortization [1] | (35,451 ) | (2,146 ) | 6 | (33,305 ) | 733 | (2 ) | (34,038 ) |
| | 23,478 | 8,743 | 59 | 14,735 | 11,036 | 298 | 3,699 |
| Risk management: | | | | | | | |
| Changes in fair value of MSRs due to changes in market inputs and/or model updates [2] | (1,157 ) | (21,182 ) | (106 ) | 20,025 | 13,470 | 205 | 6,555 |
| Net gain (loss) from derivatives economically hedging MSRs | 9,732 | 14,412 | (308 ) | (4,680 ) | (16,389 ) | (140 ) | 11,709 |
| | 8,575 | (6,770 ) | (44 ) | 15,345 | (2,919 ) | (16 ) | 18,264 |
| Mortgage Banking servicing income | $32,053 | $1,973 | 7 % | $30,080 | $8,117 | 37 % | $21,963 |

(1) Represents changes due to collection/realization of expected cash flows and curtailments.
(2) Principally reflects changes in model assumptions, including prepayment speed assumptions, which are primarily affected by changes in mortgage interest rates.

*Comparison of 2017 to* 2016

The increase in Mortgage Banking servicing income in 2017 compared to 2016 was primarily attributable to higher servicing income, net, offset by lower risk management results. The higher servicing income was primarily attributed to higher servicing fees on higher average balances of loans serviced for others. The lower risk management results were due in part to gains from prepayment model refinements in 2016 to align borrower prepayment behavior with observed borrower prepayment behavior. Mortgage servicing fees collected in the year ended December 31, 2017 increased compared to the year ended December 31, 2016 primarily as a result of higher average balances of loans serviced for others during the year. Our single family loans serviced for others portfolio was $22.63 billion at December 31, 2017 compared to $19.49 billion at December 31, 2016.

MSR risk management results represent changes in the fair value of single family MSRs due to changes in model inputs and assumptions net of the gain/(loss) from derivatives economically hedging MSRs. The fair value of MSRs is sensitive to changes in interest rates, primarily due to the effect on prepayment speeds. MSRs typically decrease in value when interest rates decline because declining interest rates tend to increase mortgage prepayment speeds and therefore reduce the expected life of the net servicing cash flows of the MSR asset. Certain other changes in MSR fair value relate to factors other than interest rate changes and are generally not within the scope of the Company's MSR economic hedging strategy. These factors may include but are not limited to the impact of changes to the housing price index, prepayment model assumptions, the level of home sales activity, changes to mortgage spreads, valuation discount rates, costs to service and policy changes by U.S. government agencies.

*Comparison of 2016 to 2015*

The increase in Mortgage Banking servicing income in 2016 compared to 2015 was primarily due to higher servicing income, partially offset by lower risk management results. The higher servicing income was primarily attributed to higher servicing fees on higher average balances of loans serviced for others and lower modeled amortization. Mortgage servicing fees collected in the year ended December 31, 2016 increased compared to the year ended December 31, 2015 primarily as a result of higher average balances of loans serviced for others during the year. Our loans serviced for others portfolio was $20.67 billion at December 31, 2016 compared to $16.35 billion at December 31, 2015.

The lower risk management results in 2016 were mainly due to adverse results during the fourth quarter driven by the unexpected and significant increases in long-term Treasury rates beginning in November 2016 following the U.S.

presidential election, coinciding with an increase in short-term interest rates by the Federal Reserve in December 2016. The unexpected and sustained increase in interest rates during the quarter resulted in asymmetrical changes in valuation between hedging derivatives and servicing valuations. This market dislocation in the fourth quarter reduced the value of our hedging derivatives to a greater extent than value of our mortgage servicing rights increased, resulting in lower risk management results.

Model assumptions are regularly updated to better align observed borrower prepayment behavior with modeled borrower prepayment behavior.

***Single family loans serviced for others*** consisted of the following.

| | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Single family | | |
| U.S. government and agency | $22,123,710 | $18,931,835 |
| Other | 507,437 | 556,621 |
| Total single family loans serviced for others | $22,631,147 | $19,488,456 |

*Comparison of 2017 to 2016*

Mortgage Banking noninterest expense in 2017 decreased from 2016 primarily due to decreased commissions, salary and related costs on lower closed loan volumes, partially offset by a $3.7 million charge related to the restructuring of our mortgage segment and other costs related to the implementation of a new loan origination system. In 2017, as a result of our mortgage banking restructuring, we have decreased our lending footprint by a net of three home loan centers to bring our total primary home loan centers to 44 as of December 31, 2017.

*Comparison of 2016 to 2015*

Mortgage Banking noninterest expense in 2016 increased from 2015 primarily due to the continued expansion of offices in new markets and increases of our mortgage production and support staff along with related salary, insurance, and benefit costs as well as increased costs resulting from new regulatory disclosure requirements for the mortgage industry. In 2016, we increased our lending footprint by adding home loan centers to bring our total primary home loan centers to 48.

**Off-Balance Sheet Arrangements**

In the normal course of business, we are a party to financial instruments with off-balance sheet risk. These financial instruments (which include commitments to originate loans and commitments to purchase loans) include potential credit risk in excess of the amount recognized in the accompanying consolidated financial statements. These transactions are designed to (1) meet the financial needs of our customers, (2) manage our credit, market or liquidity risks, (3) diversify our funding sources and/or (4) optimize capital.

For more information on off-balance sheet arrangements, see Note 13, *Commitments*, *Guarantees and Contingencies* to the financial statements of this Form 10-K.

***Commitments, Guarantees and Contingencies***

We may incur liabilities under certain contractual agreements contingent upon the occurrence of certain events. Our known contingent liabilities include:

- *Unfunded loan commitments.* We make certain unfunded loan commitments as part of our lending activities that have not been recognized in the Company’s financial statements. These include commitments to extend credit made as part of our lending activities on loans we intend to hold in our loans held for investment portfolio. The aggregate amount of these unrecognized unfunded loan commitments existing at December 31, 2017 and 2016 was $56.9 million and $42.6 million, respectively.
- 

*Credit agreements.* We extend secured and unsecured open-end loans to meet the financing needs of our customers. These commitments, which primarily related to unused home equity and commercial real estate lines of credit and business banking funding lines, totaled $456.1 million and $289.3 million at December 31, 2017 and 2016, respectively. Undistributed construction loan proceeds, where the Company has an obligation to advance funds for construction progress payments, was $706.7 million and $603.8 million at December 31, 2017 and 2016, respectively. The total amounts of unused commitments do not necessarily represent future credit exposure or cash requirements in that commitments may expire without being drawn upon.

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*Interest rate lock commitments*. The Company writes options in the form of interest rate lock commitments on single family mortgage loans that are exercisable at the option of the borrower. We are exposed to market risk on interest rate lock commitments. The fair value of interest rate lock commitments existing at December 31, 2017 and 2016, was $12.9 million and $19.2 million, respectively. We mitigate the risk of future changes in the fair value of interest rate lock commitments primarily through the use of forward sale commitments.

*Credit loss sharing*. We originate, sell and service multifamily loans through the Fannie Mae DUS program. Multifamily loans are sold to Fannie Mae subject to a loss sharing arrangement. HomeStreet Capital services the loans for Fannie Mae and shares in the risk of loss with Fannie Mae under the terms of the DUS contracts. Under the DUS program, in general the DUS lender is contractually responsible for all losses on the first 5% of the unpaid principal balance of the loan (determined as of the day prior to valuation of the asset for loss purposes) and then shares in the remainder of losses with Fannie Mae with the lender being responsible for 25% of any losses that exceed 5% of the unpaid principal balance up to 20% of the unpaid principal balance and 10% of any losses that exceed 20% of the unpaid principal balance. The maximum lender loss on most DUS program loans is 20% of the original principal balance. The total principal balance of loans outstanding under the DUS program as of December 31, 2017 and 2016 was $1.31 billion and $1.11 billion, respectively, and our loss reserve was $2.0 million and $1.8 million as of December 31, 2017 and 2016, respectively.

*Mortgage repurchase liability*. In our single family lending business, we sell residential mortgage loans to government sponsored and other entities. In addition, the Company pools Federal Housing Administration ("FHA")-insured and Department of Veterans' Affairs ("VA")-guaranteed mortgage loans into Ginnie Mae, Fannie Mae and Freddie Mac guaranteed mortgage-backed securities. We have made representations and warranties that the loans sold meet certain requirements. We may be required to repurchase mortgage loans or indemnify loan purchasers due to defects in the origination process of the loan, such as documentation errors, underwriting errors and judgments, early payment defaults and fraud.

These obligations expose us to mark-to-market and credit losses on the repurchased mortgage loans after accounting for any mortgage insurance that we may receive. Generally, the maximum amount of future payments we would be required to make for breaches of these representations and warranties would be equal to the unpaid principal balance of such loans that are deemed to have defects that were sold to purchasers plus, in certain circumstances, accrued and unpaid interest on such loans and certain expenses.

We do not typically receive repurchase requests from the FHA or VA. As an originator of FHA-insured or VA-guaranteed loans, we are responsible for obtaining the insurance with FHA or the guarantee with the VA. If we are not able to meet the requirements of FHA to get the loan insured by FHA or guaranteed by VA, we may be unable to sell the loan or be required to repurchase the loan. Loans that are found not to meet the requirements of FHA or VA, through required internal quality control reviews or through agency audits, we may be required to indemnify FHA or VA against loss. The loans remain in Ginnie Mae pools unless and until they qualify for voluntary repurchase by the Company. In general, once an FHA or VA loan becomes 90 days past due, we repurchase the FHA or VA loan to minimize the cost of interest advances on the loan. If the loan is cured through borrower efforts or through loss mitigation activities, the loan may be resold into a Ginnie Mae pool. The Company's liability for mortgage loan repurchase losses incorporates probable losses associated with such indemnification.

As of December 31, 2017 and 2016, the total principal balance of loans sold on a servicing-retained basis that were subject to the terms and conditions of these representations and warranties totaled $22.71 billion and $19.56 billion, respectively. The recorded mortgage repurchase liability for loans sold on a servicing-retained and a servicing-released basis was $3.0 million and $3.4 million at December 31, 2017 and 2016, respectively. The Company's mortgage repurchase liability reflects management's estimate of losses for loans sold on a servicing-retained and servicing-released basis for which we could have a repurchase obligation. Actual repurchase losses of $541 thousand, $1.1 million and $1.8 million were incurred for the years ended December 31, 2017, 2016 and 2015, respectively.

*Leases*. The Company is obligated under non-cancelable leases for office space and leased equipment. The office leases also contain renewal and space options. Rental expense under non-cancelable operating leases totaled $26.1

million, $22.7 million and $20.1 million for the years ended December 31, 2017, 2016 and 2015, respectively.

- *Small business investment company ("SBIC") investment funds.* In 2017 and 2016, we entered into agreements to invest $8.3 million and $5.0 million, respectively, over time in qualifying small businesses and small enterprises. At December 31, 2017 and 2016 we had unfunded commitments of $11.0 million and $4.0 million, respectively, related to these agreements.

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***Derivative Counterparty Credit Risk***

Derivative financial instruments expose us to credit risk in the event of nonperformance by counterparties to such agreements. This risk consists primarily of the termination value of agreements where we are in a favorable position. Credit risk related to derivative financial instruments is considered within the fair value measurement of the instrument. We manage the credit risk associated with our various derivative agreements through counterparty credit review, counterparty exposure limits and monitoring procedures. From time to time, we may provide collateral to certain counterparties for amounts in excess of exposure limits as outlined by the counterparty credit policies of the parties. We have entered into agreements with derivative counterparties that include netting arrangements whereby the counterparties are entitled to settle certain positions on a net basis. At December 31, 2017 and 2016, our net exposure to the credit risk of derivative counterparties was $19.8 million and $69.4 million, respectively.

***Contractual Obligations***

The following table summarizes our significant fixed and determinable contractual obligations, within the categories described below, by payment date or contractual maturity as of December 31, 2017. The payment amounts for financial instruments shown below represent principal amounts contractually due to the recipient and do not include any unamortized premiums or discounts, or other similar carrying value adjustments.

| (in thousands) | Within one year | After one but within three years | After three but within five | More than five years | Total |
|---|---|---|---|---|---|
| Deposits [1] | $4,460,052 | $ 269,919 | $ 30,827 | $154 | $4,760,952 |
| FHLB advances | 963,611 | 10,000 | — | 5,590 | 979,201 |
| Long term debt | — | — | — | 65,000 | 65,000 |
| Trust preferred securities [2] | — | — | — | 61,857 | 61,857 |
| Interest [3] | 14,815 | 15,990 | 13,457 | 41,526 | 85,788 |
| Operating leases | 26,477 | 44,589 | 32,752 | 48,752 | 152,570 |
| Purchase obligations [4] | 14,768 | 8,278 | 782 | — | 23,828 |
| Total | $5,479,723 | $ 348,776 | $ 77,818 | $222,879 | $6,129,196 |

(1) Deposits with indeterminate maturities, such as demand, savings and money market accounts, are reflected as obligations due less than one year.
(2) Trust preferred securities are included in long-term debt on the consolidated statements of financial condition.
(3) Represents the future interest obligations related to interest-bearing time deposits and long-term debt in the normal course of business. These interest obligations assume no early debt redemption. We estimated variable interest rate payments using December 31, 2017 rates, which we held constant until maturity.
(4) Represents agreements to purchase goods or services.

## Enterprise Risk Management

All financial institutions manage and control a variety of business and financial risks that can significantly affect their financial performance. Among these risks are credit risk; market risk, which includes interest rate risk and price risk; liquidity risk; and operational risk. We are also subject to risks associated with compliance/legal, strategic and reputational matters.
Our Board of Directors (the "Board") and executive management have overall and ultimate responsibility for management of these risks. The Board, its committees and senior managers oversee the management of various risks. The Company utilizes a risk management framework which includes three lines of defense. The business units, which are the first line of defense, have responsibility to identify, monitor, control and escalate risks in their respective areas. The second line of defense, comprised of independent risk management functions, operating under the Chief Risk

Officer, establishes the risk governance framework and assesses, tests and reports on risks by business unit and on an enterprise-wide basis. Our internal audit department provides independent assurance that the risk framework, policies, procedures and controls are appropriate and operating as intended and is considered the third line of defense. The Chief Risk Officer reports directly to the Enterprise Risk Management Committee of the Board and is responsible for oversight of enterprise risk management, compliance, Bank Secrecy Act, quality control and regulatory affairs functions. The Chief Audit Officer reports directly to the Audit Committee of the Board.

The Board and its committees work closely with senior management in overseeing risk. Management recommends the appropriate level of risk in our strategic and business plans and in our board-approved credit and operating policies and has responsibility for measuring, managing, controlling and reporting on risks. The Board and its committees oversee the monitoring and controlling of significant risk exposures, including the policies governing risk management. The Board authorizes its committees to take any action on its behalf as described in their respective charter or as otherwise delegated by the Board, except as otherwise specifically reserved by law, regulation, other committees' charters or the Company's charter documents for action solely by the full board or another board committee. These committees include:

- *Audit Committee.* The Audit Committee oversees the policies and management activities relating to our financial reporting and internal and external audit.
- *Finance Committee.* The Finance Committee oversees the consolidated companies' activities related to balance sheet management, major financial risks including market, interest rate, liquidity and funding risks and counterparty risk management, including trading limits.
- *Credit Committee.* The Credit Committee oversees the annual Loan Review Plan, lending policies, credit performance and trends, the allowance for credit loss policy and loan loss reserves, large borrower exposure and concentrations, and approval of broker/dealer relationships.
- *Human Resources and Corporate Governance Committee*. The Human Resources and Corporate Governance Committee (the "HRCG") of HomeStreet, Inc. reviews all matters concerning our human resources, compensation, benefits, and corporate governance. HRCG's policy objectives are to ensure that HomeStreet and its operating subsidiaries meet their corporate objectives of attracting and retaining a well-qualified workforce, to oversee our human resource strategies and policies and to ensure processes are in place to assure compliance with employment laws and regulations.
- *Enterprise Risk Management Committee.* The Enterprise Risk Management Committee (the "ERMC") oversees the Company's enterprise-wide risk management framework, including evaluating management's identification and assessment of the significant risks and the related infrastructure to address such risks and monitors the Company's compliance with its risk appetite and risk limit structures and effective remediation of non-compliance on an ongoing, enterprise-wide, and individual entity basis. The ERMC also oversees policies and management activities relating to operational, regulatory, legal and compliance risks. The ERMC does not duplicate the risk oversight of the Board's other committees, but rather helps ensure end-to-end understanding and oversight of all risk issues in one Board committee and enhances the Board's and management's understanding of the Company's aggregate enterprise-wide risk profile.

The following is a discussion of our risk management practices. The risks related to credit, liquidity, interest rate and price warrant in-depth discussion due to the significance of these risks and the impact they may have on our business.

**Credit Risk Management**

Credit risk is defined as the risk to current or anticipated earnings or capital arising from an obligor’s failure to meet the terms of any contract with the Company, including those in the lending, securities and derivative portfolios, or otherwise perform as agreed. Factors relating to the degree of credit risk include the size of the asset or transaction, the contractual terms of the related documents, the credit characteristics of the borrower, the channel through which assets are acquired, the features of loan products or derivatives, the existence and strength of guarantor support, the availability, quality and adequacy of any underlying collateral and the economic environment after the loan is originated or the asset is acquired. Our overall portfolio credit risk is also impacted by asset concentrations within the portfolio.

Our credit risk management process is primarily centrally governed. Our overall credit process includes comprehensive credit policies, judgmental or statistical credit underwriting, frequent and detailed risk measurement and modeling and loan review, quality control and audit processes. In addition, we have an independent loan review function that reports directly to the Credit Committee of the Board, and internal auditors and regulatory examiners review and perform detailed tests of our credit underwriting, loan administration and allowance processes.

The Chief Credit Officer’s primary responsibilities include directing the activities of the credit risk management function as it relates to the loan portfolio, overseeing loan portfolio performance, ensuring compliance with regulatory requirements and the Company's established credit policies, standards and limits, determining the reasonableness of our allowance for loan losses, reviewing and approving large credit exposures and delegating credit approval authorities. Senior credit administrators who oversee the lines of business have both transaction approval authority and governance authority for the approval of procedures within established policies, standards and limits. The Chief Credit Officer's role also includes direct oversight of appraisal and environmental functions. The Chief Credit Officer reports directly to the Chief Executive Officer.

The Loan Committee provides direction and oversight within our risk management framework. The committee seeks to ensure effective portfolio risk analysis and policy review and to support sound implementation of defined business and risk strategies. Additionally, the Loan Committee periodically approves credits larger than the Chief Credit Officer’s or Chief Executive Officer’s individual approval authorities allow. The members of the Loan Committee are the Chief Executive Officer, Chief Credit Officer and the Commercial Banking Director.

The loan review department's primary responsibility includes the review of our loan portfolios to provide an independent assessment of credit quality, portfolio oversight and credit management, including accuracy of loan grading. Loan review also conducts targeted credit-related reviews and credit process reviews at the request of the Board and management and reviews a sample of newly originated loans for compliance with closing conditions and accuracy of loan grades. Loan review reports directly to the Credit Committee and administratively to the Chief Credit Officer.

Credit limits for capital markets counterparties, including derivative counterparties, are defined in the Company's Counterparty Risk policy, which is reviewed annually by the Bank Loan Committee, with final approval by the Board Credit Committee. The treasury function is responsible for directing the activities related to securities and derivative portfolios, including overseeing derivative portfolio performance and ensuring compliance with established credit policies, standards and limits. The Chief Investment Officer and Treasurer reports directly to both the Chief Executive Officer and Chief Financial Officer.

***Appraisal Policy***

An integral part of our credit risk management process is the valuation of the collateral supporting the loan portfolio, which is primarily comprised of loans secured by real estate. We maintain a Board-approved appraisal policy for real estate appraisals that conforms to the Uniform Standards of Professional Appraisal Practice and FDIC regulatory requirements. Our Chief Appraiser, who is independent of the business units, is responsible for maintaining the appraisal policy and recommending changes to the policy subject to Loan Committee and Credit Committee approval.

*Real Estate*

Our appraisal policy requires that market value appraisals or evaluations be prepared prior to new loan origination, subsequent loan transactions and for loan monitoring purposes. Our appraisals are prepared by independent third-party appraisers and our staff appraisers. Evaluations are prepared by independent and qualified third-party providers. We use state certified and licensed appraisers with appropriate expertise as it relates to the subject property type and location. All appraisals contain an “as is” market value estimate based upon the definition of market value as set forth in the FDIC appraisal regulations. For applicable property types, we may also obtain “upon completion” and “upon stabilization” values. The appraisal standard for non-tract development properties (four units or less) is the retail market value of individual units. For tract development properties with five or more units, the appraisal standard is the bulk market value of the tract as a whole.

We review all appraisals and evaluations prior to the closing of a loan transaction. Commercial and single family real estate appraisals and evaluations are reviewed by either our in-house appraisal staff or by independent and qualified third-party appraisers.

For loan monitoring and problem loan management purposes our appraisal practices are as follows:

- We generally do not perform valuation monitoring for pass-graded credits because we believe they carry minimal credit risk.

- For commercial loans secured by real estate that are graded special mention, an appraisal is performed at the time of loan downgrade, and an appraisal or evaluation is performed at least every two years thereafter, depending upon property complexity, market area, market conditions, intended use and other considerations.
- For commercial loans secured by real estate that are graded substandard or doubtful and for all OREO properties, we require an independent third-party appraisal at the time of downgrade or transfer to OREO and at least every twelve months thereafter until disposition or loan upgrade. For loans where foreclosure is probable, an appraisal or evaluation is prepared at the intervening six-month period prior to foreclosure.
- For performing consumer segment loans secured by real estate that are graded special mention or substandard, property values are determined semi-annually from automated valuation model services employed by the Bank.

In addition, if we determine that market conditions, changes to the property, changes in the intended use of the property or other factors indicate an appraisal is no longer reliable, we will also obtain an updated appraisal or evaluation and assess whether a change in collateral value requires an additional adjustment to carrying value.

*Other*

Our appraisal requirements for loans not secured by real estate, such as business loans secured by equipment, include valuation methods ranging from evidence of sales price or verification with a recognized guide for new equipment to a valuation opinion by a professional appraiser for multiple pieces of used equipment.

***Loan Modifications***

We have modified loans for various reasons for borrowers not experiencing financial difficulties. Those modifications generally are short-term extensions granted to allow time for receipt of appraisals and other financial reporting information to facilitate underwriting of loan extensions and renewals.
Our policy allows modifications for borrowers with financial difficulty when there is a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest. We may enter into a loan modification to help maximize the likelihood of success for a given workout strategy. In each case we also assess whether it is in the best interests of the Company to foreclose or modify the terms. We have made concessions such as interest-only payment terms, interest rate reductions, principal and interest forgiveness and payment restructures. For single family mortgage borrowers, we have generally provided for granting interest rate reductions for periods of three years or less to reduce payments and provide the borrower time to resolve their financial difficulties. In each case, we carefully analyze the borrower’s current financial condition to assure that they can make the modified payment.

***Asset Quality and Nonperforming Assets***

Nonperforming assets ("NPAs") were $15.7 million, or 0.23% of total assets at December 31, 2017, compared to $25.8 million, or 0.41% of total assets at December 31, 2016. Nonaccrual loans of $15.0 million, or 0.33% of total loans at December 31, 2017, decreased $5.5 million, or 26.8%, from $20.5 million, or 0.53% of total loans at December 31, 2016. Net recoveries in 2017 were $3.1 million compared with net recoveries of $505 thousand in 2016 and net recoveries of $2.0 million in 2015.

At December 31, 2017, our loans held for investment portfolio, net of the allowance for loan losses, was $4.51 billion, an increase of $687.4 million from December 31, 2016. The allowance for loan losses was $37.8 million, or 0.83% of loans held for investment, compared to $34.0 million, or 0.88% of loans held for investment at December 31, 2016.

The Company recorded a provision for credit losses of $750 thousand for the year ended December 31, 2017 compared to a $4.1 million of provision for credit losses for the year ended December 31, 2016 and a $6.1 million provision for credit losses for the year ended December 31, 2015. Management considers the current level of the allowance for loan losses to be appropriate to cover estimated incurred losses inherent within our loans held for investment portfolio.

For information regarding the activity on our allowance for credit losses, which includes the reserves for unfunded commitments, and the amounts that were collectively and individually evaluated for impairment, see Note 5, *Loans and Credit Quality* to the financial statements of this Form 10-K.

The allowance for credit losses represents management’s estimate of the incurred credit losses inherent within our loan portfolio. For further discussion related to credit policies and estimates see "*Critical Accounting Policies and*

*Estimates ~~-A~~llowance for Loan Losses"* within Management's Discussion and Analysis of this Form 10-K.

The following tables present the recorded investment, unpaid principal balance and related allowance for impaired loans, broken down by those with and those without a specific reserve.

| (in thousands) | At December 31, 2017 | | |
|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance (2) | Related Allowance |
| Impaired loans: | | | |
| Loans with no related allowance recorded | $78,696 (3) | $80,904 | $ — |
| Loans with an allowance recorded | 5,150 | 5,288 | 289 |
| Total | $83,846 (1) | $86,192 | $ 289 |

| (in thousands) | At December 31, 2016 | | |
|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance (2) | Related Allowance |
| Impaired loans: | | | |
| Loans with no related allowance recorded | $86,723 | $92,431 | $ — |
| Loans with an allowance recorded | 3,785 | 3,875 | 379 |
| Total | $90,508 (1) | $96,306 | $ 379 |

| (in thousands) | At December 31, 2015 | | |
|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance (2) | Related Allowance |
| Impaired loans: | | | |
| Loans with no related allowance recorded | $90,547 | $94,058 | $ — |
| Loans with an allowance recorded | 3,126 | 3,293 | 567 |
| Total | $93,673 (1) | $97,351 | $ 567 |

(1) Includes $69.6 million, $73.1 million and $74.7 million in single family performing troubled debt restructurings ("TDRs") at December 31, 2017, 2016 and 2015, respectively.

(2) Unpaid principal balance does not include partial charge-offs, purchase discounts and premiums or nonaccrual interest paid. Related allowance is calculated on net book balances not unpaid principal balances.

(3) Includes $231 thousand of fair value option loans.

The Company had 335 impaired loan relationships totaling $83.8 million at December 31, 2017 and 282 impaired loan relationships totaling $90.5 million at December 31, 2016. Included in the total impaired loan relationship amounts were 297 single family TDR loan relationships totaling $72.0 million at December 31, 2017 and 239 single family TDR relationships totaling $76.0 million at December 31, 2016. The increase in the number of impaired loan relationships at December 31, 2017 from 2016 was primarily due to an increase in the number of single family impaired loans. At December 31, 2017, there were 286 single family impaired relationships totaling $69.6 million that were performing per their current contractual terms. Additionally, the impaired loan balance included $46.7 million of loans insured by the FHA or guaranteed by the VA. The average recorded investment in these loans for the year ended December 31, 2017 was $89.8 million, compared to $94.4 million for the year ended December 31, 2016. Impaired loans of $5.2 million and $3.8 million had a valuation allowance of $289 thousand and $379 thousand at

December 31, 2017 and 2016, respectively.

The following table presents the allowance for credit losses, including reserves for unfunded commitments, by loan class.

| | At December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2017 | | | 2016 | | | 2015 | | |
| (in thousands) | Amount | Percent of Allowance to Total Allowance | Loan Category as a % of Total Loans (1) | Amount | Percent of Allowance to Total Allowance | Loan Category as a % of Total Loans (1) | Amount | Percent of Allowance to Total Allowance | Loan Category as a % of Total Loans (1) |
| Consumer loans | | | | | | | | | |
| Single family | $9,412 | 24.1 % | 30.4 % | $8,196 | 23.2 % | 27.8 % | $8,942 | 29.2 % | 36.9 % |
| Home equity and other | 7,081 | 18.1 | 10.0 | 6,153 | 17.4 | 9.4 | 4,620 | 15.1 | 8.0 |
| | 16,493 | 42.2 | 40.4 | 14,349 | 40.6 | 37.2 | 13,562 | 44.3 | 44.9 |
| Commercial real estate loans | | | | | | | | | |
| Non-owner occupied commercial real estate | 4,755 | 12.1 | 13.8 | 4,481 | 12.7 | 15.4 | 3,594 | 11.7 | 13.9 |
| Multifamily | 3,895 | 10.0 | 16.1 | 3,086 | 8.8 | 17.6 | 1,194 | 3.9 | 13.3 |
| Construction/land development | 8,677 | 22.2 | 15.2 | 8,553 | 24.3 | 16.6 | 9,271 | 30.2 | 18.2 |
| | 17,327 | 44.3 | 45.1 | 16,120 | 45.8 | 49.6 | 14,059 | 45.8 | 45.4 |
| Commercial and industrial loans | | | | | | | | | |
| Owner occupied commercial real estate | 2,960 | 7.5 | 8.7 | 2,199 | 6.2 | 7.4 | 1,253 | 4.1 | 4.9 |
| Commercial business | 2,336 | 6.0 | 5.9 | 2,596 | 7.4 | 5.8 | 1,785 | 5.8 | 4.8 |
| | 5,296 | 13.5 | 14.5 | 4,795 | 13.6 | 13.2 | 3,038 | 9.9 | 9.7 |
| Total allowance for credit losses | $39,116 | 100.0 % | 100.0 % | $35,264 | 100.0 % | 100.0 % | $30,659 | 100.0 % | 100.0 % |

(1) Excludes loans held for investment balances that are carried at fair value.

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The following tables present the composition of TDRs by accrual and nonaccrual status.

| | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| (in thousands) | Accrual | Number of accrual relationships | Nonaccrual | Number of nonaccrual relationships | Total | Total number of relationships |
| Consumer | | | | | | |
| Single family [(1)] | $69,555 | 280 | $ 2,451 | 11 | $72,006 | 291 |
| Home equity and other | 1,254 | 16 | 36 | 2 | 1,290 | 18 |
| | 70,809 | 296 | 2,487 | 13 | 73,296 | 309 |
| Commercial real estate loans | | | | | | |
| Multifamily | 507 | 1 | — | — | 507 | 1 |
| Construction/land development | 454 | 1 | — | — | 454 | 1 |
| | 961 | 2 | — | — | 961 | 2 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 876 | 1 | — | — | 876 | 1 |
| Commercial business | 377 | 3 | 62 | 1 | 439 | 4 |
| | 1,253 | 4 | 62 | 1 | 1,315 | 5 |
| | $73,023 | 302 | $ 2,549 | 14 | $75,572 | 316 |

(1) Includes loan balances insured by the FHA or guaranteed by the VA of $46.7 million at December 31, 2017.

| | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| (in thousands) | Accrual | Number of accrual relationships | Nonaccrual | Number of nonaccrual relationships | Total | Total number of relationships |
| Consumer | | | | | | |
| Single family [(1)] | $73,147 | 229 | $ 2,885 | 10 | $76,032 | 239 |
| Home equity and other | 1,247 | 18 | 216 | 3 | 1,463 | 21 |
| | 74,394 | 247 | 3,101 | 13 | 77,495 | 260 |
| Commercial real estate loans | | | | | | |
| Multifamily | 508 | 1 | — | — | 508 | 1 |
| Construction/land development | 1,186 | 1 | 707 | 1 | 1,893 | 2 |
| | 1,694 | 2 | 707 | 1 | 2,401 | 3 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | — | — | 933 | 1 | 933 | 1 |
| Commercial business | 493 | 4 | 133 | 1 | 626 | 5 |
| | 493 | 4 | 1,066 | 2 | 1,559 | 6 |
| | $76,581 | 253 | $ 4,874 | 16 | $81,455 | 269 |

(1) Includes loan balances insured by the FHA or guaranteed by the VA of $35.1 million at December 31, 2016.

| (in thousands) | At December 31, 2015<br>Accrual | Number of accrual relationships | Nonaccrual | Number of nonaccrual relationships | Total | Total number of relationships |
|---|---|---|---|---|---|---|
| Consumer | | | | | | |
| Single family [1] | $ 74,685 | 213 | $ 2,452 | 11 | $ 77,137 | 224 |
| Home equity and other | 1,340 | 20 | 271 | 4 | 1,611 | 24 |
| | 76,025 | 233 | 2,723 | 15 | 78,748 | 248 |
| Commercial real estate loans | | | | | | |
| Multifamily | 3,014 | 2 | — | — | 3,014 | 2 |
| Construction/land development | 3,714 | 3 | — | — | 3,714 | 3 |
| | 6,728 | 5 | — | — | 6,728 | 5 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | — | — | 1,023 | 1 | 1,023 | 1 |
| Commercial business | 1,658 | 4 | 185 | 1 | 1,843 | 5 |
| | 1,658 | 4 | 1,208 | 2 | 2,866 | 6 |
| | $ 84,411 | 242 | $ 3,931 | 17 | $ 88,342 | 259 |

(1) Includes loan balances insured by the FHA or guaranteed by the VA of $29.6 million at December 31, 2015.

The increase in the number of TDR loan relationships at December 31, 2017 from 2016 and 2015 was primarily due to an increase in the number of single family loan TDRs. TDR loans within the loans held for investment portfolio and the related reserves are included in the impaired loan tables above. At December 31, 2017 and 2016 and 2015, the Company had no unfunded commitments related to TDR loans.

| | At December 31, | | | | |
|---|---|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Loans accounted for on a nonaccrual basis: [1] | | | | | |
| Consumer | | | | | |
| Single family | $11,091 | $12,717 | $12,119 | $8,368 | $8,861 |
| Home equity and other | 1,404 | 1,571 | 1,576 | 1,526 | 1,846 |
| | 12,495 | 14,288 | 13,695 | 9,894 | 10,707 |
| Commercial real estate loans | | | | | |
| Non-owner occupied commercial real estate | — | 871 | — | 193 | 3,200 |
| Multifamily | 302 | 337 | 119 | — | — |
| Construction/land development | 78 | 1,376 | 339 | — | — |
| | 380 | 2,584 | 458 | 193 | 3,200 |
| Commercial and industrial loans | | | | | |
| Owner occupied commercial real estate | 640 | 1,256 | 2,341 | 4,650 | 9,057 |
| Commercial business | 1,526 | 2,414 | 674 | 1,277 | 2,743 |
| | 2,166 | 3,670 | 3,015 | 5,927 | 11,800 |
| Total loans on nonaccrual | 15,041 | 20,542 | 17,168 | 16,014 | 25,707 |
| Other real estate owned | 664 | 5,243 | 7,531 | 9,448 | 12,911 |
| Total nonperforming assets | $15,705 | $25,785 | $24,699 | $25,462 | $38,618 |
| Loans 90 days or more past due and accruing [2] | $37,171 | $40,846 | $36,612 | $34,987 | $46,811 |
| Accruing TDR loans | $73,023 | $76,581 | $84,411 | $107,815 | $101,905 |
| Nonaccrual TDR loans | 2,549 | 4,874 | 3,931 | 4,110 | 4,731 |
| Total TDR loans | $75,572 | $81,455 | $88,342 | $111,925 | $106,636 |
| Allowance for loan losses as a percent of nonaccrual loans | 251.63 % | 165.52 % | 170.54 % | 137.51 % | 93.00 % |
| Nonaccrual loans as a percentage of total loans | 0.33 % | 0.53 % | 0.53 % | 0.75 % | 1.36 % |
| Nonperforming assets as a percentage of total assets | 0.23 % | 0.41 % | 0.50 % | 0.72 % | 1.26 % |

(1) If interest on nonaccrual loans under the original terms had been recognized, such income is estimated to have been $1.5 million, $2.2 million and $2.5 million for the years ended December 31, 2017, 2016 and 2015.

(2) FHA-insured and VA-guaranteed single family loans that are 90 days or more past due are maintained on an accrual status if they have been determined to have little or no risk of loss.

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Delinquent loans and other real estate owned by loan type consisted of the following.

| (in thousands) | At December 31, 2017 30-59 Days Past Due | 60-89 Days Past Due | Nonaccrual | 90 Days or More Past Due and Accruing | Total Past Due Loans | Other Real Estate Owned |
|---|---|---|---|---|---|---|
| Consumer loans | | | | | | |
| Single family | $ 10,493 | $ 4,437 | $ 11,091 | $ 37,171 [1] | $ 63,192 | $ 664 |
| Home equity and other | 750 | 20 | 1,404 | — | 2,174 | — |
| | 11,243 | 4,457 | 12,495 | 37,171 | 65,366 | 664 |
| Commercial real estate loans | | | | | | |
| Multifamily | — | — | 302 | — | 302 | — |
| Construction/land development | 641 | — | 78 | — | 719 | — |
| | 641 | — | 380 | — | 1,021 | — |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | — | — | 640 | — | 640 | — |
| Commercial business | 377 | — | 1,526 | — | 1,903 | — |
| | 377 | — | 2,166 | — | 2,543 | — |
| Total | $ 12,261 | $ 4,457 | $ 15,041 | $ 37,171 | $ 68,930 | $ 664 |

(1) FHA-insured and VA-guaranteed single family loans that are 90 days or more past due are maintained on accrual status if they are determined to have little to no risk of loss. At December 31, 2017, these past due loans totaled $37.2 million.

| (in thousands) | At December 31, 2016 30-59 Days Past Due | 60-89 Days Past Due | Nonaccrual | 90 Days or More Past Due and Accruing | Total Past Due Loans | Other Real Estate Owned |
|---|---|---|---|---|---|---|
| Consumer loans | | | | | | |
| Single family | $ 4,310 | $ 5,459 | $ 12,717 | $ 40,846 [1] | $ 63,332 | $ 2,133 |
| Home equity and other | 251 | 442 | 1,571 | — | 2,264 | — |
| | 4,561 | 5,901 | 14,288 | 40,846 | 65,596 | 2,133 |
| Commercial real estate loans | | | | | | |
| Non-owner occupied commercial real estate | 23 | — | 871 | — | 894 | — |
| Multifamily | — | — | 337 | — | 337 | — |
| Construction/land development | — | — | 1,376 | — | 1,376 | 2,712 |
| | 23 | — | 2,584 | — | 2,607 | 2,712 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 48 | 205 | 1,256 | — | 1,509 | 398 |
| Commercial business | 202 | — | 2,414 | — | 2,616 | — |
| | 250 | 205 | 3,670 | — | 4,125 | 398 |
| Total | $ 4,834 | $ 6,106 | $ 20,542 | $ 40,846 | $ 72,328 | $ 5,243 |

(1) FHA-insured and VA-guaranteed single family loans that are 90 days or more past due are maintained on accrual status as they have little to no risk of loss. At December 31, 2016, these past due loans totaled $40.8 million.

| (in thousands) | At December 31, 2015<br>30-59 Days Past Due | 60-89 Days Past Due | Nonaccrual | 90 Days or More Past Due and Accruing | Total Past Due Loans | Other Real Estate Owned |
|---|---|---|---|---|---|---|
| Consumer loans | | | | | | |
| Single family | $7,098 | $ 3,537 | $ 12,119 | $ 36,595 (1) | $59,349 | $ 301 |
| Home equity and other | 1,095 | 398 | 1,576 | — | 3,069 | — |
| | 8,193 | 3,935 | 13,695 | 36,595 | 62,418 | 301 |
| Commercial real estate loans | | | | | | |
| Non-owner occupied commercial real estate | — | — | — | — | — | 4,071 |
| Multifamily | — | — | 119 | — | 119 | — |
| Construction/land development | 77 | — | 339 | — | 416 | 3,159 |
| | 77 | — | 458 | — | 535 | 7,230 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 233 | — | 2,341 | — | 2,574 | — |
| Commercial business | — | — | 675 | 17 | 692 | — |
| | 233 | — | 3,016 | 17 | 3,266 | — |
| Total | $8,503 | $ 3,935 | $ 17,169 | $ 36,612 | $66,219 | $ 7,531 |

(1) FHA-insured and VA-guaranteed single family loans that are 90 days or more past due are maintained on accrual status as they have little to no risk of loss. At December 31, 2015, these past due loans totaled $36.6 million.

The following tables present the single family loan held for investment portfolio by original FICO score.

| At December 31, 2017<br>Greater Than | Less Than or Equal To | Percentage (1) |
|---|---|---|
| N/A (2) | N/A (2) | 1.9% |
| < | 500 | 0.1% |
| 500 | 549 | 0.1% |
| 550 | 599 | 0.5% |
| 600 | 649 | 4.1% |
| 650 | 699 | 13.1% |
| 700 | 749 | 30.8% |
| 750 | > | 49.4% |
| | TOTAL | 100.0% |

(1) Percentages based on aggregate loan amounts.
(2) Information is not available.

At December 31, 2016

| Greater Than | Less Than or Equal To | Percentage (1) |
|---|---|---|
| N/A (2) | N/A (2) | 2.5% |
| < | 500 | —% |
| 500 | 549 | 0.1% |
| 550 | 599 | 0.7% |
| 600 | 649 | 4.8% |
| 650 | 699 | 16.0% |
| 700 | 749 | 28.6% |
| 750 | > | 47.2% |
| | TOTAL | 100.0% |

(1) Percentages based on aggregate loan amounts.
(2) Information is not available.

## *Loan Underwriting Standards*

Our underwriting standards for single family and home equity loans require evaluating and understanding a borrower's credit, collateral and ability to repay the loan. Credit is determined based on how well a borrower manages their current and prior debts, documented by a credit report that provides credit scores and the borrower's current and past information about their credit history. Collateral is based on the type and use of property, occupancy and market value, largely determined by property appraisals or evaluations in accordance with our appraisal policy. A borrower's ability to repay the loan is based on several factors, including employment, income, current debt, assets and level of equity in the property. We also consider loan-to-property value and debt-to-income ratios, amount of liquid financial reserves, loan amount and lien position in assessing whether to originate a loan. Single family and home equity borrowers are particularly susceptible to downturns in economic trends that negatively affect housing prices and demand and levels of unemployment.

For commercial, multifamily and construction loans, we consider the same factors with regard to the borrower and the guarantors. In addition, we evaluate liquidity, net worth, leverage, other outstanding indebtedness of the borrower, an analysis of cash expected to flow through the borrower (including the outflow to other lenders) and prior experience with the borrower. We use this information to assess financial capacity, profitability and experience. Ultimate repayment of these loans is sensitive to interest rate changes, general economic conditions, liquidity and availability of long-term financing.

*Additional considerations for commercial permanent loans secured by real estate:*

Our underwriting standards for commercial permanent loans generally require that the loan-to-value ratio for these loans not exceed 75% of appraised value or discounted cash flow value, as appropriate, and that commercial properties attain debt coverage ratios (net operating income divided by annual debt servicing) of 1.25 or better.

Our underwriting standards for multifamily residential permanent loans generally require that the loan-to-value ratio for these loans not exceed 80% of appraised value, cost, or discounted cash flow value, as appropriate, and that multifamily residential properties attain debt coverage ratios of 1.15 or better. However, underwriting standards can be influenced by competition and other factors. We endeavor to maintain the highest practical underwriting standards while balancing the need to remain competitive in our lending practices.

*Additional considerations for commercial construction loans secured by real estate:*

We originate a variety of real estate construction loans. Underwriting guidelines for these loans vary by loan type but include loan-to-value limits, term limits, loan advance limits and pre-leasing requirements, as applicable.

Our underwriting guidelines for commercial real estate construction loans generally require that the loan-to-value ratio not exceed 75% and stabilized debt coverage ratios of 1.25 or better.

Our underwriting guidelines for multifamily residential construction loans generally require that the loan-to-value ratio not exceed 80% and stabilized debt coverage ratios of 1.20 or better.

Our underwriting guidelines for single family residential construction loans to builders generally require that the loan-to-value ratio not exceed 85%.

As noted above, underwriting standards can be influenced by competition and other factors. However, we endeavor to maintain the highest practical underwriting standards while balancing the need to remain competitive in our lending practices.

**Liquidity and Capital Resources**

Liquidity risk management is primarily intended to ensure we are able to maintain sources of cash to adequately fund operations and meet our obligations, including demands from depositors, draws on lines of credit and paying any creditors, on a timely and cost-effective basis, in various market conditions. Our liquidity profile is influenced by changes in market conditions, the composition of the balance sheet and risk tolerance levels. HomeStreet, Inc., HomeStreet Capital ("HSC") and the Bank have established liquidity guidelines and operating plans that detail the sources and uses of cash and liquidity.

HomeStreet, Inc., HomeStreet Capital and the Bank have different funding needs and sources of liquidity and separate regulatory capital requirements.

***HomeStreet, Inc.***

The main source of liquidity for HomeStreet, Inc. is proceeds from dividends from the Bank and HomeStreet Capital. HomeStreet, Inc. has raised capital through the issuance of common stock, senior debt and trust preferred securities. Additionally, we also have an available line of credit from which we can borrow up to $30.0 million. At December 31, 2017, no advances were outstanding against this line.

Historically, the main cash outflows have been distributions to shareholders, interest and principal payments to creditors and payments of operating expenses. HomeStreet, Inc.’s ability to pay dividends to shareholders depends substantially on dividends received from the Bank. We do not currently pay a dividend and our most recent special dividend to shareholders was declared during the first quarter of 2014. We are generally deploying our capital toward strategic growth, and at this time our Board of Directors has not authorized the payment of a dividend.

***HomeStreet Capital***

HomeStreet Capital generates positive cash flow from its servicing fee income on the DUS® portfolio, net of its costs to service the DUS® portfolio. Additional uses are HomeStreet Capital's costs to purchase the servicing rights on new production from the Bank. Minimum liquidity and reporting requirements for DUS® lenders such as HomeStreet Capital are set by Fannie Mae. HomeStreet Capital's liquidity management therefore consists of meeting Fannie Mae requirements and its own operational requirements.

***HomeStreet Bank***

The Bank’s primary sources of funds include deposits, advances from the FHLB, repayments and prepayments of loans, proceeds from the sale of loans and investment securities, interest from our loans and investment securities and capital contributions from HomeStreet, Inc. We have also raised short-term funds through the sale of securities under agreements to repurchase and federal funds purchased. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit inflows and outflows and loan prepayments are greatly influenced by interest rates, economic conditions and competition. The Bank uses the primary liquidity ratio as a measure of liquidity. The primary liquidity ratio is defined as net cash, short-term investments and other marketable assets as a percent of net deposits and short-term borrowings. At December 31, 2017, our primary liquidity ratio was 18.1% compared with 31.2% at December 31, 2016 and 25.4% at December 31, 2015.

At December 31, 2017, 2016 and 2015, the Bank had available borrowing capacity of $579.2 million, $282.8 million and $320.4 million, respectively, from the FHLB, and $331.5 million, $292.1 million and $382.1 million, respectively, from the Federal Reserve Bank of San Francisco.

***Cash Flows***

For the years ended December 31, 2017, 2016 and 2015, cash and cash equivalents increased $18.8 million, increased $21.2 million and increased $2.2 million, respectively. The following discussion highlights the major activities and transactions that affected our cash flows during these periods.

*Cash flows from operating activities*

The Company's operating assets and liabilities are used to support our lending activities, including the origination and sale of mortgage loans. For the year ended December 31, 2017, net cash of $160.6 million was provided by operating activities, as our cash proceeds from the sale of loans exceeded cash used to fund loans held for sale production. We believe that cash flows from operations, available cash balances and our ability to generate cash through short-term debt are sufficient to fund our operating liquidity needs. For the year ended December 31, 2016, net cash of $44.8 million was used in operating activities, as our net income was less than the net fair value adjustment and gain on sale of loans held for sale. For the year ended December 31, 2015, net cash of $8.3 million was provided by operating activities, as our net income exceeded the net amount of cash used to fund loans held for sale production and proceeds from the sale of loans.

*Cash flows from investing activities*

The Company's investing activities primarily include available-for-sale securities and loans originated as held for investment. For the year ended December 31, 2017, net cash of $556.2 million was used in investing activities, primarily due to $998.6 million cash used for the origination of portfolio loans net of principal repayments and $368.1 million of cash used for the purchase of investment securities, and $42.3 million used for the purchase of property and equipment, partially offset by $397.5 million from proceeds from sale of investment securities, $324.7 million proceeds from sale of loans held for investment and $105.8 million from principal repayments. For the year ended December 31, 2016, net cash of $819.3 million was used in investing activities, primarily due to cash used for the origination of portfolio loans and principal repayments and purchases of investment securities, partially offset by $153.5 million from proceeds from sale of loans originated as held for investment and $112.2 million from principal repayments and maturities of investment securities. For the year ended December 31, 2015, net cash of $418.3 million was used in investing activities, primarily due to cash used for the origination of portfolio loans and principal repayments and purchases of investment securities, partially offset by $132.4 million of net cash received from acquisitions, primarily from the Simplicity merger.

*Cash flows from financing activities*

The Company's financing activities are primarily related to customer deposits and net proceeds from the FHLB. For the year ended December 31, 2017, net cash of $414.4 million was provided by financing activities, primarily resulting from a $309.8 million growth in deposits and $111.0 million net proceeds from FHLB advances. For the year ended December 31, 2016, net cash of $885.3 million was provided by financing activities, primarily resulting from a $919.5 million growth in deposits, $58.7 million net proceeds from our equity offering and $63.2 million in net proceeds from our senior note offering, partially offset by $164.0 million from net repayments of FHLB advances. For the year ended December 31, 2015, net cash of $412.2 million was provided by financing activities, primarily resulting from net proceeds of $355.0 million of FHLB advances and a $111.9 million growth in deposits.

***Capital Management***

In July 2013, federal banking regulators (including the FDIC and the FRB) adopted new capital rules (as used in this section, the “Rules”). The Rules apply to both depository institutions (such as the Bank) and their holding companies (such as the Company). The Rules reflect, in part, certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010 (which standards are commonly referred to as “Basel III”) as well as requirements contemplated by the Dodd-Frank Act. Since 2015, the Rules have applied to both the Company and the Bank.

The Rules recognize three components, or tiers, of capital: common equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital. Common equity Tier 1 capital generally consists of retained earnings and common stock instruments (subject to certain adjustments), as well as accumulated other comprehensive income (“AOCI”) except to the extent that the Company and the Bank exercise a one-time irrevocable option to exclude certain components of AOCI. Both the Company and the Bank elected this one-time option in 2015 to exclude certain components of AOCI. Additional Tier 1 capital generally includes non-cumulative preferred stock and related surplus subject to certain adjustments and limitations. Tier 2 capital generally includes certain capital instruments (such as subordinated debt) and portions of the amounts of the allowance for loan and lease losses, subject to certain requirements and deductions. The term “Tier 1 capital” means common equity Tier 1 capital plus additional Tier 1 capital, and the term “total capital” means Tier 1 capital plus Tier 2 capital.

The Rules generally measure an institution’s capital using four capital measures or ratios. The common equity Tier 1 capital ratio is the ratio of the institution’s common equity Tier 1 capital to its total risk-weighted assets. The Tier 1 capital ratio is the ratio of the institution’s total Tier 1 capital to its total risk-weighted assets. The total capital ratio is the ratio of the institution’s total capital to its total risk-weighted assets. The leverage ratio is the ratio of the institution’s Tier 1 capital to its average total consolidated assets. To determine risk-weighted assets, assets of an institution are generally placed into a risk category and given a percentage weight based on the relative risk of that category. The percentage weights range from 0% to 1,250%. An asset’s risk-weighted value will generally be its percentage weight multiplied by the asset’s value as determined under generally accepted accounting principles. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the risk categories. An institution's federal regulator may require the institution to hold more capital than would otherwise be required under the Rules if the regulator determines that the institution's capital requirements under the Rules are not commensurate with the institution's credit, market, operational or other risks.

To be classified as "well capitalized," both the Company and the Bank are required to have a common equity Tier 1 capital ratio of at least 6.5%, a Tier 1 risk-based ratio of at least 8.0%, a total risk-based ratio of at least 10.0% and a Tier 1 leverage ratio of at least 5.0%. In addition to the preceding requirements, all financial institutions subject to the Rules, including both the Company and the Bank, are required to establish a "conservation buffer" of common equity Tier 1 capital that was subject to a three year phase-in period that began on January 1, 2016 and would have been fully phased-in on January 1, 2019 at 2.5% above the required common equity Tier 1 capital ratio, the Tier 1 risk-based ratio and the total risk-based ratio. However in 2017, the FDIC issued a final rule to extend the 2017 transition provision on a go-forward basis, so the full phase in has been halted. The required phase-in capital conservation buffer during 2017 was 0.625%. A financial institution with a conservation buffer of less than the required amount is subject to limitations on capital distributions, including dividend payments and stock repurchases, and certain discretionary bonus payments to executive officers. At December 31, 2017, our capital conservation buffers for the Company and the Bank were 3.61% and 6.02%, respectively.

The Rules set forth the manner in which certain capital elements are determined, including but not limited to, requiring certain deductions related to mortgage servicing rights and deferred tax assets. Holding companies with less than $15 billion in total assets as of December 31, 2009 (which includes the Company) are permitted under the rules to continue to include trust preferred securities issued prior to May 19, 2010 in Tier 1 capital, generally up to 25% of other Tier 1 capital. Because our trust preferred securities were issued prior to May 19, 2010, we include those in our Tier 1 capital calculations.

The Rules made changes in the methods of calculating certain risk-based assets, which in turn affects the calculation of risk- based ratios. Higher or more sensitive risk weights are assigned to various categories of assets, including commercial real estate, credit facilities that finance the acquisition, development or construction of real property, certain exposures or credits that are 90 days past due or are nonaccrual, foreign exposures, certain corporate exposures, securitization exposures, equity exposures and in certain cases mortgage servicing rights and deferred tax assets.

Certain calculations under the rules related to deductions from capital had phase-in periods through 2017. Specifically, the capital treatment of mortgage servicing rights was to be phased in through the transition periods. Under the prior rules, the Bank deducted 10% of the value of MSRs (net of deferred tax) from Tier 1 capital ratios. However, under Basel III, the Bank and Company must deduct a much larger portion of the value of MSRs from Tier 1 capital.

- MSRs in excess of 10% of Tier 1 capital before threshold based deductions must be deducted from common equity. The disallowable portion of MSRs was phased in incrementally (40% in 2015; 60% in 2016; 80% in 2017 and beyond).
- In addition, the combined balance of MSRs and deferred tax assets is limited to approximately 15% of the Bank's and the Company's common equity Tier 1 capital. These combined assets must be deducted from common equity to the extent that they exceed the 15% threshold.
- Any portion of the Bank's and the Company's MSRs that are not deducted from the calculation of common equity Tier 1 are subject to a 100% risk weight.

Both the Company and the Bank began compliance with the Rules on January 1, 2015. The phase-in of the conservation buffer began in 2016 and will take full effect on January 1, 2019. Certain calculations under the Rules will also have phase-in periods. We believe that the current capital levels of the Company and the Bank are in compliance with the standards under the Rules including the conservation buffer.

At December 31, 2017, the Bank's capital ratios continued to meet the regulatory capital category of "well capitalized" as defined by the FDIC's prompt corrective action rules.

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The following tables present regulatory capital information for HomeStreet, Inc. and HomeStreet Bank for the December 31, 2017, 2016 and 2015 respectively, under Basel III.

| **HomeStreet Bank** | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $649,864 | 9.67 % | $268,708 | 4.0% | $ 335,885 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $649,864 | 13.22% | $221,201 | 4.5% | $ 319,512 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $649,864 | 13.22% | $294,935 | 6.0% | $ 393,246 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $688,981 | 14.02% | $393,246 | 8.0% | $ 491,558 | 10.0 % |

| **HomeStreet, Inc.** | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $614,624 | 9.12 % | $269,534 | 4.0% | $ 336,918 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $555,120 | 9.86 % | $253,293 | 4.5% | $ 365,868 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $614,624 | 10.92% | $337,724 | 6.0% | $ 450,299 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $653,741 | 11.61% | $450,299 | 8.0% | $ 562,873 | 10.0 % |

| **HomeStreet Bank** | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $635,988 | 10.26% | $248,055 | 4.0% | $ 310,069 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $635,988 | 13.92% | $205,615 | 4.5% | $ 297,000 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $635,988 | 13.92% | $274,154 | 6.0% | $ 365,538 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $671,252 | 14.69% | $365,538 | 8.0% | $ 456,923 | 10.0 % |

| **HomeStreet, Inc.** | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $608,988 | 9.78 % | $249,121 | 4.0% | $ 311,402 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $550,510 | 10.54% | $234,965 | 4.5% | $ 339,395 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $608,988 | 11.66% | $313,287 | 6.0% | $ 417,716 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $644,252 | 12.34% | $417,716 | 8.0% | $ 522,146 | 10.0 % |

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| **HomeStreet Bank** | At December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As “Well Capitalized” Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $455,101 | 9.46 % | $192,428 | 4.0% | $ 240,536 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $455,101 | 13.04% | $157,074 | 4.5% | $ 226,885 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $455,101 | 13.04% | $209,432 | 6.0% | $ 279,243 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $485,761 | 13.92% | $279,243 | 8.0% | $ 349,054 | 10.0 % |

| **HomeStreet, Inc.** | At December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As “Well Capitalized” Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $480,038 | 9.95 % | $193,025 | 4.0% | $ 241,281 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | $423,005 | 10.52% | $180,912 | 4.5% | $ 261,317 | 6.5 % |
| Tier 1 risk-based capital (to risk-weighted assets) | $480,038 | 11.94% | $241,216 | 6.0% | $ 321,621 | 8.0 % |
| Total risk-based capital (to risk-weighted assets) | $510,697 | 12.70% | $321,621 | 8.0% | $ 402,026 | 10.0 % |

## Impact of Inflation

The consolidated financial statements presented in this Form 10-K have been prepared in accordance with U.S. GAAP, which requires the measurement of financial position and operating results in terms of historical dollar amounts or market value without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the cost of our operations as incurred. Unlike industrial companies, nearly all of our assets and liabilities are monetary in nature. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation.

## Operational Risk Management

Operational risk is defined as the risk to current or anticipated earnings or capital arising from inadequate or failed internal processes or systems, misconduct or errors, and adverse external events. Each line of business and the departments supporting the lines of business (collectively referred to as “business lines”) have primary responsibility for identifying, monitoring, controlling and escalating their operational risks. In addition, independent risk management functions, such as our enterprise risk management, risk and regulatory affairs, Bank Secrecy Act, quality control, and legal departments provide support to the business lines as they develop and implement operational risk management practices specific to their needs and escalate enterprise-wide operational risks to senior management and the Board. Our internal audit department provides independent assurance on the strength of operational risk controls and compliance with Company policies and procedures. Additionally, we maintain adequate change management, business resumption and data and customer information security processes. We also maintain a code of conduct with periodic training, setting a “tone from the top” that articulates a strong focus on compliance and ethical standards and a zero tolerance approach to unethical or fraudulent behavior.

**Compliance/Regulatory Risk Management**

Compliance risk is the risk to current or anticipated earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policy and procedures or ethical standards. As a regulated financial institution with a significant mortgage banking operation, we have significant compliance and regulatory risk.

To mitigate our compliance risk, and as part of a comprehensive Risk Management System, the Bank is in the process of developing and implementing a Compliance Management System (CMS) which is designed to meet the heightened standards for risk governance framework adopted by the federal banking regulators. The Bank has implemented a "three lines of defense" model: business lines have primary responsibility for identifying, monitoring and controlling compliance risks, then reporting on those compliance risks to the corporate compliance department, which is our second line of defense. The second line is responsible for providing advice to the business lines, as well as assessing, testing and reporting on the status of the Bank's compliance and identified compliance risks to our senior management and the Board of Directors. Our Internal Audit Department serves as the third line of defense, providing independent assurance on the strength of compliance risk controls and compliance with applicable laws and regulations, as well as compliance with Company policies and procedures. The Chief Audit Officer reports to the audit committees of the Board of Directors of HomeStreet and the Bank.
We are still in the process of implementing the heightened standards required for banks with assets over $10 billion as we are not yet at that level but anticipate that we will grow to that size in the next several years. As the Bank continues to grow, our regulators may require us, or we may determine in response to perceived regulatory expectations, to comply with these heightened standards more completely, or to take actions to prepare for compliance, even before the Bank's total assets equal or exceed $10 billion. In preparation for meeting those heightened standards, we have hired an experienced Chief Compliance Officer and additional compliance personnel, and we are designing and implementing additional compliance systems and internal controls.

In addition to the CMS, the Bank's Risk Management System includes a Bank Secrecy Act (BSA) department responsible for designing and implementing processes to support business line efforts meet the requirements of BSA and anti-money laundering (AML) regulations of the Department of Treasury, the Internal Revenue Service and the Office of Foreign Assets Control (OFAC) relating to combatting money laundering, terrorist financing, tax evasion and other financial crimes. As with the CMS requirements, the BSA, AML and OFAC systems being designed and implemented are intended to meet the heightened standards applicable to banks with more than $10 billion in assets. To date, the BSA department has implemented processes to identify, measure, monitor, control, and manage compliance risk as outlined within applicable BSA, AML, and OFAC requirements, and has recently separated the oversight of BSA compliance from the compliance department itself, adding a BSA Officer who reports to the Chief Risk Officer and reorganizing distributed BSA responsibilities under the BSA Officer. We are continuing to assess the adequacy of BSA resources and we are designing and implementing additional BSA compliance systems and internal controls required by the heightened standards for banks with over $10 billion in assets.
Additionally, Corporate Compliance, BSA, and the Company's senior management have established tracking processes for monitoring the status of pending regulations and implementing regulatory requirements as they are published and become effective.

**Strategic Risk Management**

Strategic risk is the risk to current or anticipated earnings, capital or enterprise value arising from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes.

Strategic risk is managed by the Board and senior management through development of strategic plans, successful implementation of business initiatives and reporting to the Board and its committees.

**Reputation Risk Management**

Reputation risk is defined as the risk to current or anticipated earnings, capital or enterprise value arising from negative public opinion.

We believe that we have an excellent reputation in the community primarily due to our longevity and significant outreach to the communities we serve.

**Accounting Developments**

See Financial Statements and Supplementary Data—Note 1, *Summary of Significant Accounting Policies*, for a discussion of accounting developments.

**ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Market Risk Management**

Market risk is defined as the sensitivity of income, fair value measurements and capital to changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates or prices. The primary market risks that we are exposed to are price and interest rate risks. Price risk is defined as the risk to current or anticipated earnings or capital arising from changes in the value of either assets or liabilities that are entered into as part of distributing or managing risk. Interest rate risk is defined as risk to current or anticipated earnings or capital arising from movements in interest rates.

For the Company, price and interest rate risks arise from the financial instruments and positions we hold. This includes loans, mortgage servicing rights, investment securities, deposits, borrowings, long-term debt and derivative financial instruments. Due to the nature of our current operations, we are not subject to foreign currency exchange or commodity price risk. Our real estate loan portfolio is subject to risks associated with the local economies of our various markets and, in particular, the regional economy of the western United States, including Hawaii.

Our price and interest rate risks are managed by the Bank’s Asset/Liability Management Committee ("ALCO"), a management committee that identifies and manages the sensitivity of earnings or capital to changing interest rates to achieve our overall financial objectives. ALCO is a management-level committee whose members include the Chief Investment Officer, acting as the chair, the Chief Executive Officer, Chief Financial Officer and other members of management. The committee meets monthly and is responsible for:

- understanding the nature and level of the Company's interest rate risk and interest rate sensitivity;
- assessing how that risk fits within our overall business strategies;
- ensuring an appropriate level of rigor and sophistication in the risk management process for the overall level of risk;
- complying with and reviewing the asset/liability management policy; and
- formulating and implementing strategies to improve balance sheet mix and earnings.

The Finance Committee of the Bank's Board provides oversight of the asset/liability management process, reviews the results of interest rate risk analysis and approves submission of the relevant policies to the board.

The spread between the yield on interest-earning assets and the cost of interest-bearing liabilities and the relative dollar amounts of these assets and liabilities are the principal items affecting net interest income. Changes in net interest rates (interest rate risk) are influenced to a significant degree by the repricing characteristics of assets and liabilities (timing risk), the relationship between various rates (basis risk), customer options (option risk) and changes in the shape of the yield curve (time-sensitive risk). We manage the available-for-sale investment securities portfolio while maintaining a balance between risk and return. The Company's funding strategy is to grow core deposits while we efficiently supplement using wholesale borrowings.

We estimate the sensitivity of our net interest income to changes in market interest rates using an interest rate simulation model that includes assumptions related to the level of balance sheet growth, deposit repricing characteristics and the rate of prepayments for multiple interest rate change scenarios. Interest rate sensitivity depends on certain repricing characteristics in our interest-earnings assets and interest-bearing liabilities, including the maturity structure of assets and liabilities and their repricing characteristics during the periods of changes in market interest rates. Effective interest rate risk management seeks to ensure both assets and liabilities respond to changes in interest rates within an acceptable timeframe, minimizing the impact of interest rate changes on net interest income and capital. Interest rate sensitivity is measured as the difference between the volume of assets and liabilities, at a point in time, that are subject to repricing at various time horizons, known as interest rate sensitivity gaps.

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The following table presents sensitivity gaps for these different intervals.

| (dollars in thousands) | December 31, 2017<br>3 Mos. or Less | More Than 3 Mos. to 6 Mos. | More Than 6 Mos. to 12 Mos. | More Than 12 Mos. to 3 Yrs. | More Than 3 Yrs. to 5 Yrs. | More Than 5 Yrs. | Non-Rate-Sensitive | Total |
|---|---|---|---|---|---|---|---|---|
| Interest-earning assets: | | | | | | | | |
| Cash & cash equivalents | $72,718 | $— | $— | $— | $— | $— | $— | $72,718 |
| FHLB Stock | — | — | — | — | — | 46,639 | — | 46,639 |
| Investment securities(1) | 37,240 | 35,978 | 46,017 | 210,030 | 135,838 | 439,201 | — | 904,304 |
| Mortgage loans held for sale | 607,445 | 67 | 136 | 598 | 689 | 1,967 | — | 610,902 |
| Loans held for investment(1) | 1,398,210 | 323,288 | 514,689 | 970,991 | 585,363 | 713,925 | — | 4,506,466 |
| Total interest-earning assets | 2,115,613 | 359,333 | 560,842 | 1,181,619 | 721,890 | 1,201,732 | — | 6,141,029 |
| Non-interest-earning assets | — | — | — | — | — | — | 601,012 | 601,012 |
| Total assets | $2,115,613 | $359,333 | $560,842 | $1,181,619 | $721,890 | $1,201,732 | $601,012 | $6,742,041 |
| Interest-bearing liabilities: | | | | | | | | |
| NOW accounts(2) | $461,349 | $— | $— | $— | $— | $— | $— | $461,349 |
| Statement savings accounts(2) | 293,858 | — | — | — | — | — | — | 293,858 |
| Money market accounts(2) | 1,834,154 | — | — | — | — | — | — | 1,834,154 |
| Certificates of deposit | 395,769 | 271,297 | 237,928 | 255,139 | 30,555 | 1 | — | 1,190,689 |
| FHLB advances | 933,611 | — | 30,000 | 10,000 | — | 5,590 | — | 979,201 |
| Long-term debt(3) | 60,274 | — | — | — | — | 65,000 | — | 125,274 |
| Total interest-bearing liabilities | 3,979,015 | 271,297 | 267,928 | 265,139 | 30,555 | 70,591 | — | 4,884,525 |
| Non-interest bearing liabilities | — | — | — | — | — | — | 1,153,136 | 1,153,136 |
| Equity | — | — | — | — | — | — | 704,380 | 704,380 |
| Total liabilities and shareholders' equity | $3,979,015 | $271,297 | $267,928 | $265,139 | $30,555 | $70,591 | $1,857,516 | $6,742,041 |
| Interest sensitivity gap | $(1,863,402) | $88,036 | $292,914 | $916,480 | $691,335 | $1,131,141 | | |
| Cumulative interest sensitivity gap | $(1,863,402) | $(1,775,366) | $(1,482,452) | $(565,972) | $125,363 | $1,256,504 | | |
| Cumulative interest sensitivity gap as a percentage of total assets | (28)% | (26)% | (22)% | (8)% | 2% | 19% | | |
| Cumulative interest-earning assets as a percentage of cumulative interest-bearing liabilities | 53% | 58% | 67% | 88% | 103% | 126% | | |

(1) Based on contractual maturities, repricing dates and forecasted principal payments assuming normal amortization and, where applicable, prepayments.
(2) Assumes 100% of interest-bearing non-maturity deposits are subject to repricing in three months or less.
(3) Based on contractual maturity.

As of December 31, 2017, the Bank's cumulative interest sensitivity gap was positive, resulting in an asset-sensitive position. Therefore, net interest income would be expected to rise in the long term if interest rates were to rise without changing the slope of the yield curve. The Bank is liability-sensitive in the "three months or less" period which generally indicates that net interest income would be expected to fall in the short term if interest rates were to rise, though deposit interest rate increases generally lag market rate increases.

Changes in the mix of interest-earning assets or interest-bearing liabilities can either increase or decrease the net interest margin, without affecting interest rate sensitivity. In addition, the interest rate spread between an earning asset and its funding

liability can vary significantly, while the timing of repricing for both the asset and the liability remains the same, thereby impacting net interest income. This characteristic is referred to as basis risk. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities that are not reflected in the interest rate sensitivity analysis. These prepayments may have a significant impact on our net interest margin. Because of these factors, an interest sensitivity gap analysis may not provide an accurate assessment of our actual exposure to changes in interest rates.

The estimated impact on our net interest income over a time horizon of one year and the change in net portfolio value as of December 31, 2017 and 2016 are provided in the table below. For the scenarios shown, the interest rate simulation assumes an instantaneous and sustained shift in market interest rates and no change in the composition or size of the balance sheet.

| | December 31, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| Change in Interest Rates | Percentage Change | | | |
| (basis points) [1] | Net Interest Income [2] | Net Portfolio Value [3] | Net Interest Income [2] | Net Portfolio Value [3] |
| +200 | (0.5)% | (8.2)% | 2.8 % | (6.2)% |
| +100 | (0.2) | (4.2) | 1.4 | (3.1) |
| -100 | 1.9 | (0.9) | 1.1 | (3.5) |
| -200 | 2.3 % | (4.8)% | (2.8)% | (5.6)% |

(1) For purposes of our model, we assume interest rates will not go below zero. This "floor" limits the effect of a potential negative interest rate shock in a low rate environment like the one we are currently experiencing.
(2) This percentage change represents the impact to net interest income for a one-year period, assuming there is no change in the structure of the balance sheet.
(3) This percentage change represents the impact to the net present value of equity, assuming there is no change in the structure of the balance sheet.

At December 31, 2017, we believe our net interest income sensitivity did not exhibit a strong bias to either an increase in interest rates or a decline in interest rates. Since December 31, 2016, the interest rate sensitivity of the Company’s assets and liabilities both decreased, with a greater decrease in the interest rate sensitivity of the Company’s liabilities. The changes in sensitivity reflect the impact of both higher market interest rates and changes to overall balance sheet composition. Some of the assumptions made in the simulation model may not materialize and unanticipated events and circumstances will occur. Modeling results in extreme interest rate decline scenarios may encounter negative rate assumptions which may cause the results to be inherently unreliable. In addition, the simulation model does not take into account any future actions that we could undertake to mitigate an adverse impact due to changes in interest rates from those expected, in the actual level of market interest rates or competitive influences on our deposits.

***Risk Management Instruments***

We originate fixed-rate residential home mortgages primarily for sale into the secondary market. These loans are hedged against interest rate fluctuations from the time of the loan commitment until the loans are sold.

We have been able to manage interest rate risk by matching both on- and off-balance sheet assets and liabilities, within reasonable limits, through a range of potential rate and repricing characteristics. Where appropriate, we also use hedging techniques including the use of forward sale commitments, option contracts and interest rate swaps.

In order to protect the economic value of our mortgage servicing rights, we employ hedging strategies utilizing derivative financial instruments including interest rate swaps, forward interest rate swaps, options on interest rate swap contracts and commitments to purchase mortgage backed securities. We utilize these instruments as economic hedges and changes in the fair value of these instruments are recognized in current income as a component of mortgage servicing income. Our mortgage servicing rights hedging policy requires management to hedge the impact on the value of our mortgage servicing rights for a low-probability, extreme and sudden increase in interest rates.

The following table presents the financial instruments classified as derivatives.

| | At December 31, 2017 | | |
|---|---|---|---|
| | | Fair value | |
| (in thousands) | Notional amount | Asset derivatives | Liability derivatives |
| Forward sale commitments | $1,687,658 | $1,311 | $(1,445) |
| Interest rate swaptions | 120,000 | — | — |
| Interest rate lock commitments | 472,733 | 12,950 | (25) |
| Interest rate swaps | 1,869,000 | 12,172 | (23,654) |
| Eurodollar Futures | 3,287,000 | — | (101) |
| | $7,436,391 | $26,433 | $(25,225) |

We may implement other hedge transactions using forward loan sales, futures, option contracts and interest rate swaps, interest rate floors, financial futures, forward rate agreements and U.S. Treasury options on futures or bonds. Prior to considering any hedging activities, we analyze the costs and benefits of the hedge in comparison to other viable alternative strategies.

**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the shareholders and the Board of Directors of HomeStreet, Inc.

**Opinion on the Financial Statements**

We have audited the accompanying consolidated statements of financial condition of HomeStreet, Inc. and subsidiaries (the "Company") as of December 31, 2017 and 2016, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control - Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 6, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.

**Basis for Opinion**

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Deloitte & Touche LLP

Seattle, Washington
March 6, 2018

We have served as the Company's auditor since 2013.

**HOMESTREET, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

| | At December 31, | |
|---|---|---|
| (in thousands, except share data) | 2017 | 2016 |
| ASSETS | | |
| Cash and cash equivalents (including interest-earning instruments of $30,268 and $34,615) | $72,718 | $53,932 |
| Investment securities (includes $846,268 and $993,990 carried at fair value) | 904,304 | 1,043,851 |
| Loans held for sale (includes $577,313 and $656,334 carried at fair value) | 610,902 | 714,559 |
| Loans held for investment (net of allowance for loan losses of $37,847 and $34,001; includes $5,477 and $17,988 carried at fair value) | 4,506,466 | 3,819,027 |
| Mortgage servicing rights (includes $258,560 and $226,113 carried at fair value) | 284,653 | 245,860 |
| Other real estate owned | 664 | 5,243 |
| Federal Home Loan Bank stock, at cost | 46,639 | 40,347 |
| Premises and equipment, net | 104,654 | 77,636 |
| Goodwill | 22,564 | 22,175 |
| Other assets | 188,477 | 221,070 |
| Total assets | $6,742,041 | $6,243,700 |
| LIABILITIES AND SHAREHOLDERS’ EQUITY | | |
| Liabilities: | | |
| Deposits | $4,760,952 | $4,429,701 |
| Federal Home Loan Bank advances | 979,201 | 868,379 |
| Accounts payable and other liabilities | 172,234 | 191,189 |
| Long-term debt | 125,274 | 125,147 |
| Total liabilities | 6,037,661 | 5,614,416 |
| Commitments and contingencies (Note 13) | | |
| Shareholders’ equity: | | |
| Preferred stock, no par value, authorized 10,000 shares, issued and outstanding, 0 shares and 0 shares | — | — |
| Common stock, no par value, authorized 160,000,000 shares, issued and outstanding, 26,888,288 shares and 26,800,183 shares | 511 | 511 |
| Additional paid-in capital | 339,009 | 336,149 |
| Retained earnings | 371,982 | 303,036 |
| Accumulated other comprehensive loss | (7,122) | (10,412) |
| Total shareholders' equity | 704,380 | 629,284 |
| Total liabilities and shareholders' equity | $6,742,041 | $6,243,700 |

See accompanying notes to consolidated financial statements.

**HOMESTREET, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands, except share data) | 2017 | 2016 | 2015 |
| Interest income: | | | |
| Loans | $215,363 | $ 190,667 | $ 152,621 |
| Investment securities | 21,753 | 18,394 | 11,590 |
| Other | 567 | 476 | 903 |
| | 237,683 | 209,537 | 165,114 |
| Interest expense: | | | |
| Deposits | 23,912 | 19,009 | 11,801 |
| Federal Home Loan Bank advances | 12,589 | 6,030 | 3,668 |
| Federal funds purchased and securities sold under agreements to repurchase | 5 | 4 | 8 |
| Long-term debt | 6,067 | 4,043 | 1,104 |
| Other | 672 | 402 | 195 |
| | 43,245 | 29,488 | 16,776 |
| Net interest income | 194,438 | 180,049 | 148,338 |
| Provision for credit losses | 750 | 4,100 | 6,100 |
| Net interest income after provision for credit losses | 193,688 | 175,949 | 142,238 |
| Noninterest income: | | | |
| Net gain on loan origination and sale activities | 255,876 | 307,313 | 236,388 |
| Loan servicing income | 35,384 | 33,059 | 24,250 |
| Income from WMS Series LLC | 598 | 2,333 | 1,624 |
| Depositor and other retail banking fees | 7,221 | 6,790 | 5,881 |
| Insurance agency commissions | 1,904 | 1,619 | 1,682 |
| Gain on sale of investment securities available for sale | 489 | 2,539 | 2,406 |
| Bargain purchase gain | — | — | 7,726 |
| Other | 10,682 | 5,497 | 1,280 |
| | 312,154 | 359,150 | 281,237 |
| Noninterest expense: | | | |
| Salaries and related costs | 293,870 | 303,354 | 240,587 |
| General and administrative | 65,036 | 63,206 | 56,821 |
| Amortization of core deposit intangibles | 1,710 | 2,166 | 1,924 |
| Legal | 1,410 | 1,867 | 2,807 |
| Consulting | 3,467 | 4,958 | 7,215 |
| Federal Deposit Insurance Corporation assessments | 3,279 | 3,414 | 2,573 |
| Occupancy | 38,268 | 30,530 | 24,927 |
| Information services | 33,143 | 33,063 | 29,054 |
| Net (benefit) cost from operation and sale of other real estate owned | (530) | 1,764 | 660 |
| | 439,653 | 444,322 | 366,568 |
| Income before income taxes | 66,189 | 90,777 | 56,907 |
| Income tax (benefit) expense | (2,757) | 32,626 | 15,588 |
| NET INCOME | $68,946 | $ 58,151 | $ 41,319 |
| Basic income per share | $2.57 | $ 2.36 | $ 1.98 |
| Diluted income per share | $2.54 | $ 2.34 | $ 1.96 |
| Basic weighted average number of shares outstanding | 26,864,657 | 24,615,990 | 20,818,045 |
| Diluted weighted average number of shares outstanding | 27,092,019 | 24,843,683 | 21,059,201 |

See accompanying notes to consolidated financial statements.

**HOMESTREET, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Net income | $68,946 | $58,151 | $41,319 |
| Other comprehensive income (loss), net of tax: | | | |
| Unrealized gain (loss) on investment securities available for sale: | | | |
| Unrealized holding gain (loss) arising during the year, net of tax expense (benefit) of $1,942, $(3,400) and $(713) | 3,607 | (6,313) | (1,325) |
| Reclassification adjustment for net gains included in net income, net of tax expense (benefit) of $172, $889 and $(264) | (317) | (1,650) | (2,670) |
| Other comprehensive income (loss) | 3,290 | (7,963) | (3,995) |
| Comprehensive income | $72,236 | $50,188 | $37,324 |

See accompanying notes to consolidated financial statements.

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**HOMESTREET, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

| (in thousands, except share data) | Number of shares | Common stock | Additional paid-in capital | Retained earnings | Accumulated other comprehensive income (loss) | Total |
|---|---|---|---|---|---|---|
| Balance, December 31, 2014 | 14,856,611 | $ 511 | $96,615 | $203,566 | $ 1,546 | $302,238 |
| Net income | — | — | — | 41,319 | — | 41,319 |
| Share-based compensation expense | — | — | 1,267 | — | — | 1,267 |
| Common stock issued | 7,219,923 | — | 124,446 | — | — | 124,446 |
| Other comprehensive loss | — | — | — | — | (3,995) | (3,995) |
| Balance, December 31, 2015 | 22,076,534 | 511 | 222,328 | 244,885 | (2,449) | 465,275 |
| Net income | — | — | — | 58,151 | — | 58,151 |
| Share-based compensation expense | — | — | 1,788 | — | — | 1,788 |
| Common stock issued | 4,723,649 | — | 112,033 | — | — | 112,033 |
| Other comprehensive loss | — | — | — | — | (7,963) | (7,963) |
| Balance, December 31, 2016 | 26,800,183 | 511 | 336,149 | 303,036 | (10,412) | 629,284 |
| Net income | | — | | 68,946 | | 68,946 |
| Share-based compensation expense | | — | 2,502 | — | | 2,502 |
| Common stock issued | 88,105 | — | 358 | — | | 358 |
| Other comprehensive income | | — | | — | 3,290 | 3,290 |
| Balance, December 31, 2017 | 26,888,288 | $ 511 | $339,009 | $371,982 | $ (7,122) | $704,380 |

See accompanying notes to consolidated financial statements.

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**HOMESTREET, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | $ 68,946 | $ 58,151 | $ 41,319 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation, amortization and accretion | 22,645 | 15,667 | 14,877 |
| Provision for credit losses | 750 | 4,100 | 6,100 |
| Net fair value adjustment and gain on sale of loans held for sale | (218,331) | (268,104) | 9,632 |
| Fair value adjustment of loans held for investment | (1,030) | (354) | 2,000 |
| Origination of mortgage servicing rights | (78,412) | (90,520) | (76,417) |
| Change in fair value of mortgage servicing rights | 36,615 | 13,280 | 27,483 |
| Net gain on sale of investment securities | (489) | (2,539) | (2,406) |
| Net gain on sale of loans originated as held for investment | (4,600) | (2,607) | (456) |
| Net fair value adjustment, gain on sale and provision for losses on other real estate owned | (383) | 1,767 | 176 |
| Loss on disposal of fixed assets | 215 | 253 | 61 |
| Loss on lease abandonment | 5,054 | — | — |
| Net deferred income tax (benefit) expense | (2,094) | 31,490 | 16,389 |
| Share-based compensation expense | 2,856 | 2,062 | 1,060 |
| Bargain purchase gain | — | — | (7,726) |
| Origination of loans held for sale | (7,763,844) | (9,169,488) | (7,265,622) |
| Proceeds from sale of loans originated as held for sale | 8,084,916 | 9,379,720 | 7,243,990 |
| Changes in operating assets and liabilities: | | | |
| Decrease (increase) in accounts receivable and other assets | 27,711 | (60,946) | (12,151) |
| (Decrease) increase in accounts payable and other liabilities | (19,957) | 43,255 | 10,002 |
| Net cash provided by (used in) operating activities | 160,568 | (44,813) | 8,311 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchase of investment securities | (368,071) | (743,861) | (247,713) |
| Proceeds from sale of investment securities | 397,492 | 164,429 | 112,259 |
| Principal repayments and maturities of investment securities | 105,801 | 112,245 | 36,798 |
| Proceeds from sale of other real estate owned | 6,105 | 5,672 | 6,110 |
| Proceeds from sale of loans originated as held for investment | 324,745 | 153,518 | 34,111 |
| Proceeds from sale of mortgage servicing rights | — | — | 4,325 |
| Mortgage servicing rights purchased from others | (565) | — | (9) |
| Capital expenditures related to other real estate owned | (57) | (720) | — |
| Origination of loans held for investment and principal repayments, net | (998,638) | (609,981) | (476,062) |
| Proceeds from sale of property and equipment | — | 1,148 | — |
| Purchase of property and equipment | (42,286) | (24,482) | (20,560) |
| Net cash acquired from acquisitions | 19,285 | 122,760 | 132,407 |
| Net cash used in investing activities | (556,189) | (819,272) | (418,334) |

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Increase in deposits, net | $ 309,798 | $ 919,497 | $ 111,906 |
| Proceeds from Federal Home Loan Bank advances | 10,972,200 | 14,734,636 | 10,618,900 |
| Repayment of Federal Home Loan Bank advances | (10,861,200 ) | (14,898,636 ) | (10,263,900 ) |
| Proceeds from federal funds purchased and securities sold under agreements to repurchase | 875,166 | 64,804 | 82,204 |
| Repayment of federal funds purchased and securities sold under agreements to repurchase | (875,166 ) | (64,804 ) | (132,204 ) |
| Proceeds from Federal Home Loan Bank stock repurchase | 187,766 | 284,662 | 153,657 |
| Purchase of Federal Home Loan Bank stock | (194,058 ) | (279,436 ) | (158,565 ) |
| Proceeds from debt issuance, net | (65 ) | 63,184 | — |
| (Payments) proceeds from equity raise, net | (45 ) | 58,713 | — |
| Proceeds from stock issuance, net | 11 | 2,713 | 178 |
| Excess tax benefit related to the exercise of stock options | — | — | 29 |
| Net cash provided by financing activities | 414,407 | 885,333 | 412,205 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 18,786 | 21,248 | 2,182 |
| CASH AND CASH EQUIVALENTS: | | | |
| Beginning of year | 53,932 | 32,684 | 30,502 |
| End of period | $ 72,718 | $ 53,932 | $ 32,684 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | | |
| Cash paid during the period for: | | | |
| Interest paid | $ 42,889 | $ 28,672 | $ 16,647 |
| Federal and state income taxes (refunded) paid , net | (21,885 ) | 14,441 | 11,328 |
| Non-cash activities: | | | |
| Loans held for investment foreclosed and transferred to other real estate owned | 1,125 | 2,056 | 4,396 |
| Loans transferred from held for investment to held for sale | 419,494 | 169,745 | 76,178 |
| Loans transferred from held for sale to held for investment | 100,049 | 12,311 | 25,668 |
| Ginnie Mae loans recognized with the right to repurchase, net | 3,534 | 6,775 | 7,857 |
| Simplicity acquisition: | | | |
| Assets acquired, excluding cash acquired | — | — | 738,279 |
| Liabilities assumed | — | — | 718,916 |
| Bargain purchase gain | — | — | 7,345 |
| Common stock issued | — | — | 124,214 |
| Orange County Business Bank acquisition: | | | |
| Assets acquired, excluding cash acquired | — | 165,786 | — |
| Liabilities assumed | — | 141,267 | — |
| Goodwill | — | 8,360 | — |
| Common stock issued | $ — | $ 50,373 | $ — |

See accompanying notes to consolidated financial statements.

**HomeStreet, Inc. and Subsidiaries**
**Notes to Consolidated Financial Statements**

**NOTE 1–SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

HomeStreet, Inc. and its wholly owned subsidiaries (the "Company") is a diversified financial services company serving customers primarily in the western United States, including Hawaii. The Company is principally engaged in commercial banking, mortgage banking, and consumer/retail banking activities. The Company's consolidated financial statements include the accounts of HomeStreet, Inc. and its wholly owned subsidiaries, HomeStreet Capital Corporation, HomeStreet Statutory Trusts and HomeStreet Bank (the "Bank"), and the Bank's subsidiaries, HomeStreet/WMS, Inc., HomeStreet Reinsurance, Ltd., Continental Escrow Company, HomeStreet Foundation, HS Properties, Inc., HS Evergreen Corporate Center LLC, Union Street Holdings LLC, HS Cascadia Holdings LLC and YNB Real Estate LLC. HomeStreet Bank was formed in 1986 and is a state-chartered commercial bank.

The Company's accounting and financial reporting policies conform to accounting principles generally accepted in the United States of America (U.S. GAAP). Inter-company balances and transactions have been eliminated in consolidation. In preparing the consolidated financial statements, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and revenues and expenses during the reporting periods and related disclosures. These estimates that require application of management's most difficult, subjective or complex judgments often result in the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. Management has made significant estimates in several areas, including the fair value of assets acquired and liabilities assumed in business combinations (Note 2, *Business Combinations*), allowance for credit losses (Note 5, *Loans and Credit Quality*), valuation of residential mortgage servicing rights and loans held for sale (Note 12, *Mortgage Banking Operations*), valuation of certain loans held for investment (Note 5, *Loans and Credit Quality*), valuation of investment securities (Note 4, *Investment Securities*), valuation of derivatives (Note 11, *Derivatives and Hedging Activities*), other real estate owned (Note 6, *Other Real Estate Owned*), and taxes (Note 14, *Income Taxes*). Actual results could differ materially from those estimates. Certain amounts in the financial statements from prior periods have been reclassified to conform to the current financial statement presentation.

Cash and Cash Equivalents

Cash and cash equivalents include cash, interest-earning overnight deposits at other financial institutions, and other investments with original maturities equal to three months or less. For the consolidated statements of cash flows, the Company considered cash equivalents to be investments that are readily convertible to known amounts, so near to their maturity that they present an insignificant risk of a change in fair value due to change in interest rates, and purchased in conjunction with cash management activities. Restricted cash of $4.4 million and $4.0 million at December 31, 2017 and 2016, respectively, is included in cash and cash equivalents for FNMA DUS pledged securities and related reserves. In addition, restricted cash of $1.2 million and $2.4 million at December 31, 2017 and 2016, respectively, is included in accounts receivable and other assets for reinsurance-related reserves.

Investment Securities

We classify investment securities as trading, held to maturity ("HTM"), or available for sale ("AFS") at the date of acquisition. Purchases and sales of securities are generally recorded on a trade-date basis. We include and record certain certificates of deposit that meet the definition of a security as HTM investments.

Investment securities that we might not hold until maturity are classified as AFS and are reported at fair value in the statement of financial condition. Fair value measurement is based upon quoted market prices in active markets, if available. If quoted prices in active markets are not available, fair value is measured using pricing models or other model-based valuation techniques such as the present value of future cash flows, which consider prepayment assumptions and other factors such as credit losses and market liquidity. Unrealized gains and losses are excluded from earnings and reported, net of tax, in other comprehensive income ("OCI"). Purchase premiums and discounts are recognized in interest income using the effective interest method over the life of the securities. Purchase premiums or discounts related to mortgage-backed securities are amortized or accreted using projected prepayment speeds. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

AFS investment securities in unrealized loss positions are evaluated for other-than-temporary impairment ("OTTI") at least quarterly. For AFS debt securities, a decline in fair value is considered to be other-than-temporary if the Company does not

expect to recover the entire amortized cost basis of the security. For AFS equity securities, the Company considers a decline in fair value to be other-than-temporary if it is probable that the Company will not recover its cost basis.
Debt securities are classified as HTM if the Company has both the intent and ability to hold those securities to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost adjusted for amortization of purchase premiums and accretion of purchase discounts. Transfers of securities from available for sale to held to maturity are accounted for at fair value as of the date of the transfer. The difference between the fair value and the par value at the date of transfer is considered a premium or discount and is accounted for accordingly. Any unrealized gain or loss at the date of the transfer is reported in OCI, and is amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount, and will offset or mitigate the effect on interest income of the amortization of the premium or discount for that held to maturity security.
Impairment may result from credit deterioration of the issuer or collateral underlying the security. In performing an assessment of recoverability, all relevant information is considered, including the length of time and extent to which fair value has been less than the amortized cost basis, the cause of the price decline, credit performance of the issuer and underlying collateral, and recoveries or further declines in fair value subsequent to the balance sheet date.

For debt securities, the Company measures and recognizes OTTI losses through earnings if (1) the Company has the intent to sell the security or (2) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. In these circumstances, the impairment loss is equal to the full difference between the amortized cost basis and the fair value of the security. For securities that are considered other-than-temporarily-impaired that the Company has the intent and ability to hold in an unrealized loss position, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to other factors, which is recognized as a component of OCI.

For equity securities, the Company recognizes OTTI losses through earnings if the Company intends to sell the security. The Company also considers other relevant factors, including its intent and ability to retain the security for a period of time sufficient to allow for any anticipated recovery in market value, and whether evidence exists to support a realizable value equal to or greater than the carrying value. Any impairment loss on an equity security is equal to the full difference between the amortized cost basis and the fair value of the security.

Federal Home Loan Bank Stock

As a borrower from the Federal Home Loan Bank of Des Moines and the Federal Home Loan Bank of San Francisco ("FHLB"), the Company is required to purchase an amount of FHLB stock based on our outstanding borrowings with the FHLB. This stock is used as collateral to secure the borrowings from the FHLB and is accounted for as a cost-method investment. FHLB stock is reviewed at least quarterly for possible OTTI, which includes an analysis of the FHLB's cash flows, capital needs and long-term viability.

Loans Held for Sale

Loans originated for sale in the secondary market, which is our principal market, or as whole loan sales are classified as loans held for sale. Management has elected the fair value option for all single family loans held for sale (originated with the intent to be held for sale) and records these loans at fair value. The fair value of loans held for sale is generally based on observable market prices from other loans in the secondary market that have similar collateral, credit, and interest rate characteristics. If quoted market prices are not readily available, the Company may consider other observable market data such as dealer quotes for similar loans or forward sale commitments. In certain cases, the fair value may be based on a discounted cash flow model. Gains and losses from changes in fair value on loans held for sale are recognized in net gain on mortgage loan origination and sale activities within noninterest income. Direct loan origination costs and fees for single family loans originated as held for sale are recognized in earnings. The change in fair value of loans held for sale is primarily driven by changes in interest rates subsequent to loan funding and changes in the fair value of related servicing asset, resulting in revaluation adjustments to the recorded fair value. The use of the fair value option allows the change in the fair value of loans to more effectively offset the change in the fair value of derivative instruments that are used as economic hedges to loans held for sale.

Multifamily and SBA loans held for sale are accounted for at the lower of amortized cost or fair value. Related gains and losses are recognized in net gain on mortgage loan origination and sale activities. Direct loan origination costs and fees for multifamily and SBA loans classified as held for sale are deferred at origination and recognized in earnings at the time of sale.

Loans Held for Investment

Loans held for investment are reported at the principal amount outstanding, net of cumulative charge-offs, interest applied to principal (for loans accounted for using the cost recovery method), unamortized net deferred loan origination fees and costs and unamortized premiums or discounts on purchased loans. Deferred fees and costs and premiums and discounts are amortized over the contractual terms of the underlying loans using the constant effective yield (the interest method) or straight-line method. Interest on loans is accrued and recognized as interest income at the contractual rate of interest. A determination is made as of the loan commitment date as to whether a loan will be held for sale or held for investment. This determination is based primarily on the type of loan or loan program and its related profitability characteristics.

When a loan is designated as held for investment, the intent is to hold these loans for the foreseeable future or until maturity or pay-off. If subsequent changes occur, the Company may change its intent to hold these loans. Once a determination has been made to sell such loans, they are immediately transferred to loans held for sale and carried at the lower of cost or fair value.

From time to time, the Company will originate loans to facilitate the sale of other real estate owned without a sufficient down payment from the borrower. Such loans are accounted for using the installment method and any gain on sale is deferred.

*Nonaccrual Loans*

Loans are placed on nonaccrual status when the full and timely collection of principal and interest is doubtful, generally when the loan becomes 90 days or more past due for principal or interest payment or if part of the principal balance has been charged off.

All payments received on nonaccrual loans are accounted for using the cost recovery method. Under the cost recovery method, all cash collected is applied to first reduce the principal balance. A loan may be returned to accrual status if all delinquent principal and interest payments are brought current and the collectability of the remaining principal and interest payments in accordance with the loan agreement is reasonably assured. Loans that are well-secured and in the process of collection are maintained on accrual status, even if they are 90 days or more past due. Loans whose repayments are insured by the Federal Housing Administration ("FHA") or guaranteed by the Department of Veterans' Affairs ("VA") are maintained on accrual status even if 90 days or more past due.

*Impaired Loans*

A loan is considered impaired when it is probable that all contractual principal and interest payments due will not be collected in accordance with the terms of the loan agreement. Factors considered by management in determining whether a loan is impaired include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due.

*Troubled Debt Restructurings*

A loan is accounted for and reported as a troubled debt restructuring (“TDR”) when, for economic or legal reasons, we grant a concession to a borrower experiencing financial difficulty that we would not otherwise consider. A restructuring that results in only an insignificant delay in payment is not considered a concession. A delay may be considered insignificant if the payments subject to the delay are insignificant relative to the unpaid principal or collateral value and the contractual amount due, or the delay in timing of the restructured payment period is insignificant relative to the frequency of payments, the debt's original contractual maturity or original expected duration.

TDRs are designated as impaired because interest and principal payments will not be received in accordance with original contract terms. TDRs that are performing and on accrual status as of the date of the modification remain on accrual status. TDRs that are nonperforming as of the date of modification generally remain as nonaccrual until the prospect of future payments in accordance with the modified loan agreement is reasonably assured, generally demonstrated when the borrower maintains compliance with the restructured terms for a predetermined period, normally at least six months. TDRs with temporary below-market concessions remain designated as a TDR and impaired regardless of the accrual or performance status until the loan is paid off. However, if the TDR loan has been modified in a subsequent restructure with market terms and the borrower is not currently experiencing financial difficulty, then the loan may be de-designated as a TDR.

Allowance for Credit Losses

Credit quality within the loans held for investment portfolio is continuously monitored by management and is reflected within the allowance for credit losses. The allowance for credit losses is maintained at a level that, in management's judgment, is appropriate to cover losses inherent within the Company’s loans held for investment portfolio, including unfunded credit

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commitments, as of the balance sheet date. The allowance for loan losses, as reported in our consolidated statements of financial condition, is adjusted by a provision for loan losses, which is recognized in earnings, and reduced by the charge-off of loan amounts, net of recoveries.

The loss estimation process involves procedures to appropriately consider the unique characteristics of its two loan portfolio segments, the consumer loan portfolio segment and the commercial loan portfolio segment. These two segments are further disaggregated into loan classes, the level at which credit risk is monitored. When computing allowance levels, credit loss assumptions are estimated using a model that categorizes loan pools based on loss history, delinquency status and other credit trends and risk characteristics. Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the overall loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for credit losses in those future periods.

Credit quality is assessed and monitored by evaluating various attributes and utilizes such information in our evaluation of the adequacy of the allowance for credit losses. The following provides the credit quality indicators and risk elements that are most relevant and most carefully considered and monitored for each loan portfolio segment.

*Consumer Loan Portfolio Segment*

The consumer loan portfolio segment is comprised of the single family and home equity loan classes, which are underwritten after evaluating a borrower’s capacity, credit, and collateral. Capacity refers to a borrower’s ability to make payments on the loan. Several factors are considered when assessing a borrower’s capacity, including the borrower’s employment, income, current debt, assets, and level of equity in the property. Credit refers to how well a borrower manages their current and prior debts as documented by a credit report that provides credit scores and the borrower’s current and past information about their credit history. Collateral refers to the type and use of property, occupancy, and market value. Property appraisals are obtained to assist in evaluating collateral. Loan-to-property value and debt-to-income ratios, loan amount, and lien position are also considered in assessing whether to originate a loan. These borrowers are particularly susceptible to downturns in economic trends such as conditions that negatively affect housing prices and demand and levels of unemployment.

*Commercial Loan Portfolio Segment*

The commercial loan portfolio segment is comprised of the commercial real estate, non-owner occupied, multifamily residential, construction/land development, owner occupied and commercial business loan classes, whose underwriting standards consider the factors described for single family and home equity loan classes as well as others when assessing the borrower’s and associated guarantors or other related party’s financial position. These other factors include assessing liquidity, the level and composition of net worth, leverage, considering all other lender amounts and position, an analysis of cash expected to flow through the obligors including the outflow to other lenders, and prior experience with the borrower. This information is used to assess adequate financial capacity, profitability, and experience. Ultimate repayment of these loans is sensitive to interest rate changes, general economic conditions, liquidity, and availability of long-term financing.

*Loan Loss Measurement*

Allowance levels are influenced by loan volumes, loan asset quality ratings ("AQR") migration or delinquency status, historic loss experience and other conditions influencing loss expectations, such as economic conditions. The methodology for evaluating the adequacy of the allowance for loan losses has two basic components: first, an asset-specific component involving the identification of impaired loans and the measurement of impairment for each individual loan identified; and second, a formula-based component for estimating probable loan principal losses for all other loans.

*Impaired Loans*

When a loan is identified as impaired, impairment is measured based on net realizable value, or the difference between the discounted value of the expected future cash flows, based on the original effective interest rate, and the recorded investment balance of the loan. For impaired loans, we recognize impairment if we determine that the net realizable value of the impaired loan is less than the recorded investment of the loan (net of previous charge-offs and deferred loan fees and costs), except when the sole remaining source of collection is the underlying collateral. In these cases impairment is measured as the difference between the recorded investment balance of the loan and the fair value of the collateral. The fair value of the collateral is adjusted for the estimated cost to sell if repayment or satisfaction of a loan is dependent on the sale (rather than only on the operation) of the collateral.

The starting point for determining the fair value of collateral is through obtaining external appraisals. Generally, collateral values for impaired loans are updated every twelve months, either from external third parties or in-house certified appraisers. A third party appraisal is required at least annually. Third party appraisals are obtained from a pre-approved list of independent, third party, local appraisal firms. Approval and addition to the list is based on experience, reputation, character, consistency and knowledge of the respective real estate market. Generally, appraisals are internally reviewed by the appraisal services group to ensure the quality of the appraisal and the expertise and independence of the appraiser. For performing consumer segment loans secured by real estate that are classified as collateral dependent, the Bank determines the fair value estimates semi-annually using automated valuation services. Once the impairment amount is determined an asset-specific allowance is provided for equal to the calculated impairment and included in the allowance for loan losses. If the calculated impairment is determined to be permanent or not recoverable, the impairment will be charged off. Factors considered by management in determining if impairment is permanent or not recoverable include whether management judges the loan to be uncollectible, repayment is deemed to be protracted beyond reasonable time frames or the loss becomes evident owing to the borrower's lack of assets or, for single family loans, the loan is 180 days or more past due unless both well-secured and in the process of collection.

*Estimate of Probable Loan Losses*

In estimating the formula-based component of the allowance for loan losses, loans are segregated into loan classes. Loans are designated into loan classes based on loans pooled by product types and similar risk characteristics or areas of risk concentration.

In determining the allowance for loan losses we derive an estimated credit loss assumption from a model that categorizes loan pools based on loan type and AQR or delinquency bucket. This model calculates an expected loss percentage for each loan category by considering the probability of default, based on the migration of loans from performing to loss by AQR or delinquency buckets using two-year analysis periods for commercial segments and one-year analysis periods for consumer segments, and the potential severity of loss, based on the aggregate net lifetime losses incurred per loan class.

The formula-based component of the allowance for loan losses also considers qualitative factors for each loan class, including changes in the following: (1) lending policies and procedures; (2) international, national, regional and local economic business conditions and developments that affect the collectability of the portfolio, including the condition of various markets; (3) the nature and volume of the loan portfolio including the terms of the loans; (4) the experience, ability, and depth of the lending management and other relevant staff; (5) the volume and severity of past due and adversely classified or graded loans and the volume of nonaccrual loans; (6) the quality of our loan review system; (7) the value of underlying collateral for collateral-dependent loans. Additional factors include (8) the existence and effect of any concentrations of credit, and changes in the level of such concentrations and (9) the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio. Qualitative factors are expressed in basis points and are adjusted downward or upward based on management's judgment as to the potential loss impact of each qualitative factor to a particular loan pool at the date of the analysis.

*Unfunded Loan Commitments*

The Company maintains a separate allowance for losses on unfunded loan commitments, which is included in accounts payable and other liabilities on the consolidated statements of financial condition. Management estimates the amount of probable losses by calculating a one-year commitment usage factor and applying the loss factors used in the allowance for loan loss methodology to the results of the usage calculation to estimate the liability for credit losses related to unfunded commitments for each loan type.

Other Real Estate Owned

Other real estate owned ("OREO") represents real estate acquired for debts previously contracted with the Company, generally through the foreclosure of loans. In certain cases, such as foreclosures on loans involving both the Company and other participating lenders, other real estate owned may be held in the form of an investment in an unconsolidated legal entity that is in-substance real estate. These properties are initially recorded at the net realizable value (fair value of collateral less estimated costs to sell). Upon transfer of a loan to other real estate owned, an appraisal is obtained and any excess of the loan balance over the net realizable value is charged against the allowance for loan losses. The Company allows up to 90 days after foreclosure to finalize determination of net realizable value. Subsequent declines in net realizable value identified from the ongoing analysis of such properties are recognized in current period earnings within noninterest expense as a provision for losses on other real estate owned. The net realizable value of these assets is reviewed and updated at least every six months depending on the type of property, or more frequently as circumstances warrant.

As part of our subsequent events analysis process, we review updated independent third-party appraisals received and internal collateral valuations received subsequent to the reporting period-end to determine whether the fair value of loan collateral or OREO has changed. Additionally, we review agreements to sell OREO properties executed prior to and subsequent to the reporting period-end to identify changes in the fair value of OREO properties. If we determine that current valuations have changed materially from the prior valuations, we record any additional loan impairments or adjustments to OREO carrying values as of the end of the prior reporting period.

From time to time the Company may elect to accelerate the disposition of certain OREO properties in a time frame faster than the expected marketing period assumed in the appraisal supporting our valuation of such properties. At the time a property is identified and the decision to accelerate its disposition is made, that property's underlying fair value is re-measured. Generally, to achieve an accelerated time frame in which to sell a property, the price that the Company is willing to accept for the disposition of the property decreases. Accordingly, the net realizable value of these properties is adjusted to reflect this change in valuation.

Mortgage Servicing Rights

We initially record all mortgage servicing rights ("MSRs") at fair value. For subsequent measurement of MSRs, accounting standards permit the election of either fair value or the lower of amortized cost or fair value. Management has elected to account for single family MSRs at fair value during the life of the MSR, with changes in fair value recorded through current period earnings. Fair value adjustments encompass market-driven valuation changes as well as modeled amortization involving the run-off of value that occurs due to the passage of time as individual loans are paid by borrowers. We account for multifamily and SBA MSRs at the lower of amortized cost or fair value.

MSRs are recorded as separate assets on our consolidated statements of financial condition upon purchase of the rights or when we retain the right to service loans that we have sold. Net gains on mortgage loan origination and sale activities depend, in part, on the initial fair value of MSRs, which is based on a discounted cash flow model.

Mortgage servicing income includes the changes in fair value over the reporting period of both our single family MSRs and the derivatives used to economically hedge our single family MSRs. Subsequent fair value measurements of single family MSRs, which are not traded in an active market with readily observable market prices, are determined by considering the present value of estimated future net servicing cash flows. Changes in the fair value of single family MSRs result from changes in (1) model inputs and assumptions and (2) modeled amortization, representing the collection and realization of expected cash flows and curtailments over time. The significant model inputs used to measure the fair value of single family MSRs include assumptions regarding market interest rates, projected prepayment speeds, discount rates, estimated costs of servicing and other income and additional expenses associated with the collection of delinquent loans.

Market expectations about loan duration, and correspondingly the expected term of future servicing cash flows, may vary from time to time due to changes in expected prepayment activity, especially when interest rates rise or fall. Market expectations of increased loan prepayment speeds may negatively impact the fair value of the single family MSRs. Fair value is also dependent on the discount rate used in calculating present value, which is imputed from observable market activity and market participants. Management reviews and adjusts the discount rate on an ongoing basis. An increase in the discount rate would reduce the estimated fair value of the single family MSRs asset.

For further information on how the Company measures the fair value of its single family MSRs, including key economic assumptions and the sensitivity of fair value to changes in those assumptions, see Note 12, *Mortgage Banking Operations*.

Investment in WMS Series LLC

HomeStreet/WMS, Inc. (Windermere Mortgage Services, Inc.), a wholly owned and consolidated subsidiary of the Bank, has an affiliated business arrangement with Windermere Real Estate, WMS Series Limited Liability Company ("WMS LLC"). The Company and Windermere Real Estate each have 50% joint control over the governance of WMS LLC. The operations of WMS LLC, which is subdivided into 28 individual operating series, are recorded using the equity method of accounting. The Company recognizes its proportionate share of the results of operations of WMS LLC as income from WMS Series LLC in noninterest income within the Company's consolidated statements of operations.

Equity method investment income from WMS LLC was $598 thousand, $2.7 million, and $2.5 million for the years ended December 31, 2017, 2016 and 2015, respectively. The Company’s investment in WMS LLC was $2.0 million and $2.7 million, which is included in accounts receivable and other assets at December 31, 2017 and 2016, respectively.

The Company provides contracted services to WMS LLC related to accounting, loan shipping, loan underwriting, quality control, secondary marketing, and information systems support performed by Company employees on behalf of WMS LLC. The Company recorded contracted services income/(loss) of $844 thousand, $370 thousand, and $(960) thousand for the years ended December 31, 2017, 2016 and 2015, respectively. Income related to WMS LLC, including equity method investment income, is classified as income from WMS Series LLC in noninterest income within the consolidated statements of operations.

The Company purchased $574.3 million, $589.2 million and $616.9 million of single family mortgage loans from WMS LLC for the years ended December 31, 2017, 2016 and 2015, respectively. The Company provides a $25.0 million secured line of credit that allows WMS LLC to fund and close single family mortgage loans in the name of WMS LLC. The outstanding balance of the secured line of credit was $6.1 million and $6.9 million at December 31, 2017, and 2016, respectively. The highest outstanding balance of the secured line of credit was $13.0 million and $17.0 million during 2017 and 2016, respectively. The line of credit matures July 1, 2018.

Premises and Equipment

Furniture and equipment and leasehold improvements are stated at cost less accumulated depreciation or amortization and depreciated or amortized over the shorter of the useful life of the related asset or the term of the lease, generally 3 to 39 years, using the straight-line method. Management periodically evaluates furniture and equipment and leasehold improvements for impairment.

Goodwill

Goodwill is recorded upon completion of a business combination as the difference between the purchase price and the fair value of net identifiable assets acquired. Subsequent to initial recognition, the Company tests goodwill for impairment during the third quarter of each fiscal year, or more often if events or circumstances, such as adverse changes in the business climate, indicate there may be impairment. Goodwill was not impaired at December 31, 2017 or 2016, nor was any goodwill written off due to impairment during 2017, 2016 or 2015.

Changes in the carrying amount of goodwill are detailed in the following table:

| | (in thousands) |
|---|---|
| Goodwill balance at December 31, 2015 | $ 11,521 |
| Acquisitions | 10,654 |
| Goodwill balance at December 31, 2016 | 22,175 |
| Acquisitions | 389 |
| Goodwill balance at December 31, 2017 | $ 22,564 |

Trust Preferred Securities

Trust preferred securities allow investors the ability to invest in junior subordinated debentures of the Company, which provide the Company with long-term financing. The transaction begins with the formation of a Variable Interest Entity ("VIE") established as a trust by the Company. This trust issues two classes of securities: common securities, all of which are purchased and held by the Company and recorded in other assets on the consolidated statements of financial position, and trust preferred securities, which are sold to third-party investors. The trust holds subordinated debentures (debt) issued by the Company, which the Company records in long-term debt on the consolidated statement of financial position. The trust finances the purchase of the subordinated debentures with the proceeds from the sale of its common and preferred securities.

The junior subordinated debentures are the sole assets of the trust, and the coupon rate on the debt mirrors the dividend payment on the preferred security. The Company also has the right to defer interest payments for up to five years and has the right to call the preferred securities. These preferred securities are non-voting and do not have the right to convert to shares of the issuer. The trust's common equity securities issued to the Company are not considered to be equity at risk because the equity securities were financed by the trust through the purchase of the debentures from the Company. As a consequence, the Company holds no variable interest in the trust, and therefore, is not the trust's primary beneficiary.

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

From time to time, the Company may enter into federal funds transactions involving purchasing reserve balances on a short-term basis, or sales of securities under agreements to repurchase the same securities (“repurchase agreements”). Repurchase agreements are accounted for as secured financing arrangements with the obligation to repurchase securities sold reflected as a liability in the consolidated statements of financial condition. The dollar amount of securities underlying the repurchase agreements remains in investment securities available for sale. For short-term instruments, including securities sold under agreements to repurchase and federal funds purchased, the carrying amount is a reasonable estimate of the fair value.

Income Taxes

Our income tax expense, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits reflect management’s best assessment of estimated current and future taxes to be paid. We are subject to federal income tax and also state income taxes in a number of different states. Significant judgments and estimates are required in determining the consolidated income tax expense.
Deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, which will result in taxable or deductible amounts in the future. Changes in tax laws and rates may affect recorded deferred tax assets and liabilities and our effective tax rate in the future. Such changes are accounted for in the period of enactment, and are reflected as discrete tax items in the Company’s tax provision.
The Company records net deferred tax assets to the extent it is believed that these assets will more likely than not be realized. In making this determination, the Company considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies, and recent financial operations. After reviewing and weighing all of the positive and negative evidence, if the positive evidence outweighs the negative evidence, then the Company does not record a valuation allowance for deferred tax assets. If the negative evidence outweighs the positive evidence, then a valuation allowance for all or a portion of the deferred tax assets is recorded.
The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax laws and regulations in different jurisdictions. Accounting Standards Codification ("ASC") 740 states that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation processes, on the basis of the technical merits. We record unrecognized tax benefits as liabilities in accordance with ASC 740 (including any potential interest and penalties) and we adjust these liabilities when our judgment changes as a result of the evaluation of new information not previously available. Because of the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the unrecognized tax benefit liabilities. These differences will be reflected as increases or decreases to income tax expense in the period in which new information is available.

Derivatives and Hedging Activities

In order to reduce the risk of significant interest rate fluctuations on the value of certain assets and liabilities, such as certain mortgage loans held for sale or mortgage servicing rights, the Company utilizes derivatives, such as forward sale commitments, interest rate futures, option contracts, interest rate swaps and swaptions as risk management instruments in its hedging strategy.

All free-standing derivatives are required to be recorded on the consolidated statements of financial condition at fair value. As permitted under U.S. GAAP, the Company nets derivative assets and liabilities, and related collateral, when a legally enforceable master netting agreement exists between the Company and the derivative counterparty. The accounting for changes in fair value of a derivative depends on whether or not the transaction has been designated and qualifies for hedge accounting. Derivatives that are not designated as hedges are reported and measured at fair value through earnings. The Company does not use derivatives for trading purposes.

Before initiating a position where hedge accounting treatment is desired, the Company formally documents the relationship between the hedging instrument(s) and the hedged item(s), as well as its risk management objective and strategy.

For derivative instruments qualifying for hedge accounting treatment, the instrument is designed as either: (1) a hedge of changes in fair value of a recognized asset or liability or of an unrecognized firm commitment (a fair value hedge), or (2) a hedge of the variability in expected future cash flows associated with an existing recognized asset or liability or a probable forecasted transaction (a cash flow hedge).

Derivatives where the Company has not attempted to achieve or attempted but did not achieve hedge accounting treatment are referred to as economic hedges. The changes in fair value of these instruments are recorded in our consolidated statements of operations in the period in which the change occurs.

In a fair value hedge, changes in the fair value of the derivative and, to the extent that it is effective, changes in the fair value of the hedged asset or liability attributable to the hedged risk are recorded through current period earnings in the same financial statement category as the hedged item.

In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings during the same period in which the hedged item affects earnings. The ineffective portion is recognized immediately in noninterest income – other.

The Company discontinues hedge accounting when (1) it determines that the derivative is no longer expected to be highly effective in offsetting changes in fair value or cash flows of the designated item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated from the hedge relationship; or (4) it is no longer probable that a hedged forecasted transaction will occur by the end of the originally specified time period.

If the Company determines that the derivative no longer qualifies as a fair value or cash flow hedge and therefore hedge accounting is discontinued, the derivative (if retained) will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings. For a discontinued fair value hedge, the previously hedged item is no longer adjusted for changes in fair value.

When the Company discontinues hedge accounting because it is not probable that a forecasted transaction will occur, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings, and the gains and losses in accumulated other comprehensive income will be recognized immediately in earnings. When the Company discontinues hedge accounting because the hedging instrument is sold, terminated, or de-designated as a hedge, the amount reported in accumulated other comprehensive income through the date of sale, termination, or de-designation will continue to be reported in accumulated other comprehensive income until the forecasted transaction affects earnings. For fair value hedges that are de-designated, the net gain or loss on the underlying transactions being hedged is amortized to other noninterest income over the remaining contractual life of the loans at the time of de-designation. Changes in the fair value of these derivative instruments after de-designation of fair value hedge accounting are recorded in noninterest income in the consolidated statements of operations. As of December 31, 2017, the Company had no derivatives that were designated as fair value hedges or cash flow hedges.

Interest rate lock commitments ("IRLCs") for single family mortgage loans that we intend to sell are considered free-standing derivatives. For determining the fair value measurement of IRLCs we consider several factors including the fair value in the secondary market of the underlying loan resulting from the exercise of the commitment, the expected net future cash flows related to the associated servicing of the loan and the probability that the loan will not fund according to the terms of the commitment (referred to as a fall-out factor). The value of the underlying loan is affected primarily by changes in interest rates. Management uses forward sales commitments to hedge the interest rate exposure from IRLCs. A forward loan sale commitment protects the Company from losses on sales of loans arising from the exercise of the loan commitments by securing the ultimate sales price and delivery date of the loan. The Company takes into account various factors and strategies in determining the portion of the mortgage pipeline it wants to hedge economically. Unrealized and realized gains and losses on derivative contracts utilized for economically hedging the mortgage pipeline are recognized as part of the net gain on mortgage loan origination and sale activities within noninterest income.

The Company is exposed to credit risk if derivative counterparties to derivative contracts do not perform as expected. This risk consists primarily of the termination value of agreements where the Company is in a favorable position. The Company minimizes counterparty credit risk through credit approvals, limits, monitoring procedures, and obtaining collateral, as appropriate.

Share-Based Employee Compensation

The Company has share-based employee compensation plans as more fully discussed in Note 16, *Share-Based Compensation Plan*s. Under the accounting guidance for stock compensation, compensation expense recognized includes the cost for share-based awards, such as nonqualified stock options and restricted stock grants, which are recognized as compensation expense over the requisite service period (generally the vesting period) on a straight line basis. For stock awards that vest upon the satisfaction of a market condition, the Company estimates the service period over which the award is expected to vest. If all conditions to the vesting of an award are satisfied prior to the end of the estimated vesting period, any unrecognized compensation costs associated with the portion of the award that vested earlier than expected are immediately recognized in earnings.

Fair Value Measurement

The term "fair value" is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The Company’s approach is to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. The degree of management judgment involved in estimating the fair value of a financial instrument or other asset is dependent upon the availability of quoted market prices or observable market value inputs for internal valuation models, used for estimating fair value. For financial instruments that are actively traded in the marketplace or whose values are based on readily available market data, little judgment is necessary when estimating the instrument’s fair value. When observable market prices and data are not readily available, significant management judgment often is necessary to estimate fair value. In those cases, different assumptions could result in significant changes in valuation. See Note 17, *Fair Value Measurement*.

Commitments, Guarantees, and Contingencies

U.S. GAAP requires that a guarantor recognize, at the inception of a guarantee, a liability in an amount equal to the fair value of the obligation undertaken in issuing the guarantee. A guarantee is a contract that contingently requires the guarantor to pay a guaranteed party based upon: (a) changes in an underlying asset, liability or equity security of the guaranteed party; or (b) a third party’s failure to perform under a specified agreement. The Company initially records guarantees at the inception date fair value of the obligation assumed and records the amount in other liabilities. For indemnifications provided in sales agreements, a portion of the sale proceeds is allocated to the guarantee, which adjusts the gain or loss that would otherwise result from the transaction. For these indemnifications, the initial liability is amortized to income as the Company’s risk is reduced (i.e., over time as the Company's exposure is reduced or when the indemnification expires).

Contingent liabilities, including those that exists as a result of a guarantee or indemnification, are recognized when it becomes probable that a loss has been incurred and the amount of the loss is reasonably estimable. The contingent portion of a guarantee is not recognized if the estimated amount of loss is less than the carrying amount of the liability recognized at inception of the guarantee (as adjusted for any amortization).

The Company typically sells loans servicing retained in either a pooled loan securitization transaction with a government-sponsored enterprise ("GSE"), a whole loan sale to a GSE, or a whole loan sale to market participants such as other financial institutions, who purchase the loans for investment purposes or include them in a private label securitization transaction, or the loans are pooled and sold into a conforming loan securitization with a GSE, provided loan origination parameters conform to GSE guidelines. Substantially all of the Company’s loan sales are pooled loan securitization transactions with GSEs. These conforming loan securitizations are guaranteed by GSEs, such as Fannie Mae, Ginnie Mae and Freddie Mac.

The Company may be required to repurchase mortgage loans or indemnify loan purchasers due to defects in the origination process of the loan, such as documentation errors, underwriting errors and judgments, early payment defaults and fraud. These obligations expose the Company to any credit loss on the repurchased mortgage loans after accounting for any mortgage insurance that it may receive. Generally, the maximum amount of future payments the Company would be required to make for breaches of these representations and warranties would be equal to the unpaid principal balance of such loans that are deemed to have defects that were sold to purchasers plus, in certain circumstances, accrued and unpaid interest on such loans and certain expenses. See Note 13, *Commitments, Guarantees, and Contingencies*.

The Company sells multifamily loans through the Fannie Mae Delegated Underwriting and Servicing Program ("DUS"®) (DUS® is a registered trademark of Fannie Mae). that are subject to a credit loss sharing arrangement. The Company may also from time to time sell loans with recourse. When loans are sold with recourse or subject to a loss sharing arrangement, a liability is recorded based on the estimated fair value of the obligation under the accounting guidance for guarantees. These liabilities are included within other liabilities. See Note 13, *Commitments, Guarantees, and Contingencies*.

Earnings per Share

Basic earnings per share ("EPS") is computed by dividing net income available to common shareholders by the weighted average common shares outstanding during the period. Diluted EPS is computed by dividing net income available to common shareholders by the weighted average common shares outstanding, plus the effect of common stock equivalents (for example, stock options and unvested restricted stock). Stock options issued under stock-based compensation plans that have an antidilutive effect and shares of restricted stock whose vesting is contingent upon conditions that have not been satisfied at the end of the period are excluded from the computation of diluted EPS. Weighted average common shares outstanding include shares held by the HomeStreet, Inc. 401(k) Savings Plan.

Business Segments

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is regularly reviewed by the Company's chief operating decision maker for the purpose of allocating resources and evaluating the performance of the Company's businesses. The results for these business segments are based on management’s accounting process, which assigns income statement items and assets to each responsible operating segment. This process is dynamic and is based on management's view of the Company's operations. See Note 19, *Business Segments*.

Advertising Expense
Advertising costs, which we consider to be media and marketing materials, are expensed as incurred. We incurred $6.8 million, $7.4 million and $8.5 million in advertising expense during the years ended December 31, 2017, 2016 and 2015, respectively.

Recent Accounting Developments

In February 2018 the Financial Accounting Standards Board ('"FASB") issued Accounting Standards Update ("ASU") No. 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income,* or ASU 2018-02. The amendments in this Update allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The Update does not have any impact on the underlying ASC 740 guidance that requires the effect of a change in tax law be included in income from continuing operations. The amendments in this Update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted and should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company is currently evaluating the provisions of this guidance to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In August 2017 the FASB issued ASU No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities,* or ASU 2017-12. This standard better aligns an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. To meet that objective, the amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedge instruments and the hedged item in the financial statements. Adoption for this ASU is required for fiscal years and interim periods beginning after December 15, 2018 and early adoption is permitted. The Company is currently evaluating the provisions of this guidance to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In March 2017 the FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and other Costs (Subtopic 320-20): Premium Amortization on Purchased Callable Debt Securities,* or ASU 2017-08. This standard shortens the amortization period for the premium to the earliest call date to more closely align interest income recorded on bonds held at a premium or a discount with the economics of the underlying instrument. Adoption of ASU 2017-08 is required for fiscal years and interim periods within those fiscal years, beginning after December, 15, 2018, early adoption is permitted. The Company is currently evaluating the provisions of this guidance to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment,* or ASU 2017-04, which eliminates Step 2 from the goodwill impairment test. ASU 2017-04 also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Adoption of ASU 2017-04 is required for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019 with early adoption being permitted for annual or interim goodwill impairment tests performed on testing dates after January 1,

2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.
In January 2017, the FASB issued ASU No. 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business,* for determining whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The new standard is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017 with early adoption permitted for transactions that occurred before the issuance date or effective date of the standard if the transactions were not reported in financial statements that have been issued or made available for issuance. The standard must be applied prospectively. Upon adoption, the standard will impact how we assess acquisitions (or disposals) of assets or businesses. Management does not expect the adoption of ASU 2017-01 to have a material impact on its consolidated financial statements.
On November 17, 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash: a Consensus of the FASB Emerging Issues Task Force.* This ASU requires a company's cash flow statement to explain the changes during a reporting period of the totals for cash, cash equivalents, restricted cash, and restricted cash equivalents. Additionally, amounts for restricted cash and restricted cash equivalents are to be included with cash and cash equivalents if the cash flow statement includes a reconciliation of the total cash balances for a reporting period. This ASU is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017, with early application permitted. Management does not anticipate that this guidance will have a material impact on the Company's consolidated financial statements.
On August 26, 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230):, Classification of Certain Cash Receipts and Cash Payments*. The amendments in this ASU were issued to reduce diversity in how certain cash receipts and payments are presented and classified in the statement of cash flows in eight specific areas. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years and should be applied using a retrospective transition method to each period presented. Early application was permitted upon issuance of the ASU. Management is currently evaluating the impact of this ASU but does not expect this ASU to have a material impact on the Company's consolidated financial statements.
In June 2016, FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. Current GAAP requires an "incurred loss" methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. The main objective of this ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The amendment affects loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial asset not excluded from the scope that have the contractual right to receive cash. The amendments in this ASU replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments in this ASU require a financial asset (or group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. The measurement of expected credit losses will be based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendments in this ASU broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The use of forecasted information incorporates more timely information in the estimate of expected credit loss, which will be more decision useful to users of the financial statements. The amendments in this ASU will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is still evaluating the effects this ASU will have on the Company's consolidated financial statements. The Company has formed an internal committee to oversee the project. Upon adoption, the Company expects a change in the processes and procedures to calculate the allowance for loan losses, including changes in assumptions and estimates to consider expected credit losses over the life of the loan versus the current accounting

practice that utilizes the incurred loss model. The new guidance may result in an increase in the allowance for loan losses; however, management is still assessing the magnitude of the increase and its impact on the Company's consolidated financial statements. In addition, the current accounting policy and procedures for other-than-temporary impairment on investment securities available for sale will be replaced with an allowance approach. The Company has begun developing and implementing processes to address the amendments of this ASU.

On February 25, 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The amendments in this ASU require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. This ASU simplifies the accounting for sale and leaseback transactions. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application was permitted upon issuance of the ASU. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. During 2018, a proposed ASU was issued by the FASB that provides a practical expedient that would allow companies to use an optional transition method, which would allow for a cumulative adjustment to retained earnings during the period of adoption and prior periods would not require restatement. Management is currently evaluating the provisions of this guidance to determine the potential impact the new standard will have on the Company's consolidated financial statements. While we have not quantified the impact to our balance sheet, upon the adoption of this ASU we expect to report increased assets and liabilities on our Consolidated Statement of Financial Condition as a result of recognizing right-of-use assets and lease liabilities related to these leases and certain equipment under non-cancelable operating lease agreements, which currently are not on our Consolidated Statement of Financial Condition.

In January 2016, FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities.* The amendments in this ASU require equity securities to be measured at fair value with changes in the fair value recognized through net income. The amendments allow equity investments that do not have readily determinable fair values to be remeasured at fair value under certain circumstances and require enhanced disclosures about those investments. This ASU simplifies the impairment assessment of equity investments without readily determinable fair values. This ASU also eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the consolidated statement of financial position. The amendments in this ASU require separate presentation in other comprehensive income of the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. This ASU excludes from net income gains or losses that the entity may not realize because those financial liabilities are not usually transferred or settled at their fair values before maturity. The amendments in this ASU require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the consolidated statement of financial position or in the accompanying notes to the financial statements. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The implementation of this guidance will not have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).* This ASU clarifies the principles for recognizing revenue from contracts with customers. On August 12, 2015, the FASB issued ASU 2015-14 to defer the effective date of ASU 2014-09. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. On March 17, 2016, the FASB issued Accounting Standards Update 2016-08 to clarify the implementation guidance on principal versus agent considerations. We intend to adopt this new guidance on January 1, 2018. We completed an analysis that includes (1) identification of all revenue streams included in the financial statements; (2) of the revenue streams identified, determine which are within the scope of the pronouncement; (3) determination of size, timing and amount of revenue recognition for streams of income within the scope of this pronouncement; (4) determination of the sample size of contracts for further analysis; and (5) completion of analysis on sample of contracts to evaluate the impact of the new guidance. Based on this analysis, we developed processes and procedures in 2017 to address the amendments of this ASU, including new disclosures. The implementation of this guidance will not have a material impact on our consolidated financial statements.

**NOTE 2–BUSINESS COMBINATIONS:**

Recent Acquisition Activity

On September 15, 2017, the Company completed its acquisition of one branch and its related deposits in Southern California, from Opus Bank. The application of the acquisition method of accounting resulted in goodwill of $389 thousand.

On November 10, 2016, the Company completed its acquisition of two branches and their related deposits in Southern California, from Boston Private Bank and Trust. The provisional application of the acquisition method of accounting resulted in goodwill of $2.3 million.

On August 12, 2016, the Company completed its acquisition of certain assets and liabilities, including two branches in Lake Oswego, Oregon from The Bank of Oswego. The application of the acquisition method of accounting resulted in goodwill of $19 thousand.

On February 1, 2016, the Company completed its acquisition of Orange County Business Bank ("OCBB") located in Irvine, California through the merger of OCBB with and into HomeStreet Bank with HomeStreet Bank as the surviving subsidiary. The purchase price of this acquisition was $55.9 million. OCBB shareholders as of the effective time received merger consideration equal to 0.5206 shares of HomeStreet common stock, and $1.1641 in cash upon the surrender of their OCBB shares, which resulted in the issuance of 2,459,461 shares of HomeStreet common stock. The application of the acquisition method of accounting resulted in goodwill of $8.4 million.

Simplicity Acquisition

On March 1, 2015, the Company completed its acquisition of Simplicity Bancorp, Inc., a Maryland corporation (“Simplicity”) and Simplicity’s wholly owned subsidiary, Simplicity Bank. Simplicity’s principal business activities prior to the merger were attracting retail deposits from the general public, originating or purchasing loans, primarily loans secured by first mortgages on owner-occupied, one-to-four family residences and multi-family residences located in Southern California and, to a lesser extent, commercial real estate, automobile and other consumer loans; and the origination and sale of fixed-rate, conforming, one-to-four family residential real estate loans in the secondary market, usually with servicing retained. The primary objective for this acquisition is to grow our Commercial and Consumer Banking segment by expanding the business of the former Simplicity branches by offering additional banking and lending products to former Simplicity customers as well as new customers. The acquisition was accomplished by the merger of Simplicity with and into HomeStreet, Inc. with HomeStreet, Inc. as the surviving corporation, followed by the merger of Simplicity Bank with and into HomeStreet Bank with HomeStreet Bank as the surviving subsidiary. The results of operations of Simplicity are included in the consolidated results of operations from the date of acquisition.

At the closing, there were 7,180,005 shares of Simplicity common stock, par value $0.01, outstanding, all of which were cancelled and exchanged for an equal number of shares of HomeStreet common stock, no par value, issued to Simplicity’s stockholders. In connection with the merger, all outstanding options to purchase Simplicity common stock were cancelled in exchange for a cash payment equal to the difference between a calculated price of HomeStreet common stock and the exercise price of the option, provided, however, that any options that were out-of-the-money at the time of closing were cancelled for no consideration. The calculated price of $17.53 was determined by averaging the closing price of HomeStreet common stock for the 10 trading days prior to but not including the 5th business day before the closing date. The aggregate consideration paid by us in the Simplicity acquisition was approximately $471 thousand in cash and 7,180,005 shares of HomeStreet common stock with a fair value of approximately $124.2 million as of the acquisition date. We used current liquidity sources to fund the cash consideration.

The acquisition was accounted for under the acquisition method of accounting pursuant to ASC 805, *Business Combinations*. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of acquisition date. The Company made significant estimates and exercised significant judgment in estimating the fair values and accounting for such acquired assets and assumed liabilities.

A summary of the consideration paid, the assets acquired and liabilities assumed in the merger are presented below:

| (in thousands) | March 1, 2015 | |
|---|---|---|
| Fair value consideration paid to Simplicity shareholders: | | |
| Cash paid (79,399 stock options, consideration based on intrinsic value at a calculated price of $17.53) | | $471 |
| Fair value of common shares issued (7,180,005 shares at $17.30 per share) | | 124,214 |
| Total purchase price | | 124,685 |
| Fair value of assets acquired: | | |
| Cash and cash equivalents | $112,667 | |
| Investment securities | 26,845 | |
| Acquired loans | 664,148 | |
| Mortgage servicing rights | 980 | |
| Federal Home Loan Bank stock | 5,520 | |
| Premises and equipment | 2,966 | |
| Bank-owned life insurance | 14,501 | |
| Core deposit intangibles | 7,450 | |
| Accounts receivable and other assets | 15,869 | |
| Total assets acquired | 850,946 | |
| Fair value of liabilities assumed: | | |
| Deposits | 651,202 | |
| Federal Home Loan Bank advances | 65,855 | |
| Accounts payable and accrued expenses | 1,859 | |
| Total liabilities assumed | 718,916 | |
| Net assets acquired | | 132,030 |
| Bargain purchase (gain) | | $(7,345 ) |

The application of the acquisition method of accounting resulted in a bargain purchase gain of $7.3 million which was reported as a component of noninterest income on our consolidated statements of operations. A substantial portion of the assets acquired from Simplicity were mortgage-related assets, which generally decrease in value as interest rates rise and increase in value as interest rates fall. The bargain purchase gain was driven largely by a substantial decline in long-term interest rates between the period shortly after our announcement of the Simplicity acquisition and its closing, which resulted in an increase in the fair value of the acquired mortgage assets and the overall net fair value of assets acquired. In addition, the Company believes it was able to acquire Simplicity for less than the fair value of its net assets due to Simplicity’s stock trading below its book value for an extended period of time prior to the announcement of the acquisition. The Company negotiated a purchase price per share for Simplicity that was above the prevailing stock price thereby representing a premium to the shareholders. The stock consideration transferred was based on a 1:1 stock conversion ratio. The price of the Company’s shares declined between the time the deal was announced and when it closed which also attributed to the bargain purchase gain. The acquisition of Simplicity by the Company was approved by Simplicity’s shareholders. For tax purposes, the bargain purchase gain is a non-taxable event.

The operations of Simplicity are included in the Company's operating results as of the acquisition date of March 1, 2015 through the period ended December 31, 2017. Acquisition-related costs were expensed as incurred in noninterest expense as merger and integration costs.

The following table provides a breakout of Simplicity merger-related expense for the year ended December 31, 2015:

| (in thousands) | Year Ended December 31, 2015 |
|---|---|
| Noninterest expense | |
| Salaries and related costs | $ 7,669 |
| General and administrative | 1,256 |
| Legal | 530 |
| Consulting | 5,539 |
| Occupancy | 335 |
| Information services | 481 |
| Total noninterest expense | $ 15,810 |

The $664.1 million estimated fair value of loans acquired from Simplicity was determined by utilizing a discounted cash flow methodology considering credit and interest rate risk. Cash flows were determined by estimating future credit losses and the rate of prepayments. Projected monthly cash flows were then discounted to present value based on the Company’s weighted average cost of capital. The discount for acquired loans from Simplicity was $16.6 million as of the acquisition date.

A core deposit intangible (“CDI”) of $7.5 million was recognized related to the core deposits acquired from Simplicity. A discounted cash flow method was used to estimate the fair value of the certificates of deposit. The CDI is amortized over its estimated useful life of approximately ten years using an accelerated method and will be reviewed for impairment quarterly.

The fair value of savings and transaction deposit accounts was assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. A discounted cash flow method was used to estimate the fair value of the certificates of deposit. A premium, which will be amortized over the contractual life of the deposits, of $4.0 million was recorded for certificates of deposit.

The fair value of Federal Home Loan Bank advances was estimated using a discounted cash flow method. A premium, which will be amortized over the contractual life of the advances, of $855 thousand was recorded for the Federal Home Loan Bank advances.

The Company determined that the disclosure requirements related to the amounts of revenues and earnings of the acquiree included in the consolidated statements of operations since the acquisition date is impracticable. The financial activity and operating results of the acquiree were commingled with the Company’s financial activity and operating results as of the acquisition date.

**NOTE 3–REGULATORY CAPITAL REQUIREMENTS:**

In July 2013, federal banking regulators (including the Federal Deposit Insurance Corporation "FDIC" and the Federal Reserve Bank "FRB") adopted new capital rules (the “Rules”). The Rules apply to both depository institutions (such as the Bank) and their holding companies (such as the Company). The Rules reflect, in part, certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010 (which standards are commonly referred to as “Basel III”) as well as requirements contemplated by the Dodd-Frank Act. The Rules applied to both the Company and the Bank beginning in 2015.

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank and the Company to maintain minimum amounts and ratios of Tier 1 leverage capital, common equity Tier 1 capital, Tier 1 risk-based capital and total risk-based capital (as defined in the regulations). The regulators also have the ability to impose elevated capital requirements in certain circumstances. At December 31, 2017 and 2016 the Bank's capital ratios meet the regulatory capital category of "well capitalized" as defined by the Rules.

The Bank's and the Company's capital amounts and ratios under Basel III are included in the following tables:

| | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| **HomeStreet Bank** | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $ 649,864 | 9.67 % | $ 268,708 | 4.0 % | $ 335,885 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | 649,864 | 13.22 | 221,201 | 4.5 | 319,512 | 6.5 |
| Tier 1 risk-based capital (to risk-weighted assets) | 649,864 | 13.22 | 294,935 | 6.0 | 393,246 | 8.0 |
| Total risk-based capital (to risk-weighted assets) | 688,981 | 14.02 | 393,246 | 8.0 | 491,558 | 10.0 |

| | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| **HomeStreet, Inc.** | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $ 614,624 | 9.12 % | $ 269,534 | 4.0 % | $ 336,918 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | 555,120 | 9.86 | 253,293 | 4.5 | 365,868 | 6.5 |
| Tier 1 risk-based capital (to risk-weighted assets) | 614,624 | 10.92 | 337,724 | 6.0 | 450,299 | 8.0 |
| Total risk-based capital (to risk-weighted assets) | 653,741 | 11.61 | 450,299 | 8.0 | 562,873 | 10.0 |

| | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| **HomeStreet Bank** | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As "Well Capitalized" Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $ 635,988 | 10.26 % | $ 248,055 | 4.0 % | $ 310,069 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | 635,988 | 13.92 | 205,615 | 4.5 | 297,000 | 6.5 |
| Tier 1 risk-based capital (to risk-weighted assets) | 635,988 | 13.92 | 274,154 | 6.0 | 365,538 | 8.0 |
| Total risk-based capital (to risk-weighted assets) | 671,252 | 14.69 | 365,538 | 8.0 | 456,923 | 10.0 |

| **HomeStreet, Inc.** | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To Be Categorized As “Well Capitalized” Under Prompt Corrective Action Provisions | |
| (in thousands) | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Tier 1 leverage capital (to average assets) | $ 608,988 | 9.78 % | $ 249,121 | 4.0 % | $ 311,402 | 5.0 % |
| Common equity risk-based capital (to risk-weighted assets) | 550,510 | 10.54 | 234,965 | 4.5 | 339,395 | 6.5 |
| Tier 1 risk-based capital (to risk-weighted assets) | 608,988 | 11.66 | 313,287 | 6.0 | 417,716 | 8.0 |
| Total risk-based capital (to risk-weighted assets) | 644,252 | 12.34 | 417,716 | 8.0 | 522,146 | 10.0 |

At periodic intervals, the FDIC and the Washington State Department of Financial Institutions ("WDFI") routinely examine the Bank’s financial statements as part of their legally prescribed oversight of the banking industry. Based on their examinations, these regulators can direct that the Bank’s financial statements be adjusted in accordance with their findings.

## NOTE 4–INVESTMENT SECURITIES:

The following tables sets forth certain information regarding the amortized cost and fair values of our investment securities available for sale and held to maturity.

| | At December 31, 2017 | | | |
|---|---|---|---|---|
| (in thousands) | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| AVAILABLE FOR SALE | | | | |
| Mortgage-backed securities: | | | | |
| Residential | $ 133,654 | $ 4 | $ (3,568 ) | $ 130,090 |
| Commercial | 24,024 | 8 | (338 ) | 23,694 |
| Municipal bonds | 389,117 | 2,978 | (3,643 ) | 388,452 |
| Collateralized mortgage obligations: | | | | |
| Residential | 164,502 | 3 | (4,081 ) | 160,424 |
| Commercial | 100,001 | 9 | (1,441 ) | 98,569 |
| Corporate debt securities | 25,146 | 67 | (476 ) | 24,737 |
| U.S. Treasury securities | 10,899 | — | (247 ) | 10,652 |
| Agency debentures | 9,861 | — | (211 ) | 9,650 |
| | $ 857,204 | $ 3,069 | $ (14,005 ) | $ 846,268 |
| HELD TO MATURITY | | | | |
| Mortgage-backed securities: | | | | |
| Residential | $ 12,062 | $ 35 | $ (99 ) | $ 11,998 |
| Commercial | 21,015 | 75 | (161 ) | 20,929 |
| Collateralized mortgage obligations | 3,439 | — | — | 3,439 |
| Municipal bonds | 21,423 | 339 | (97 ) | 21,665 |
| Corporate debt securities | 97 | — | — | 97 |

| | | | |
|---|---|---|---|
| $58,036 | $ 449 | $(357 ) | $58,128 |

| (in thousands) | At December 31, 2016 Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|---|---|---|---|---|
| AVAILABLE FOR SALE | | | | |
| Mortgage-backed securities: | | | | |
| Residential | $181,158 | $ 31 | $(4,115 ) | $177,074 |
| Commercial | 25,896 | 13 | (373 ) | 25,536 |
| Municipal bonds | 473,153 | 1,333 | (6,813 ) | 467,673 |
| Collateralized mortgage obligations: | | | | |
| Residential | 194,982 | 32 | (3,813 ) | 191,201 |
| Commercial | 71,870 | 29 | (1,135 ) | 70,764 |
| Corporate debt securities | 52,045 | 110 | (1,033 ) | 51,122 |
| U.S. Treasury securities | 10,882 | — | (262 ) | 10,620 |
| | $1,009,986 | $ 1,548 | $(17,544 ) | $993,990 |
| HELD TO MATURITY | | | | |
| Mortgage-backed securities: | | | | |
| Residential | $13,844 | $ 71 | $(90 ) | $13,825 |
| Commercial | 16,303 | 70 | (64 ) | 16,309 |
| Municipal bonds | 19,612 | 99 | (459 ) | 19,252 |
| Corporate debt securities | 102 | — | — | 102 |
| | $49,861 | $ 240 | $(613 ) | $49,488 |

Mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMO") represent securities issued by government sponsored enterprises ("GSEs"). Each of the MBS and CMO securities in our investment portfolio are guaranteed by Fannie Mae, Ginnie Mae or Freddie Mac. Municipal bonds are comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by either collateral or revenues from the specific project being financed) issued by various municipal corporations. As of December 31, 2017 and 2016, all securities held, including municipal bonds and corporate debt securities, were rated investment grade based upon external ratings where available and, where not available, based upon internal ratings which correspond to ratings as defined by Standard and Poor’s Rating Services (“S&P”) or Moody’s Investors Services (“Moody’s”). As of December 31, 2017 and 2016, substantially all securities held had ratings available by external ratings agencies.

Investment securities available for sale and held to maturity that were in an unrealized loss position are presented in the following tables based on the length of time the individual securities have been in an unrealized loss position.

| | At December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| (in thousands) | Gross unrealized losses | Fair value | Gross unrealized losses | Fair value | Gross unrealized losses | Fair value |
| AVAILABLE FOR SALE | | | | | | |
| Mortgage-backed securities: | | | | | | |
| Residential | $(182) | $18,020 | $(3,386) | $110,878 | $(3,568) | $128,898 |
| Commercial | (113) | 15,265 | (225) | 6,748 | (338) | 22,013 |
| Municipal bonds | (760) | 105,415 | (2,883) | 134,103 | (3,643) | 239,518 |
| Collateralized mortgage obligations: | | | | | | |
| Residential | (612) | 53,721 | (3,469) | 104,555 | (4,081) | 158,276 |
| Commercial | (538) | 57,236 | (903) | 35,225 | (1,441) | 92,461 |
| Corporate debt securities | (15) | 5,272 | (461) | 13,365 | (476) | 18,637 |
| U.S. Treasury securities | (3) | 997 | (244) | 9,655 | (247) | 10,652 |
| Agency debentures | (211) | 9,650 | — | — | (211) | 9,650 |
| | $(2,434) | $265,576 | $(11,571) | $414,529 | $(14,005) | $680,105 |
| HELD TO MATURITY | | | | | | |
| Mortgage-backed securities: | | | | | | |
| Residential | $(13) | $2,662 | $(86) | $4,452 | $(99) | $7,114 |
| Commercial | (161) | 15,900 | — | — | (161) | 15,900 |
| Collateralized mortgage obligations | — | 3,439 | — | — | — | 3,439 |
| Municipal bonds | (3) | 2,185 | (94) | 9,465 | (97) | 11,650 |
| | $(177) | $24,186 | $(180) | $13,917 | $(357) | $38,103 |

| | At December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or more | | Total | |
| (in thousands) | Gross unrealized losses | Fair value | Gross unrealized losses | Fair value | Gross unrealized losses | Fair value |
| AVAILABLE FOR SALE | | | | | | |
| Mortgage-backed securities: | | | | | | |
| Residential | $(3,842) | $144,240 | $(273) | $9,907 | $(4,115) | $154,147 |
| Commercial | (373) | 23,798 | — | — | (373) | 23,798 |
| Municipal bonds | (6,813) | 283,531 | — | — | (6,813) | 283,531 |
| Collateralized mortgage obligations: | | | | | | |
| Residential | (3,052) | 175,490 | (761) | 11,422 | (3,813) | 186,912 |
| Commercial | (1,005) | 60,926 | (130) | 5,349 | (1,135) | 66,275 |
| Corporate debt securities | (472) | 24,447 | (561) | 11,677 | (1,033) | 36,124 |
| U.S. Treasury securities | (262) | 10,620 | — | — | (262) | 10,620 |
| | $(15,819) | $723,052 | $(1,725) | $38,355 | $(17,544) | $761,407 |
| HELD TO MATURITY | | | | | | |
| Mortgage-backed securities: | | | | | | |
| Residential | $(90) | $5,481 | $— | $— | $(90) | $5,481 |
| Commercial | (64) | 13,156 | — | — | (64) | 13,156 |
| Municipal bonds | (459) | 11,717 | — | — | (459) | 11,717 |
| | $(613) | $30,354 | $— | $— | $(613) | $30,354 |

The Company has evaluated securities available for sale that are in an unrealized loss position and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any issuer- or industry-specific credit event. The Company has not identified any expected credit losses on its debt securities as of December 31, 2017 and 2016. In addition, as of December 31, 2017 and 2016, the Company had not made a decision to sell any of its debt securities held, nor did the Company consider it more likely than not that it would be required to sell such securities before recovery of their amortized cost basis.

The following tables present the fair value of investment securities available for sale and held to maturity by contractual maturity along with the associated contractual yield for the periods indicated below. Contractual maturities for mortgage-backed securities and collateralized mortgage obligations as presented exclude the effect of expected prepayments. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations before the underlying mortgages mature. The weighted-average yield is computed using the contractual coupon of each security weighted based on the fair value of each security and does not include adjustments to a tax equivalent basis.

| | At December 31, 2017 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Within one year | | After one year through five years | | After five years through ten years | | After ten years | | Total | |
| (in thousands) | Fair Value | Weighted Average Yield | Fair Value | Weighted Average Yield | Fair Value | Weighted Average Yield | Fair Value | Weighted Average Yield | Fair Value | Weighted Average Yield |
| AVAILABLE FOR SALE | | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | | |
| Residential | $— | — % | $— | — % | $8,914 | 1.63 % | $121,176 | 1.97 % | $130,090 | 1.94 % |
| Commercial | — | — | 15,356 | 2.07 | 4,558 | 2.03 | 3,780 | 2.98 | 23,694 | 2.21 |
| Municipal bonds | 641 | 2.64 | 24,456 | 3.10 | 39,883 | 3.25 | 323,472 | 3.81 | 388,452 | 3.71 |
| Collateralized mortgage obligations: | | | | | | | | | | |
| Residential | — | — | — | — | — | — | 160,424 | 2.10 | 160,424 | 2.10 |
| Commercial | — | — | 12,550 | 2.09 | 21,837 | 2.38 | 64,182 | 2.13 | 98,569 | 2.18 |
| Agency debentures | — | — | — | — | 9,650 | 2.26 | — | — | 9,650 | 2.26 |
| Corporate debt securities | 1,048 | 2.11 | 6,527 | 2.80 | 11,033 | 3.49 | 6,129 | 3.57 | 24,737 | 3.27 |
| U.S. Treasury securities | 997 | 1.22 | — | — | 9,655 | 1.76 | — | — | 10,652 | 1.71 |
| Total available for sale | $2,686 | 1.90 % | $58,889 | 2.58 % | $105,530 | 2.67 % | $679,163 | 2.90 % | $846,268 | 2.85 % |
| HELD TO MATURITY | | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | | |
| Residential | $— | — % | $— | — % | $— | — % | $11,998 | 2.93 % | $11,998 | 2.93 % |
| Commercial | — | — | 6,577 | 2.15 | 14,352 | 2.71 | — | — | 20,929 | 2.53 |
| Collateralized mortgage obligations | — | — | — | — | — | — | 3,439 | 1.90 | 3,439 | 1.90 |
| Municipal bonds | — | — | 1,846 | 3.35 | 4,630 | 2.57 | 15,189 | 3.50 | 21,665 | 3.28 |
| Corporate debt securities | — | — | — | — | — | — | 97 | 6.00 | 97 | 6.00 |
| Total held to maturity | $— | — % | $8,423 | 2.41 % | $18,982 | 2.68 % | $30,723 | 3.10 % | $58,128 | 2.86 % |

| | At December 31, 2016 | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Within one year | | | After one year through five years | | | After five years through ten years | | | After ten years | | | Total | | |
| (in thousands) | Fair Value | Weighted Average Yield | | Fair Value | Weighted Average Yield | | Fair Value | Weighted Average Yield | | Fair Value | Weighted Average Yield | | Fair Value | Weighted Average Yield | |
| AVAILABLE FOR SALE | | | | | | | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | | | | | | | |
| Residential | $1 | 0.29 | % | $— | — | % | $2,122 | 1.59 | % | $174,951 | 2.03 | % | $177,074 | 2.02 | % |
| Commercial | — | — | | 20,951 | 2.13 | | 4,585 | 2.06 | | — | — | | 25,536 | 2.11 | |
| Municipal bonds | 3,479 | 3.30 | | 20,939 | 2.94 | | 52,043 | 2.55 | | 391,212 | 3.08 | | 467,673 | 3.02 | |
| Collateralized mortgage obligations: | | | | | | | | | | | | | | | |
| Residential | — | — | | — | — | | 1,639 | 1.32 | | 189,562 | 2.06 | | 191,201 | 2.06 | |
| Commercial | — | — | | 10,860 | 1.84 | | 19,273 | 2.74 | | 40,631 | 1.91 | | 70,764 | 2.12 | |
| Corporate debt securities | — | — | | 10,516 | 2.67 | | 21,493 | 3.74 | | 19,113 | 3.54 | | 51,122 | 3.45 | |
| U.S. Treasury securities | 999 | 0.64 | | — | — | | 9,621 | 1.76 | | — | — | | 10,620 | 1.66 | |
| Total available for sale | $4,479 | 2.70 | % | $63,266 | 2.43 | % | $110,776 | 2.69 | % | $815,469 | 2.57 | % | $993,990 | 2.57 | % |
| HELD TO MATURITY | | | | | | | | | | | | | | | |
| Mortgage-backed securities: | | | | | | | | | | | | | | | |
| Residential | $— | — | % | $— | — | % | $— | — | % | $13,825 | 3.11 | % | $13,825 | 3.11 | % |
| Commercial | — | — | | 4,581 | 2.06 | | 11,728 | 2.71 | | — | — | | 16,309 | 2.53 | |
| Municipal bonds | — | — | | — | — | | 6,450 | 2.73 | | 12,802 | 3.31 | | 19,252 | 3.11 | |
| Corporate debt securities | — | — | | — | — | | — | — | | 102 | 6.00 | | 102 | 6.00 | |
| Total held to maturity | $— | — | % | $4,581 | 2.06 | % | $18,178 | 2.72 | % | $26,729 | 3.22 | % | $49,488 | 2.93 | % |

Sales of investment securities available for sale were as follows.

| | Years Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| (in thousands) | 2017 | | 2016 | | 2015 | |
| Proceeds | $397,492 | | $164,430 | | $112,259 | |
| Gross gains | 1,214 | | 2,782 | | 2,571 | |
| Gross losses | (725 | ) | (243 | ) | (165 | ) |

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The following table summarizes the carrying value of securities pledged as collateral to secure public deposits, borrowings and other purposes as permitted or required by law.

| (in thousands) | At December 31, 2017 | At December 31, 2016 |
|---|---|---|
| Federal Home Loan Bank to secure borrowings | $ 425,866 | $ 103,171 |
| Washington and California State to secure public deposits | 118,828 | 30,364 |
| Securities pledged to secure derivatives in a liability position | 7,308 | 9,359 |
| Other securities pledged | 6,089 | 8,123 |
| Total securities pledged as collateral | $ 558,091 | $ 151,017 |

The Company assesses the creditworthiness of the counterparties that hold the pledged collateral and has determined that these arrangements have little risk. There were no securities pledged under repurchase agreements at December 31, 2017 and 2016.

Tax-exempt interest income on securities available for sale totaling $8.8 million, $6.3 million and $3.6 million for the years ended December 31, 2017, 2016 and 2015, respectively, was recorded in the Company's consolidated statements of operations.

## NOTE 5–LOANS AND CREDIT QUALITY:

For a detailed discussion of loans and credit quality, including accounting policies and the methodology used to estimate the allowance for credit losses, see Note 1, *Summary of Significant Accounting Policies.*

The Company's portfolio of loans held for investment is divided into two portfolio segments, consumer loans and commercial loans, which are the same segments used to determine the allowance for loan losses. Within each portfolio segment, the Company monitors and assesses credit risk based on the risk characteristics of each of the following loan classes: single family and home equity and other loans within the consumer loan portfolio segment and non-owner occupied commercial real estate, multifamily, construction/land development, owner occupied commercial real estate and commercial business loans within the commercial loan portfolio segment.

Loans held for investment consist of the following:

| | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Consumer loans | | |
| Single family[1] | $ 1,381,366 | $ 1,083,822 |
| Home equity and other | 453,489 | 359,874 |
| Total consumer loans | 1,834,855 | 1,443,696 |
| Commercial real estate loans | | |
| Non-owner occupied commercial real estate | 622,782 | 588,672 |
| Multifamily | 728,037 | 674,219 |
| Construction/land development | 687,631 | 636,320 |
| Total commercial real estate loans | 2,038,450 | 1,899,211 |

| | | |
|---|---|---|
| Commercial and industrial loans | | |
| Owner occupied commercial real estate | 391,613 | 282,891 |
| Commercial business | 264,709 | 223,653 |
| Total commercial and industrial loans | 656,322 | 506,544 |
| Loans held for investment before deferred fees, costs and allowance | 4,529,627 | 3,849,451 |
| Net deferred loan fees and costs | 14,686 | 3,577 |
| | 4,544,313 | 3,853,028 |
| Allowance for loan losses | (37,847 ) | (34,001 ) |
| Total loans held for investment | $4,506,466 | $3,819,027 |

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(1) Includes $5.5 million and $18.0 million at December 31, 2017 and December 31, 2016, respectively, of loans where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.

Loans in the amount of $1.81 billion and $1.59 billion at December 31, 2017 and 2016, respectively, were pledged to secure borrowings from the FHLB as part of our liquidity management strategy. Additionally, loans totaling $663.8 million and $554.7 million at December 31, 2017 and 2016, respectively, were pledged to secure borrowings from the Federal Reserve Bank. The FHLB and Federal Reserve Bank do not have the right to sell or re-pledge these loans.

It is the Company's policy to make loans to officers, directors, and their associates in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with other persons. The following is a summary of activity during the years ended December 31, 2017 and 2016 with respect to such aggregate loans to these related parties and their associates:

| | Years Ended December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Beginning balance, January 1 | $4,379 | $4,511 |
| Principal repayments and advances, net | (2,411) | (132) |
| Ending balance, December 31 | $1,968 | $4,379 |

**Credit Risk Concentrations**

Concentrations of credit risk arise when a number of customers are engaged in similar business activities or activities in the same geographic region, or when they have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions.

Loans held for investment are primarily secured by real estate located in the Pacific Northwest, California and Hawaii. At December 31, 2017, we had concentrations representing 10% or more of the total portfolio by state and property type for the loan class of single family within the state of Washington and California, which represented 15.0% and 10.9% of the total portfolio, respectively. At December 31, 2016 we had concentrations representing 10% or more of the total portfolio by state and property type for the loan classes of single family and non-owner occupied real estate within the state of Washington, which represented 13.8% and 10.1% of the total portfolio, respectively.

**Credit Quality**

Management considers the level of allowance for loan losses to be appropriate to cover credit losses inherent within the loans held for investment portfolio as of December 31, 2017. In addition to the allowance for loan losses, the Company maintains a separate allowance for losses related to unfunded loan commitments, and this amount is included in accounts payable and other liabilities on the consolidated statements of financial condition. Collectively, these allowances are referred to as the allowance for credit losses.

For further information on the policies that govern the determination of the allowance for loan losses levels, see Note 1, *Summary of Significant Accounting Policies.*

Activity in the allowance for credit losses was as follows.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Allowance for credit losses (roll-forward): | | | |
| Beginning balance | $35,264 | $30,659 | $22,524 |
| Provision for credit losses | 750 | 4,100 | 6,100 |
| Recoveries, net of charge-offs | 3,102 | 505 | 2,035 |
| Ending balance | $39,116 | $35,264 | $30,659 |
| Components: | | | |
| Allowance for loan losses | $37,847 | $34,001 | $29,278 |
| Allowance for unfunded commitments | 1,269 | 1,263 | 1,381 |
| Allowance for credit losses | $39,116 | $35,264 | $30,659 |

Activity in the allowance for credit losses by loan portfolio and loan class was as follows.

| (in thousands) | Year Ended December 31, 2017 Beginning balance | Charge-offs | Recoveries | (Reversal of) Provision | Ending balance |
|---|---|---|---|---|---|
| Consumer loans | | | | | |
| Single family | $8,196 | $(2) | $ 1,495 | $(277) | $9,412 |
| Home equity and other | 6,153 | (707) | 818 | 817 | 7,081 |
| Total consumer loans | 14,349 | (709) | 2,313 | 540 | 16,493 |
| Commercial real estate loans | | | | | |
| Non-owner occupied commercial real estate | 4,481 | — | — | 274 | 4,755 |
| Multifamily | 3,086 | — | — | 809 | 3,895 |
| Construction/land development | 8,553 | — | 1,017 | (893) | 8,677 |
| Total commercial real estate loans | 16,120 | — | 1,017 | 190 | 17,327 |
| Commercial and industrial loans | | | | | |
| Owner occupied commercial real estate | 2,199 | — | — | 761 | 2,960 |
| Commercial business | 2,596 | (411) | 892 | (741) | 2,336 |
| Total commercial and industrial loans | 4,795 | (411) | 892 | 20 | 5,296 |
| Total allowance for credit losses | $35,264 | $(1,120) | $ 4,222 | $ 750 | $39,116 |

| (in thousands) | Year Ended December 31, 2016 Beginning balance | Charge-offs | Recoveries | (Reversal of) Provision | Ending balance |
|---|---|---|---|---|---|
| Consumer loans | | | | | |
| Single family | $ 8,942 | $ (790 ) | $ 90 | $ (46 ) | $ 8,196 |
| Home equity and other | 4,620 | (839 ) | 920 | 1,452 | 6,153 |
| Total consumer loans | 13,562 | (1,629 ) | 1,010 | 1,406 | 14,349 |
| Commercial real estate loans | | | | | |
| Non-owner occupied commercial real estate | 3,594 | — | — | 887 | 4,481 |
| Multifamily | 1,194 | — | — | 1,892 | 3,086 |
| Construction/land development | 9,271 | (42 ) | 1,143 | (1,819 ) | 8,553 |
| Total commercial real estate loans | 14,059 | (42 ) | 1,143 | 960 | 16,120 |
| Commercial and industrial loans | | | | | |
| Owner occupied commercial real estate | 1,253 | — | — | 946 | 2,199 |
| Commercial business | 1,785 | (27 ) | 50 | 788 | 2,596 |
| Total commercial and industrial loans | 3,038 | (27 ) | 50 | 1,734 | 4,795 |
| Total allowance for credit losses | $ 30,659 | $ (1,698 ) | $ 2,203 | $ 4,100 | $ 35,264 |

The following tables disaggregate our allowance for credit losses and recorded investment in loans by impairment methodology.

| (in thousands) | At December 31, 2017<br>Allowance: collectively evaluated for impairment | Allowance: individually evaluated for impairment | Total | Loans: collectively evaluated for impairment | Loans: individually evaluated for impairment | Total |
|---|---|---|---|---|---|---|
| Consumer loans | | | | | | |
| Single family | $9,188 | $ 224 | $9,412 | $1,300,939 | $ 74,967 | $1,375,906 |
| Home equity and other | 7,036 | 45 | 7,081 | 452,182 | 1,290 | 453,472 |
| Total consumer loans | 16,224 | 269 | 16,493 | 1,753,121 | 76,257 | 1,829,378 |
| Commercial real estate loans | | | | | | |
| Non-owner occupied commercial real estate | 4,755 | — | 4,755 | 622,782 | — | 622,782 |
| Multifamily | 3,895 | — | 3,895 | 727,228 | 809 | 728,037 |
| Construction/land development | 8,677 | — | 8,677 | 687,177 | 454 | 687,631 |
| Total commercial real estate loans | 17,327 | — | 17,327 | 2,037,187 | 1,263 | 2,038,450 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 2,960 | — | 2,960 | 388,624 | 2,989 | 391,613 |
| Commercial business | 2,316 | 20 | 2,336 | 261,603 | 3,106 | 264,709 |
| Total commercial and industrial loans | 5,276 | 20 | 5,296 | 650,227 | 6,095 | 656,322 |
| Total loans evaluated for impairment | 38,827 | 289 | 39,116 | 4,440,535 | 83,615 | 4,524,150 |
| Loans held for investment carried at fair value | | | | 5,246 | 231 | 5,477 (1) |
| Total loans held for investment | $38,827 | $ 289 | $39,116 | $4,445,781 | $ 83,846 | $4,529,627 |

| (in thousands) | At December 31, 2016<br>Allowance: collectively evaluated for impairment | Allowance: individually evaluated for impairment | Total | Loans: collectively evaluated for impairment | Loans: individually evaluated for impairment | Total |
|---|---|---|---|---|---|---|
| Consumer loans | | | | | | |
| Single family | $7,871 | $ 325 | $8,196 | $985,219 | $ 80,676 | $1,065,895 |
| Home equity and other | 6,104 | 49 | 6,153 | 358,350 | 1,463 | 359,813 |
| Total consumer loans | 13,975 | 374 | 14,349 | 1,343,569 | 82,139 | 1,425,708 |
| Commercial real estate loans | | | | | | |
| Non-owner occupied commercial real estate | 4,481 | — | 4,481 | 587,801 | 871 | 588,672 |
| Multifamily | 3,086 | — | 3,086 | 673,374 | 845 | 674,219 |
| Construction/land development | 8,553 | — | 8,553 | 634,427 | 1,893 | 636,320 |
| Total commercial real estate loans | 16,120 | — | 16,120 | 1,895,602 | 3,609 | 1,899,211 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 2,199 | — | 2,199 | 281,424 | 1,467 | 282,891 |
| Commercial business | 2,591 | 5 | 2,596 | 220,360 | 3,293 | 223,653 |
| Total commercial and industrial loans | 4,790 | 5 | 4,795 | 501,784 | 4,760 | 506,544 |
| Total loans evaluated for impairment | 34,885 | 379 | 35,264 | 3,740,955 | 90,508 | 3,831,463 |
| Loans held for investment carried at fair value | | | | | | 17,988 (1) |
| Total loans held for investment | $34,885 | $ 379 | $35,264 | $3,740,955 | $ 90,508 | $3,849,451 |

(1) Comprised of single family loans where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.

Impaired Loans

The following tables present impaired loans by loan portfolio segment and loan class.

| (in thousands) | At December 31, 2017 Recorded investment (1) | Unpaid principal balance (2) | Related allowance |
|---|---|---|---|
| With no related allowance recorded: | | | |
| Consumer loans | | | |
| Single family | $71,264 (4) | $72,424 | $ — |
| Home equity and other | 782 | 807 | — |
| Total consumer loans | 72,046 | 73,231 | — |
| Commercial real estate loans | | | |
| Multifamily | 809 | 837 | — |
| Construction/land development | 454 | 454 | — |
| Total commercial real estate loans | 1,263 | 1,291 | — |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 2,989 | 3,288 | — |
| Commercial business | 2,398 | 3,094 | — |
| Total commercial and industrial loans | 5,387 | 6,382 | — |
| | $78,696 | $80,904 | $ — |
| With an allowance recorded: | | | |
| Consumer loans | | | |
| Single family | $3,934 | $4,025 | $ 224 |
| Home equity and other | 508 | 508 | 45 |
| Total consumer loans | 4,442 | 4,533 | 269 |
| Commercial and industrial loans | | | |
| Commercial business | 708 | 755 | 20 |
| Total commercial and industrial loans | 708 | 755 | 20 |
| | $5,150 | $5,288 | $ 289 |
| Total: | | | |
| Consumer loans | | | |
| Single family(3) | $75,198 | $76,449 | $ 224 |
| Home equity and other | 1,290 | 1,315 | 45 |
| Total consumer loans | 76,488 | 77,764 | 269 |
| Commercial real estate loans | | | |
| Multifamily | 809 | 837 | — |
| Construction/land development | 454 | 454 | — |
| Total commercial real estate loans | 1,263 | 1,291 | — |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 2,989 | 3,288 | — |
| Commercial business | 3,106 | 3,849 | 20 |
| Total commercial and industrial loans | 6,095 | 7,137 | 20 |
| Total impaired loans | $83,846 | $86,192 | $ 289 |

(1) Includes partial charge-offs and nonaccrual interest paid and purchase discounts and premiums.

(2) Unpaid principal balance does not include partial charge-offs, purchase discounts and premiums or nonaccrual interest paid. Related allowance is calculated on net book balances not unpaid principal balances.

(3) Includes $69.6 million in single family performing TDRs.

(4) Includes $231 thousand of fair value option loans.

| (in thousands) | At December 31, 2016 Recorded investment (1) | Unpaid principal balance (2) | Related allowance |
|---|---|---|---|
| With no related allowance recorded: | | | |
| Consumer loans | | | |
| Single family | $77,756 | $80,573 | $ — |
| Home equity and other | 946 | 977 | — |
| Total consumer loans | 78,702 | 81,550 | — |
| Commercial real estate loans | | | |
| Non-owner occupied commercial real estate | 871 | 898 | — |
| Multifamily | 845 | 851 | — |
| Construction/land development | 1,893 | 2,819 | — |
| Total commercial real estate loans | 3,609 | 4,568 | — |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 1,467 | 1,948 | — |
| Commercial business | 2,945 | 4,365 | — |
| Total commercial and industrial loans | 4,412 | 6,313 | — |
| | $86,723 | $92,431 | $ — |
| With an allowance recorded: | | | |
| Consumer loans | | | |
| Single family | $2,920 | $3,011 | $ 325 |
| Home equity and other | 517 | 517 | 49 |
| Total consumer loans | 3,437 | 3,528 | 374 |
| Commercial and industrial loans | | | |
| Commercial business | 348 | 347 | 5 |
| Total commercial and industrial loans | 348 | 347 | 5 |
| | $3,785 | $3,875 | $ 379 |
| Total: | | | |
| Consumer loans | | | |
| Single family(3) | $80,676 | $83,584 | $ 325 |
| Home equity and other | 1,463 | 1,494 | 49 |
| Total consumer loans | 82,139 | 85,078 | 374 |
| Commercial real estate loans | | | |
| Non-owner occupied commercial real estate | 871 | 898 | — |
| Multifamily | 845 | 851 | — |
| Construction/land development | 1,893 | 2,819 | — |
| Total commercial real estate loans | 3,609 | 4,568 | — |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 1,467 | 1,948 | — |
| Commercial business | 3,293 | 4,712 | 5 |
| Total commercial and industrial loans | 4,760 | 6,660 | 5 |
| Total impaired loans | $90,508 | $96,306 | $ 379 |

(1) Includes partial charge-offs and nonaccrual interest paid and purchase discounts and premiums.
(2) Unpaid principal balance does not include partial charge-offs, purchase discounts and premiums or nonaccrual interest paid. Related allowance is calculated on net book balances not unpaid principal balances.

(3) Includes $73.1 million in single family performing TDRs.

The following table provides the average recorded investment and interest income recognized on impaired loans by portfolio segment and class.

| (in thousands) | Year Ended December 31, 2017 | | Year Ended December 31, 2016 | | Year Ended December 31, 2015 | |
|---|---|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Consumer loans | | | | | | |
| Single family | $80,519 | $ 2,963 | $82,745 | $ 2,873 | $78,824 | $ 2,670 |
| Home equity and other | 1,432 | 80 | 1,408 | 68 | 1,922 | 83 |
| Total consumer loans | 81,951 | 3,043 | 84,153 | 2,941 | 80,746 | 2,753 |
| Commercial real estate loans | | | | | | |
| Non-owner occupied commercial real estate | 686 | — | 435 | — | 10,862 | 375 |
| Multifamily | 824 | 25 | 1,299 | 47 | 4,035 | 111 |
| Construction/land development | 917 | 73 | 2,286 | 87 | 4,535 | 207 |
| Total commercial real estate loans | 2,427 | 98 | 4,020 | 134 | 19,432 | 693 |
| Commercial and industrial loans | | | | | | |
| Owner occupied commercial real estate | 2,922 | 170 | 2,648 | 22 | 3,554 | 69 |
| Commercial business | 2,533 | 144 | 3,591 | 83 | 4,431 | 163 |
| Total commercial and industrial loans | 5,455 | 314 | 6,239 | 105 | 7,985 | 232 |
| | $89,833 | $ 3,455 | $94,412 | $ 3,180 | $108,163 | $ 3,678 |

Credit Quality Indicators

Management regularly reviews loans in the portfolio to assess credit quality indicators and to determine appropriate loan classification and grading in accordance with applicable bank regulations. The Company's risk rating methodology assigns risk ratings ranging from 1 to 10, where a higher rating represents higher risk. The Company differentiates its lending portfolios into homogeneous loans and non-homogeneous loans.

The 10 risk rating categories can be generally described by the following groupings for non-homogeneous loans:

*Pass.* We have five pass risk ratings which represent a level of credit quality that ranges from no well-defined deficiency or weakness to some noted weakness, however the risk of default on any loan classified as pass is expected to be remote. The five pass risk ratings are described below:

*Minimal Risk.* A minimal risk loan, risk rated 1-Exceptional, is to a borrower of the highest quality. The borrower has an unquestioned ability to produce consistent profits and service all obligations and can absorb severe market disturbances with little or no difficulty.

*Low Risk.* A low risk loan, risk rated 2-Superior, is similar in characteristics to a minimal risk loan. Balance sheet and operations are slightly more prone to fluctuations within the business cycle; however, debt capacity and debt service coverage remains strong. The borrower will have a strong demonstrated ability to produce profits and absorb market disturbances.

*Modest Risk.* A modest risk loan, risk rated 3-Excellent, is a desirable loan with excellent sources of repayment and no currently identifiable risk associated with collection. The borrower exhibits a very strong capacity to repay the loan in accordance with the repayment agreement. The borrower may be susceptible to economic cycles, but will have cash reserves to weather these cycles.

*Average Risk.* An average risk loan, risk rated 4-Good, is an attractive loan with sound sources of repayment and no material collection or repayment weakness evident. The borrower has an acceptable capacity to pay in accordance with the agreement. The borrower is susceptible to economic cycles and more efficient competition, but should have modest reserves sufficient to survive all but the most severe downturns or major setbacks.

*Acceptable Risk.* An acceptable risk loan, risk rated 5-Acceptable, is a loan with lower than average, but still acceptable credit risk. These borrowers may have higher leverage, less certain but viable repayment sources, have limited financial reserves and may possess weaknesses that can be adequately mitigated through collateral, structural or credit enhancement. The borrower is susceptible to economic cycles and is less resilient to negative market forces or financial events. Reserves may be insufficient to survive a modest downturn.

*Watch.* A watch loan, risk rated 6-Watch, is still pass-rated, but represents the lowest level of acceptable risk due to an emerging risk element or declining performance trend. Watch ratings are expected to be temporary, with issues resolved or manifested to the extent that a higher or lower rating would be appropriate. The borrower should have a plausible plan, with reasonable certainty of success, to correct the problems in a short period of time. Borrowers rated watch are characterized by elements of uncertainty, such as:

- The borrower may be experiencing declining operating trends, strained cash flows or less-than anticipated performance. Cash flow should still be adequate to cover debt service, and the negative trends should be identified as being of a short-term or temporary nature.
- The borrower may have experienced a minor, unexpected covenant violation.
- Companies who may be experiencing tight working capital or have a cash cushion deficiency.
- A loan may also be a watch if financial information is late, there is a documentation deficiency, the borrower has experienced unexpected management turnover, or if they face industry issues that, when combined with performance factors create uncertainty in their future ability to perform.
- Delinquent payments, increasing and material overdraft activity, request for bulge and/or out- of-formula advances may be an indicator of inadequate working capital and may suggest a lower rating.
- Failure of the intended repayment source to materialize as expected, or renewal of a loan (other than cash/marketable security secured or lines of credit) without reduction are possible indicators of a watch or worse risk rating.

*Special Mention.* A special mention loan, risk rated 7-Special Mention, 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 loans or the institutions credit position at some future date. They contain unfavorable characteristics and are generally undesirable. Loans in this category are currently protected but are potentially weak and constitute an undue and unwarranted credit risk, but not to the point of a substandard classification. A special mention loan has potential weaknesses, which if not checked or corrected, weaken the loan or inadequately protect the Company's position at some future date. Such weaknesses include:

- Performance is poor or significantly less than expected. There may be a temporary debt-servicing deficiency or inadequate working capital as evidenced by a cash cushion deficiency, but not to the extent that repayment is compromised. Material violation of financial covenants is common.
- Loans with unresolved material issues that significantly cloud the debt service outlook, even though a debt servicing deficiency does not currently exist.
- Modest underperformance or deviation from plan for real estate loans where absorption of rental/sales units is necessary to properly service the debt as structured. Depth of support for interest carry provided by owner/guarantors may mitigate and provide for improved rating.
- This rating may be assigned when a loan officer is unable to supervise the credit properly, an inadequate loan agreement, an inability to control collateral, failure to obtain proper documentation, or any other deviation from prudent lending practices.
- Unlike a substandard credit, there should be a reasonable expectation that these temporary issues will be corrected within the normal course of business, rather than liquidation of assets, and in a reasonable period of time.

*Substandard.* A substandard loan, risk rated 8-Substandard, is inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the loan. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans classified substandard. Loans are classified as substandard when they have unsatisfactory characteristics causing unacceptable levels of risk. A substandard loan normally has one or more well-defined weaknesses that could jeopardize repayment of the loan. The likely need to liquidate assets to correct the problem, rather than repayment from successful operations is the key distinction between special mention and substandard. The following are examples of well-defined weaknesses:

- Cash flow deficiencies or trends are of a magnitude to jeopardize current and future payments with no immediate relief. A loss is not presently expected, however the outlook is sufficiently uncertain to preclude ruling out the possibility.
- The borrower has been unable to adjust to prolonged and unfavorable industry or economic trends.
- Material underperformance or deviation from plan for real estate loans where absorption of rental/sales units is necessary to properly service the debt and risk is not mitigated by willingness and capacity of owner/guarantor to support interest payments.
- Management character or honesty has become suspect. This includes instances where the borrower has become uncooperative.
- Due to unprofitable or unsuccessful business operations, some form of restructuring of the business, including liquidation of assets, has become the primary source of loan repayment. Cash flow has deteriorated, or been diverted, to the point that sale of collateral is now the Company's primary source of repayment (unless this was the original source of repayment). If the collateral is under the Company's control and is cash or other liquid, highly marketable securities and properly margined, then a more appropriate rating might be special mention or watch.
- The borrower is involved in bankruptcy proceedings where collateral liquidation values are expected to fully protect the Company against loss.
- There is material, uncorrectable faulty documentation or materially suspect financial information.

*Doubtful.* Loans classified as doubtful, risk rated 9-Doubtful, have 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 possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work towards strengthening of the loan, classification as a loss (and immediate charge-off) is deferred until more exact status may be determined. Pending factors include proposed merger, acquisition, liquidation procedures, capital injection, and perfection of liens on additional collateral and refinancing plans. In certain circumstances, a doubtful rating will be temporary, while the Company is awaiting an updated collateral valuation. In these cases, once the collateral is valued and appropriate margin applied, the remaining un-collateralized portion will be charged-off. The remaining balance, properly margined, may then be upgraded to substandard, however must remain on non-accrual.

*Loss.* Loans classified as loss, risk rated 10-Loss, are considered un-collectible and of such little value that the continuance as an active Company asset is not warranted. This rating does not mean that the loan has no recovery or salvage value, but rather that the loan should be charged-off now, even though partial or full recovery may be possible in the future.

*Impaired.* Loans are classified as impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal and interest when due, in accordance with the terms of the original loan agreement, without unreasonable delay. This generally includes all loans classified as nonaccrual and troubled debt restructurings. Impaired loans are risk rated for internal and regulatory rating purposes, but presented separately for clarification.

Homogeneous loans maintain their original risk rating until they are greater than 30 days past due, and risk rating reclassification is based primarily on the past due status of the loan. The risk rating categories can be generally described by the following groupings for commercial and commercial real estate homogeneous loans:

*Watch.* A homogeneous watch loan, risk rated 6, is 30-59 days past due from the required payment date at month-end.

*Special Mention.* A homogeneous special mention loan, risk rated 7, is 60-89 days past due from the required payment date at month-end.

S*ubstandard.* A homogeneous substandard loan, risk rated 8, is 90-179 days past due from the required payment date at month-end.

*Loss.* A homogeneous loss loan, risk rated 10, is 180 days and more past due from the required payment date. These loans are generally charged-off in the month in which the 180 day time period elapses.

The risk rating categories can be generally described by the following groupings for residential and home equity and other homogeneous loans:

*Watch.* A homogeneous retail watch loan, risk rated 6, is 60-89 days past due from the required payment date at month-end.

*Substandard.* A homogeneous retail substandard loan, risk rated 8, is 90-180 days past due from the required payment date at month-end.

*Loss.* A homogeneous retail loss loan, risk rated 10, becomes past due 180 cumulative days from the contractual due date. These loans are generally charged-off in the month in which the 180 day period elapses.

Residential and home equity loans modified in a troubled debt restructure are not considered homogeneous. The risk rating classification for such loans are based on the non-homogeneous definitions noted above.

The following tables summarize designated loan grades by loan portfolio segment and loan class.

| | At December 31, 2017 | | | | |
|---|---|---|---|---|---|
| (in thousands) | Pass | Watch | Special mention | Substandard | Total |
| Consumer loans | | | | | |
| Single family | $1,355,965 [1] | $2,982 | $ 11,328 | $ 11,091 | $1,381,366 |
| Home equity and other | 451,194 | 143 | 751 | 1,401 | 453,489 |
| | 1,807,159 | 3,125 | 12,079 | 12,492 | 1,834,855 |
| Commercial real estate loans | | | | | |
| Non-owner occupied commercial real estate | 613,181 | 8,801 | — | 800 | 622,782 |
| Multifamily | 693,190 | 34,038 | 507 | 302 | 728,037 |
| Construction/land development | 664,025 | 22,062 | 1,466 | 78 | 687,631 |
| | 1,970,396 | 64,901 | 1,973 | 1,180 | 2,038,450 |
| Commercial and industrial loans | | | | | |
| Owner occupied commercial real estate | 361,429 | 20,949 | 6,399 | 2,836 | 391,613 |
| Commercial business | 220,461 | 39,588 | 1,959 | 2,701 | 264,709 |
| | 581,890 | 60,537 | 8,358 | 5,537 | 656,322 |
| | $4,359,445 | $128,563 | $ 22,410 | $ 19,209 | $4,529,627 |

| | At December 31, 2016 | | | | |
|---|---|---|---|---|---|
| (in thousands) | Pass | Watch | Special mention | Substandard | Total |
| Consumer loans | | | | | |
| Single family | $1,051,463 [1] | $4,348 | $ 15,172 | $ 12,839 | $1,083,822 |
| Home equity and other | 357,191 | 597 | 514 | 1,572 | 359,874 |
| | 1,408,654 | 4,945 | 15,686 | 14,411 | 1,443,696 |
| Commercial real estate loans | | | | | |
| Non-owner occupied commercial real estate | 562,950 | 23,741 | 1,110 | 871 | 588,672 |
| Multifamily | 660,234 | 13,140 | 508 | 337 | 674,219 |
| Construction/land development | 615,675 | 16,074 | 3,083 | 1,488 | 636,320 |
| | 1,838,859 | 52,955 | 4,701 | 2,696 | 1,899,211 |
| Commercial and industrial loans | | | | | |
| Owner occupied commercial real estate | 247,046 | 28,778 | 6,055 | 1,012 | 282,891 |

| | | | | | |
|---|---|---|---|---|---|
| Commercial business | 171,883 | 42,767 | 3,385 | 5,618 | 223,653 |
| | 418,929 | 71,545 | 9,440 | 6,630 | 506,544 |
| | $3,666,442 | $129,445 | $ 29,827 | $ 23,737 | $3,849,451 |

(1) Includes $5.5 million and $18.0 million of loans at December 31, 2017 and 2016, respectively, where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.

As of December 31, 2017 and 2016, none of the Company's loans were rated Doubtful or Loss.

Nonaccrual and Past Due Loans
Loans are placed on nonaccrual status when the full and timely collection of principal and interest is doubtful, generally when the loan becomes 90 days or more past due for principal or interest payment or if part of the principal balance has been charged off. Loans whose repayments are insured by the FHA or guaranteed by the VA are generally maintained on accrual status even if 90 days or more past due.

The following tables present an aging analysis of past due loans by loan portfolio segment and loan class.

| | At December 31, 2017 | | | | | | |
|---|---|---|---|---|---|---|---|
| (in thousands) | 30-59 days past due | 60-89 days past due | 90 days or more past due | Total past due | Current | Total loans | 90 days or more past due and accruing |
| Consumer loans | | | | | | | |
| Single family | $ 10,493 | $ 4,437 | $ 48,262 | $ 63,192 | $ 1,318,174 (1) | $ 1,381,366 | $ 37,171 (2) |
| Home equity and other | 750 | 20 | 1,404 | 2,174 | 451,315 | 453,489 | — |
| | 11,243 | 4,457 | 49,666 | 65,366 | 1,769,489 | 1,834,855 | 37,171 |
| Commercial real estate loans | | | | | | | |
| Non-owner occupied commercial real estate | — | — | — | — | 622,782 | 622,782 | — |
| Multifamily | — | — | 302 | 302 | 727,735 | 728,037 | — |
| Construction/land development | 641 | — | 78 | 719 | 686,912 | 687,631 | — |
| | 641 | — | 380 | 1,021 | 2,037,429 | 2,038,450 | — |
| Commercial and industrial loans | | | | | | | |
| Owner occupied commercial real estate | — | — | 640 | 640 | 390,973 | 391,613 | — |
| Commercial business | 377 | — | 1,526 | 1,903 | 262,806 | 264,709 | — |
| | 377 | — | 2,166 | 2,543 | 653,779 | 656,322 | — |
| | $ 12,261 | $ 4,457 | $ 52,212 | $ 68,930 | $ 4,460,697 | $ 4,529,627 | $ 37,171 |

| | At December 31, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| (in thousands) | 30-59 days past due | 60-89 days past due | 90 days or more past due | Total past due | Current | Total loans | 90 days or more past due and accruing |
| Consumer loans | | | | | | | |
| Single family | $ 4,310 | $ 5,459 | $ 53,563 | $ 63,332 | $ 1,020,490 (1) | $ 1,083,822 | $ 40,846 (2) |
| Home equity and other | 251 | 442 | 1,571 | 2,264 | 357,610 | 359,874 | — |
| | 4,561 | 5,901 | 55,134 | 65,596 | 1,378,100 | 1,443,696 | 40,846 |
| Commercial real estate loans | | | | | | | |
| Non-owner occupied commercial real estate | 23 | — | 871 | 894 | 587,778 | 588,672 | — |
| Multifamily | — | — | 337 | 337 | 673,882 | 674,219 | — |
| Construction/land development | — | — | 1,376 | 1,376 | 634,944 | 636,320 | — |
| | 23 | — | 2,584 | 2,607 | 1,896,604 | 1,899,211 | — |
| Commercial and industrial loans | | | | | | | |
| Owner occupied commercial real estate | 48 | 205 | 1,256 | 1,509 | 281,382 | 282,891 | — |
| Commercial business | 202 | — | 2,414 | 2,616 | 221,037 | 223,653 | — |
| | 250 | 205 | 3,670 | 4,125 | 502,419 | 506,544 | — |
| | $ 4,834 | $ 6,106 | $ 61,388 | $ 72,328 | $ 3,777,123 | $ 3,849,451 | $ 40,846 |

(1) Includes $5.5 million and $18.0 million of loans at December 31, 2017 and 2016 respectively, where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.
(2) FHA-insured and VA-guaranteed single family loans that are 90 days or more past due are maintained on accrual status if they are determined to have little to no risk of loss.

The following tables present performing and nonperforming loan balances by loan portfolio segment and loan class.

| | At December 31, 2017 | | |
|---|---|---|---|
| (in thousands) | Accrual | Nonaccrual | Total |
| Consumer loans | | | |
| Single family | $ 1,370,275 [1] | $ 11,091 | $ 1,381,366 |
| Home equity and other | 452,085 | 1,404 | 453,489 |
| | 1,822,360 | 12,495 | 1,834,855 |
| Commercial real estate loans | | | |
| Non-owner occupied commercial real estate | 622,782 | — | 622,782 |
| Multifamily | 727,735 | 302 | 728,037 |
| Construction/land development | 687,553 | 78 | 687,631 |
| | 2,038,070 | 380 | 2,038,450 |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 390,973 | 640 | 391,613 |
| Commercial business | 263,183 | 1,526 | 264,709 |
| | 654,156 | 2,166 | 656,322 |
| | $ 4,514,586 | $ 15,041 | $ 4,529,627 |

| | At December 31, 2016 | | |
|---|---|---|---|
| (in thousands) | Accrual | Nonaccrual | Total |
| Consumer loans | | | |
| Single family | $ 1,071,105 [1] | $ 12,717 | $ 1,083,822 |
| Home equity and other | 358,303 | 1,571 | 359,874 |
| | 1,429,408 | 14,288 | 1,443,696 |
| Commercial real estate loans | | | |
| Non-owner occupied commercial real estate | 587,801 | 871 | 588,672 |
| Multifamily | 673,882 | 337 | 674,219 |
| Construction/land development | 634,944 | 1,376 | 636,320 |
| | 1,896,627 | 2,584 | 1,899,211 |
| Commercial and industrial loans | | | |
| Owner occupied commercial real estate | 281,635 | 1,256 | 282,891 |
| Commercial business | 221,239 | 2,414 | 223,653 |
| | 502,874 | 3,670 | 506,544 |
| | $ 3,828,909 | $ 20,542 | $ 3,849,451 |

(1) Includes $5.5 million and $18.0 million of loans at December 31, 2017 and 2016, respectively, where a fair value option election was made at the time of origination and, therefore, are carried at fair value with changes recognized in the consolidated statements of operations.

The following tables present information about TDR activity during the periods presented.

| | Year Ended December 31, 2017 | | | |
|---|---|---|---|---|
| (dollars in thousands) | Concession type | Number of loan modifications | Recorded investment | Related charge-offs |
| Consumer loans | | | | |
| Single family | | | | |
| | Interest rate reduction | 56 | $ 10,040 | $ — |
| | Payment restructure | 102 | 21,356 | — |
| Home equity and other | | | | |
| | Payment restructure | 2 | 351 | — |
| Total consumer | | | | |
| | Interest rate reduction | 56 | 10,040 | — |
| | Payment restructure | 104 | 21,707 | — |
| | | 160 | 31,747 | — |
| Commercial and industrial loans | | | | |
| Commercial business | | | | |
| | Payment restructure | 1 | 18 | — |
| Total commercial and industrial | | | | |
| | Payment restructure | 1 | 18 | — |
| | | 1 | 18 | — |
| Total loans | | | | |
| | Interest rate reduction | 56 | 10,040 | — |
| | Payment restructure | 105 | 21,725 | — |
| | | 161 | $ 31,765 | $ — |

| | Year Ended December 31, 2016 | | | |
|---|---|---|---|---|
| (dollars in thousands) | Concession type | Number of loan modifications | Recorded investment | Related charge-offs |
| Consumer loans | | | | |
| Single family | | | | |
| | Interest rate reduction | 36 | $ 7,453 | $ — |
| | Payment restructure | 51 | 10,578 | — |
| Home equity and other | | | | |
| | Interest rate reduction | 2 | 113 | — |
| | Payment restructure | 1 | 192 | — |
| Total consumer | | | | |
| | Interest rate reduction | 38 | 7,566 | — |
| | Payment restructure | 52 | 10,770 | — |
| | | 90 | 18,336 | — |
| Commercial and industrial loans | | | | |
| Commercial business | | | | |
| | Payment restructure | 1 | 51 | — |
| Total commercial and industrial | | | | |
| | Payment restructure | 1 | 51 | — |
| | | 1 | 51 | — |
| Total loans | | | | |
| | Interest rate reduction | 38 | 7,566 | — |
| | Payment restructure | 53 | 10,821 | — |
| | | 91 | $ 18,387 | $ — |

| | Year Ended December 31, 2015 | | | |
|---|---|---|---|---|
| (dollars in thousands) | Concession type | Number of loan modifications | Recorded investment | Related charge-offs |
| Consumer loans | | | | |
| Single family | | | | |
| | Interest rate reduction | 47 | $ 10,167 | $ — |
| Home equity and other | | | | |
| | Interest rate reduction | 2 | 130 | — |
| Total consumer | | | | |
| | Interest rate reduction | 49 | 10,297 | — |
| | | 49 | 10,297 | — |
| Commercial and industrial loans | | | | |
| Commercial business | | | | |
| | Interest rate reduction | 2 | 482 | — |
| Total commercial and industrial | | | | |
| | Interest rate reduction | 2 | 482 | — |
| | | 2 | 482 | — |
| Total loans | | | | |
| | Interest rate reduction | 51 | 10,779 | — |
| | | 51 | $ 10,779 | $ — |

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The following table presents loans that were modified as TDRs within the previous 12 months and subsequently re-defaulted during the years ended December 31, 2017 and 2016, respectively. A TDR loan is considered re-defaulted when it becomes doubtful that the objectives of the modifications will be met, generally when a consumer loan TDR becomes 60 days or more past due on principal or interest payments or when a commercial loan TDR becomes 90 days or more past due on principal or interest payments.

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| (dollars in thousands) | Number of loan relationships that re-defaulted | Recorded investment | Number of loan relationships that re-defaulted | Recorded investment |
| Consumer loans | | | | |
| Single family | 21 | $ 4,286 | 19 | $ 4,464 |
| Home equity and other | — | — | 1 | 93 |
| | 21 | $ 4,286 | 20 | $ 4,557 |

**NOTE 6–OTHER REAL ESTATE OWNED:**

Other real estate owned consisted of the following.

| | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Single family | $664 | $2,133 |
| Commercial real estate | — | 552 |
| Construction/land development | — | 5,381 |
| | 664 | 8,066 |
| Valuation allowance | — | (2,823 ) |
| | $664 | $5,243 |

Activity in other real estate owned was as follows.

| | Years Ended December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Beginning balance | $5,243 | $7,531 |
| Additions | 1,113 | 5,417 |
| Loss provisions | (33 ) | (1,553 ) |
| Reductions related to sales | (5,659 ) | (6,152 ) |
| Ending balance | $664 | $5,243 |

Activity in the valuation allowance for other real estate owned was as follows.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Beginning balance | $3,095 | $1,764 | $1,303 |
| Loss provisions | 33 | 1,553 | 695 |
| (Charge-offs), net of recoveries | (3,128 ) | (222 ) | (234 ) |
| Ending balance | $— | $3,095 | $1,764 |

The components of the net cost of operation and sale of other real estate owned are as follows.

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Maintenance (reimbursements) costs | $(114) | $469 | $453 |
| Loss provisions | — | 1,332 | 695 |
| Net gain on sales | (416) | (37) | (447) |
| Net operating income (loss) | — | — | (41) |
| Net (income) cost from operation and sale of other real estate owned | $(530) | $1,764 | $660 |

At December 31, 2017, we had concentrations within the state of Washington, primarily in Spokane County, representing 76.8% of the total balance of other real estate owned. At December 31, 2016, we had concentrations within the state of Washington, primarily in Thurston County, representing 78.2% of the total balance of other real estate owned.

**NOTE 7–PREMISES AND EQUIPMENT, NET:**

Premises and equipment consisted of the following.

| | December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Furniture and equipment | $70,657 | $65,089 |
| Leasehold improvements | 57,402 | 45,075 |
| Land and buildings | 28,898 | 10,437 |
| | 156,957 | 120,601 |
| Less: accumulated depreciation | (52,303) | (42,965) |
| | $104,654 | $77,636 |

Depreciation expense for the years ended December 31, 2017, 2016, and 2015, was $13.5 million, $11.4 million, and $10.9 million, respectively.

**NOTE 8–DEPOSITS:**

Deposit balances, including stated rates, were as follows.

| (in thousands) | At December 31, 2017 | 2016 |
|---|---|---|
| Noninterest-bearing accounts | $980,902 | $964,829 |
| NOW accounts, 0.00% to 1.98% at December 31, 2017 and 0.00% to 1.00% at December 31, 2016 | 461,349 | 468,812 |
| Statement savings accounts, due on demand, 0.05% to 1.13% at December 31, 2017 and December 31, 2016 | 293,858 | 301,361 |
| Money market accounts, due on demand, 0.00% to 1.80% and at December 31, 2017 and 0.00% to 1.70% at December 31, 2016 | 1,834,154 | 1,603,141 |
| Certificates of deposit, 0.05% to 3.80% at December 31, 2017 and December 31, 2016 | 1,190,689 | 1,091,558 |
| | $4,760,952 | $4,429,701 |

There were $178.4 million and $21.8 million in public funds included in deposits at December 31, 2017 and 2016, respectively.

Interest expense on deposits was as follows.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| NOW accounts | $1,964 | $1,950 | $1,773 |
| Statement savings accounts | 1,007 | 1,029 | 1,032 |
| Money market accounts | 8,604 | 7,398 | 4,945 |
| Certificates of deposit | 12,337 | 8,632 | 4,051 |
| | $23,912 | $19,009 | $11,801 |

The weighted-average interest rates on certificates of deposit at December 31, 2017, 2016 and 2015 were 1.12%, 0.96% and 0.96% respectively.

Certificates of deposit outstanding mature as follows.

| (in thousands) | December 31, 2017 |
|---|---|
| Within one year | $889,790 |
| One to two years | 236,414 |
| Two to three years | 33,505 |
| Three to four years | 13,412 |
| Four to five years | 17,415 |
| Thereafter | 153 |
| | $1,190,689 |

The aggregate amount of time deposits in denominations of more than $250 thousand at December 31, 2017 and 2016 was $88.8 million and $87.4 million, respectively. There were $345.5 million and $234.4 million of brokered deposits at December 31, 2017 and 2016, respectively.

**NOTE 9–FEDERAL HOME LOAN BANK AND OTHER BORROWINGS:**

Federal Home Loan Bank

The Company borrows funds through advances from the FHLB. FHLB advances totaled $979.2 million and $868.4 million as of December 31, 2017, and 2016, respectively.

Weighted-average interest rates on the advances were 1.58%, 0.91%, and 0.64% at December 31, 2017, 2016 and 2015, respectively. The advances may be collateralized by stock in the FHLB, pledged securities, and unencumbered qualifying loans. The Company has an available line of credit with the FHLB equal to 35.0% of assets, subject to collateralization requirements. Based on the amount of qualifying collateral available, borrowing capacity from the FHLB was $579.2 million as of December 31, 2017. The FHLB is not contractually bound to continue to offer credit to the Company, and the Company's access to credit from this agency for future borrowings may be discontinued at any time.

FHLB advances outstanding by contractual maturities were as follows.

| | At December 31, 2017 | | |
|---|---|---|---|
| (in thousands) | Advances outstanding | Weighted-average interest rate | |
| 2018 | $963,611 | 1.53 | % |
| 2019 | 10,000 | 4.27 | |
| 2020 | — | — | |
| 2021 | — | — | |
| 2022 and thereafter | 5,590 | 5.31 | |
| | $979,201 | 1.58 | % |

The Company, as a member of the FHLB, is required to own shares of FHLB stock. This requirement is based upon the amount of either the eligible collateral or advances outstanding from the FHLB. As of December 31, 2017 and 2016, the Company held $46.6 million and $40.3 million, respectively, of FHLB stock. FHLB stock is carried at par value and is restricted to transactions between the FHLB and its member institutions. FHLB stock can only be purchased or redeemed at par value. Both cash and dividends received on FHLB stock are reported in earnings.

Management periodically evaluates FHLB stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of ultimate recoverability of par value rather than recognizing temporary declines in value. The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB; and (4) the liquidity position of the FHLB. Based on this evaluation, the Company determined there is no other-than-temporary impairment of the FHLB stock investment as of December 31, 2017, or 2016.

Federal Reserve Bank of San Francisco

The Company may also borrow on a collateralized basis from the Federal Reserve Bank of San Francisco ("FRBSF"). At December 31, 2017 and 2016, there were no outstanding borrowings from the FRBSF. Based on the amount of qualifying collateral available, borrowing capacity from the FRBSF was $331.5 million at December 31, 2017. The FRBSF is not contractually bound to offer credit to the Company, and the Company's access to credit from this agency for future borrowings may be discontinued at any time.

Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

Federal funds transactions involve lending reserve balances on a short-term basis. Securities borrowed or purchased under agreements to resell are collateralized lending transactions utilized to accommodate customer transactions, earn interest rate spreads, and obtain securities for settlement and for collateral. At December 31, 2017 and 2016, we had no balance of federal funds purchased and securities sold under agreements to repurchase.

**NOTE 10–LONG-TERM DEBT:**

At December 31, 2017 and 2016, the Company had long-term debt balance of $125.3 million and $125.1 million, respectively, consisting of senior notes issued during 2016 and junior subordinated debentures issued in prior years.

In 2016, the Company closed on $65.0 million in aggregate principal amount of its 6.50% Senior Notes due 2026 (the "Senior Notes") at an offering price of 100% plus accrued interest, which represented $63.4 million of long-term debt balance at December 31, 2017.

The Company raised capital by issuing trust preferred securities during the period from 2005 through 2007, resulting in a debt balance of $61.9 million that remains outstanding at December 31, 2017. In connection with the issuance of trust preferred securities, HomeStreet, Inc. issued to HomeStreet Statutory Trust Junior Subordinated Deferrable Interest Debentures. The sole assets of the HomeStreet Statutory Trust are the Subordinated Debt Securities I, II, III, and IV.

The Subordinated Debt Securities are as follows:

| | HomeStreet Statutory | | | |
|---|---|---|---|---|
| (in thousands) | I | II | III | IV |
| Date issued | June 2005 | September 2005 | February 2006 | March 2007 |
| Amount | $5,155 | $20,619 | $20,619 | $15,464 |
| Interest rate | 3 MO LIBOR + 1.70% | 3 MO LIBOR + 1.50% | 3 MO LIBOR + 1.37% | 3 MO LIBOR + 1.68% |
| Maturity date | June 2035 | December 2035 | March 2036 | June 2037 |
| Call option(1) | 5 years | 5 years | 5 years | 5 years |

(1) Call options are exercisable at par.

**NOTE 11–DERIVATIVES AND HEDGING ACTIVITIES:**

To reduce the risk of significant interest rate fluctuations on the value of certain assets and liabilities, such as certain mortgage loans held for sale or MSRs, the Company utilizes derivatives, such as forward sale commitments, futures, option contracts, interest rate swaps and swaptions as risk management instruments in its hedging strategy. Derivative transactions are measured in terms of notional amount, which is not recorded in the consolidated statements of financial condition. The notional amount is generally not exchanged and is used as the basis for interest and other contractual payments.

The use of derivatives as interest rate risk management instruments helps minimize significant, unplanned fluctuations in earnings, fair value of assets and liabilities, and cash flows caused by interest rate volatility. This approach involves mitigating the repricing characteristics of certain assets or liabilities so that changes in interest rates do not have a significant adverse effect on net interest margin and cash flows. As a result of interest rate fluctuations, hedged assets and liabilities will gain or lose market value. In a fair value hedging strategy, the effect of this gain or loss will generally be offset by the gain or loss on the derivatives linked to hedged assets or liabilities. In a cash flow hedging strategy, management manages the variability of cash payments due to interest rate fluctuations by the effective use of derivatives linked to hedged assets and liabilities. We held no derivatives designated as a fair value, cash flow or foreign currency hedge instrument at December 31, 2017 or 2016. Derivatives are reported at their respective fair values in the other assets or accounts payable and other liabilities line items on the consolidated statements of financial condition, with changes in fair value reflected in current period earnings.

As permitted under U.S. GAAP, the Company nets derivative assets and liabilities when a legally enforceable master netting agreement exists between the Company and the derivative counterparty, which are documented under industry standard master agreements and credit support annexes. The Company's master netting agreements provide that following an uncured payment default or other event of default the non-defaulting party may promptly terminate all transactions between the parties and determine a net amount due to be paid to, or by, the defaulting party. An event of default may also occur under a credit support annex if a party fails to make a collateral delivery (which remains uncured following applicable notice and grace periods). The Company's right of offset requires that master netting agreements are legally enforceable and that the exercise of rights by the non-defaulting party under these agreements will not be stayed, or avoided under applicable law upon an event of default including bankruptcy, insolvency or similar proceeding.

The collateral used under the Company's master netting agreements is typically cash, but securities may be used under agreements with certain counterparties. Receivables related to cash collateral that has been paid to counterparties is included in other assets on the Company's consolidated statements of financial condition. Any securities pledged to counterparties as collateral remain on the consolidated statement of financial condition. Refer to Note 4, *Investment Securities* for further information on securities collateral pledged. At December 31, 2017 and 2016, the Company did not hold any collateral received from counterparties under derivative transactions.

The Company's derivative activities are monitored by the asset/liability management committee. The treasury function, which includes asset/liability management, is responsible for hedging strategies developed through analysis of data from financial models and other internal and industry sources. The resulting hedging strategies are incorporated into the overall risk management strategies.

For further information on the policies that govern derivative and hedging activities, see Note 1, *Summary of Significant Accounting Policies*.

The notional amounts and fair values for derivatives consist of the following.

| | At December 31, 2017 | | |
|---|---|---|---|
| | Notional amount | Fair value derivatives | |
| (in thousands) | | Asset | Liability |
| Forward sale commitments | $1,687,658 | $1,311 | $(1,445) |
| Interest rate swaptions | 120,000 | — | — |
| Interest rate lock and purchase loan commitments | 472,733 | 12,950 | (25) |
| Interest rate swaps | 1,869,000 | 12,171 | (23,654) |
| Eurodollar futures | $3,287,000 | — | (101) |
| Total derivatives before netting | $7,436,391 | 26,432 | (25,225) |
| Netting adjustment/Cash collateral [(1)] | | (6,646) | 23,505 |
| Carrying value on consolidated statements of financial condition | | $19,786 | $(1,720) |

| | At December 31, 2016 | | |
|---|---|---|---|
| | Notional amount | Fair value derivatives | |
| (in thousands) | | Asset | Liability |
| Forward sale commitments | $3,596,677 | $24,623 | $(15,203) |
| Interest rate swaptions | 20,000 | 1 | — |
| Interest rate lock and purchase loan commitments | 746,102 | 19,586 | (367) |
| Interest rate swaps | 1,689,850 | 15,016 | (26,829) |
| Total derivatives before netting | $6,052,629 | 59,226 | (42,399) |
| Netting adjustment/Cash collateral [(1)] | | 10,174 | 37,836 |

| | | |
|---|---|---|
| Carrying value on consolidated statements of financial condition | $69,400 | $(4,563) |

(1) Includes cash collateral of $16.9 million and $48.0 million at December 31, 2017 and 2016, respectively, as part of netting adjustments which primarily consists of collateral transferred by the Company at the initiation of derivative transactions and held by the counterparty as security.

The following tables present gross and net information about derivative instruments.

| (in thousands) | At December 31, 2017 Gross fair value | Netting adjustments/Cash collateral[1] | Carrying value | Securities not offset in consolidated balance sheet (disclosure-only netting) | Net amount |
|---|---|---|---|---|---|
| Derivative assets | $26,432 | $ (6,646 ) | $19,786 | $ — | $19,786 |
| Derivative liabilities | $(25,225 ) | $ 23,505 | $(1,720 ) | $ 1,213 | $(507 ) |

| (in thousands) | At December 31, 2016 Gross fair value | Netting adjustments/Cash collateral [1] | Carrying value | Securities not offset in consolidated balance sheet (disclosure-only netting) | Net amount |
|---|---|---|---|---|---|
| Derivative assets | $59,226 | $ 10,174 | $69,400 | $ — | $69,400 |
| Derivative liabilities | $(42,399 ) | $ 37,836 | $(4,563 ) | $ 1,820 | $(2,743 ) |

(1) Includes cash collateral of $16.9 million and $48.0 million at December 31, 2017 and 2016, respectively, as part of netting adjustments which primarily consists of collateral transferred by the Company at the initiation of derivative transactions and held by the counterparty as security.

Free-standing derivatives are used for fair value interest rate risk management purposes and do not qualify for hedge accounting treatment, referred to as economic hedges. Economic hedges are used to hedge against adverse changes in fair value of single family mortgage servicing rights (“single family MSRs”), interest rate lock commitments (“IRLCs”) for single family mortgage loans that the Company intends to sell, and single family mortgage loans held for sale.

Free-standing derivatives used as economic hedges for single family MSRs typically include positions in interest rate futures, options on 10-year treasury contracts, forward sales commitments on mortgage-backed securities, and interest rate swap and swaption contracts. The single family MSRs and the free-standing derivatives are carried at fair value with changes in fair value included in mortgage servicing income.

The free-standing derivatives used as economic hedges for IRLCs and single family mortgage loans held for sale are forward sales commitments on mortgage-backed securities and option contracts. IRLCs, single family mortgage loans held for sale, and the free-standing derivatives (“economic hedges”) are carried at fair value with changes in fair value included in net gain on mortgage loan origination and sale activities.

The following table presents the net gain (loss) recognized on derivatives, including economic hedge derivatives, within the respective line items in the statement of operations for the periods indicated.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Recognized in noninterest income: | | | |
| Net (loss) gain on loan origination and sale activities [1] | $(28,549) | $12,443 | $2,080 |
| Loan servicing income (loss) [2] | 9,732 | (4,680) | 11,709 |
| Other [3] | — | 735 | — |
| | $(18,817) | $8,498 | $13,789 |

(1) Comprised of interest rate lock commitments ("IRLCs") and forward contracts used as an economic hedge of IRLCs and single family mortgage loans held for sale.
(2) Comprised of interest rate swaps, interest rate swaptions and forward contracts used as an economic hedge of single family MSRs.
(3) Comprised of interest rate swaps, interest rate swaptions and forward contracts used as an economic hedge of fair value option loans held for investment.

## NOTE 12–MORTGAGE BANKING OPERATIONS:

Loans held for sale consisted of the following.

| (in thousands) | At December 31, 2017 | 2016 |
|---|---|---|
| Single family | $577,313 | $656,334 |
| Multifamily DUS® [1] | 29,651 | 35,506 |
| SBA | 3,938 | 5,207 |
| CRE Non-DUS® [1][2] | — | 17,512 |
| Total loans held for sale | $610,902 | $714,559 |

(1) Fannie Mae Multifamily Delegated Underwriting and Servicing Program (“DUS®) is a registered trademark of Fannie Mae.
(2) Loans originated as Held for Investment.

Loans sold consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Single family | $7,508,949 | $8,785,412 | $7,038,635 |
| Multifamily DUS ® [1] | 347,084 | 301,442 | 204,744 |
| SBA | 26,841 | 17,308 | 14,275 |
| CRE Non-DUS® [1][2] | 321,699 | 150,903 [3] | 15,038 |
| Total loans sold | $8,204,573 | $9,255,065 | $7,272,692 |

(1) Fannie Mae Multifamily DUS® is a registered trademark of Fannie Mae.
(2) Loans originated as Held for Investment.
(3) Included $63.2 million in single family loans sold transferred to held for investment during 2016.

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Gain on loan origination and sale activities, including the effects of derivative risk management instruments, consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Single family: | | | |
| Servicing value and secondary market gains[1] | $209,027 | $260,477 | $205,513 |
| Loan origination and funding fees | 26,822 | 29,966 | 22,221 |
| Total single family | 235,849 | 290,443 | 227,734 |
| Multifamily DUS® | 13,210 | 11,397 | 7,125 |
| SBA | 2,439 | 1,414 | 1,070 |
| CRE Non-DUS® [2] | 4,378 | 4,059 | 459 |
| Total gain on loan origination and sale activities | $255,876 | $307,313 | $236,388 |

(1) Comprised of gains and losses on interest rate lock and purchase loan commitments (which considers the value of servicing), single family loans held for sale, forward sale commitments used to economically hedge secondary market activities, and changes in the Company's repurchase liability for loans that have been sold.
(2) Loan originated as held for investment.

The Company’s portfolio of loans serviced for others is primarily comprised of loans held in U.S. government and agency MBS issued by Fannie Mae, Freddie Mac and Ginnie Mae. Loans serviced for others are not included in the consolidated statements of financial condition as they are not assets of the Company.

The composition of loans serviced for others that contribute to loan servicing income is presented below at the unpaid principal balance.

| (in thousands) | At December 31, 2017 | 2016 |
|---|---|---|
| Single family | | |
| U.S. government and agency | $22,123,710 | $18,931,835 |
| Other | 507,437 | 556,621 |
| | 22,631,147 | 19,488,456 |
| Commercial | | |
| Multifamily DUS® | 1,311,399 | 1,108,040 |
| Other | 79,797 | 69,323 |
| | 1,391,196 | 1,177,363 |
| Total loans serviced for others | $24,022,343 | $20,665,819 |

The Company has made representations and warranties that the loans sold meet certain requirements. The Company may be required to repurchase mortgage loans or indemnify loan purchasers due to defects in the origination process of the loan, such as documentation errors, underwriting errors and judgments, appraisal errors, early payment defaults and fraud. For further information on the Company's mortgage repurchase liability, see Note 13, *Commitments, Guarantees and Contingencies.*

The following is a summary of changes in the Company's liability for estimated mortgage repurchase losses.

| (in thousands) | Years Ended December 31, 2017 | 2016 |
|---|---|---|
| Balance, beginning of period | $3,382 | $2,922 |
| Additions, net of adjustments[1] | 174 | 1,542 |
| Realized losses [2] | (541 ) | (1,082 ) |
| Balance, end of period | $3,015 | $3,382 |

(1) Includes additions for new loan sales and changes in estimated probable future repurchase losses on previously sold loans.
(2) Includes principal losses and accrued interest on repurchased loans, "make-whole" settlements, settlements with claimants and certain related expense.

The Company has agreements with investors to advance scheduled principal and interest amounts on delinquent loans. Advances are also made to fund the foreclosure and collection costs of delinquent loans prior to the recovery of reimbursable amounts from investors or borrowers. Advances of $5.3 million and $7.5 million were recorded in other assets as of December 31, 2017 and 2016, respectively.

When the Company has the unilateral right to repurchase Ginnie Mae pool loans it has previously sold (generally loans that are more than 90 days past due), the Company then records the loan on its consolidated statement of financial condition. At December 31, 2017 and 2016, delinquent or defaulted mortgage loans currently in Ginnie Mae pools that the Company has recognized on its consolidated statements of financial condition totaled $39.3 million and $35.8 million, respectively, with a corresponding amount recorded within accounts payable and other liabilities on the consolidated statements of financial condition. The recognition of previously sold loans does not impact the accounting for the previously recognized MSRs.

Revenue from mortgage servicing, including the effects of derivative risk management instruments, consisted of the following.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Servicing income, net: | | | |
| Servicing fees and other | $66,192 | $53,654 | $42,016 |
| Changes in fair value of single family MSRs due to modeled amortization [1] | (35,451 ) | (33,305 ) | (34,038 ) |
| Amortization of multifamily and SBA MSRs | (3,932 ) | (2,635 ) | (1,992 ) |
| | 26,809 | 17,714 | 5,986 |
| Risk management, single family MSRs: | | | |
| Changes in fair value of MSRs due to changes in market inputs and/or model updates [2] | (1,157 ) | 20,025 | 6,555 |
| Net gain (loss) from derivatives economically hedging MSR | 9,732 | (4,680 ) | 11,709 |
| | 8,575 | 15,345 | 18,264 |
| Loan servicing income | $35,384 | $33,059 | $24,250 |

(1) Represents changes due to collection/realization of expected cash flows and curtailments.
(2) Principally reflects changes in market inputs, which include current market interest rates and prepayment model updates, both of which affect future prepayment speed and cash flow projections.

All MSRs are initially measured and recorded at fair value at the time loans are sold. Single family MSRs are subsequently carried at fair value with changes in fair value reflected in earnings in the periods in which the changes occur, while multifamily and SBA MSRs are subsequently carried at the lower of amortized cost or fair value.

The fair value of MSRs is determined based on the price that would be received to sell the MSRs in an orderly transaction between market participants at the measurement date. The Company determines fair value using a valuation model that calculates the net present value of estimated future cash flows. Estimates of future cash flows include contractual servicing fees, ancillary income and costs of servicing, the timing of which are impacted by assumptions, primarily expected prepayment speeds and discount rates, which relate to the underlying performance of the loans.

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The initial fair value measurement of MSRs is adjusted up or down depending on whether the underlying loan pool interest rate is at a premium, discount or par. Key economic assumptions used in measuring the initial fair value of capitalized single family MSRs were as follows.

| | Years Ended December 31, | | |
|---|---|---|---|
| (rates per annum) (1) | 2017 | 2016 | 2015 |
| Constant prepayment rate ("CPR") (2) | 13.36 % | 13.93 % | 14.95 % |
| Discount rate (3) | 10.27 % | 10.28 % | 10.29 % |

(1) Weighted average rates for sales during the period for sales of loans with similar characteristics.
(2) Represents the expected lifetime average.
(3) Discount rate is a rate based on market observations.

Key economic assumptions and the sensitivity of the current fair value for single family MSRs to immediate adverse changes in those assumptions were as follows.

| (dollars in thousands) | At December 31, 2017 |
|---|---|
| Fair value of single family MSR | $ 258,560 |
| Expected weighted-average life (in years) | 6.12 |
| Constant prepayment rate (1) | 12.40 % |
| Impact on 25 basis points adverse change in interest rates | $ (21,004 ) |
| Impact on 50 basis points adverse change in interest rates | $ (42,036 ) |
| Discount rate | 10.40 % |
| Impact on fair value of 100 basis points increase | $ (8,958 ) |
| Impact on fair value of 200 basis points increase | $ (17,567 ) |

(1) Represents the expected lifetime average.

These sensitivities are hypothetical and subject to key assumptions of the underlying valuation model. As the table above demonstrates, the Company’s methodology for estimating the fair value of MSRs is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the MSRs is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made as of a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The changes in single family MSRs measured at fair value are as follows.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Beginning balance | $226,113 | $156,604 | $112,439 |
| Additions and amortization: | | | |
| Originations | 68,499 | 82,789 | 70,659 |
| Purchases | 565 | — | 989 |
| Changes due to modeled amortization[1] | (35,451) | (33,305) | (34,038) |
| Net additions and amortization | 33,613 | 49,484 | 37,610 |
| Changes in fair value of MSRs due to changes in market inputs and/or model updates [2] | (1,166) | 20,025 | 6,555 |
| Ending balance | $258,560 | $226,113 | $156,604 |

(1) Represents changes due to collection/realization of expected cash flows and curtailments.

(2) Principally reflects changes in market inputs, which include current market interest rates and prepayment model updates, both of which affect future prepayment speed and cash flow projections.

MSRs resulting from the sale of multifamily loans are recorded at fair value and subsequently carried at the lower of amortized cost or fair value. Multifamily MSRs are amortized in proportion to, and over, the estimated period the net servicing income will be collected.

The changes in multifamily MSRs measured at the lower of amortized cost or fair value were as follows.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Beginning balance | $19,747 | $14,651 | $10,885 |
| Origination | 9,915 | 7,731 | 5,758 |
| Amortization | (3,569) | (2,635) | (1,992) |
| Ending balance | $26,093 | $19,747 | $14,651 |

At December 31, 2017, the expected weighted-average life of the Company’s multifamily MSRs was 10.33 years. Projected amortization expense for the gross carrying value of multifamily MSRs is estimated as follows.

| (in thousands) | At December 31, 2017 |
|---|---|
| 2018 | $ 3,527 |
| 2019 | 3,429 |
| 2020 | 3,355 |
| 2021 | 3,146 |
| 2022 | 2,825 |
| 2023 and thereafter | 9,811 |
| Carrying value of multifamily MSR | $ 26,093 |

The projected amortization expense of multifamily MSRs is an estimate and subject to key assumptions of the underlying valuation model. The amortization expense for future periods was calculated by applying the same quantitative factors, such as actual MSR prepayment experience and discount rates, which were used to determine amortization expense. These factors are inherently subject to significant fluctuations, primarily due to the effect that changes in interest rates may have on expected loan prepayment experience. Accordingly, any projection of MSR amortization in future periods is limited by the conditions that existed at the time the calculations were performed and may not be indicative of actual amortization expense that will be recorded in future periods.

**NOTE 13–COMMITMENTS, GUARANTEES AND CONTINGENCIES:**

Commitments

Commitments to extend credit are agreements to lend to customers in accordance with predetermined contractual provisions. These commitments may be for specific periods or contain termination clauses and may require the payment of a fee by the borrower. The total amount of unused commitments do not necessarily represent future credit exposure or cash requirements in that commitments may expire without being drawn upon.

The Company makes certain unfunded loan commitments as part of its lending activities that have not been recognized in the Company's financial statements. These include commitments to extend credit made as part of the Company's lending activities on loans the Company intends to hold in its loans held for investment portfolio. The aggregate amount of these unrecognized unfunded loan commitments existing at December 31, 2017 and 2016 was $56.9 million and $42.6 million, respectively.

In the ordinary course of business, the Company extends secured and unsecured open-end loans to meet the financing needs of its customers. Undistributed construction loan commitments, where the Company has an obligation to advance funds for construction progress payments, were $706.7 million and $603.8 million at December 31, 2017 and 2016, respectively. Unused home equity and commercial banking funding lines totaled $456.1 million and $289.3 million at December 31, 2017 and 2016, respectively. The Company has recorded an allowance for credit losses on loan commitments, included in accounts payable and other liabilities on the consolidated statements of financial condition, of $1.3 million and $1.3 million at December 31, 2017 and 2016, respectively.

The Company is in certain agreements to invest in qualifying small businesses and small enterprises that have not been recognized in the Company's financial statements. At December 31, 2017 and 2016 we had a $11.0 million and $4.0 million, respectively, future commitment to invest in these enterprises.

The Company is obligated under non-cancelable leases for office space and leased equipment. Generally, the office leases also contain five-year renewal and space options. Rental expense under non-cancelable operating leases totaled $26.1 million, $22.7 million, and $20.1 million for the years ended December 31, 2017, 2016, and 2015, respectively.

Minimum rental payments for all non-cancelable leases were as follows.

| (in thousands) | At December 31, 2017 |
|---|---|
| 2018 | $ 26,477 |
| 2019 | 23,685 |
| 2020 | 20,904 |
| 2021 | 17,757 |
| 2022 | 14,995 |
| 2023 and thereafter | 48,752 |
| Total minimum payments | $ 152,570 |

Guarantees

In the ordinary course of business, the Company sells loans through the Fannie Mae Multifamily Delegated Underwriting and Servicing Program ("DUS®) that are subject to a credit loss sharing arrangement. The Company services the loans for Fannie Mae and shares in the risk of loss with Fannie Mae under the terms of the DUS contracts. Under the program, the DUS lender is contractually responsible for the first 5% of losses and then shares in the remainder of losses with Fannie Mae with a maximum lender loss of 20% of the original principal balance of each DUS loan. For loans that have been sold through this program, a liability is recorded for this loss sharing arrangement under the accounting guidance for guarantees. As of December 31, 2017 and 2016, the total unpaid principal balance of loans sold under this program was $1.31 billion and $1.11 billion, respectively. The Company's reserve liability related to this arrangement totaled $2.0 million and $1.8 million at December 31, 2017 and 2016, respectively. There were no actual losses incurred under this arrangement during the years ended December 31, 2017, 2016 and 2015.

Mortgage repurchase liability

In the ordinary course of business, the Company sells residential mortgage loans to GSEs and other entities. In addition, the Company pools FHA-insured and VA-guaranteed mortgage loans into Ginnie Mae, Fannie Mae and Freddie Mac guaranteed mortgage-backed securities. The Company has made representations and warranties that the loans sold meet certain requirements. The Company may be required to repurchase mortgage loans or indemnify loan purchasers due to defects in the origination process of the loan, such as documentation errors, underwriting errors and judgments, early payment defaults and fraud.

These obligations expose the Company to mark-to-market and credit losses on the repurchased mortgage loans after accounting for any mortgage insurance that we may receive. Generally, the maximum amount of future payments the Company would be required to make for breaches of these representations and warranties would be equal to the unpaid principal balance of such loans that are deemed to have defects that were sold to purchasers plus, in certain circumstances, accrued and unpaid interest on such loans and certain expenses.

The Company does not typically receive repurchase requests from the FHA or VA. As an originator of FHA-insured or VA-guaranteed loans, the Company is responsible for obtaining the insurance with FHA or the guarantee with the VA. If loans are later found not to meet the requirements of FHA or VA, through required internal quality control reviews or through agency audits, the Company may be required to indemnify FHA or VA against losses. The loans remain in Ginnie Mae pools unless and until they are repurchased by the Company. In general, once an FHA or VA loan becomes 90 days past due, the Company repurchases the FHA or VA residential mortgage loan to minimize the cost of interest advances on the loan. If the loan is cured through borrower efforts or through loss mitigation activities, the loan may be resold into a Ginnie Mae pool. The Company's liability for mortgage loan repurchase losses incorporates probable losses associated with such indemnification.

The total unpaid principal balance of loans sold on a servicing-retained basis that were subject to the terms and conditions of these representations and warranties totaled $22.71 billion and $19.56 billion as of December 31, 2017 and 2016, respectively. At December 31, 2017 and 2016, the Company had recorded a mortgage repurchase liability for loans sold on a servicing-retained and servicing-released basis, included in accounts payable and other liabilities on the consolidated statements of financial condition, of $3.0 million and $3.4 million, respectively.

Contingencies

In the normal course of business, the Company may have various legal claims and other similar contingent matters outstanding for which a loss may be realized. For these claims, the Company establishes a liability for contingent losses when it is probable that a loss has been incurred and the amount of loss can be reasonably estimated. For claims determined to be reasonably possible but not probable of resulting in a loss, there may be a range of possible losses in excess of the established liability. At December 31, 2017, we reviewed our legal claims and determined that there were no material claims that were considered to be probable or reasonably possible of resulting in a material loss. As a result, the Company did not have any material amounts reserved for legal claims as of December 31, 2017.

**NOTE 14–INCOME TAXES:**

On December 22, 2017, President Trump signed into law a major tax legislation commonly referred to as the Tax Cuts and Jobs Act ("Tax Reform Act"). The Tax Reform Act reduces the U.S. federal corporate income tax rate from 35 percent to 21 percent and makes many other changes to the U.S. tax code. Upon enactment, we were required to revalue our deferred tax assets and liabilities at the new statutory tax rate. As a result of this revaluation, we have recognized a one-time, non-cash, $23.3 million deferred income tax benefit in our 2017 year-end provision.

Income tax (benefit) expense consisted of following:

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Current (benefit) expense | | | |
| Federal | $(649) | $(1,154) | $(1,469) |
| State and local | 62 | 1,595 | 668 |
| Deferred expense (benefit) | | | |
| Federal | 17,637 | 27,538 | 15,301 |
| Revaluation of deferred items | (23,325) | — | — |
| State and local | 528 | 3,058 | 602 |
| Tax credit investment amortization | 2,990 | 1,589 | 486 |
| Total income tax (benefit) expense | $(2,757) | $32,626 | $15,588 |

Income tax (benefit) expense differed from amounts computed at the federal income tax statutory rate as follows:

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Income taxes at statutory rate | $23,166 | $31,772 | $19,917 |
| State income tax expense net of federal tax benefit | 1,207 | 2,073 | 715 |
| Tax-exempt interest | (2,855) | (2,177) | (1,307) |
| Tax credits | (2,041) | (1,389) | (903) |
| Amortization of and pass-through losses from low income housing investments | 1,716 | 1,018 | 658 |
| Change in state rate | (714) | 811 | 722 |
| Bargain purchase gain | — | — | (2,704) |
| Reversal of deferred tax consequences on historical AFS | (2) | — | (1,107) |
| Impact from Federal Rate Change | (23,325) | — | — |
| Uncertain tax positions | 76 | — | — |
| Other, net | 15 | 518 | (403) |
| Total income tax (benefit) expense | $(2,757) | $32,626 | $15,588 |

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and those amounts used for tax return purposes. The following is a summary of the Company's significant portions of deferred tax assets and liabilities:

| | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Deferred tax assets: | | |
| Provision for loan losses | $11,844 | $18,123 |
| Federal and state net operating loss carryforwards | 3,914 | 7,073 |
| Other real estate owned | — | 1,196 |
| Accrued liabilities | 4,747 | 4,453 |
| Other investments | 145 | 283 |
| Leases | 2,336 | 3,121 |
| Unrealized loss on investment available for sale securities | 2,286 | 5,714 |
| Tax credits | 1,695 | 1,369 |
| Stock-based compensation | 993 | 1,164 |
| Loan valuation | 1,857 | 4,547 |
| Other, net | 1,158 | 2,163 |
| | 30,975 | 49,206 |
| Deferred tax liabilities: | | |
| Mortgage servicing rights | (58,195) | (76,680) |
| FHLB dividends | (316) | (522) |
| Deferred loan fees and costs | (3,828) | (3,653) |
| Premises and equipment | (5,267) | (6,960) |
| Intangibles | (1,371) | (2,813) |
| Other, net | (141) | (107) |
| | (69,118) | (90,735) |
| Net deferred tax liability | $(38,143) | $(41,529) |

The Company currently has a net deferred tax liability. This net deferred tax liability is included in accounts payable and other liabilities on the consolidated statements of financial condition. The Company's net deferred tax liability is now significantly lower compared to the prior year, due primarily to the new lower federal income tax rate effective January 1, 2018.

Management assesses the available positive and negative evidence to estimate if sufficient future taxable income will be generated to utilize the existing deferred tax assets. As of December 31, 2017 management determined that sufficient evidence exists to support the future utilization of all of the Company's deferred tax assets.

Utilization of the federal and state net operating loss and tax credit carryforwards may be subject to an annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986, as amended. Specifically, the Company is subject to annual limitations on the amounts of net operating loss and credit carryover that the Company can use from its pre-IPO period, or from the pre-acquisition periods of the companies that it has acquired in prior years. At December 31, 2017 and 2016, the Company has federal net operating loss carryforwards totaling $10.8 million and $16.1 million, respectively, which expire between 2029 and 2036. In addition, as of December 31, 2017, the Company has minimum tax credits of $1.6 million which never expire. The Tax Reform Act repeals the corporate alternative minimum tax rules and makes any unused minimum tax credit partially refundable in the tax years 2018 -

2020, and fully refundable in the tax year 2021. Accordingly, we expect to utilize all of the remaining minimum tax credit before 2022. We also have state net operating loss carryforwards as of December 31, 2017 and 2016 of $17.4 million and $14.0 million, respectively, that expire between 2018 and 2036.

Retained earnings at December 31, 2017 and 2016 include approximately $12.7 million in tax basis bad debt reserves for which no income tax liability has been recorded. This represents the balance of bad debt reserves created for tax purposes as of December 31, 1987. These amounts are subject to recapture (i.e., included in taxable income) in certain events, such as in the event HomeStreet Bank ceases to be a bank. In the event of recapture, the Company will incur both federal and state tax liabilities on this pre-1988 bad debt reserve balance at the then prevailing corporate tax rates.

The Company has recorded unrecognized tax positions of $514 thousand and $438 thousand as of December 31, 2017 and 2016, respectively, both periods including potential interest of $19 thousand. Any resolution of our unrecognized tax positions would impact our effective tax rate. We periodically evaluate our exposures associated with our filing positions. During 2017, we updated the amount of recorded potential liability based on actual proposed adjustments received from the relevant tax authority. We expect our uncertain tax positions will be settled within the next 12 months.

A reconciliation of our unrecognized tax positions, excluding accrued interest and penalties, for the years ended December 31, 2017, 2016 and 2015 is as follows:

| | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Balance, beginning of year | $419 | $419 | $— |
| Increases related to prior year tax positions | 76 | — | 419 |
| Balance, end of year | $495 | $419 | $419 |

The Company files federal income tax returns with the Internal Revenue Service and state income tax returns with various state tax authorities. The Company is no longer subject to federal income tax examinations for tax years prior to 2014 or state income tax examination for tax years prior to 2012.

**NOTE 15–401(k) SAVINGS PLAN:**

The Company maintains a 401(k) Savings Plan for the benefit of its employees. Substantially all of the Company's employees are eligible to participate in the HomeStreet, Inc. 401(k) Savings Plan (the "Plan"). The Plan provides for payment of retirement benefits to employees pursuant to the provisions of the plan and in conformity with Section 401(k) of the Internal Revenue Code. Employees may elect to have a portion of their salary contributed to the Plan. New employees are automatically enrolled in the Plan at a 3.0% deferral rate unless they elect otherwise. Participants receive a vested employer matching contribution equal to 100% of the first 3.0% of eligible compensation deferred by the participant and 50% of the next 2.0% of eligible compensation deferred by the participant.

Salaries and related costs for the years ended December 31, 2017, 2016, and 2015, included employer contributions of $8.5 million, $7.7 million and $6.1 million, respectively.

**NOTE 16–SHARE-BASED COMPENSATION PLANS:**

For the years ended December 31, 2017, 2016, and 2015, the Company recognized $2.5 million, $1.8 million, and $1.1 million of compensation cost, respectively, for share-based compensation awards.

<u>2014 Equity Incentive Plan</u>

In May 2014, the shareholders approved the Company's 2014 Equity Incentive Plan (the “2014 EIP”). Under the 2014 EIP, all of the Company’s officers, employees, directors and/or consultants are eligible to receive awards. Awards which may be granted under the 2014 EIP include incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock awards, restricted stock units, unrestricted stock, performance share awards and performance compensation awards. The maximum amount of HomeStreet, Inc. common stock available for grant under the 2014 EIP is 900,000 shares, which includes shares of common stock that were still available for issuance under the 2010 Plan and the 2011 Plan.

*Nonqualified Stock Options*

The Company grants nonqualified options to key senior management personnel. A summary of changes in nonqualified stock options granted for the year ended December 31, 2017 is as follows:

| | Number | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value [2] (in thousands) |
|---|---|---|---|---|
| Options outstanding at December 31, 2016 | 268,547 | $ 12.00 | 5.2 years | $ 5,263 |
| Exercised | (1,000 ) | 11.00 | 0.0 years | 15 |
| Options outstanding at December 31, 2017 | 267,547 | 12.01 | 4.2 years | 4,533 |
| Options that are exercisable and expected to be exercisable [1] | 267,547 | 12.01 | 4.2 years | 4,533 |
| Options exercisable | 267,547 | $ 12.01 | 4.2 years | $ 4,533 |

(1) Adjusted for estimated forfeitures.
(2) Intrinsic value is the amount by which fair value of the underlying stock exceeds the exercise price.

Under this plan, 1,000 options have been exercised during the year ended December 31, 2017, resulting in cash received and related income tax benefits totaling $16 thousand. As of December 31, 2017, there were no unrecognized compensation costs related to stock options. Compensation costs are recognized over the requisite service period, which typically is the vesting period.

As observable market prices are generally not available for estimating the fair value of stock options, an option-pricing model is utilized to estimate fair value. There were no options granted during the years ended December 31, 2017, 2016 and 2015.

*Restricted Shares*

The Company grants restricted shares to key senior management personnel and directors. A summary of the status of restricted shares follows.

| | Number | Weighted Average Grant Date Fair Value |
|---|---|---|
| Restricted shares outstanding at December 31, 2016 | 256,454 | $ 19.34 |
| Granted | 163,070 | 27.06 |
| Cancelled or forfeited | (38,146 ) | 22.36 |
| Vested | (74,703 ) | 18.76 |
| Restricted shares outstanding at December 31, 2017 | 306,675 | 23.21 |

At December 31, 2017, there was $3.8 million of total unrecognized compensation cost related to nonvested restricted shares. Unrecognized compensation cost is generally expected to be recognized over a weighted average period of 1.9 years. Restricted share awards granted to senior management vest based upon the achievement of certain market conditions. One-third vested when the 30-day rolling average share price exceeded 25% of the grant date fair value; one-third vested when the 30-day rolling average share price exceeded 40% of the grant date fair value; and one-third vested when the 30-day rolling average share price exceeded 50% of the grant date fair value. The Company accrues compensation expense based upon an estimate of the awards' expected vesting period. If a market condition is satisfied prior to the end of the estimated vesting period any unrecognized compensation costs associated with the portion of restricted shares that vested earlier than expected are immediately recognized in earnings.

Certain restricted stock awards granted to senior management during 2017 and 2016 contain both service conditions and performance conditions. Restricted stock units (“RSUs”) are stock awards with a pro-rata three year vesting, and the fair market value of the awards are determined at the grant date. Performance share units ("PSUs") are stock awards where the number of shares ultimately received by the employee depends on the company’s performance against specified targets and vest over a three-year period. The fair value of each PSU is determined on the grant date, based on the company’s stock price, and assumes that performance targets will be achieved. Over the performance period, the number of shares of stock that will be issued is adjusted upward or downward based upon the probability of achievement of performance targets. The ultimate number of shares issued and the related compensation cost recognized as expense will be based on a comparison of the final performance metrics to the specified targets. Compensation cost is recognized over the requisite three-year service period on a straight-line basis and adjusted for changes in the probability that the performance targets will be achieved.

**NOTE 17–FAIR VALUE MEASUREMENT:**

The term "fair value" is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The Company's approach is to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements.

Fair Value Hierarchy
A three-level valuation hierarchy has been established under ASC 820 for disclosure of fair value measurements. The valuation hierarchy is based on the observability of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement. The levels are defined as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. This includes quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability for substantially the full term of the financial instrument.
- Level 3 – Unobservable inputs for the asset or liability. These inputs reflect the Company's assumptions of what market participants would use in pricing the asset or liability.

The Company's policy regarding transfers between levels of the fair value hierarchy is that all transfers are assumed to occur at the end of the reporting period.

Valuation Processes
The Company has various processes and controls in place to ensure that fair value measurements are reasonably estimated. The Finance Committee of the Board provides oversight and approves the Company's Asset/Liability Management Policy ("ALMP"). The Company's ALMP governs, among other things, the application and control of the valuation models used to measure fair value. On a quarterly basis, the Company's Asset/Liability Management Committee ("ALCO") and the Finance Committee of the Board review significant modeling variables used to measure the fair value of the Company's financial instruments, including the significant inputs used in the valuation of single family MSRs. Additionally, ALCO periodically obtains an independent review of the MSR valuation process and procedures, including a review of the model architecture and the valuation assumptions. The Company obtains an MSR valuation from an independent valuation firm monthly to assist with the validation of the fair value estimate and the reasonableness of the assumptions used in measuring fair value.

The Company's real estate valuations are overseen by the Company's appraisal department, which is independent of the Company's lending and credit administration functions. The appraisal department maintains the Company's appraisal policy and recommends changes to the policy subject to approval by the Company's Loan Committee and the Credit

Committee of the Board. The Company's appraisals are prepared by independent third-party appraisers and the Company's internal appraisers. Single family appraisals are generally reviewed by the Company's single family loan underwriters. Single family appraisals with unusual, higher risk or complex characteristics, as well as commercial real estate appraisals, are reviewed by the Company's appraisal department.

We obtain pricing from third party service providers for determining the fair value of a substantial portion of our investment securities available for sale. We have processes in place to evaluate such third party pricing services to ensure information obtained and valuation techniques used are appropriate. For fair value measurements obtained from third party services, we monitor and review the results to ensure the values are reasonable and in line with market experience for similar classes of securities. While the inputs used by the pricing vendor in determining fair value are not provided, and therefore unavailable for our review, we do perform certain procedures to validate the values received, including comparisons to other sources of valuation (if available), comparisons to other independent market data and a variance analysis of prices by Company personnel that are not responsible for the performance of the investment securities.

Estimation of Fair Value

Fair value is based on quoted market prices, when available. In cases where a quoted price for an asset or liability is not available, the Company uses valuation models to estimate fair value. These models incorporate inputs such as forward yield curves, loan prepayment assumptions, expected loss assumptions, market volatilities, and pricing spreads utilizing market-based inputs where readily available. The Company believes its valuation methods are appropriate and consistent with those that would be used by other market participants. However, imprecision in estimating unobservable inputs and other factors may result in these fair value measurements not reflecting the amount realized in an actual sale or transfer of the asset or liability in a current market exchange.

The following table summarizes the fair value measurement methodologies, including significant inputs and assumptions, and classification of the Company's assets and liabilities.

| Asset/Liability class | Valuation methodology, inputs and assumptions | Classification |
|---|---|---|
| Cash and cash equivalents | Carrying value is a reasonable estimate of fair value based on the short-term nature of the instruments. | Estimated fair value classified as Level 1. |
| Investment securities | | |
| Investment securities available for sale | Observable market prices of identical or similar securities are used where available.<br><br>If market prices are not readily available, value is based on discounted cash flows using the following significant inputs:<br><br>• Expected prepayment speeds<br><br>• Estimated credit losses<br><br>• Market liquidity adjustments | Level 2 recurring fair value measurement. |
| Investment securities held to maturity | Observable market prices of identical or similar securities are used where available.<br><br>If market prices are not readily available, value is based on discounted cash flows using the following significant inputs:<br><br>• Expected prepayment speeds<br><br>• Estimated credit losses<br><br>• Market liquidity adjustments | Carried at amortized cost.<br><br>Estimated fair value classified as Level 2. |
| Loans held for sale | | |
| Single family loans, excluding loans transferred from held for investment | Fair value is based on observable market data, including:<br><br>• Quoted market prices, where available<br><br>• Dealer quotes for similar loans<br><br>• Forward sale commitments | Level 2 recurring fair value measurement. |
| | When not derived from observable market inputs, fair value is based on discounted cash flows, which considers the following inputs:<br>• Current lending rates for new loans<br><br>• Expected prepayment speeds<br><br>• Estimated credit losses<br>• Market liquidity adjustments | Estimated fair value classified as Level 3. |
| Loans originated as held for investment and transferred to held for sale | Fair value is based on discounted cash flows, which considers the following inputs:<br><br>• Current lending rates for new loans<br><br>• Expected prepayment speeds<br><br>• Estimated credit losses<br>• Market liquidity adjustments | Carried at lower of amortized cost or fair value.<br><br>Estimated fair value classified as Level 3. |
| Multifamily loans (DUS®) and other | The sale price is set at the time the loan commitment is made, and as such subsequent changes in market conditions have a very limited effect, if any, on the value of these loans carried on the consolidated statements of financial condition, which are typically sold within 30 days of origination. | Carried at lower of amortized cost or fair value.<br><br>Estimated fair value classified as Level 2. |

| Asset/Liability class | Valuation methodology, inputs and assumptions | Classification |
|---|---|---|
| Loans held for investment | | |
| Loans held for investment, excluding collateral dependent loans and loans transferred from held for sale | Fair value is based on discounted cash flows, which considers the following inputs:<br>• Current lending rates for new loans<br>• Expected prepayment speeds<br>• Estimated credit losses<br>• Market liquidity adjustments | For the carrying value of loans see Note 1–Summary of Significant Accounting Policies.<br><br>Estimated fair value classified as Level 3. |
| Loans held for investment, collateral dependent | Fair value is based on appraised value of collateral, which considers sales comparison and income approach methodologies. Adjustments are made for various factors, which may include:<br>• Adjustments for variations in specific property qualities such as location, physical dissimilarities, market conditions at the time of sale, income producing characteristics and other factors<br>• Adjustments to obtain "upon completion" and "upon stabilization" values (e.g., property hold discounts where the highest and best use would require development of a property over time)<br>• Bulk discounts applied for sales costs, holding costs and profit for tract development and certain other properties | Carried at lower of amortized cost or fair value of collateral, less the estimated cost to sell.<br><br>Classified as a Level 3 nonrecurring fair value measurement in periods where carrying value is adjusted to reflect the fair value of collateral. |
| Loans held for investment transferred from loans held for sale | Fair value is based on discounted cash flows, which considers the following inputs:<br>• Current lending rates for new loans<br>• Expected prepayment speeds<br>• Estimated credit losses<br>• Market liquidity adjustments | Level 3 recurring fair value measurement. |
| Mortgage servicing rights | | |
| Single family MSRs | For information on how the Company measures the fair value of its single family MSRs, including key economic assumptions and the sensitivity of fair value to changes in those assumptions, see Note 12*, Mortgage Banking Operations*. | Level 3 recurring fair value measurement. |
| Multifamily MSRs and SBA | Fair value is based on discounted estimated future servicing fees and other revenue, less estimated costs to service the loans. | Carried at lower of amortized cost or fair value.<br><br>Estimated fair value classified as Level 3. |
| Derivatives | | |
| Eurodollar futures | Fair value is based on closing exchange prices. | Level 1 recurring fair value measurement. |
| Interest rate swaps<br>Interest rate swaptions<br>Forward sale commitments | Fair value is based on quoted prices for identical or similar instruments, when available.<br><br>When quoted prices are not available, fair value is based on internally developed modeling techniques, which require the use of multiple observable market inputs including:<br>• Forward interest rates<br>• Interest rate volatilities | Level 2 recurring fair value measurement. |

| | | |
|---|---|---|
| Interest rate lock and purchase loan commitments | The fair value considers several factors including:<br>• Fair value of the underlying loan based on quoted prices in the secondary market, when available.<br>• Value of servicing<br>• Fall-out factor | Level 3 recurring fair value measurement. |
| **Asset/Liability class** | **Valuation methodology, inputs and assumptions** | **Classification** |
| Other real estate owned ("OREO") | Fair value is based on appraised value of collateral, less the estimated cost to sell. See discussion of "loans held for investment, collateral dependent" above for further information on appraisals. | Carried at lower of amortized cost or fair value of collateral (Level 3), less the estimated cost to sell. |
| Federal Home Loan Bank stock | Carrying value approximates fair value as FHLB stock can only be purchased or redeemed at par value. | Carried at par value.<br>Estimated fair value classified as Level 2. |
| Deposits | | |
| Demand deposits | Fair value is estimated as the amount payable on demand at the reporting date. | Carried at historical cost.<br>Estimated fair value classified as Level 2. |
| Fixed-maturity certificates of deposit | Fair value is estimated using discounted cash flows based on market rates currently offered for deposits of similar remaining time to maturity. | Carried at historical cost.<br>Estimated fair value classified as Level 2. |
| Federal Home Loan Bank advances | Fair value is estimated using discounted cash flows based on rates currently available for advances with similar terms and remaining time to maturity. | Carried at historical cost.<br>Estimated fair value classified as Level 2. |
| Long-term debt | Fair value is estimated using discounted cash flows based on current lending rates for similar long-term debt instruments with similar terms and remaining time to maturity. | Carried at historical cost.<br>Estimated fair value classified as Level 2. |

The following tables present the levels of the fair value hierarchy for the Company's assets and liabilities measured at fair value on a recurring basis.

| (in thousands) | Fair Value at December 31, 2017 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Investment securities available for sale | | | | |
| Mortgage backed securities: | | | | |
| Residential | $130,090 | $ — | $130,090 | $— |
| Commercial | 23,694 | — | 23,694 | — |
| Municipal bonds | 388,452 | — | 388,452 | — |
| Collateralized mortgage obligations: | | | | |
| Residential | 160,424 | — | 160,424 | — |
| Commercial | 98,569 | — | 98,569 | — |
| Corporate debt securities | 24,737 | — | 24,737 | — |
| U.S. Treasury securities | 10,652 | — | 10,652 | — |
| Agency debentures | 9,650 | — | 9,650 | — |
| Single family mortgage servicing rights | 258,560 | — | — | 258,560 |
| Single family loans held for sale | 577,313 | — | 575,977 | 1,336 |
| Single family loans held for investment | 5,477 | — | — | 5,477 |
| Derivatives | | | | |
| Forward sale commitments | 1,311 | — | 1,311 | — |
| Interest rate lock and purchase loan commitments | 12,950 | — | — | 12,950 |
| Interest rate swaps | 12,172 | — | 12,172 | — |
| Total assets | $1,714,051 | $ — | $1,435,728 | $278,323 |
| Liabilities: | | | | |
| Derivatives | | | | |
| Eurodollar futures | $101 | $ 101 | $— | $— |
| Forward sale commitments | 1,445 | — | 1,445 | — |
| Interest rate lock and purchase loan commitments | 25 | — | — | 25 |
| Interest rate swaps | 23,654 | — | 23,654 | — |
| Total liabilities | $25,225 | $ 101 | $25,099 | $25 |

| (in thousands) | Fair Value at December 31, 2016 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Investment securities available for sale | | | | |
| Mortgage backed securities: | | | | |
| Residential | $177,074 | $ — | $177,074 | $— |
| Commercial | 25,536 | — | 25,536 | — |
| Municipal bonds | 467,673 | — | 467,673 | — |
| Collateralized mortgage obligations: | | | | |
| Residential | 191,201 | — | 191,201 | — |
| Commercial | 70,764 | — | 70,764 | — |
| Corporate debt securities | 51,122 | — | 51,122 | — |
| U.S. Treasury securities | 10,620 | — | 10,620 | — |
| Single family mortgage servicing rights | 226,113 | — | — | 226,113 |
| Single family loans held for sale | 656,334 | — | 614,524 | 41,810 |
| Single family loans held for investment | 17,988 | — | — | 17,988 |
| Derivatives | | | | |
| Forward sale commitments | 24,623 | — | 24,623 | — |
| Interest rate swaptions | 1 | — | 1 | — |
| Interest rate lock and purchase loan commitments | 19,586 | — | — | 19,586 |
| Interest rate swaps | 15,016 | — | 15,016 | — |
| Total assets | $1,953,651 | $ — | $1,648,154 | $305,497 |
| Liabilities: | | | | |
| Derivatives | | | | |
| Forward sale commitments | $15,203 | $ — | $15,203 | $— |
| Interest rate lock and purchase loan commitments | 367 | — | — | 367 |
| Interest rate swaps | 26,829 | — | 26,829 | — |
| Total liabilities | $42,399 | $ — | $42,032 | $367 |

There were no transfers between levels of the fair value hierarchy during the years ended December 31, 2017 and 2016.

Level 3 Recurring Fair Value Measurements

The Company's level 3 recurring fair value measurements consist of single family mortgage servicing rights, single family loans held for investment where fair value option was elected, certain single family loans held for sale, and interest rate lock and purchase loan commitments, which are accounted for as derivatives. For information regarding fair value changes and activity for single family MSRs during the years ended December 31, 2017 and 2016, see Note 12, *Mortgage Banking Operations*.

The fair value of IRLCs considers several factors including the fair value in the secondary market of the underlying loan resulting from the exercise of the commitment, the expected net future cash flows related to the associated servicing of the loan (referred to as the value of servicing) and the probability that the commitment will not be converted into a funded loan (referred to as a fall-out factor). The fair value of IRLCs on loans held for sale, while based on interest rates observable in the market, is highly dependent on the ultimate closing of the loans. The significance of the fall-out factor to the fair value measurement of an individual IRLC is generally highest at the time that the rate lock is initiated and declines as closing procedures are performed and the underlying loan gets closer to funding. The fall-out factor applied is based on historical experience. The value of servicing is impacted by a variety of factors, including prepayment assumptions, discount rates, delinquency rates, contractually specified servicing fees, servicing costs, and underlying portfolio characteristics. Because these inputs are not observable in market trades, the fall-out factor and value of servicing are considered to be level 3 inputs. The fair value of IRLCs decreases in value upon an increase in the fall-out factor and increases in value upon an increase in the value of servicing. Changes in the fall-out factor and value of servicing do not increase or decrease based on movements in other significant unobservable inputs.

The Company recognizes unrealized gains and losses from the time that an IRLC is initiated until the gain or loss is realized at the time the loan closes, which generally occurs within 30-90 days. For IRLCs that fall out, any unrealized gain or loss is

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reversed, which generally occurs at the end of the commitment period. The gains and losses recognized on IRLC derivatives generally correlates to volume of single family interest rate lock commitments made during the reporting period (after adjusting for estimated fallout) while the amount of unrealized gains and losses realized at settlement generally correlates to the volume of single family closed loans during the reporting period.

The Company uses the discounted cash flow model to estimate the fair value of certain loans that have been transferred from held for sale to held for investment and single family loans held for sale when the fair value of the loans is not derived using observable market inputs. The key assumption in the valuation model is the implied spread to benchmark interest rate curve. The implied spread is not directly observable in the market and is derived from third party pricing which is based on market information from comparable loan pools. The fair value estimate of these certain single family loans that have been transferred from held for sale to held for investment and these certain single family loans held for sale is sensitive to changes in the benchmark interest rate which might result in a significantly higher or lower fair value measurement.

The Company transferred certain loans from held for sale to held for investment. These loans were originated as held for sale loans where the Company had elected fair value option. The Company determined these loans to be level 3 recurring assets as the valuation technique included a significant unobservable input. The total amount of held for investment loans where fair value option election was made was $5.5 million and $18.0 million at December 31, 2017 and December 31, 2016, respectively.

The following information presents significant Level 3 unobservable inputs used to measure fair value of single family loans held for investment where fair value option was elected.

| (dollars in thousands) | At December 31, 2017 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|
| Loans held for investment, fair value option | $5,477 | Income approach | Implied spread to benchmark interest rate curve | 3.61% | 4.96% | 4.10% |

| (dollars in thousands) | At December 31, 2016 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|
| Loans held for investment, fair value option | $17,988 | Income approach | Implied spread to benchmark interest rate curve | 3.62% | 4.97% | 4.49% |

The following information presents significant Level 3 unobservable inputs used to measure fair value of certain single family loans held for sale where fair value option was elected.

| (dollars in thousands) | At December 31, 2017 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|
| Loans held for sale, fair value option | $1,336 | Income approach | Implied spread to benchmark interest rate curve | 3.93% | 3.93% | 3.93% |
| | | | Market price movement from comparable bond | (0.38)% | (0.10)% | (0.24)% |

| (dollars in thousands) | At December 31, 2016 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|
| Loans held for sale, fair value option | $41,810 | Income approach | Implied spread to benchmark interest rate curve | 3.46% | 6.14% | 4.23% |
| | | | Market price movement from comparable bond | (0.49)% | (0.11)% | (0.27)% |

The following table presents fair value changes and activity for Level 3 interest rate lock and purchase loan commitments.

| (in thousands) | Years Ended December 31, 2017 | 2016 |
|---|---|---|
| Beginning balance, net | $19,219 | $17,711 |
| Total realized/unrealized gains | 126,082 | 146,462 |
| Settlements | (132,376) | (144,954) |
| Ending balance, net | $12,925 | $19,219 |

The following table presents fair value changes and activity for Level 3 loans held for sale and loans held for investment.

| (in thousands) | Year Ended December 31, 2017 Beginning balance | Additions | Transfers | Payoffs/Sales | Change in mark to market | Ending balance |
|---|---|---|---|---|---|---|
| Loans held for sale | $41,810 | $ 4,327 | $12,797 | $ (58,396) | $ 798 | $ 1,336 |
| Loans held for investment | 17,988 | 127 | (12,272) | (480) | 114 | 5,477 |

| (in thousands) | Year Ended December 31, 2016 Beginning balance | Additions | Transfers | Payoffs/Sales | Change in mark to market | Ending balance |
|---|---|---|---|---|---|---|
| Loans held for sale | $49,322 | $ 14,454 | $(4,913) | $ (14,524) | $(2,529) | $41,810 |
| Loans held for investment | 21,544 | 357 | 4,913 | (7,608) | (1,218) | 17,988 |

The following information presents significant Level 3 unobservable inputs used to measure fair value of interest rate lock and purchase loan commitments.

| (dollars in thousands) | At December 31, 2017 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|
| Interest rate lock and purchase loan commitments, net | $12,925 | Income approach | Fall out factor | —% | 58.38% | 12.05% |
| | | | Value of servicing | 0.69% | 1.73% | 1.09% |

| (dollars in thousands) | At December 31, 2016 Fair Value | Valuation Technique | Significant Unobservable Input | Low | High | Weighted Average |
|---|---|---|---|---|---|---|

| | | | | | | |
|---|---|---|---|---|---|---|
| Interest rate lock and purchase loan commitments, net | $19,219 | Income approach | Fall out factor | 0.50% | 60.34% | 11.95% |
| | | | Value of servicing | 0.65% | 2.27% | 1.08% |

Nonrecurring Fair Value Measurements

Certain assets held by the Company are not included in the tables above, but are measured at fair value on a nonrecurring basis. These assets include certain loans held for investment and other real estate owned that are carried at the lower of cost or fair value of the underlying collateral, less the estimated cost to sell. The estimated fair values of real estate collateral are generally based on internal evaluations and appraisals of such collateral, which use the market approach and income approach methodologies. All impaired loans are subject to an internal evaluation completed quarterly by management as part of the allowance process.

The fair value of commercial properties are generally based on third-party appraisals that consider recent sales of comparable properties, including their income-generating characteristics, adjusted (generally based on unobservable inputs) to reflect the general assumptions that a market participant would make when analyzing the property for purchase. The Company uses a fair value of collateral technique to apply adjustments to the appraisal value of certain commercial loans held for investment that are collateralized by real estate. During the year ended December 31, 2017, the Company recorded adjustments ranging from 0.00% to 100.00% to the appraisal values of certain commercial loans held for investment that are collateralized by real estate.
During the year ended December 31, 2016, the Company recorded no adjustments to the appraisal values of certain commercial loans held for investment that are collateralized by real estate.

The Company uses a fair value of collateral technique to apply adjustments to the stated value of certain commercial loans held for investment that are not collateralized by real estate and to the appraisal value of OREO. During the year ended December 31, 2017, the Company applied a range of stated value adjustments of 0.0% to 100.0% to the stated value of commercial loans held for investment, with a weighted average of 46.7%. During the year ended December 31, 2016, the Company applied a range of stated value adjustments of 7.0% to 63.4% to the stated value of commercial loans held for investment, with a weighted average of 57.5% and a range of 0.0% to 49.1% to the appraisal value of OREO, with a weighted average of 17.9%. During the year ended December 31, 2017, the Company did not apply any adjustment to the appraisal value of OREO.

Residential properties are generally based on unadjusted third-party appraisals. Factors considered in determining the fair value include geographic sales trends, the value of comparable surrounding properties as well as the condition of the property.

These adjustments include management assumptions that are based on the type of collateral dependent loan and may increase or decrease an appraised value. Management adjustments vary significantly depending on the location, physical characteristics and income producing potential of each individual property. The quality and volume of market information available at the time of the appraisal can vary from period-to-period and cause significant changes to the nature and magnitude of the unobservable inputs used. Given these variations, changes in these unobservable inputs are generally not a reliable indicator for how fair value will increase or decrease from period to period.

The following tables present assets that had changes in their recorded fair value during the years ended December 31, 2017 and 2016 and what we still held at the end of the respective reporting period.

| (in thousands) | Year Ended December 31, 2017 Fair Value of Assets Held at December 31, 2017 | Level 1 | Level 2 | Level 3 | Total Gains (Losses) |
|---|---|---|---|---|---|
| Loans held for investment[1] | $1,918 | $ — | $ — | $1,918 | $(163) |
| Total | $1,918 | $ — | $ — | $1,918 | $(163) |

| (in thousands) | Year Ended December 31, 2016 Fair Value of Assets Held at December 31, 2016 | Level 1 | Level 2 | Level 3 | Total Gains (Losses) |
|---|---|---|---|---|---|
| Loans held for investment[1] | $4,586 | $ — | $ — | $4,586 | $(881) |
| Other real estate owned[2] | 5,933 | — | — | 5,933 | (1,332) |
| Total | $10,519 | $ — | $ — | $10,519 | $(2,213) |

(1) Represents the carrying value of loans for which adjustments are based on the fair value of the collateral.
(2) Represents other real estate owned where an updated fair value of collateral is used to adjust the carrying amount subsequent to the initial classification as other real estate owned.

Fair Value of Financial Instruments

The following presents the carrying value, estimated fair value and the levels of the fair value hierarchy for the Company's financial instruments other than assets and liabilities measured at fair value on a recurring basis.

| (in thousands) | At December 31, 2017 Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| Assets: | | | | | |
| Cash and cash equivalents | $72,718 | $72,718 | $72,718 | $— | $ — |
| Investment securities held to maturity | 58,036 | 58,128 | — | 58,128 | — |
| Loans held for investment | 4,500,989 | 4,497,884 | — | — | 4,497,884 |
| Loans held for sale – multifamily and other | 33,589 | 33,589 | — | 33,589 | — |
| Mortgage servicing rights – multifamily | 26,093 | 28,362 | — | — | 28,362 |
| Federal Home Loan Bank stock | 46,639 | 46,639 | — | 46,639 | — |
| Liabilities: | | | | | |
| Deposits | $4,760,952 | $4,739,563 | $— | $4,739,563 | $ — |
| Federal Home Loan Bank advances | 979,201 | 981,441 | — | 981,441 | — |
| Long-term debt | 125,274 | 108,530 | — | 108,530 | — |

| (in thousands) | At December 31, 2016 Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| Assets: | | | | | |
| Cash and cash equivalents | $53,932 | $53,932 | $53,932 | $— | $ — |
| Investment securities held to maturity | 49,861 | 49,488 | — | 49,488 | — |
| Loans held for investment | 3,801,039 | 3,840,990 | — | — | 3,840,990 |
| Loans held for sale – transferred from held for investment | 17,512 | 17,512 | — | — | 17,512 |
| Loans held for sale – multifamily and other | 40,712 | 40,712 | — | 40,712 | — |
| Mortgage servicing rights – multifamily | 19,747 | 21,610 | — | — | 21,610 |
| Federal Home Loan Bank stock | 40,347 | 40,347 | — | 40,347 | — |
| Liabilities: | | | | | |
| Deposits | $4,429,701 | $4,410,213 | $— | $4,410,213 | $ — |
| Federal Home Loan Bank advances | 868,379 | 870,782 | — | 870,782 | — |
| Long-term debt | 125,147 | 122,357 | — | 122,357 | — |

## NOTE 18–EARNINGS PER SHARE:

The following table summarizes the calculation of earnings per share.

| (in thousands, except share and per share data) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Net income | $68,946 | $ 58,151 | $ 41,319 |
| Weighted average shares: | | | |
| Basic weighted-average number of common shares outstanding | 26,864,657 | 24,615,990 | 20,818,045 |
| Dilutive effect of outstanding common stock equivalents [1] | 227,362 | 227,693 | 241,156 |
| Diluted weighted-average number of common stock outstanding | 27,092,019 | 24,843,683 | 21,059,201 |
| Earnings per share: | | | |
| Basic earnings per share | $2.57 | $ 2.36 | $ 1.98 |
| Diluted earnings per share | $2.54 | $ 2.34 | $ 1.96 |

(1) Excluded from the computation of diluted earnings per share (due to their antidilutive effect) for the years ended December 31, 2017, 2016 and 2015 were certain stock options and unvested restricted stock issued to key senior management personnel and directors of the Company. The aggregate number of common stock equivalents related to such options and unvested restricted shares, which could potentially be dilutive in future periods, was 3,224, zero and zero at December 31, 2017, 2016 and 2015, respectively.

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**NOTE 19–BUSINESS SEGMENTS:**

The Company's business segments are determined based on the products and services provided, as well as the nature of the related business activities, and they reflect the manner in which financial information is currently evaluated by management. The Company organizes the segments into two lines of business: Commercial and Consumer Banking Segment and Mortgage Banking Segment.

A description of the Company's business segments and the products and services that they provide is as follows.

***Commercial and Consumer Banking*** provides diversified financial products and services to our commercial and consumer customers through bank branches and through ATMs, online, mobile and telephone banking. These products and services include deposit products; residential, consumer, business and agricultural portfolio loans; non-deposit investment products; insurance products and cash management services. We originate construction loans, bridge loans and permanent loans for our portfolio primarily on single family residences, and on office, retail, industrial and multifamily property types. We originate multifamily real estate loans through our Fannie Mae DUS business, whereby loans are sold to or securitized by Fannie Mae, while the Company generally retains the servicing rights. This segment also reflects the results for the management of the Company's portfolio of investment securities.

***Mortgage Banking*** originates single family residential mortgage loans for sale in the secondary markets. The majority of our mortgage loans are sold to or securitized by Fannie Mae, Freddie Mac or Ginnie Mae, while we retain the right to service these loans. We have become a rated originator and servicer of jumbo loans, allowing us to sell these loans to other securitizers. Additionally, we purchase loans from WMS Series LLC through a correspondent arrangement with that company. We also sell loans on a servicing-released and servicing-retained basis to securitizers and correspondent lenders. A small percentage of our loans are brokered to other lenders or sold on a servicing-released basis to correspondent lenders. On occasion, we may sell a portion of our MSR portfolio. We reflect the results from the management of loan funding and the interest rate risk associated
with the secondary market loan sales and the retained single family mortgage servicing rights within this business segment.

We use various management accounting methodologies to assign certain income statement items to the responsible operating segment, including:

- a funds transfer pricing ("FTP") system, which allocates interest income credits and funding charges between the segments, assigning to each segment a funding credit for its liabilities, such as deposits, and a charge to fund its assets;
- an allocation of charges for services rendered to the segments by centralized functions, such as corporate overhead, which are generally based on each segment's consumption patterns; and
- an allocation of the Company's consolidated income taxes which are based on the effective tax rate applied to the segment's pretax income or loss.

The FTP methodology is based on external market factors and aligns the expected weighted-average life of the financial asset or liability to external economic data, such as the U.S. Dollar LIBOR/Swap curve, and provides a consistent basis for determining the cost of funds to be allocated to each operating segment.

Financial highlights by operating segment were as follows.

| (in thousands) | Year Ended December 31, 2017 Mortgage Banking | Commercial and Consumer Banking | Total |
|---|---|---|---|
| Condensed income statement: | | | |
| Net interest income [1] | $19,896 | $174,542 | $194,438 |
| Provision for credit losses | — | 750 | 750 |
| Noninterest income | 269,794 | 42,360 | 312,154 |
| Noninterest expense | 290,676 | 148,977 | 439,653 |
| (Loss) income before income taxes | (986 ) | 67,175 | 66,189 |
| Income tax (benefit) expense | (27,871 ) | 25,114 | (2,757 ) |
| Net income | $26,885 | $42,061 | $68,946 |
| Total assets | $866,712 | $5,875,329 | $6,742,041 |

| (in thousands) | Year Ended December 31, 2016 Mortgage Banking | Commercial and Consumer Banking | Total |
|---|---|---|---|
| Condensed income statement: | | | |
| Net interest income [1] | $26,034 | $154,015 | $180,049 |
| Provision for credit losses | — | 4,100 | 4,100 |
| Noninterest income | 323,468 | 35,682 | 359,150 |
| Noninterest expense | 305,937 | 138,385 | 444,322 |
| Income before income taxes | 43,565 | 47,212 | 90,777 |
| Income tax expense | 16,214 | 16,412 | 32,626 |
| Net income | $27,351 | $30,800 | $58,151 |
| Total assets | $974,248 | $5,269,452 | $6,243,700 |

| (in thousands) | Year Ended December 31, 2015 Mortgage Banking | Commercial and Consumer Banking | Total |
|---|---|---|---|
| Condensed income statement: | | | |
| Net interest income [1] | $28,318 | $120,020 | $148,338 |
| Provision for credit losses | — | 6,100 | 6,100 |
| Noninterest income | 251,870 | 29,367 | 281,237 |
| Noninterest expense | 243,970 | 122,598 | 366,568 |
| Income before income taxes | 36,218 | 20,689 | 56,907 |
| Income tax expense | 12,916 | 2,672 | 15,588 |
| Net income | $23,302 | $18,017 | $41,319 |
| Total assets | $848,445 | $4,046,050 | $4,894,495 |

(1) Net interest income is the difference between interest earned on assets and the cost of liabilities to fund those assets. Interest earned includes actual interest earned on segment assets and, if the segment has excess liabilities, interest credits for providing funding to the other segment. The cost of liabilities includes interest expense on segment liabilities and, if the segment does not have enough liabilities to fund its assets, a

funding charge based on the cost of excess liabilities from another segment.

**NOTE 20–ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):**

The following table shows changes in accumulated other comprehensive income (loss) from unrealized gain (loss) on available-for-sale securities, net of tax.

| (in thousands) | Years Ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Beginning balance | $(10,412) | $(2,449) | $1,546 |
| Other comprehensive income (loss) before reclassifications | 3,607 | (6,313) | (1,325) |
| Amounts reclassified from accumulated other comprehensive income (loss) | (317) | (1,650) | (2,670) |
| Net current-period other comprehensive income (loss) | 3,290 | (7,963) | (3,995) |
| Ending balance | $(7,122) | $(10,412) | $(2,449) |

The following table shows the affected line items in the consolidated statements of operations from reclassifications of unrealized gain (loss) on available-for-sale securities from accumulated other comprehensive income (loss).

| Affected Line Item in the Consolidated Statements of Operations | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Gain on sale of investment securities available for sale | $489 | $2,539 | $2,406 |
| Income tax expense (benefit) | 172 | 889 | (264) |
| Total, net of tax | $317 | $1,650 | $2,670 |

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**NOTE 21–PARENT COMPANY FINANCIAL STATEMENTS:**

Condensed financial information for HomeStreet, Inc. is as follows.

| **Condensed Statements of Financial Condition** | At December 31, | |
|---|---|---|
| (in thousands) | 2017 | 2016 |
| Assets: | | |
| Cash and cash equivalents | $ 14,101 | $ 12,260 |
| Other assets | 7,319 | 9,700 |
| Investment in stock of subsidiaries | 807,398 | 732,135 |
| Total assets | $ 828,818 | $ 754,095 |
| Liabilities: | | |
| Other liabilities | $ 1,021 | $ 1,521 |
| Long-term debt | 123,417 | 123,290 |
| Total liabilities | 124,438 | 124,811 |
| Shareholders’ Equity: | | |
| Preferred stock, no par value | — | — |
| Common stock, no par value | 511 | 511 |
| Additional paid-in capital | 339,009 | 336,149 |
| Retained earnings | 371,982 | 303,036 |
| Accumulated other comprehensive loss | (7,122) | (10,412) |
| Total stockholder's equity | 704,380 | 629,284 |
| Total liabilities and stockholder's equity | $ 828,818 | $ 754,095 |

| **Condensed Statements of Operations** | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Net interest expense | $ (4,625) | $ (2,680) | $ (1,036) |
| Noninterest income | 1,904 | 1,622 | 1,686 |
| (Loss) income before income tax benefit and equity in income of subsidiaries | (2,721) | (1,058) | 650 |
| Dividend from subsidiaries to parent | 4,000 | 4,697 | 13,181 |
| | 1,279 | 3,639 | 13,831 |
| Noninterest expense | 6,681 | 7,746 | 7,239 |
| (Loss) income before income tax benefit | (5,402) | (4,107) | 6,592 |
| Income tax benefit | (3,381) | (4,656) | (561) |
| Income from subsidiaries | 70,967 | 57,602 | 34,166 |
| Net income | $ 68,946 | $ 58,151 | $ 41,319 |
| | | | |
| Other comprehensive income (loss) | 3,290 | (7,963) | (3,995) |
| Comprehensive income | $ 72,236 | $ 50,188 | $ 37,324 |

| **Condensed Statements of Cash Flows** | Years Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 |
| Net cash (used in) provided by operating activities | $(3,395 ) | $ 990 | $2,654 |
| Cash flows from investing activities: | | | |
| Net purchases of and proceeds from investment securities | 2,546 | (5,029 ) | 673 |
| Net payments for investments in and advances to subsidiaries | 2,685 | (116,090) | (992 ) |
| Net cash provided by (used in) investing activities | 5,231 | | |