WATERSTONE
FINANCIAL, INC.

# 2011

ANNUAL REPORT

# Letter to Shareholders

2011 has proven to be another difficult year for WaterStone and the financial industry. Unemployment levels have remained elevated and the Wisconsin real estate market continues to struggle with a large inventory of homes and a continual pipeline of foreclosures. This environment has made it challenging for WaterStone to show improvement in reducing our non-performing assets; and has led to continued operating losses as we support the problem loans and real estate acquired through foreclosure.

Despite the continuance of distressed economic times, we have been able to stabilize the portfolio and maintain high levels of capital and liquidity to assure future stability. Our non-performing and delinquent loans remained level the past year after declining in 2010. We continue to be a very active lender and deposit gatherer in the communities we serve. When the economy and real estate markets improve, we are positioned to reduce problem assets and return to profitability.

Our mortgage lending subsidiary, Waterstone Mortgage Corp., had another successful year. For the second year in a row, Waterstone Mortgage originated over $1 billion in mortgage loans and provided a significant contribution to our operating income.

Our Board, management team and employees are committed to the success of WaterStone. Each and every day we seek to add value for our customers and shareholders.

Respectfully,

Doug Gordon

Douglas Gordon
President/CEO

## *90th Anniversary Highlights*

The WaterStone Bank Fund was creatively used to celebrate the Bank's 90th Anniversary and increase brand awareness while supporting the community. The Bank hosted an online contest to give a total of $90,000 to a few lucky local nonprofits or schools during the month of April, 2011. The $90,000 was donated based on the votes submitted by the general public from April 1 through April 30, 2011. The lucky nonprofit or school that received the most votes during April received $30,000. The four nonprofits or schools with the next highest number of votes each received $15,000.

- 278 Nonprofits or Schools participated.
- 8,548,522 votes were placed.
- An invaluable amount of exposure for WaterStone and general goodwill was generated.

### *Community Feedback:*

"We truly appreciate WaterStone Bank's commitment to the nonprofit organizations and offer to celebrate their 90th anniversary through philanthropy - speaks volumes as to why they have been an important part of the community for so many years."

*~ community member*

"You must be elated with the unbelievable participation of the global community in WaterStone Bank's Giving Back Charity Contest. Before now, how many people knew of the large number of charities doing good work in our community? The Child Development Center of St. Joseph did not win the contest, but the spirit of community sponsored giving was energized as this message of the contest spread across America."

*~ Jose, The Child Development Center of St. Joseph*

Doug Gordon

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Nominees for Terms expiring in 2015

Continuing Directors - Terms expiring in 2014

Continuing Directors - Terms expiring in 2013

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- WR UHYLHZ WKH FRPPLWWHH VWUXFWXUH DQG PDNH UHFRPPH
  FRPPLWWHH PHPEHUVKLS DQG
- WR GHYHORS DQG UHFRPPHQG WR WKH ERDUG RI GLUHFWRUV
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- a statement that the writer is a shareholder and is proposing a candidate for consideration by the nominating committee;
- the name and address of the shareholder as they appear on our books and number of shares of our common stock that are owned beneficially by such shareholder (if the shareholder is not a holder RI UHFRUG  DSSURSULDWH HYLGH will be required); KH VKDUHKROGHU¶V
- the name, address and contact information for the candidate, and the number of shares of common stock that are owned by the candidate (if the candidate is not a holder of record, appropriate HYLGHQFH RI WKH VKDUH d be provided); ¶V RZQHUVKLS VKRXO
- D VWDWHPHQW RI WKH FDQGLGDWH¶V EXVLQHVV DQG HGXFDW
- such other information regarding the candidate as would be required to be included in the Proxy Statement pursuant to SEC Regulation 14A;
- a statement detailing any relationship between us and the candidate;
- a statement detailing any relationship between the candidate and any of our customers, suppliers or competitors;
- detailed information about any relationship or understanding between the proposing shareholder and the candidate; and
- a statement that the candidate is willing to be considered and willing to serve as a director if nominated and elected.

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Board Leadership Structure and Risk Oversight Role. The role of chairman of the board of directors and chief executive officer/president of the Company are not currently held by the same person. The chairman of the board has never been an officer or employee of the Company or the Bank. The foregoing structure is not mandated by any provision of law or our articles of incorporation or bylaws, but the board of directors currently believes that this structure provides for an appropriate balance of authority between management and the board. The board of directors reserves the right to establish a different structure in the future.

The board of directors of the Company, all of the members of which are also members of the board of directors of the Bank, is actively involved in the Company's and Bank's risk oversight activities, through the work of numerous committees of the Company and Bank, and the policy approval function of the board of directors of the Bank.

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- forward the communication to the director or directors to whom it is addressed;
- attempt to handle the inquiry directly, i.e. where it is a request for information about us or it is a stock-related matter; or
- not forward the communication if it is primarily commercial in nature, relates to an improper or irrelevant topic, or is unduly hostile, threatening, illegal or otherwise inappropriate.

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WKH (TXLW\ ,QFHQWLYH 3ODQ DSSURYHG E\ VKDUHKROGHUV LQ 0D\
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RIILFHUV LQ -DQXDU\ DQG ZHUH UHSRUWHG DV D 7KH &RPSHQVDWLRQ
&RPPLWWHH WDUJHWHG ORQJ WHUP HTXLW\ LQFHQWLYHV DW DSSUR[LP
H[HFXWLYH PDQDJHPHQW :LWK UHJDUG WR WKH FKLHI H[HFXWLYH RIIL
HTXLW\ LQFHQWLYHV DW PRUH WKDQ 7KH DOORFDWLRQ EHWZHHQ FRPSHQV
DQG WKH RSWLRQ DZDUGV ZDV JHQHUDOO\ DQ HTXDO VSOLW 7KLV LV
WKRVH H[HFXWLYHV WKDW JUHDWHU SRWHQWLDO LQ WKH YHVWLQJ SHULRG DQG ZKR DUH
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DZDUGV

7KH LQLWLDO JUDQWV RI UHVWULFWHG VWRFN DZDUGV DQG RSWLR
PDGH WR %DQN H[HFXWLYHV RQ -DQXDU\ 7KDW GDWH ZDV EHIRUH
DYDLODEOH DQG ZDV PRUH WKDQ D PRQWK SULRU WR RXU IRXUWK TXDU
SULFH RI WKH RSWLRQ DZDUGV JUDQWHG ZHUH HTXDO WR WKH FORVLQ
JUDQW 7KH HTXLW\ LQFHQWLYH HOHPHQWV RI WRWDO FRPSHQVDWLRQ Y
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'LYLGHQGV SDLG ZLWK UHVSHFW WR VKDUHV RI RXU VWRFN DOORFDWHG
ORDQ RU FUHGLWHG SURSRUWLRQDWHO\ WR SDUWLFLSDQW DFFRXQWV

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5HJXODWRU\ OLPLWDWLRQV RQ UHVWULFWHG VWRFN DQG VWRFN RSWLR
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Report of the Compensation Committee on Executive Compensation 7KH FRPSHQVDWLRQ FRPPLW
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7KH ERDUG RI GLUHFWRUV XQDQLPRXVO\ [illegible]
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7KH IROORZLQJ WDEOH VKRZV WKH FRPSHQVDWLRQ RI 'RXJODV 6
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(623 WUXVW ERUURZHG IXQGV IURP :DWHUVWRQH )LQDQFLDO IRU WKH S
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WKH FKDULWDEOH IRXQGDWLRQ 7KH WUXVW GRHV QRW DQWLFLSDWH S

7KH FRPPRQ VWRFN SXUFKDVHG E\ WKH (623 VHUYHV DV FROODWH
SULQFLSDOO\ IURP :DWHU6WRQH %DQN GLVFUHWLRQDU\ FRQWULEXWLR
GRFXPHQWV SURYLGH WKDW WKH ORDQ PD\ EH UHSDLG RYHU D VKRUWH
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DOORFDWLRQ DPRQJ SDUWLFLSDQWV DV WKH ORDQ LV UHSDLG

&RQWULEXWLRQV WR WKH (623 DQG VKDUHV UHOHDVHG IURP WKH V
UHSD\PHQW RI WKH (623 ORDQ DUH DOORFDWHG DPRQJ (623 SDUWLFLSD
RI DOORFDWLRQ %HQHILWV XQGHU WKH SODQ YHVW LQ DFFRUGDQFH Z
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VHSDUDWLRQ IURP VHUYLFH

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DPRXQW DQG PDQQHU RI GLVFUHWLRQDU\ FRQWULEXWLRQV ZLOO EH DI
SROLFLHV WKH UHTXLUHPHQWV RI DSSOLFDEOH ODZV DQG UHJXODWLR
FRQWULEXWLRQV WR WKH (623 DUH QRW IL[HG WKHUHIRUH EHQHILWV
UHTXLUHG WR UHFRUG FRPSHQVDWLRQ H[SHQVH HDFK \HDU LQ DQ DPR[
FRPPLWWHG WR EH UHOHDVHG GXULQJ WKH \HDU HQGHG 'HFHPEHU ZHUH DOORFDWHG W
LQ WKH (623 ZKLFK UHVXOWHG LQ FRPSHQVDWLRQ H[SHQVH 'HFHPEHU

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DFFRXQWV 7KH WUXVWHH YRWHV DOO DOORFDWHG VKDUHV KHOG LQ W
XQDOORFDWHG VKDUHV DQG DOORFDWHG VKDUHV IRU ZKLFK QR LQVWU
WKH ILGXFLDU\ UHVSRQVLELOLWLHV RI WKH WUXVWHH

7KH (623 PXVW PHHW FHUWDLQ UHTXLUHPHQWV RI WKH ,QWHUQDO
,QFRPH 6HFXULW\ $FW :DWHU6WRQH %DQN KDV UHFHLYHG D GHWHUPLQDWLRQ OHWWHU I

N 3O7KH :DWHU6WRQH %DQN N 3ODQ DQG WKH :DWHUVWRQH
WD[ TXDOLILHG SODQV XQGHU 6HFWLRQ D RI WKH ,QWHUQDO 5HYHQ
6HFWLRQ N RI WKH ,QWHUQDO 5HYHQXH &RGH %DQN HPSOR\HHV R
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UHFHLYH DQ\ PDWFKLQJ RU GLVFUHWLRQDU\ FRQWULEXWLRQV PDGH WR
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3DUWLFLSDQWV DUH DOZD\V YHVWHG LQ WKHLU HOHFWLYH GHIHUUD
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FRPSOHWLRQ RI WZR \HDUV RI VHUYLFH DQG HQGLQJ ZLWK WKH FRPSOH
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| 7KRPDV ( 'DOXP 'LUHFWRU | | | | |

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LQ DFFRUGDQFH ZLWK )$6% $6& 7RSLF

,Q ZHSDLG HDFK QRQ RIILFHU GLUHFWRU DQ DQQXDO UHWDLQHU
ERWK WKH &KDLUPDQ RI WKH %RDUG DQG WKH &KDLUPDQ RI WKH $XGLW
RI WKH &RPSHQVDWLRQ &RPPLWWHH DQG WKH 1RPLQDWLQJ DQG &RUSR
)LQDOO\ HDFK UHJXODU QRQ FKDLUSHUVRQ PHPEHU RI HDFK RI WKH W
DQQXDO IHH 7KHVH DPRXQWV ZHUH XQFKDQJHG IURP 7KH &RPSHQVDWLRQ &RPPLWWHH
FRPPLVVLRQHG D WKLUG SDUW\ FRPSHQVDWLRQ DQDO\VLV LQ WR E
H[HFXWLYH DQG GLUHFWRU FRPSHQVDWLRQ IRU FDOHQGDU

,Q FRQQHFWLRQ ZLWK LWV IXQFWLRQ WR RYHUVHH DQG PRQLWRU
KDV GRQH WKH IROORZLQJ

- UHYLHZHG DQG GLVFXVVHG WKH DXGLWHG ILQDQFLDO VWDWHPHQWV PDQDJHPHQW
- GLVFXVVHG ZLWK RXU .30* //3 LQGHSHQGHQW UHJLVWHUHG SXEOLF DFFRXQWLQ UHTXLUHG WR EH GLVFXVVHG E\ 6WDWHPHQWV RQ $XGLWLQJ 6WDQ
- UHFHLYHG WKH ZULWWHQ GLVFORVXUHV DQG WKH OHWWHU IURP .3 6WDQGDUG 1R ,QGHSHQGHQFH 'LVFXVVLRQV ZLWK $XGLW &RPPL LQGHSHQGHQFH

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7KH ILUP RI .30* //3 KDV DXGLWHG WKH ERRNV DQG UHFRUGV RI :D HQGHG 'HFHPEHU DQG KDV VHUYHG DV WKH %DQN¶V SULQFLSDO 5HSUHVHQWDWLYHV RI .30* //3 DUH H[SHFWHG WR EH SUHVHQW DW WK DQG WR PDNH D VWDWHPHQW LI WKH\ VR GHVLUH

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 2054

# F O R M 1 0 - K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF

For the fiscal year ende December 31 2011

Commission file numbe 000-51507

# WATERSTONE FINANCIAL , INC.

(Exact name of registrant as specified in its cha

| | |
|---|---|
| Federally Chartered Corporation | 39-0691250 |
| (State or other jurisdiction incorporation or organizatio | (I.R.S. Employer Identification No |
| 11200 W Plank Ct, Wauwatosa, WI | 53226 |
| (Address of principal executive offic | (Zip Code |

Registrant's telephone number, including area (414) 761-1000

Securities registered pursuant to Section 12(b) of the

| | |
|---|---|
| Common Stock, $0.01 Par Va | The NASDAQ Stock Market, LL |
| (Title of class | (Name of each exchange on which registe |

Securities registered pursuant to Section 12(g) of the
NONE

Indicate by check mark whether the registrant is a well-known seasoned issuer (as defined in Rule 405 of the 1933 Act).

Yes No

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of t 1934 Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of th Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was requi to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, ev Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding months (or for such shorter period that the registrant was required to submit and post such files)

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, ar will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated b reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ X ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule12b-2 of the Exchange Act

| | | | |
|---|---|---|---|
| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller Reporting Company |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Exchange Act).

Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the last sale price on June 30, 2011, as reported by the NASDAQ Capital Market® was approximately $70.3 million.

As of February 29, 2012, 31,350,097 shares of the Registrant's Common Stock were validly issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

| Document | Part of Form 10-K Into Which Portions of Document are Incorporated |
|---|---|
| Proxy Statement for Annual Meeting Shareholders oMay 22, 2012 | Part III |

WATERSTONE FINANCIAL , INC.

FORM 10-K ANNUAL REPORT TO THE SECURITIES AND EXCHANGE COMMISSION
FOR THE YEAR ENDED DECEMBER 31, 2011

TABLE OF CONTENTS

## Part 1

Waterstone Financial, Inc. and its subsidiaries, including WaterStone Bank, SSB, are referred to herein as the "Company," "Waterstone Financial," or "we."

## Item 1. Business

Introduction

Waterstone Financial, Inc. is the mid-tier stockholding company subsidiary of Lamplighter Financial, MHC, formed as part of the reorganization of WaterStone Bank into mutual holding company form. WaterStone Bank was converted from a mutual to a stock savings bank as part of our reorganization. At December 31, 2011, 74% of Waterstone Financial, Inc. outstanding shares were held by Lamplighter Financial, HMC and 26% were held by public shareholders. In this report, we refer to WaterStone Bank, our wholly owned subsidiary, both before and after the reorganization, as "WaterStone Bank" or the "Bank."

On September 28, 2007, the Company completed its charter conversion to change the Company's charter from a Wisconsin corporation to that of a federal corporation. Similarly, the Company's mutual holding company parent, Lamplighter Financial, MHC (the "MHC"), also completed its charter conversion to change the MHC's charter from a Wisconsin chartered mutual holding company to a federally chartered mutual holding company. Shareholders were not required to exchange stock certificates in the name of Wauwatosa Holdings, Inc. for stock certificates in the name of Waterstone Financial, Inc. All references to Waterstone Financial, Inc. include Wauwatosa Holdings, Inc. WaterStone Bank continues to be a Wisconsin chartered savings bank.

The Company maintains a website at www.wsbonline.com. We make available through that website, free of charge, copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, amendments to those reports and proxy materials as soon as is reasonably practical after the Company electronically files those materials with, or furnishes them to, the Securities and Exchange Commission. You may access those reports by following the links under "Investor Relations" at the Company's website.

### Cautionary Factors

This Form 10-K contains or incorporates by reference various forward-looking statements concerning the Company's prospects that are based on the current expectations and beliefs of management. Forward-looking statements may also be made by the Company from time to time in other reports and documents as well as in oral presentations. When used in written documents or oral statements, the words "anticipate," "believe," "estimate," "expect," "objective" and similar expressions and verbs in the future tense, are intended to identify forward-looking statements. The statements contained herein and such future statements involve or may involve certain assumptions, risks and uncertainties, many of which are beyond the Company's control, that could cause the Company's actual results and performance to differ materially from what is expected. In addition to the assumptions and other factors referenced specifically in connection with such statements, the following factors could impact the business and financial prospects of the Company:

- our ability to maintain higher regulatory capital levels as imposed by federal and state regulators;
- adverse changes in real estate markets;
- adverse changes in the securities markets;
- general economic conditions, either nationally or in our market area, that are worse than expected;
- inflation and changes in interest rates that reduce our margins or reduce the fair value of financial instruments;
- changes in interest rates that reduce loan origination volumes and, ultimately, income from our mortgage banking operations;
- legislative or regulatory changes that adversely affect our business;
- our ability to maintain adequate levels of liquidity given regulatory limits on sources of funding and rates that can be paid for funding;
- our ability to enter new markets successfully and to take advantage of growth opportunities;
- significantly increased competition among depository and other financial institutions;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies and the Financial Accounting Standards Board; and
- changes in consumer spending, borrowing and savings habits.

See also the factors regarding future operations discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" below.

## BUSINESS OF WATERSTONE BANK

### General

Our principal business consists of attracting deposits from the general public in the areas surrounding our eight banking offices and our nine automated teller machines ("ATM"), including stand-alone ATM facilities, located in Milwaukee, Washington and Waukesha counties, Wisconsin.

We invest those deposits, together with funds generated from operations, primarily in residential real estate mortgage loans. At December 31, 2011, residential real estate mortgage loans comprised 88.5% of our total loans receivable. On that same date, our residential real estate mortgage loan portfolio was comprised of first mortgage loans secured by one-to four-family residences (39.7%), and over four-family residences (44.0%). The remainder of our residential real estate mortgage loans consisted of home equity loans and lines of credit (4.8%) secured by a junior position on one-to four-family residences. The remainder of our loans receivable consists of construction and land mortgages, commercial mortgages, commercial business loans and consumer loans.

Our revenues are derived principally from interest on loans and securities and mortgage banking activities. Our primary sources of funds are deposits, borrowings and principal and interest payments on loans and securities.

### Business Strategy

Our business strategy is to operate as a well-capitalized and profitable community bank dedicated to providing a complete range of banking products and services available through multiple delivery channels. Our principal business activity historically has been the origination of residential mortgage loans, including over four-family properties. In 2006, we added a mortgage banking subsidiary and in 2007, we added additional business loan and deposit products and expanded our consumer loan product base. There can be no assurances that we will successfully implement our business strategy.

Elements of our business strategy are as follows:

- Improve Asset Quality. By all measures, our asset quality has deteriorated over th
five years. We have taken a number of significant steps to improve our underwr
loans and monitoring asset quality. In 2006, we rewrote our underwriting p
strengthened our underwriting and administrative standards and implemented
officers' loan committee for review and approval of all loans in excess of $50
We hired senior loan officers experienced in systematically identifying, obje
evaluating and documenting good credit risks. In 2007, we added an independe
underwriting function for all residential loans and a loan review function to ensu
newly implemented controls and safeguards are uniformly implemented and a
We also expanded our collections staff and upgraded our information manageme
systems to reduce the number of past-due loans that become chronically delinquent

2008, we hired a Chief Credit Officer (CCO) and moved the credit analysis and lo review functions to a newly formed credit department headed by the CCO. The reports directly to the Chief Executive Officer. Notwithstanding the forgoing, in t current distressed economic environment at December 31, 2011 non-accrual loans totaled $78.2 million, or 6.4% of total loans receivable and real estate owned tota $56.7 million. During the year ended December 31, 2011, net charge-offs totaled $18.8 million.

- Capital Maintenance. Given the continuing weakness in our local and nation economies, it is imperative that the Company maintain its current level of c strength. Continuing loan losses have eroded total shareholders' equity by 16.0% since December 31, 2007. The Company will continue reducing total assets during the ending December 31, 2012 in order to maintain or increase its 9.8% equity to tota assets ratio that existed as of December 31, 2011. However, a declining asset base will reduce our ability to generate net interest income.

- Adequate Liquidity. Until such time as we achieve our goal of improved asset q we will maintain higher than usual levels of balance sheet liquidity. We have more than tripled our cash and cash equivalents balances from less than $25 million at D 31, 2008 to $80 million at December 31, 2011. Generally, higher levels of liquidit result in lower levels of interest income; however, the Company believes that ready cash under current economic conditions is important to the operation of c business.

- Mortgage Banking. We offer owner-occupied residential real estate mortgage l through eight WaterStone Bank offices and thirty-eight Waterstone Mortga Corporation offices in eleven states. Mortgage banking has historically been a vo industry and continues to be so. However, we are committed to and continue to in this product line. Transaction volume will vary significantly and proportiona movements in mortgage interest rates but we strive to maintain a standard n margin even as transaction volume varies.

- Continuing Emphasis on Residential Real Estate Lending. We offer long-term, fixed-rate loans and indexed, adjustable mortgage loans to our owner-occupied residenti mortgage customers. We intend to continue our emphasis on the origination residential real estate loans, especially over four-family loans. Current loans-to-borrower limitations cap the amount of credit that we can extend to a single or affiliated group of borrowers at 15% of WaterStone Bank's capital.

- Expansion of Product Offerings. In 2007, the Bank began offering variable r indexed residential mortgage loan and long-term fixed rate residential mortgage loa Expanded on-line banking and other forms of electronic banking have also provided th opportunity to add more commercial transaction accounts to our funding mix. In 2011 the Bank began offering mobile banking capabilities which allow for account balan and transaction inquires, balance transfers and bill pay.

Competition

We face competition within our market area both in making real estate loans and attracting deposits. The Milwaukee-Waukesha-West Allis metropolitan statistical area has a high concentration of financial institutions including large commercial banks, community banks and credit unions. The FDIC has determined that our market area is a “high-rate” area with regard to deposit pricing as compared to the rest of the United States. As of June 30, 2011, based on the FDIC’s annual Summary of Deposits Report, we had the seventh largest market share in our metropolitan statistical area representing 2.0% of all deposits.

Our competition for loans and deposits comes principally from commercial banks, savings institutions, mortgage banking firms and credit unions. We face additional competition for deposits from money market funds, brokerage firms, and mutual funds. Our primary focus is to build and develop profitable consumer and commercial customer relationships while maintaining our role as a community bank.

Market Area

The Bank’s market area is broadly defined as the Milwaukee, Wisconsin metropolitan market which is geographically located in the southeast corner of the state. More specifically, our primary market area is Milwaukee and Waukesha counties and the five surrounding counties of Ozaukee, Washington, Jefferson, Walworth and Racine. The Bank has four branch offices in Milwaukee County, three branch offices in Waukesha County and one branch office in Washington County. At June 30, 2011, 46.8% of deposits in the state of Wisconsin were located in the seven County metropolitan Milwaukee market.

Our primary market area for deposits includes the communities in which we maintain our banking office locations. Our primary lending market area is broader than our primary deposit market area and includes all of the primary market area noted above but extends further west to the Madison, Wisconsin market and further north to the Appleton and Green Bay, Wisconsin markets. In addition, our mortgage banking operation has ten offices in Pennsylvania, nine offices in Wisconsin, five offices in Minnesota, four offices in Florida, two offices each in Arizona, Idaho and Indiana and one office each in Iowa, Illinois, Maryland and Ohio.

Lending Activities

The scope of the discussion included under “Lending Activities” is limited to lending operations related to loans originated for investment. A discussion of the lending activities related to loans originated for sale is included under “Mortgage Banking Activities.”

Historically, our principal lending activity has been originating mortgage loans for the purchase or refinancing of residential real estate. Generally, we retain the loans that we originate which we refer to as loans originated for investment. One- to four-family residential mortgage loans represented $498.8 million, or 39.7%, of our total loan portfolio at December 31, 2011. Over four-family residential mortgage loans represented $552.2 million, or 44.0%, of our total loan portfolio at December 31, 2011. We also offer construction and land loans, commercial real estate loans, home equity lines of credit and commercial loans. At December 31, 2011, construction and land loans, commercial real estate loans, home equity loans and commercial business loans totaled $45.2 million, $65.4 million, $60.0 million and $34.4 million, respectively.

Loan Portfolio Composition. The following table sets forth the composition of our loan portfolio in dollar amounts and as a percentage of the total portfolio at the dates indicated.

| | At December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | | 2010 | | 2009 | | 2008 | | 2007 | |
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| | (Dollars in Thousands) | | | | | | | | | |
| Mortgage loans: | | | | | | | | | | |
| Residential real estate: | | | | | | | | | | |
| One- to four-family | $ 498,788 | 39.71% | $ 584,014 | 43.34% | $ 681,578 | 46.31% | $ 790,486 | 48.70% | $ 672,362 | 45.64% |
| Over four-family | 552,240 | 43.95% | 542,602 | 40.26% | 536,731 | 36.47% | 512,746 | 31.59% | 477,766 | 32.45% |
| Home equity | 60,002 | 4.78% | 71,952 | 5.34% | 85,964 | 5.84% | 89,648 | 5.52% | 85,954 | 5.84% |
| Construction and land | 45,212 | 3.60% | 56,794 | 4.21% | 69,814 | 4.74% | 131,840 | 8.12% | 156,289 | 10.61% |
| Commercial | 65,434 | 5.21% | 51,733 | 3.84% | 48,948 | 3.33% | 55,193 | 3.40% | 51,983 | 3.53% |
| Commercial business | 34,364 | 2.74% | 40,442 | 3.00% | 48,094 | 3.27% | 43,006 | 2.65% | 28,222 | 1.92% |
| Consumer | 109 | 0.01% | 154 | 0.01% | 619 | 0.04% | 365 | 0.02% | 286 | 0.01% |
| Total loans | 1,256,149 | 100.00% | 1,347,691 | 100.00% | 1,471,748 | 100.00% | 1,623,284 | 100.00% | 1,472,862 | 100.00% |
| Undisbursed loan proceeds | (37,433) | | (39,265) | | (49,818) | | (61,192) | | (67,549) | |
| Net deferred loan fees and premiums | (2,052) | | (1,989) | | (1,920) | | (2,334) | | (3,265) | |
| Loans receivable | 1,216,664 | | 1,306,437 | | 1,420,010 | | 1,559,758 | | 1,402,048 | |
| Allowance for loan losses | (32,430) | | (29,175) | | (28,494) | | (25,167) | | (12,839) | |
| Loans, net | $1,184,234 | | $1,277,262 | | $1,391,516 | | $1,534,591 | | $1,389,209 | |

Loan Portfolio Maturities and Yields. The following table summarizes the final maturities of our loan portfolio at December 31, 2011. Maturities are based upon the final contractual payment dates and do not reflect the impact of prepayments and scheduled monthly payments that will occur.

| Maturity Date | One- to four-family Amount | One- to four-family Weighted Average Rate | Over four-family Amount | Over four-family Weighted Average Rate | Home Equity Amount | Home Equity Weighted Average Rate | Construction and Land Amount | Construction and Land Weighted Average Rate |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in Thousands) | | | | | | | |
| Jan 1, 2012 – Dec 31, 2012 | $ 43,941 | 6.36% | $ 61,454 | 6.06% | $ 28,434 | 4.50% | $ 27,739 | 4.80% |
| Jan 1, 2013 – Dec 31, 2013 | 35,083 | 5.80% | 70,230 | 5.97% | 9,034 | 4.28% | 5,522 | 6.87% |
| Jan 1, 2014 – Dec 31, 2014 | 27,293 | 6.13% | 54,307 | 5.69% | 5,709 | 4.06% | 1,192 | 4.77% |
| Jan 1, 2015 – Dec 31, 2015 | 707 | 6.20% | 2,429 | 5.85% | 7,581 | 3.70% | 1,288 | 3.52% |
| Jan 1, 2016 – Dec 31, 2016 | 5,660 | 4.70% | 7,600 | 5.33% | 3,807 | 5.06% | 1,140 | 2.79% |
| Jan 1, 2017 and thereafter | 386,104 | 5.60% | 356,220 | 5.49% | 5,437 | 5.15% | 8,331 | 5.35% |
| Total | $ 498,788 | 5.70% | $ 552,240 | 5.63% | $ 60,002 | 4.42% | $ 45,212 | 5.07% |

| Maturity Date | Commercial Real Estate Amount | Commercial Real Estate Weighted Average Rate | Commercial Business Amount | Commercial Business Weighted Average Rate | Consumer Amount | Consumer Weighted Average Rate | Total Amount | Total Weighted Average Rate |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in Thousands) | | | | | | | |
| Jan 1, 2012 – Dec 31, 2012 | $ 6,673 | 6.21% | $ 22,751 | 5.44% | $ 90 | 6.68% | $ 191,082 | 5.64% |
| Jan 1, 2013 – Dec 31, 2013 | 6,410 | 6.15% | 4,816 | 6.19% | 8 | 5.64% | 131,103 | 5.86% |
| Jan 1, 2014 – Dec 31, 2014 | 8,943 | 5.57% | 2,949 | 5.92% | 11 | 6.75% | 100,404 | 5.70% |
| Jan 1, 2015 – Dec 31, 2015 | 7,805 | 6.25% | 1,941 | 5.14% | - | - | 21,751 | 5.06% |
| Jan 1, 2016 – Dec 31, 2016 | 11,127 | 5.98% | 1,265 | 6.14% | - | - | 30,599 | 5.36% |
| Jan 1, 2017 and thereafter | 24,476 | 5.90% | 642 | 6.39% | - | - | 781,210 | 5.56% |
| Total | $ 65,434 | 5.97% | $ 34,364 | 5.61% | $ 109 | 6.61% | $ 1,256,149 | 5.60% |

The following table sets forth the scheduled repayments of fixed and adjustable rate loans a December 31, 2011 that are contractually due after December 31, 2012.

| | Due After December 31, 2012 | | |
|---|---|---|---|
| | Fixed | Adjustable | Total |
| | (In Thousands) | | |
| Mortgage loans | | | |
| Real estate loans: | | | |
| One- to four-family | $22,019 | $432,828 | $454,847 |
| Over four-family | 72,053 | 418,733 | 490,786 |
| Home equity | 2797 | 28,771 | 31,568 |
| Construction and land | 815 | 16,658 | 17,473 |
| Commercial | 32,497 | 26,264 | 58,761 |
| Commercial | 9,883 | 1,730 | 11,613 |
| Consumer | 19 | - | 19 |
| Total loans | $140,083 | $924,984 | $1,065,067 |

One- to Four-Family Residential Mortgage Loans. WaterStone Bank's primary lending activity is originating residential mortgage loans secured by properties located in Milwaukee and surrounding countie One- to four-family residential mortgage loans totaled $498.8 million, or 39.7% of total loans at December 31, 2011. One- to four-family residential mortgage loans originated for investment during the year ended December 31, 2011 totaled $13.7 million, or 11.7% of all loans originated. Our one- to four-family residential mortgage loans have fixed and adjustable rates. Our variable-rate mortgage loans genera provide for maximum rate adjustments of 100 basis points per adjustment, with a lifetime maximum adjustment of either 300 or 600 basis points, regardless of the initial rate. Our variable-rate mortgage loar typically amortize over terms of up to 30 years. Portfolio one- to four-family variable-rate loans at December 31, 2011 are not necessarily indexed. They are adjustable semi-annually at our discretion with t limits noted above. The Company does not and has never offered residential mortgage loans specifical designed for borrowers with sub-prime credit scores, including Alt-A and negative amortization loans. Further, prior to 2007, we did not offer indexed, variable-rate loans other than home equity lines of credi and we have never offered “teaser rate” first mortgage products.

Variable rate mortgage loans can decrease the interest rate risk associated with changes in mark interest rates by periodically repricing, but involve other risks because, as interest rates increase, th underlying payments by the borrower increase, thus increasing the potential for default by the borrower. A the same time, the marketability of the underlying collateral may be adversely affected by higher interes rates. Upward adjustment of the contractual interest rate is also limited by the maximum periodic and lifetime interest rate adjustments permitted by our loan documents and, therefore, the effectiveness o variable rate mortgage loans in decreasing the risk associated with changes in interest rates may be limit during periods of rapidly rising interest rates. Moreover, during periods of rapidly declining interest rates the interest income received from the adjustable rate loans can be significantly reduced, thereby adverse affecting interest income.

All residential mortgage loans that we originate include "due-on-sale" clauses, which give us the right to declare a loan immediately due and payable in the event that, among other things, the borrower sells otherwise disposes of the real property subject to the mortgage and the loan is not repaid. We also requ homeowner's insurance and where circumstances warrant, flood insurance on properties securing real est loans. The average single family first mortgage loan balance was $188,000 and the largest outstandi balance was $4.0 million on December 31, 2011. The average two- to four-family first mortgage loan balance was $144,000 on December 31, 2011 and the largest outstanding balance was $5.2 million, which a consolidation loan that is collateralized by twenty-nine properties.

Over Four-family Real Estate Loans. Over four-family loans totaled $552.2 million, or 44.0% of total loans at December 31, 2011. Over four-family loans originated during the year ended December 3 2011 totaled $60.4 million or 51.8% of all loans originated for investment. These loans are generally secured by properties located in our primary market area. Our over four-family real estate underwriting policies generally provide that such real estate loans may be made in amounts of up to 80% of the apprais value of the property provided the loan complies with our current loans-to-one borrower limit. Over four-family real estate loans are offered with interest rates that are fixed for periods of up to five years or ar variable and either adjust based on a market index or at our discretion. Contractual maturities do not exce 10 years while principal and interest payments are typically based on a 30-year amortization period. I reaching a decision on whether to make an over four-family real estate loan, we consider gross revenues a the net operating income of the property, the borrower's expertise and credit history, business cash flow, a the appraised value of the underlying property. In addition, we will also consider the terms and conditions o the leases and the credit quality of the tenants. We generally require that the properties securing these r estate loans have debt service coverage ratios (the ratio of earnings before interest, taxes, depreciation a amortization divided by interest expense and current maturities of long term debt) of at least 1.15 times Generally, over four-family loans made to corporations, partnerships and other business entities requi personal guarantees by the principals and by the owners of 20% or more of the borrower.

An over four-family borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, payment history reviews and periodic face-to-face meetings with th borrower. We generally require borrowers with aggregate outstanding balances exceeding $1.0 million t provide updated financial statements and federal tax returns annually. These requirements also apply to guarantors on these loans. We also require borrowers with rental investment property to provide an annu report of income and expenses for the property, including a tenant list and copies of leases, as applicab The average outstanding over four-family mortgage loan balance was $704,000 on December 31, 2011 wi the largest outstanding balance at $9.5 million. At December 31, 2011, our largest exposure to one borrow or to a related group of borrowers was $20.4 million, and consisted of six separate loans on residenti properties with over four units. The largest loan in the group is a loan with an outstanding balance a December 31, 2011 of $6.4 million secured by a 112 unit apartment building.

Loans secured by over four-family real estate generally involve larger principal amounts and greate risk than owner-occupied, one- to four-family residential mortgage loans. Because payments on loan secured by over four-family properties often depend on the successful operation or management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or t economy.

Home Equity Loans We also offer home equity loans and home equity lines of credit, both of which are secured by owner-occupied and non-owner occupied one- to four-family residences. At December 3 2011, outstanding home equity loans and equity lines of credit totaled $60.0 million, or 4.8% of total loans outstanding. At December 31, 2011, the unadvanced portion of home equity lines of credit totaled $21. million. Home equity loans and lines originated during the year ended December 31, 2011 totaled $4.

million, or 3.7% of all loans originated for investment. The underwriting standards utilized for home equity loans and home equity lines of credit include a determination of the applicant's credit history, an assessme of the applicant's ability to meet existing obligations and payments on the proposed loan, and the value of th collateral securing the loan. Home equity loans are offered with adjustable rates of interest and with term up to 10 years. The loan-to-value ratio for our home equity loans and our lines of credit is generally limited to 90% when combined with the first security lien, if applicable. Our home equity lines of credit have ten-year terms and adjustable rates of interest, subject to a contractual floor, which are indexed to the prime ra as reported in *The Wall Street Journal*. Interest rates on home equity lines of credit are generally limited to a maximum rate of 18%. The average outstanding home equity loan balance was $45,000 at December 3 2011 with the largest outstanding balance at that date of $938,000.

Residential Construction and Land Loans. We originate construction loans to individuals and contractors for the construction and acquisition of single and multi-family residences. At December 31 2011, construction mortgage loans totaled $45.2 million, or 3.6%, of total loans. Construction and land loan originated during the year ended December 31, 2011 totaled $3.5 million, or 3.0% of all loans originated fo investment. At December 31, 2011, the unadvanced portion of these construction loans totaled $5.7 million

Our construction mortgage loans generally provide for the payment of interest only during the construction phase, which is typically up to nine months although our policy is to consider construction periods as long as 12 months or more. At the end of the construction phase, the construction loan converts a longer term mortgage loan. Construction loans can be made with a maximum loan-to-value ratio of 90% provided that the borrower obtains private mortgage insurance if the loan balance exceeds 80% of the less of the appraised value or sales price of the secured property. The average outstanding construction lo balance totaled $700,000 on December 31, 2011 and ranged from $60,000 to $4.2 million. The average outstanding land loan balance was $405,000 on December 31, 2011 with the largest outstanding balance $5.0 million.

Before making a commitment to fund a residential construction loan, we require an appraisal of the property by an independent licensed appraiser. We also review and inspect each property befor disbursement of funds during the term of the construction loan. Loan proceeds are disbursed after inspecti based on the percentage of completion method.

Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends large upon the accuracy of the initial estimate of the value of the property at completion of construction compare to the estimated cost (including interest) of construction and other assumptions. If the estimate o construction cost is inaccurate, we may be required to advance funds beyond the amount originall committed in order to protect the value of the property. Additionally, if the estimate of value is inaccurate, we may be confronted with a project, when completed, with a value that is insufficient to ensure full repayment of the loan.

Commercial Real Estate Loans. Commercial real estate loans totaled $65.4 million at December 31, 2011, or 5.2% of total loans, and are made up of loans secured by office and retail buildings, churche restaurants, other retail properties and mixed use properties. Commercial real estate loans originated duri the year ended December 31, 2011 totaled $25.4 million, or 21.8% of all loans originated for investment These loans are generally secured by property located in our primary market area. Our commercial re estate underwriting policies provide that such real estate loans may be made in amounts of up to 80% of t appraised value of the property. Commercial real estate loans are offered with interest rates that are fixed u to five years or are variable and either adjust based on a market index or at our discretion. Contractu maturities do not exceed 10 years while principal and interest payments are typically based on a 30-ye amortization period. In reaching a decision on whether to make a commercial real estate loan, we consid gross revenues and the net operating income of the property, the borrower's expertise and credit histor business cash flow, and the appraised value of the underlying property. In addition, we will also consider th terms and conditions of the leases and the credit quality of the tenants. We generally require that th properties securing these real estate loans have debt service coverage ratios (the ratio of earnings bef interest, taxes, depreciation and amortization divided by interest expense and current maturities of long ter debt) of at least 1.15 times. Environmental surveys are required for commercial real estate loans whe environmental risks are identified. Generally, commercial real estate loans made to corporations partnerships and other business entities require personal guarantees by the principals and by the owners 20% or more of the borrower.

A commercial borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, payment history reviews and periodic face-to-face meetings with th borrower. We generally require borrowers with aggregate outstanding balances exceeding $1.0 million t provide annually updated financial statements and federal tax returns. These requirements also apply to guarantors on these loans. We also require borrowers to provide an annual report of income and expens for the property, including a tenant list and copies of leases, as applicable. The average commercial re estate loan in our portfolio at December 31, 2011 was $564,000 with the largest outstanding balance at $3 million.

Commercial Loans. Commercial loans totaled $34.4 million at December 31, 2011, or 2.7% of total loans, and are made up of loans secured by accounts receivable, inventory, equipment and real esta Commercial loans originated during the year ended December 31, 2011 totaled $9.4 million, or 8.0% of a loans originated. These loans are generally made to borrowers that are located in our primary market are Working capital lines of credit are granted for the purpose of carrying inventory and accounts receivable o purchasing equipment. These lines require that certain working capital ratios must be maintained and a monitored on a monthly or quarterly basis. Working capital lines of credit are short-term loans of 12 months or less with variable interest rates. At December 31, 2011, the unadvanced portion of working capital line of credit totaled $10.3 million. Outstanding balances fluctuate up to the maximum commitment amount based on fluctuations in the balance of the underlying collateral. Personal property loans secured b equipment are considered commercial business loans and are generally made for terms of up to 84 mon and for up to 80% of the value of the underlying collateral. Interest rates on equipment loans may be eithe fixed or variable. Commercial business loans are generally variable rate loans with initial fixed rate periods of up to five years. These loans generally amortize over 15 to 25 years.

A commercial borrower's financial information is monitored on an ongoing basis by requiring periodic financial statement updates, usually quarterly, payment history reviews and periodic face-to-fac meetings with the borrower. The average outstanding commercial loan at December 31, 2011 was $174,0 with the largest outstanding balance at $2.4 million.

The following table shows loan origination, principal repayment activity, transfers to real estate owned, charge-offs and sales during the periods indicated.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | (In Thousands) | | |
| Total loans at beginning of year | $ 1,443,824 | $ 1,516,800 | 1,636,277 |
| Mortgage loans originated for investment: | | | |
| Residential | | | |
| One- to four-family | 13,651 | 11,390 | 25,660 |
| Over four-family | 60,367 | 69,602 | 66,657 |
| Home equity | 4,328 | 5,528 | 8,491 |
| Construction and land | 3,487 | 8,355 | 7,914 |
| Commercial | 25,398 | 5,813 | 7,352 |
| Total mortgage loans originated for investment | 107,231 | 100,688 | 116,074 |
| Consumer loans originated for investment | - | 76 | 180 |
| Commercial loans originated for investment | 9,366 | 11,204 | 12,640 |
| Total loans originated for investment | 116,597 | 111,968 | 128,894 |
| Principal repayments | (200,544) | (169,093) | (202,998) |
| Transfers to real estate owned | (28,259) | (41,781) | (54,072) |
| Loan principal charge-offs | (18,821) | (25,151) | (23,360) |
| Net activity in loans held for investment | (131,027) | (124,057) | (151,536) |
| Loans originated for sale | 1,027,346 | 1,084,362 | 739,151 |
| Loans sold | (1,035,196) | (1,033,281) | (707,092) |
| Net activity in loans held for sale | (7,850) | 51,081 | 32,059 |
| Total loans receivable and held for sale at end of period | $ 1,304,94 | 1,443,82 | 1,516,80 |

Origination and Servicing of Loans. All loans originated by us are underwritten pursuant to internally developed policies and procedures. While we generally underwrite owner-occupied residentia mortgage loans to Freddie Mac and Fannie Mae standards, due to several unique characteristics, our loa originated prior to 2008 do not conform to the secondary market standards. The unique features of thes loans include: interest payments in advance of the month in which they are earned, discretionary rat adjustments that are not tied to an independent index and pre-payment penalties.

Exclusive of our mortgage banking operations, we generally retain in our portfolio a significant majority of the loans that we originate. At December 31, 2011, WaterStone Bank was servicing $4.1 million in loan participations originated by the Bank and subsequently sold to unrelated third parties. Loan servicin includes collecting and remitting loan payments, accounting for principal and interest, contacting delinquen mortgagors, supervising foreclosures and property dispositions in the event of unremedied defaults, makin certain insurance and tax payments on behalf of the borrowers and generally administering the loans.

Loan Approval Procedures and Authority. WaterStone Bank's lending activities follow written, non-discriminatory, underwriting standards and loan origination procedures established by WaterSton Bank's board of directors. The loan approval process is intended to assess the borrower's ability to repay t loan, the viability of the loan and the adequacy of the value of the property that will secure the loan, if applicable. To assess the borrower's ability to repay, we review the employment and credit history an information on the historical and projected income and expenses of borrowers.

Loan officers are authorized to approve and close any loan that qualifies under WaterStone Bank underwriting guidelines within the following lending limits:

- A secured one- to four-family mortgage loan up to $500,000 for a borrower with total outstanding loans from the Bank of less than $1,000,000 that is independently underwritten can be approved by select loan officers.
- A loan up to $500,000 for a borrower with total outstanding loans from the Bank of less than $500,000 can be approved by select commercial loan officers.
- Any secured mortgage loan ranging from $500,001 to $2,999,999 or any new loan to a borrower with outstanding loans from the Bank exceeding $1,000,000 must be approved by the Officer Loan Committee.
- Any loan for $3,000,000 or more must be approved by the Officer Loan Committee and the board of directors prior to closing. Any new loan to a borrower with outstanding loans from the Bank exceeding $10,000,000 must be approved by the board of directors prior to closing.

## Asset Quality

When a loan becomes more than 30 days delinquent, WaterStone Bank sends a letter advising t borrower of the delinquency. The borrower is given 30 days to pay the delinquent payments or to contac WaterStone Bank to make arrangements to bring the loan current over a longer period of time. If the borrower fails to bring the loan current within 90 days from the original due date or to make arrangements t cure the delinquency over a longer period of time, the matter is referred to legal counsel and foreclosure o other collection proceedings are considered. We may consider forbearance in select cases where a tempor loss of income might result, if a reasonable plan is presented by the borrower to cure the delinquency in reasonable period of time after his or her income resumes.

All loans are reviewed on a regular basis, and such loans are placed on non-accrual status when th become more than 90 or more days delinquent. When loans are placed on non-accrual status, unpaid accr interest is reversed, and further income is recognized only to the extent received.

Non-Performing Assets. Non-performing assets consist of non-accrual loans and other real estate owned. Loans are generally placed on non-accrual status when contractually past due 90 days or more as interest or principal payments. Additionally, whenever management becomes aware of facts o circumstances that may adversely impact the collectibility of principal or interest on loans, management ma place such loans on non-accrual status immediately, rather than waiting until the loan becomes 90 days pa due. At that time, previously accrued and uncollected interest on such loans is reversed and addition income is recorded only to the extent that payments are received and the collection of principal is reasonab assured. Generally, loans are restored to accrual status when the obligation is brought current, has perform in accordance with the contractual terms for a reasonable period of time, and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

The table below sets forth the amounts and categories of our non-accrual loans and real estate own
at the dates indicated.

| | At December 31, | | | | | | |
|---|---|---|---|---|---|---|---|
| | | 2011 | | 2010 | 2009 | 2008 | 2007 |
| | (Dollars in Thousands) | | | | | | |
| Non-accrual loans: | | | | | | | |
| Residential | | | | | | | |
| One- to four-family | $ | 55,60 | $ | 56,75 | 45,98 | 42,18 | 32,58 |
| Over four-family | | 13,68 | | 20,58 | 16,68 | 35,78 | 38,21 |
| Home equit | | 1,33 | | 71 | 1,15 | 2,015 | 1,33 |
| Construction and land | | 6,94 | | 3,01 | 6,26 | 18,27 | 3,855 |
| Commercial real estate | | 51 | | 1,57 | 2,77 | 9,325 | 4,35 |
| Commercial | | 13 | | 1,53 | 2,44 | 15 | - |
| Consumer | | - | | - | - | - | - |
| Total non-accrual loar | | 78,21 | | 84,17 | 75,31 | 107,73 | 80,35 |
| | | | | | | | |
| Real estate owned | | | | | | | |
| One- to four-family | | 27,44 | | 28,14 | 27,01 | 16,72 | 4,98 |
| Over four-family | | 16,23 | | 14,90 | 8,82 | 6,057 | 75 |
| Construction and land | | 8,79 | | 9,92 | 10,45 | 1,09 | 2,61 |
| Commercial real estate | | 4,19 | | 4,78 | 4,63 | 78 | 18 |
| Total real estate own | | 56,67 | | 57,75 | 50,92 | 24,65 | 8,54 |
| | | | | | | | |
| Total non-performing assets | $ | 134,88 | | 141,93 | 126,24 | 132,38 | 88,89 |
| | | | | | | | |
| Total performing troubled debt restructurings | $ | 24,58 | $ | 33,59 | 42,73 | 2,40 | 2,22 |
| | | | | | | | |
| Total non-accrual loans to total loans, r | | 6.43% | | 6.44% | 5.30% | 6.91% | 5.73% |
| Total non-accrual loans and performing troul debt restructurings to total loans receiv | | 8.45% | | 9.01% | 8.31% | 7.06% | 5.89% |
| Total non-accrual loans to total ass | | 4.57% | | 4.65% | 4.03% | 5.71% | 4.70% |
| Total non-performing assets to total as | | 7.88% | | 7.85% | 6.76% | 7.02% | 5.20% |

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All loans that exceed 90 days with respect to past due principal and interest are recognized as no
accrual. Troubled debt restructurings which are still on nonaccrual either due to being past due greater th
90 days, or which have not yet performed under the modified terms for a reasonable period of time, ar
included in the table above. In addition, loans which are past due less than 90 days are evaluated
determine the likelihood of collectability given other credit risk factors such as early stage delinquency, the
nature of the collateral or the results of a borrower fiscal review. When the collection of all contractual
principal and interest is determined to be unlikely, the loan is moved to non-accrual status and an update
appraisal of the underlying collateral is ordered. This process generally takes place between contractual pa
due dates 60 and 90 days. Upon determining the updated estimated value of the collateral, a loan lo
provision is recorded to establish a specific reserve to the extent that the outstanding principal balanc
exceeds the updated estimated net realizable value of the collateral. When a loan is determined to
uncollectible, typically coinciding with the initiation of foreclosure action, the specific reserve is reviewed
for adequacy, adjusted if necessary, and charged-off.

Total non-accrual loans decreased by $6.0 million, or 7.1%, to $78.2 million as of December 31,
2011 compared to $84.2 million as of December 31, 2010. Notwithstanding the decrease in non-accru
loans during the current year, the ratio of non-accrual loans to total loans remained consistent at 6.43%
December 31, 2011 compared to 6.44% at December 31, 2010. A total of $59.7 million in loans were place

on non-accrual status during the year ended December 31, 2011. Offsetting the addition were $28.3 millio in transfers to real estate owned (net of charge-offs), $11.2 million in principal pay downs, $14.1 million in charge-offs and $12.1 million in loans that returned to accrual status and other adjustments.

Of the $78.2 million in total non-accrual loans as of December 31, 2011, $59.0 million in loans have been specifically reviewed to assess whether a specific valuation allowance is necessary. A specif valuation allowance is established for an amount equal to the impairment when the carrying value of the loa exceeds the present value of expected future cash flows, discounted at the loan's original effective intere rate or the fair value of the underlying collateral with an adjustment made for costs to dispose of the asse Based upon these specific reviews, a total of $10.1 million in partial charge-offs have been recorded wit respect to these loans as of December 31, 2011. Partially charged-off loans measured for impairment bas upon net realizable collateral value are maintained in a "non-performing" status and are disclosed a impaired loans. In addition, specific reserves totaling $7.1 million have been recorded as of December 3 2011. The remaining $19.2 million of non-accrual loans were reviewed on an aggregate basis and $4 million in general valuation allowance was deemed necessary as of December 31, 2011. The $4.6 million general valuation allowance is based upon a migration analysis performed with respect to similar non-accru loans in prior periods.

There were no accruing loans past due 90 days or more during the years ended December 31, 20 2010 or 2009.

Troubled Debt Restructurings.

The following table summarizes troubled debt restructurings:

| | At December 31, | |
|---|---|---|
| | 2011 | 2010 |
| | (Dollars in Thousands) | |
| Troubled debt restructurings | | |
| Substandard | $ 47,220 | 15,768 |
| Watch | 8,192 | 20,703 |
| Total troubled debt restructurings | $ 55,412 | 36,471 |

Troubled debt restructurings increased $18.9 million, or 51.9%, to $55.4 million at December 31, 2011 from $36.5 million at December 31, 2010. During the three months ended September 30, 2011, th Company adopted Accounting Standards Update 2011-02, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring, which provided additional guidance for creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financ difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring Based upon the provisions of this standard, the Company determined that 40 loans totaling $10.8 million n previously classified as troubled debt restructurings met the definition of a troubled debt restructuring se forth under the ASU 2011-02. In all cases, the $10.8 million in loans were modified under a legal agreeme such as a bankruptcy plan or a stipulation agreement meant to prevent a foreclosure. In all cases, these lo had previously been, and continue to be classified as impaired, substandard and nonperforming. As ea loan had been previously identified as impaired, an impairment review had been performed with respect t each loan and appropriate provisions for loan loss had been provided in prior periods. As such, th classification of these loans as troubled debt restructurings had no impact on the allowance for loan losses.

All troubled debt restructurings are considered to be impaired and are risk rated as either substanda or watch and are included in the internal risk rating tables disclosed in Note 3 in the notes to the financia statements. Specific reserves have been established to the extent that the collateral-based impairm analyses indicate that a collateral shortfall exists or to the extent that a discounted cash flow analysis resu in an impairment.

Loan Delinquency.

The following table summarizes loan delinquency in total dollars and as a percentage of the total loan portfolio:

| | | At December 31, 2011 | 2010 |
|---|---|---|---|
| | | (Dollars in Thousands) | |
| Loans past due less than 90 days | $ | 36,798 | 28,807 |
| Loans past due 90 days or more | | 56,612 | 61,856 |
| Total loans past dı | $ | 93,41( | 90,66ɜ |
| Total loans past due to total loans receivable | | 7.68% | 6.94% |

Total loans past due increased by $2.7 million, or 3.0%, to $93.4 million at December 31, 2011 from $90.7 million at December 31, 2010. Loans past due less than 90 days increased by $8.0 million, or 27.7% during the year ended December 31, 2011while loans past due 90 days or more decreased by $5.2 million, 8.5%. The $8.0 million increase in loans past due less than 90 days was solely attributable to a $12.3 millio lending relationship collateralized by over four-family residential real estate.

Real Estate Owned.

Total real estate owned decreased by $1.1 million, or 1.9%, to $56.7 million at December 31, 2011 compared to $57.8 million at December 31, 2010. During the year ended December 31, 2011, $28.3 millio was transferred from loans to real estate owned upon completion of foreclosure. Declines in property value evidenced by updated appraisals, responses to list prices on properties held for sale and/or deterioration the condition of properties resulted in write-downs totaling $6.8 million during the year ended December 31 2011. During the same period, sales of real estate owned totaled $22.4 million. New appraisals received real estate owned and collateral dependent impaired loans are based upon an “as is value” assumpti During the period of time in which we are awaiting receipt of an updated appraisal, loans evaluated fo impairment based upon collateral value are measured by the following:

- Applying an updated adjustment factor (as described previously) to an existing appraisal;
- Confirming that the physical condition of the real estate has not significantly changed since the las valuation date;
- Comparing the estimated current value of the collateral to that of updated sales values experienced similar collateral;
- Comparing the estimated current value of the collateral to that of updated values seen on curren appraisals of similar collateral; and
- Comparing the estimated current value to that of updated listed sales prices on our real estate own and that of similar properties (not owned by the Company).

We owned 323 properties as of December 31, 2011, compared to 284 properties at December 3 2010. Of the $56.7 million in real estate owned properties as of December 31, 2011, $47.9 million consist one– to four-family, over four-family and commercial real estate properties. Of all real estate owned, thes property types present the greatest opportunity to offset operating expenses through the generation of ren income. Of the $47.9 million in one- to four-family, over four-family and commercial real estate properties, $32.7 million, or 68.3%, represent properties that are generating rental revenue or are being managed w the intent of attracting a lessee to generate revenue. Foreclosed properties are recorded at the lower carrying value or fair value with charge-offs, if any, charged to the allowance for loan losses upon transfer t real estate owned. The fair value is primarily based upon updated appraisals in addition to an analysis current real estate market conditions.

Allowance for Loan Losses

We establish valuation allowances on loans that are deemed to be impaired. A loan is considere impaired when, based on current information and events, it is probable that we will not be able to collect a amounts due according to the contractual terms of the loan agreement. A valuation allowance is establish for an amount equal to the impairment when the carrying amount of the loan exceeds the present value of t expected future cash flows, discounted at the loan's original effective interest rate or the fair value of th underlying collateral.

We also establish valuation allowances based on an evaluation of the various risk components th are inherent in the loan portfolio. The risk components that are evaluated include past loan loss experienc the level of non-performing and classified assets; current economic conditions; volume, growth, and composition of the loan portfolio; adverse situations that may affect the borrower's ability to repay; the estimated value of any underlying collateral; regulatory guidance; and other relevant factors. The allowanc is increased by provisions charged to earnings and recoveries of previously charged-off loans and reduced charge-offs. The appropriateness of the allowance for loan losses is reviewed and approved quarterly by t WaterStone Bank board of directors. The allowance reflects management's best estimate of the amou needed to provide for the probable loss on impaired loans and other inherent losses in the loan portfolio, a is based on a risk model developed and implemented by management and approved by the WaterStone B board of directors.

Actual results could differ from this estimate, and future additions to the allowance may be necessar based on unforeseen changes in loan quality and economic conditions. In addition, the Federal Depos Insurance Corporation and the Wisconsin Department of Financial Institutions, as an integral part of thei examination process, periodically review WaterStone Bank's allowance for loan losses. Such regulators hav the authority to require WaterStone Bank to recognize additions to the allowance based on their judgments information available to them at the time of their review or examination.

Any loan that is 90 or more days delinquent is placed on non-accrual and classified as a non performing asset. A loan is classified as impaired when it is probable that we will be unable to collect al amounts due in accordance with the terms of the loan agreement. Non-performing assets are then evalua and accounted for in accordance with generally accepted accounting principles.

The following table sets forth activity in our allowance for loan losses for the periods indicated.

| | At or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| | (Dollars in Thousands) | | | | |
| Balance at beginning of period | $ 29,175 | 28,494 | 25,167 | 12,839 | 7,195 |
| Provision for loan losses | 22,077 | 25,832 | 26,687 | 37,629 | 11,697 |
| Charge-offs: | | | | | |
| Mortgage loans | | | | | |
| One- to four-family | 11,553 | 16,906 | 13,602 | 8,397 | 1,397 |
| Over four-family | 3,996 | 3,439 | 3,304 | 10,056 | 634 |
| Home equity | 634 | 619 | 861 | 394 | 120 |
| Construction and land | 1,745 | 2,319 | 3,957 | 5,088 | 3,982 |
| Commercial real estate | 734 | 575 | 910 | 1,838 | 27 |
| Consumer | 10 | 13 | 9 | 4 | 3 |
| Commercial | 619 | 1,470 | 1,000 | - | - |
| Total charge-offs | 19,291 | 25,341 | 23,643 | 25,777 | 6,163 |
| Recoveries: | | | | | |
| Mortgage loans | | | | | |
| One- to four-family | 311 | 127 | 181 | 313 | 68 |
| Over four-family | 40 | 55 | 23 | 31 | - |
| Home equity | 7 | 3 | 1 | 1 | 1 |
| Construction and land | 69 | 2 | 77 | 125 | - |
| Commercial real estate | 6 | 1 | - | - | 40 |
| Consumer | 1 | 1 | 1 | 6 | 1 |
| Commercial | 35 | 1 | - | - | - |
| Total recoveries | 469 | 190 | 283 | 476 | 110 |
| Net charge-offs | 18,822 | 25,151 | 23,360 | 25,301 | 6,053 |
| Allowance at end of year | $ 32,43[illegible] | 29,17[illegible] | 28,49[illegible] | 25,16[illegible] | 12,83[illegible] |
| Ratios: | | | | | |
| Allowance for loan losses to non-performing loans at end of period | 41.46% | 34.66% | 37.83% | 23.36% | 15.98% |
| Allowance for loan losses to net loans outstanding at end of period | 2.67% | 2.23% | 2.01% | 1.61% | 0.92% |
| Net charge-offs to average loans outstanding (annualized) | 1.43% | 1.75% | 1.54% | 1.67% | 0.44% |
| Current year provision for loan losses to net charge-offs | 117.29% | 102.71% | 114.24% | 148.73% | 193.24% |
| Net charge-offs to beginning of the year allowance | 64.51% | 88.27% | 92.82% | 197.06% | 84.13% |

Allocation of Allowance for Loan Losses.The following table sets forth the allowance for loan losses allocated by loan category, the total loan balances by category, and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

| | At December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | | 2009 | | |
| | Allowance for Loan Losses | % of Loans in Category to Total Loans | % of Allowance in Category to Total Allowance | Allowance for Loan Losses | % of Loans in Category to Total Loans | % of Allowance in Category to Total Allowance | Allowance for Loan Losses | % of Loans in Category to Total Loans | % of Allowance in Category to Total Allowance |
| | (Dollars in Thousands) | | | | | | | | |
| Real Estate: | | | | | | | | | |
| Residential | | | | | | | | | |
| One- to four-family | $ 17,475 | 39.71% | 53.89% | $ 16,150 | 43.34% | 55.36% | $ 17,875 | 46.31% | 62.73% |
| Over four-family | 8,252 | 43.95% | 25.44% | 6,877 | 40.26% | 23.57% | 5,208 | 36.47% | 18.28% |
| Home equity | 1,998 | 4.78% | 6.16% | 1,196 | 5.34% | 4.10% | 1,642 | 5.84% | 5.76% |
| Construction and land | 2,922 | 3.60% | 9.01% | 3,252 | 4.21% | 11.14% | 2,635 | 4.74% | 9.25% |
| Commercial Real Estate | 941 | 5.21% | 2.90% | 671 | 3.84% | 2.30% | 720 | 3.33% | 2.53% |
| Commercial | 814 | 2.74% | 2.51% | 1,001 | 3.00% | 3.43% | 371 | 3.27% | 1.30% |
| Consumer | 28 | 0.01% | 0.09% | 28 | 0.01% | 0.10% | 43 | 0.04% | 0.15% |
| Total allowance for loan losses | $ 32,430 | 100.00% | 100.00% | $ 29,175 | 100.00% | 100.00% | $ 28,494 | 100.00% | 100.00% |

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2008 | | | 2007 | | |
| | Allowance for Loan Losses | % of Loans in Category to Total Loans | % of Allowance in Category to Total Allowance | Allowance for Loan Losses | % of Loans in Category to Total Loans | % of Allowance in Category to Total Allowance |
| | (Dollars In Thousands) | | | | | |
| Real Estate: | | | | | | |
| Residential | | | | | | |
| One- to four-family | $ 14,218 | 48.70% | 56.49% | $ 5,433 | 45.64% | 42.32% |
| Over four-family | 6,844 | 31.59% | 27.20% | 4,369 | 32.45% | 34.03% |
| Home equity | 1,027 | 5.52% | 4.08% | 536 | 5.84% | 4.17% |
| Construction and land | 2,137 | 8.12% | 8.49% | 2,087 | 10.61% | 16.26% |
| Commercial Real Estate | 445 | 3.40% | 1.77% | 280 | 3.53% | 2.18% |
| Commercial | 457 | 2.65% | 1.82% | 99 | 1.92% | 0.77% |
| Consumer | 39 | 0.02% | 0.15% | 35 | 0.01% | 0.27% |
| Total allowance for loan losses | $ 25,167 | 100.00% | 100.00% | $ 12,839 | 100.00% | 100.00% |

All impaired loans meeting the criteria established by management are evaluated either individually, based primarily on the value of the collateral securing each loan and the ability of the borrowers to repay according to the terms of the loans, or based upon an analysis of the present value of the expected future cash flows under the original contract terms as compared to the modified terms in the case of certain troubled debt restructurings. Specific loss allowances are established as required by this analysis. At least once each quarter, management evaluates the adequacy of the balance of the allowance for loan losses based on several factors some of which are not loan specific, but are reflective of the inherent losses in the loan portfolio. This process includes, but is not limited to, a periodic review of loan collectibility in light of historical experience, the nature and volume of loan activity, conditions that may affect the ability of the borrower to repay, underlying value of collateral and economic conditions in our immediate market area. All loans for which a specific loss review is not required are segregated by loan type and a loss allowance is established by using loss experience data and management's judgment concerning other matters it considers significant including trends in non-performing loan balances, impaired loan balances, classified asset balances and the current economic environment. The allowance is allocated to each category of loans based on the results of the above analysis.

The above analysis is both quantitative and subjective, as it requires us to make estimates that are susceptible to revisions as more information becomes available. Although we believe that we have established the allowance at levels appropriate to absorb probable and estimable losses, additions may be necessary if future economic conditions differ substantially from the current environment.

At December 31, 2011, the allowance for loan losses was $32.4 million, compared to $29.2 million at December 31, 2010. As of December 31, 2011, the allowance for loan losses to total loans receivable was 2.67% and was equal to 41.46% of non-performing loans, compared to 2.23% and 34.66%, respectively, at December 31, 2010. The $3.2 million increase in the allowance for loan loss during the year ended December 31, 2011 is attributable to a $1.5 million increase in specific loan loss reserves related to impaired loans and a $1.7 million increase in the general valuation allowance. The $1.5 million increase in specific loan loss reserves was primarily the result of collateral shortfalls pertaining to a relatively small number of lending relationships that were identified as impaired during the year ended December 31, 2011. The reserves established with respect to these loans resulted in an overall increase in specific reserves, despite a decrease in the overall level of impaired loans during the year ended December 31, 2011. The increase in the general valuation allowance resulted from an increase in loans that, while they may still be performing have been identified as having higher risk characteristics. During the year ended December 31, 2011, the increase in the amount and number of loans identified as exhibiting elevated levels of risk with respect to loss outweighed the decline in non-performing loans. Loans with elevated risk profiles include loans internally classified as substandard. These loans resulted in a $2.7 million increase to the general valuation allowance during the year. This was partially offset by a $915,000 reduction to the general valuation allowance due primarily to an $89.8 million decrease in the balance of loans outstanding. Weakness in the residential real estate market has continued for the past four years and the risk of loss on loans secured by residential real estate remains at an elevated level.

Net charge-offs totaled $18.8 million, or 1.43% of average loans for the year ended

December 31, 2011, compared to $25.2 million, or 1.75% of average loans for the year ended December 31, 2010. The decrease in net charge-offs was primarily the result of a decrease in charge-offs related to loans secured by one- to four-family residential loans. Net charge-offs related to loans secured by one- to four-family residential loans totaled decreased $5.5 million, or 33.0%, to $11.2 million for the year ended December 31, 2011, as compared to $16.8 million for the year ended December 31, 2010. The majority of charge-offs in this category relate to two borrower types, borrowers with single family residential jumbo loans and borrowers who are considered small real estate investors. The primary reason for the decrease in net charge-offs within the one-to four-family residential loans related to a $5.2 million decrease in charge-offs related to residential jumbo lending relationships. Lending relationships with borrowers that had residential jumbo loans accounted for $5.0 million of net charge-offs in one-to four-family loans for the year ended December 31, 2011, as compared to $10.2 million of net charge-offs during the year ended December 31, 2010. The decrease in net charge-offs related to single family jumbo loans results from the continuing run off of this portion of the portfolio.

The $22.1 million loan loss provision for the year ended December 31, 2011 reflects the Company's determination that the allowance for loan losses should total $32.4 million following the net charge-offs recorded during the period and a review of the Bank's loan portfolio and general economic conditions.

Our revised underwriting policies and procedures emphasize the fact that credit decisions must rely on both the credit quality of the borrower and the estimated value of the underlying collateral. Credit quality is assured only when the estimated value of the collateral is objectively determined and is not subject to significant fluctuation. The quantified deterioration of the credit quality of our loan portfolio as described above is the direct result of borrowers who were not financially strong enough to make regular interest and principal payments or maintain their properties when the economic environment no longer allowed them the option of converting estimated real estate value increases into short-term cash flow.

Mortgage Banking Activity

In addition to the lending activities previously discussed, the Company also originates residential mortgage loans for the purpose of sale on the secondary market. The Company originated $1.03 billion in mortgage loans held for sale during the year ended December 31, 2011 as compared to $1.08 billion during the year ended December 31, 2010. Proceeds from sales to third parties during the year ended December 31, 2011 totaled $1.07 billion as compared to $1.07 billion during the year ended December 31, 2010. These sales generated approximately $39.8 million and $35.5 million in mortgage banking income for the periods ended December 31, 2011 and 2010, respectively. Despite the increase in revenues generated by the our mortgage banking operations, net income related to this segment decreased by $839,000 to $1.7 million during the year ended December 31, 2011 compared to $2.5 million during the year ended December 31, 2010. The decrease in net income was the result of an increase in compensation, occupancy and other administrative expenses.

The increase in mortgage banking income was the result of an increase in average sales margin which was driven by the following factors: an increase in pricing on all products in all geographic markets, a change in product mix towards real estate purchase loans which yield a higher margin than loans originated for the purpose of a refinancing and change in the geographic composition of origination activity towards higher yielding geographic markets.

Despite the increase in pricing, overall loan origination volumes remained relatively consistent which reflects the continued strong demand for fixed-rate loans due in large part to historically low interest rates on these products. While the loan origination volume remained relatively consistent during the years ended December 31, 2011 and 2010, there was a shift in the mix of loan purpose toward loans originated for the purpose of a residential property purchase, which yield a higher return, as opposed to a loan originated for the purpose of refinancing an existing mortgage loan. During the year ended December 31, 2011, approximately 64% of all loans were originated for purchase and 36% were originated to refinance an existing loan. During the year ended December 31, 2010, approximately 45% of all loans were originated for purchase and 55% were originated to refinance an existing loan. In addition to the shift in product mix during the year ended December 31, 2011, there was a shift in origination volume by geographic market. Loan origination volumes increased by a combined $164.1 million during the year ended December 31, 2011 as compared to the year ended December 31, 2010 with respect to three of our higher yielding geographic markets. In addition, during the same time frame, loan origination volumes decreased by approximately $165.5 million in one of our lower yielding geographic markets. While margins increased in all markets, this shift in origination volumes by market, resulted in higher average margins during the year ended December 31, 2011.

Compensation expense increased $3.5 million, or 14.7%, to $26.9 million for the year ended December 31, 2011 compared to $23.5 million during the year ended December 31, 2010. The increase resulted from both an increase in commissions earned on the higher margin sales noted above, as well as an increase in administrative compensation expenses that resulted from an increased cost of compliance related to new regulations. Occupancy expense increased $778,000, or 31.8%, to $3.2 million during the year ended December 31, 2011 as compared to $2.4 million during the year ended December 31, 2010. The increase resulted from an expansion of the branch network that occurred primarily throughout the year ended December 31, 2010. The year ended December 31, 2011 now reflects a full year of expense related to those locations. Other noninterest expense increased $1.8 million, or 30.6%, to $7.9 million during the year ended December 31, 2011 as compared to $6.0 million during the year ended December 31, 2010. The increase resulted from an expansion of the branch network that occurred primarily throughout the year ended December 31, 2010. The year ended December 31, 2011 now reflects a full year of expense related to those locations.

Investment Activities

Wauwatosa Investments, Inc. is WaterStone Bank’s investment subsidiary located in Las Vegas, Nevada. Wauwatosa Investments, Inc. manages the Bank’s investment portfolio. The Bank’s Treasurer and its Treasury Officer are responsible for implementing our Investment Policy and monitoring the investment activities of Wauwatosa Investments, Inc. The Investment Policy is reviewed annually by management and changes to the policy are recommended to and subject to the approval of our board of directors. Authority to make investments under the approved Investment Policy guidelines is delegated by the board to designated employees. While general investment strategies are developed and authorized by management, the execution of specific actions rests with the Treasurer and Treasury Officer who may act jointly or severally. In addition, the President of Wauwatosa Investments, Inc. has execution authority for securities transactions. The Treasurer and Treasury Officer are responsible for ensuring that the guidelines and requirements included in the Investment Policy are followed and that all securities are considered prudent for investment. The Treasurer, the Treasury Officer and the President of Wauwatosa Investments, Inc. are authorized to execute investment transactions (purchases and sales) without the prior approval of the board and within the scope of the established Investment Policy.

Our Investment Policy requires that all securities transactions be conducted in a safe and sound manner. Investment decisions are based upon a thorough analysis of each security instrument to determine its quality, inherent risks, fit within our overall asset/liability management objectives, effect on our risk-based capital measurement and prospects for yield and/or appreciation.

Consistent with our overall business and asset/liability management strategy, which focuses on sustaining adequate levels of core earnings, our investment portfolio is comprised primarily of securities that are classified as available for sale. At December 31, 2011 and 2010, we owned one structured note that has been classified as held to maturity. During the year ended December 31, 2011, collateralized mortgage obligations with a total book value of $3.2 million were sold at a gain of $53,000. During the year ended December 31, 2010, municipal securities with a total book value of $14.0 million were sold at a gain of $11,000. During the same period, collateralized mortgage obligations with a total book value of $6.7 million were sold at a gain of $44,000. Two available for sale municipal securities with a total book value of $503,000 were sold in 2009 at a gain of $12,000. Impairment losses of $456,000 and $1.1 million were recognized as an other than temporary impairment during 2011 and 2009, respectively, related to collateralized mortgage obligationsThere were no impairment losses recognized as other than temporary impairment during the year ended December 31, 2010. A cumulative effect adjustment of $1.1 million was made in 2009 effective January 1, 2009 in connection with the early adoption of new guidance impacting ASC Topic 820, Fair Value Measurements and Disclosures, which partially reversed the impairment loss recognized during the year ended December 31, 2008.

Available for Sale Portfolio

Government Sponsored Enterprise Bonds. At December 31, 2011, our Government sponsored enterprise bond portfolio totaled $71.3 million, all of which were issued by government sponsored enterprises such as Federal National Mortgage Associated (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Federal Farm Credit Banks (FFCB) and the Federal Home Loan Bank (FHLB) and were classified as available for sale. The weighted average yield on these securities was 1.14% and the weighted average remaining average life was 2.8 years at December 31, 2011. While these securities generally provide lower yields than other investments in our securities investment portfolio, we maintain these investments, to the extent appropriate, for liquidity purposes and prepayment protection. The estimated fair value of our government sponsored enterprise bond portfolio at December 31, 2011 was $139,000 more than the amortized cost of $71.2 million. A total of $46.6 million of government enterprise bonds are pledged as collateral for borrowings at December 31, 2011.

Mortgage-backed Securities and Collateralized Mortgage Obligations. We purchase mortgage-backed securities and collateralized mortgage obligations guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae and collateralized mortgage obligations issued by investment banks. We invest in mortgage-backed securities and collateralized mortgage obligations to achieve positive interest rate spreads with minimal administrative expense, and to lower our credit risk. We regularly monitor the credit quality of this portfolio.

Mortgage-backed securities and collateralized mortgage obligations are created by the pooling of mortgages and the issuance of a security with an interest rate which is less than the interest rate on the underlying mortgages. These securities typically represent a participation interest in a pool of single-family or multi-family mortgages, although we focus our investments on mortgage related securities backed by one- to four-family mortgages. The issuers of such securities pool and resell the participation interests in the form of securities to investors such as WaterStone Bank, and in the case of government agency sponsored issues, guarantee the payment of principal and interest to investors. Mortgage-backed securities and collateralized mortgage obligations generally yield less than the loans that underlie such securities because of the cost of payment guarantees, if any, and credit enhancements. These fixed-rate securities are usually more liquid than individual mortgage loans.

At December 31, 2011, mortgage-backed securities totaled $35.4 million. The mortgage-backed securities portfolio had a weighted average yield of 3.74% and a weighted average remaining life of 3.0 years at December 31, 2011. The estimated fair value of our mortgage-backed securities portfolio at December 31, 2011 was $1.9 million more than the amortized cost of $33.6 million. Mortgage-backed securities valued at $32.2 million are pledged as collateral for borrowings at December 31, 2011. Investments in mortgage-backed securities involve a risk that actual prepayments may differ from estimated prepayments over the life of the security, which may require adjustments to the amortization of any premium or accretion of any discount relating to such instruments, thereby changing the net yield on such securities. There is also reinvestment risk associated with the cash flows from such securities or if such securities are redeemed by the issuer. In addition, the market value of such securities may be adversely affected in a rising interest rate environment, particularly since all of our mortgage-backed securities have a fixed rate of interest. The relatively short weighted average remaining life of our mortgage-backed security portfolio mitigates our potential risk of loss in a rising interest rate environment.

At December 31, 2011, collateralized mortgage obligations totaled $51.6 million. Of this total, $33.2 million are backed by government sponsored enterprises or U.S. Government agencies. The remaining $18.4 million were issued by investment banks. At December 31, 2011, the estimated fair value of the securities issued by investment banks was $1.0 million less than the amortized cost of $19.4 million.

The collateralized mortgage obligations portfolio had a weighted average yield of 4.49% and a weighted average remaining life of 3.2 years at December 31, 2011. The estimated fair value of our collateralized mortgage obligations portfolio at December 31, 2011 was $478,000 less than the amortized cost of $52.1 million. Collateralized mortgage obligations valued at $24.4 million are pledged as collateral for borrowings at December 31, 2011. Investments in collateralized mortgage obligations involve a risk that actual prepayments may differ from estimated prepayments over the life of the security, which may require adjustments to the amortization of any premium or accretion of any discount relating to such instruments, thereby changing the net yield on such securities. There is also reinvestment risk associated with the cash flows from such securities or if such securities are redeemed by the issuer. In addition, the market value of such securities may be adversely affected in a rising interest rate environment, particularly since all of our collateralized mortgage obligations have a fixed rate of interest. The relatively short weighted average remaining life of our collateralized mortgage obligation portfolio mitigates our potential risk of loss in a rising interest rate environment.

All collateralized mortgage obligations issued by investment banks were rated AAA by Moody's at the date of purchase. As of December 31, 2011, all securities continue to be rated as investment grade, except that two collateralized mortgage obligations issued by investment banks with other than temporary impairment have been downgraded to either CCC or CC by S&P and to either Caa1 or Caa2 by Moody's. The estimated fair value of these securities was $18.4 million at December 31, 2011. The Company performed a cash flow analysis to determine whether an other-than-temporary impairment was warranted with respect to these two securities. This evaluation indicated that the two collateralized mortgage obligations were other-than-temporarily impaired. Estimates of discounted cash flows based on expected yield at time of original purchase, prepayment assumptions based on actual and anticipated prepayment speed, actual and anticipated default rates and estimated level of severity given the loan to value ratios, credit scores, geographic locations, vintage and levels of subordination related to the security and its underlying collateral resulted in a projected credit loss on the collateralized mortgage obligations.

During the year ended December 31, 2011, the Company's analysis resulted in approximately $456,000 in credit losses that were charged to earnings with respect to one of these two collateralized mortgage obligations. This security had an amortized cost of $16.4 million and an estimated fair value of $15.4 million as of December 31, 2011. The analysis with respect to the second collateralized mortgage obligation indicated no additional estimated credit loss. This security had an amortized cost of $3.03 million and an estimated fair value of $3.04 million as of December 31, 2011

Municipal Obligations. These securities consist of obligations issued by school districts, counties and municipalities or their agencies and include general obligation bonds, industrial development revenue bonds and other revenue bonds. Our Investment Policy requires that such non-Wisconsin state agency or municipal obligations be rated AA or better by a nationally recognized rating agency. A security that is downgraded below investment grade will require additional analysis of creditworthiness and a determination will be made to hold or dispose of the investment. At December 31, 2011, our municipal obligations portfolio totaled $39.1 million, all of which was classified as available for sale. The weighted average yield on this portfolio was 3.24% at December 31, 2011, with a weighted average remaining life of 7.2 years. The estimated market value of our municipal obligations bond portfolio at December 31, 2011 was $1.4 million more than the amortized cost of $37.6 million. The estimated market value of the municipal obligations portfolio has been negatively impacted in the current economic environment by both the financial difficulties being encountered by the companies that insure the bonds and by the credit quality of the municipalities. Based upon an assessment performed as of December 31, 2011, we have determined that no securities in this category are other than temporarily impaired.

Other Debt Securities. As of December 31, 2011, we held a trust preferred security with a fair value of $5.1 million and amortized cost of $5.0 million. This security, which yields 10.0% is callable beginning in the second quarter of 2013 with final maturity in 2068. Based upon an assessment performed as of December 31, 2011, the Company has determined that this security is not other than temporarily impaired.

Certificates of Deposit. At December 31, 2011, we held certificates of deposit with a fair value and amortized cost of $3.9 million. The weighted average yield on these securities was 1.09% and the weighted average remaining average life was 2.6 years at December 31, 2011. While these certificates generally provide lower yields than other investments in our securities investment portfolio, we maintain these investments, to the extent appropriate, for liquidity purposes and prepayment protection.

Held to Maturity Portfolio. As of December 31, 2011, we held one structured corporate note that has been designated as held to maturity since its purchase in 2007. The corporate note has an amortized cost of $2.6 million and an estimated fair value of $2.5 million. The final maturity of this security is 2022, however, it is callable quarterly. The corporate note has a yield of 7.5%. We have determined that the security is not other-than-temporarily impaired at December 31, 2011.

## Investment Securities Portfolio.

The following table sets forth the carrying values of our available for sale securities portfolio at the dates indicated.

| | At December 31, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2011 | | 2010 | | 2009 | | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | |
| | (In Thousands) | | | | | | |
| Securities available for sale: | | | | | | | |
| Mortgage-backed securities | $ | 33,561 | 35,417 | 42,607 | 44,330 | 39,785 | 41,513 |
| Collateralized mortgage obligations | | | | | | | |
| Government sponsored enterprise issued | | 32,650 | 33,196 | 38,262 | 39,277 | 43,372 | 44,960 |
| Private label issued | | 19,475 | 18,451 | 26,199 | 25,447 | 36,681 | 30,362 |
| Government sponsored enterprise bonds | | 71,210 | 71,349 | 57,327 | 57,698 | 40,400 | 40,589 |
| Municipal obligations | | 37,644 | 39,068 | 31,804 | 31,120 | 43,599 | 43,241 |
| Other debt securities | | 5,000 | 5,118 | 5,000 | 5,294 | 5,250 | 4,750 |
| Certificates of deposit | | 3,920 | 3,920 | - | - | - | - |
| Total securities available for sa | $ | 203,460 | 206,519 | 201,199 | 203,166 | 209,087 | 205,415 |

Portfolio Maturities and Yields. The composition and maturities of the securities portfolio at December 31, 2011 are summarized in t following table. Maturities are based on the final contractual payment dates and do not reflect the impact of prepayments or redemptions that may occur. Municipal obligation yields have not been adjusted to a tax-equivalent basis. Certain mortgage related sec have interest rates that are adjustable and will reprice annually within the various maturity ranges. These repricing schedules are not re in the table below.

| | One Year or Less | | More than One Year through Five Years | | More than Five Years through Ten Years | | More than Ten Years | | Total Securities | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield |
| | | | | | (Dollars in Thousands) | | | | | |
| Securities available for sale: | | | | | | | | | | |
| Mortgage-backed securities | - | - | 34,250 | 3.75% | - | - | 1,167 | 3.45% | $35,417 | 3.74 |
| Collateralized mortgage obligations | | | | | | | | | | |
| Government sponsored enterprise issued | $6,971 | 4.69% | 26,225 | 2.66% | - | - | - | - | 33,196 | |
| Private label issued | - | - | $3,043 | 6.44% | 15,408 | 6.93% | - | - | 18,451 | 6.85 |
| Government sponsored enterprise bonds | 4,028 | 0.37% | 67,321 | 1.18% | - | - | - | - | 71,349 | 1.14 |
| Municipal obligations | 4,708 | 1.18% | 19,812 | 2.94% | 3,763 | 4.41% | 10,785 | 4.29% | 39,068 | 3.24 |
| Other debt securities | - | - | - | - | - | - | 5,118 | 10.00% | 5,118 | 10.00 |
| Certificates of deposit | | | 3,920 | 1.09% | | | | | 3,920 | 1.09% |
| Total securities available for sa | $15,70 | 2.51% | 154,571 | 2.35% | 19,171 | 6.50% | 17,070 | 5.92% | 206,519 | 3.07% |
| Securities held to maturity: | | | | | | | | | | |
| Corporate notes | - | - | - | - | - | - | $ 2,648 | 7.50% | $ 2,648 | 7.50% |

## Sources of Funds

General. Deposits have traditionally been our primary source of funds for use in lending and investment activities. We also rely on advances from the Federal Home Loan Bank of Chicago and borrowings from other commercial banks in the form of repurchase agreements collateralized by investment securities. In addition to deposits and borrowings, we derive funds from scheduled loan payments, investment maturities, loan prepayments, retained earnings and income on earning assets. While scheduled loan payments and income on earning assets are relatively stable sources of funds, deposit inflows and outflows can vary widely and are influenced by prevailing market interest rates, economic conditions and competition from other financial institutions.

Deposits. A majority of our depositors are persons who work or reside in Milwaukee and Waukesha Counties and, to a lesser extent, other southeastern Wisconsin communities. We offer a selection of deposit instruments, including checking, savings, money market deposit accounts, and fixed-term certificates of deposit. Deposit account terms vary, with the principal differences being the minimum balance required, the amount of time the funds must remain on deposit and the interest rate. Certificates of deposit comprised 83.6% of total deposits at December 31, 2011, and had a weighted average cost of 1.53% on that date. Our reliance on certificates of deposit has resulted in a higher cost of funds than would otherwise be the case if demand deposits, savings and money market accounts made up a larger part of our deposit base. Development of our branch network and expansion of our commercial products and services are expected to result in decreased reliance on higher cost certificates of deposit in the long-term by aggressively seeking lower cost savings, checking and money market accounts.

Interest rates paid, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies and market rates, liquidity requirements, rates paid by competitors and growth goals. As a result of the Consent Order jointly issued by the FDIC and the WDFI, effective March 1, 2010, maximum deposit rates that the Bank may offer are limited by the FDIC. To attract and retain deposits, we rely upon personalized customer service, long-standing relationships and competitive interest rates.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and other prevailing interest rates and competition. The variety of deposit accounts that we offer allows us to be competitive in obtaining funds and responding to changes in consumer demand. Based on historical experience, management believes our deposits are relatively stable. It is unclear whether future levels of deposits will reflect our historical experience particularly in view of new FDIC limits on the rates we may offer on deposits. The ability to attract and maintain money market accounts and certificates of deposit, and the rates paid on these deposits, has been and will continue to be significantly affected by market conditions. At December 31, 2011 and December 31, 2010, $878.7 million and $974.4 million, or 83.6% and 85.1%, respectively, of our deposit accounts were certificates of deposit, of which $787.9 million and $347.5 million, respectively, had maturities of one year or less. The percentage of our deposit accounts that are certificates of deposit is greater than most of our competitors.

Deposits obtained from brokers totaled $399,000 and $14.4 million at December 31, 2011 and 2010, respectively. Brokered deposits have historically been utilized when the relative cost compares favorably to the cost of retail deposits generated directly by the Bank. Brokered deposits have also been historically utilized in order to obtain significant additional deposit funding over a period of weeks rather than months. A consent order issued by state and federal regulators effective December 18, 2009 prohibits the Bank from accepting new or renewing existing brokered deposits.

Total deposits decreased by $94.2 million, or 8.2%, from December 31, 2010 to December 31, 2011. This net decrease was the result of a $95.7 million, or 9.8%, decrease in certificates of deposit, which was partially offset by a $699,000, or 0.7%, increase in money market and savings accounts and a $722,000, or 1.1%, increase in demand deposits. The $95.7 million decrease in certificates of deposit consisted of an $81.7 million decrease in deposits originated through our local retail network and a $14.0 million decrease in non-local brokered deposits. Brokered deposits totaling $399,000 will mature during the year ended December 31, 2011 and cannot be renewed as long as the Bank remains under the terms of the current consent order.

The following table sets forth the distribution of total deposit accounts, by account type, at the dates indicated.

| | At December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | | 2009 | | |
| | Balance | Percent | Weighted Average Rate | Balance | Percent | Weighted Average Rate | Balance | Percent | Weighted Average Rate |
| | (Dollars in Thousands) | | | | | | | | |
| Deposit type: | | | | | | | | | |
| Demand deposits | $28,812 | 2.74% | 0.00% | $30,030 | 2.62% | 0.00% | $24,255 | 2.08% | 0.00% |
| NOW accounts | 39,645 | 3.77% | 0.08% | 37,705 | 3.29% | 0.08% | 37,165 | 3.19% | 0.08% |
| Regular savings | 45,511 | 4.33% | 0.20% | 44,540 | 3.89% | 0.22% | 45,219 | 3.88% | 0.48% |
| Money market and savings deposits | 58,591 | 5.57% | 0.41% | 58,863 | 5.14% | 0.48% | 46,809 | 4.02% | 0.46% |
| Total transaction accounts | 172,559 | 16.41% | 0.21% | 171,138 | 14.94% | 0.24% | 153,448 | 13.17% | 0.18% |
| Certificates of deposit | 878,733 | 83.59% | 1.53% | 974,391 | 85.06% | 1.74% | 1,011,442 | 86.83% | 2.52% |
| Total deposits | $1,051,292 | 100.00% | 1.31% | $1,145,529 | 100.00% | 1.51% | $1,164,890 | 100.00% | 2.21% |

At December 31, 2011, the aggregate balance of certificates of deposit of $100,000 or more was approximately $232.8 million. The following table sets forth the maturity of those certificates at December 31, 2011.

| Due in: | (In Thousands) |
|---|---|
| Three months or less | $49,830 |
| Over three months through six months | 85,9 |
| Over six months through 12 months | 75,2 |
| Over 12 months | 21,7 |
| Total | $232,782 |

Borrowings. Our borrowings at December 31, 2011 consist of advances from the Federal Home Loan Bank of Chicago, repurchase agreements collateralized by investment securities and $27.1 million outstanding on a bank line of credit totaling $50.0 million used to finance loans held for sale. The following table sets forth information concerning balances and interest rates on borrowings at the dates and for the periods indicated.

| | At or For the Year Ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| Borrowings: | (Dollars in Thousands) | | |
| Balance outstanding at end of period | $ 461,138 | $ 456,959 | $ 507,900 |
| Weighted average interest rate at the end of period | 3.93% | 3.94% | 3.85% |
| Maximum amount of borrowings outstanding at any month end during the period | 465,290 | 506,902 | 512,000 |
| Average balance outstanding during the period | 446,401 | 481,808 | 511,384 |
| Weighted average interest rate during the period | 3.93% | 4.03% | 3.90% |

## Legal Proceedings

The Company and its subsidiaries are not involved in any legal proceedings where the outcome, if adverse to us, would have a material and adverse affect on our financial condition or results of operations.

## Subsidiary Activities

Waterstone Financial currently has one wholly-owned subsidiary, WaterStone Bank, which in turn has three wholly-owned subsidiaries. Wauwatosa Investments, Inc., which holds and manages our investment portfolio, is located and incorporated in the state of Nevada. Waterstone Mortgage Corporation is a mortgage banking business incorporated in Wisconsin. Main Street Real

Estate Holdings, LLC, is an inactive Wisconsin limited liability corporation and previously owned Bank office facilities and held Bank office facility leases.

Wauwatosa Investments, IncEstablished in 1998, Wauwatosa Investments, Inc. operates in Nevada as WaterStone Bank's investment subsidiary. This wholly-owned subsidiary owns and manages the majority of the consolidated investment portfolio. It has its own board of directors currently comprised of its President, the WaterStone Bank Chief Financial Officer, Treasury Officer and the Chairman of the Company's board of directors.

Waterstone Mortgage Corporation.Acquired in February 2006, Waterstone Mortgage Corporation is a mortgage banking business with nine offices in Wisconsin, ten offices in Pennsylvania, five offices in Minnesota, four offices in Florida, two offices in each of Arizona, Idaho and Indiana and one office in each of Illinois, Iowa, Maryland and Ohio. Waterstone Mortgage Corporation was the largest mortgage broker in the Milwaukee area based on 2011 dollar volume of retail first and second mortgages originated. It has its own board of directors currently comprised of its President, its CFO and its Senior Vice President plus the WaterStone Bank CEO, CFO and Senior Vice President and General Counsel.

Main Street Real Estate Holdings, LLC.Established in 2002, Main Street Real Estate Holdings, LLC was established to acquire and hold Bank office and retail facilities both owned and leased. Main Street Real Estate Holdings, LLC is currently inactive.

## Personnel

As of December 31, 2011, we had 574 full-time equivalent employees. Our employees are not represented by any collective bargaining group. Management believes that we have good relations with our employees.

## Supervision and Regulation

The following discussion is only a summary of the primary laws and regulations affecting the powers and operations of WaterStone Bank, Waterstone Financial, and Lamplighter Financial, MHC. It is not intended to be a comprehensive description of all laws and regulations applicable to these entities and is qualified in its entirety by reference to the applicable laws and regulations.

## Regulation of WaterStone Bank

WaterStone Bank is a stock savings bank organized under the laws of the State of Wisconsin. The lending, investment, and other business operations of WaterStone Bank are governed by Wisconsin law and regulations, as well as applicable federal law and regulations, and WaterStone Bank is prohibited from engaging in any operations not authorized by such laws and regulations. WaterStone Bank is subject to extensive regulation by the Wisconsin Department of Financial Institutions, Division of Banking ("WDFI") and by the Federal Deposit Insurance Corporation ("FDIC"), as its deposit insurer and primary federal regulator. WaterStone Bank's deposit accounts are insured up to applicable limits by the FDIC under its Deposit Insurance Fund ("DIF"). A summary of the primary laws and regulations that govern the operations of WaterStone Bank are set forth below.

Intrastate and Interstate Merger and Branching Activities

Wisconsin Law and Regulation. Any Wisconsin savings bank meeting certain requirements may, upon approval of the WDFI, establish one or more branch offices in the state of Wisconsin or the states of Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, and Ohio. In addition, upon WDFI approval, a Wisconsin savings bank may establish a branch office in any other state as the result of a merger or consolidation.

Federal Law and Regulation. The Interstate Banking Act (the "IBA") permits the federal banking agencies to, under certain circumstances, approve acquisition transactions between banks located in different states, regardless of whether an acquisition would be prohibited under state law. The IBA, as amended, authorizes de novo branching into another state at locations at which banks chartered by the host state could establish a branch. Additionally, the IBA authorizes branching by merger, subject to certain state law limitations.

Loans and Investments

Wisconsin Law and Regulations. Under Wisconsin law and regulation, WaterStone Bank is authorized to make, invest in, sell, purchase, participate or otherwise deal in mortgage loans or interests in mortgage loans without geographic restriction, including loans made on the security of residential and commercial property. Wisconsin savings banks also may lend funds on a secured or unsecured basis for business, commercial or agricultural purposes, provided the total of all such loans does not exceed 20% of WaterStone Bank's total assets, unless the WDFI authorizes a greater amount. Loans are subject to certain other limitations, including percentage restrictions based on WaterStone Bank's total assets.

Wisconsin savings banks may invest funds in certain types of debt and equity securities, including obligations of federal, state and local governments and agencies. Subject to prior approval of the WDFI, compliance with capital requirements and certain other restrictions, Wisconsin savings banks may invest in residential housing development projects. Wisconsin savings banks may also invest in service corporations or subsidiaries with the prior approval of the WDFI, subject to certain restrictions.

Wisconsin savings banks may make loans and extensions of credit, both direct and indirect, to one borrower in amounts up to 15% of WaterStone Bank's capital plus an additional 10% for loans fully secured by readily marketable collateral. In addition, and notwithstanding the 15% of capital and additional 10% of capital limitations set forth above, Wisconsin savings banks may make loans to one borrower, or a related group of borrowers, for any purpose in an amount not to exceed $500,000, or to develop domestic residential housing units in an amount not to exceed the lesser of $30 million or 30% of WaterStone Bank's capital, subject to certain conditions. At December 31, 2011, WaterStone Bank did not have any loans which exceeded the "loans-to-one borrower" limitations.

Finally, under Wisconsin law, WaterStone Bank must qualify for and maintain a level of qualified thrift investments equal to 60% of its assets as prescribed in Section 7701(a)(19) of the Internal Revenue Code of 1986, as amended. A Wisconsin savings bank that fails to meet this qualified thrift lender test becomes subject to certain operating restrictions otherwise applicable only to commercial banks. At December 31, 2011, WaterStone Bank maintained 99.0% of its assets in qualified thrift investments and therefore met the qualified thrift lender requirement.

Federal Law and Regulation. FDIC regulations also govern the equity investments of WaterStone Bank, and, notwithstanding Wisconsin law and regulations, FDIC regulations prohibit WaterStone Bank from making certain equity investments and generally limit WaterStone Bank's equity investments to those that are permissible for national banks and their subsidiaries. Under FDIC regulations, WaterStone Bank must obtain prior FDIC approval before directly, or indirectly through a majority-owned subsidiary, engaging "as principal" in any activity that is not permissible for a national bank unless certain exceptions apply. The activity regulations provide that state banks that meet applicable minimum capital requirements would be permitted to engage in certain activities that are not permissible for national banks, including certain real estate and securities activities conducted through subsidiaries. The FDIC will not approve an activity that it determines presents a significant risk to the FDIC insurance fund. The activities of WaterStone Bank and its subsidiaries are permissible under applicable federal regulations.

Loans to, and other transactions with, affiliates of WaterStone Bank, such as Waterstone Financial and Lamplighter Financial, MHC, are restricted by the Federal Reserve Act and regulations issued by the FRB thereunder. See "Transactions with Affiliates and Insiders" below.

Lending Standards

Wisconsin Law and Regulation. Wisconsin law and regulations issued by the WDFI impose on Wisconsin savings banks certain fairness in lending requirements and prohibit savings banks from discriminating against a loan applicant based upon the applicant's physical condition, developmental disability, sex, marital status, race, color, creed, national origin, religion or ancestry.

Federal Law and Regulation. The federal banking agencies adopted uniform regulations prescribing standards for extensions of credit that are secured by liens on interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate. Under the joint regulations adopted by the federal banking agencies, all insured depository institutions, such as WaterStone Bank, must adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens or interests in real estate or are made for the purpose of financing permanent improvements to real estate. These policies must establish loan portfolio diversification standards, prudent underwriting standards (including loan-to-value limits) that are clear and measurable, loan administration procedures, and documentation, approval and reporting requirements. The real estate lending policies must reflect consideration of the Interagency Guidelines for Real Estate Lending Policies that have been adopted by the federal bank regulators.

The Interagency Guidelines, among other things, require a depository institution to establish internal loan-to-value limits for real estate loans that are not in excess of the following supervisory limits:

- for loans secured by raw land, the supervisory loan-to-value limit is 65% of the value of the collateral;

- for land development loans (i.e., loans for the purpose of improving unimproved property prior to the erection of structures), the supervisory limit is 75%;

- for loans for the construction of commercial, over four-family or other non-residential property, the supervisory limit is 80%;

- for loans for the construction of one- to four-family properties, the supervisory limit is 85%; and

- for loans secured by other improved property (e.g., farmland, completed commercial property and other income-producing property, including non-owner occupied, one-to four-family property), the limit is 85%.

Although no supervisory loan-to-value limit has been established for owner-occupied, one-to four-family and home equity loans, the Interagency Guidelines state that for any such loan with a loan-to-value ratio that equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Deposits

Wisconsin Law and Regulation Under Wisconsin law, WaterStone Bank is permitted to establish deposit accounts and accept deposits. WaterStone Bank's board of directors, or its designee, determines the rate and amount of interest to be paid on or credited to deposit accounts subject to FDIC limitations.

Deposit Insurance

Wisconsin Law and Regulation Under Wisconsin law, WaterStone Bank is required to obtain and maintain insurance on its deposits from a deposit insurance corporation. The deposits of WaterStone Bank are insured up to the applicable limits by the FDIC.

Federal Law and Regulation. WaterStone Bank is a member of the DIF, which is administered by the FDIC. The Bank's deposit accounts are insured by the FDIC, generally up to a maximum of $250,000. In addition, noninterest-bearing transaction accounts are fully insured regardless of the dollar amount until December 31, 2012.

The FDIC imposes an assessment against all depository institutions. On February 27, 2009 the FDIC issued a final rule that alters the way the FDIC calculates federal deposit insurance assessment rates beginning in the second quarter of 2009 and thereafter. Under the rule, the FDIC first establishes an institution's initial base assessment rate. This initial base assessment rate ranged, at the time, depending on the risk category of the institution, from 12 to 45 basis points. The FDIC then adjusts the initial base assessment (higher or lower) to obtain the total base assessment rate. The adjustments to the initial base assessment rate are based upon an institution's levels of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate ranged from 7 to 77.5 basis points of the institution's deposits.

On February 7, 2011, as required by the Dodd-Frank Wall Street Reform Act of 2010 (the

“Dodd-Frank Act”) the FDIC approved a final rule that changed the FDIC insurance premium assessment base from domestic deposits to average assets minus average tangible equity and made certain changes to the potential adjustments. The rule lowers overall assessment rates in order to generate the same approximate amount of revenue under the new larger base as was raised under the old base. The assessment rates in total (including potential adjustments) now range from between 2.5 and 9 basis points on the broader base for banks in the lowest risk category, and 30 to 45 basis points for banks in the highest risk category. These changes went into effect beginning with the second quarter of 2011.

The FDIC issued an interim rule that provided for a special assessment to be collected on September 30, 2009, based on June 30, 2009, Call Report data. The special assessment increased the Bank’s FDIC premium expense by $876,000 in 2009. On November 12, 2009, the FDIC issued a rule requiring all depository institutions to prepay their estimated assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. Under the rule, this prepayment was due on December 31, 2009. The assessment rate for the fourth quarter of 2009 and for 2010 was based on each institution’s total base assessment rate for the third quarter of 2009, modified to assume that the assessment rate in effect on September 30, 2009 had been in effect for the entire third quarter, and the assessment rate for 2011 and 2012 would be equal to the modified third quarter assessment rate plus an additional 3 basis points. In addition, each institution’s base assessment rate for each period was calculated using its third quarter assessment base, adjusted quarterly for an estimated 5% annual growth rate in the assessment base through the end of 2012. WaterStone Bank received a waiver from the FDIC relative to the 2010, 2011 and 2012 prepayment.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not know of any practice, condition or violation that might lead to termination of deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (FICO) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2011, the annualized FICO assessment was equal to .68 basis points of total assets less tangible capital.

### Capitalization

Wisconsin Law and Regulation. Wisconsin savings banks are required to maintain a minimum capital to assets ratio of 6% and must maintain total capital necessary to ensure the continuation of insurance of deposit accounts by the FDIC. If the WDFI determines that the financial condition, history, management or earning prospects of a savings bank are not adequate, the WDFI may require a higher minimum capital level for the savings bank. If a Wisconsin savings bank's capital ratio falls below the required level, the WDFI may direct the savings bank to adhere to a specific written plan established by the WDFI to correct the savings bank's capital deficiency, as well as a number of other restrictions on the savings bank's operations, including a prohibition on the declaration of dividends. At December 31, 2011 and 2010, WaterStone Bank’s capital to assets ratio, as calculated under Wisconsin law, was 9.31% and 9.12%, respectively.

Federal Law and Regulation Under FDIC regulations, federally insured state-chartered banks that are not members of the Federal Reserve System ("state non-member banks"), such as WaterStone Bank, are required to comply with minimum capital requirements. For an institution determined by the FDIC to not be anticipating or experiencing significant growth and to be, in general, a strong banking organization, rated composite 1 under the Uniform Financial Institutions Ranking System established by the Federal Financial Institutions Examination Council, the minimum Tier I leverage capital to total assets ratio is 3%. For all other institutions, the minimum leverage capital ratio is not less than 4%. Tier I leverage capital is the sum of common shareholders' equity, non-cumulative perpetual preferred stock (including any related surplus) and minority investments in certain subsidiaries, less intangible assets (except for certain servicing rights and credit card relationships) and certain other specified items.

The FDIC regulations require state non-member banks to maintain certain levels of regulatory capital in relation to regulatory risk-weighted assets. The ratio of regulatory capital to regulatory risk-weighted assets is referred to as a bank's "risk-based capital ratio." Risk-based capital ratios are determined by allocating assets and specified off-balance sheet items (including recourse obligations, direct credit substitutes and residual interests) to four risk-weighted categories generally ranging from 0% to 100%, with higher levels of capital being required for the categories perceived as representing greater risk. For example, under the FDIC's risk-weighting system, cash and securities backed by the full faith and credit of the U.S. government are given a 0% risk weight, loans secured by one-to-four family residential properties generally have a 50% risk weight, and commercial loans have a risk weighting of 100%.

State non-member banks, such as WaterStone Bank, must maintain a minimum ratio of total capital to risk-weighted assets of at least 8%, of which at least one-half must be Tier I capital. Total capital consists of Tier I capital plus Tier 2 or supplementary capital items, which include allowances for loan losses in an amount of up to 1.25% of risk-weighted assets, cumulative preferred stock and certain other capital instruments, and a portion of the net unrealized gain on equity securities. The includable amount of Tier 2 capital cannot exceed the amount of the institution's Tier I capital. Banks that engage in specified levels of trading activities are subject to adjustments in their risk based capital calculation to ensure the maintenance of sufficient capital to support market risk.

The FDIC, along with the other federal banking agencies, has adopted a regulation providing that the agencies will take into account the exposure of a bank's capital and economic value to changes in interest rate risk in assessing a bank's capital adequacy. The FDIC also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution's capital level is, or is likely to become, inadequate in light of the particular circumstances. As such, in connection with a consent order effective December 18, 2009, federal and state regulators require that WaterStone Bank maintain a minimum Tier I capital ratio of 8.50% and a minimum total risk-based capital ratio of 12.00%. WaterStone Bank was in compliance with the higher regulatory minimums at December 31, 2011 with a Tier I capital ratio of 9.16% and a total risk-based capital ratio of 14.58%.

Unlike bank holding companies, savings and loan holding companies are not currently subject to specific regulatory capital requirements. The Dodd-Frank Act, however, requires the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. That will eliminate the inclusion of certain instruments from tier 1 capital, such as trust preferred securities, that are currently includable for bank holding companies. Instruments issued by mutual holding companies by May 9, 2010, are grandfathered. There is a five year transition period from the July 21, 2010 date of enactment of the Dodd-Frank Act before the capital requirements will apply to savings and loan holding companies.

The Dodd-Frank Act also extends the “source of strength” doctrine to savings and loan holding companies. The regulatory agencies must promulgate regulations implementing the “source of strength” policy that requires holding companies act as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

Safety and Soundness Standards

Each federal banking agency, including the FDIC, has adopted guidelines establishing general standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, asset quality, earnings and compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder.

Prompt Corrective Regulatory Action

The Federal Deposit Insurance Corporation Improvement Act requires, among other things, that federal bank regulatory authorities take “prompt corrective action” with respect to institutions that do not meet minimum capital requirements. For these purposes, the statute establishes five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Under the regulations, a bank shall be deemed to be (i) “well capitalized” if it has total risk-based capital of 10.0% or more, has a Tier I risk-based capital ratio of 6.0% or more, has a Tier I leverage capital ratio of 5.0% or more and is not subject to any written capital order or directive; (ii) “adequately capitalized” if it has a total risk-based capital ratio of 8.0% or more, a Tier I risk-based capital ratio of 4.0% or more and a Tier I leveraged capital ratio of 4.0% or more (3.0% under certain circumstance) and does not meet the definition of “well capitalized”; (iii) “undercapitalized” if it has a total risk-based capital ratio that is less than 8.0%, a Tier I risk-based capital ratio that is less than 4.0% or a Tier I leverage capital ratio that is less than 4.0% (3.0% under certain circumstances); (iv) “significantly undercapitalized” if it has a total risk-based capital ratio that is less than 6.0%, a Tier I risk-based capital ratio that is less than 3.0%; and (v) “critically undercapitalized” if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%. Federal law and regulations also specify circumstances under which a federal banking agency may reclassify a well capitalized institution as adequately capitalized and may require an adequately capitalized institution to comply with supervisory actions as if it were in the next lower category (except that the FDIC may not reclassify a significantly undercapitalized institution as critically undercapitalized).

The Federal Deposit Insurance Corporation may order savings banks which have insufficient capital to take corrective actions. For example, a savings bank which is categorized as "undercapitalized" would be subject to growth limitations and would be required to submit a capital restoration plan, and a holding company that controls such a savings bank would be required to guarantee that the savings bank complies with the restoration plan. A "significantly undercapitalized" savings bank would be subject to additional restrictions. Savings banks deemed by the Federal Deposit Insurance Corporation to be "critically undercapitalized" would be subject to the appointment of a receiver or conservator.

At December 31, 2011, WaterStone Bank was considered well-capitalized with a Tier 1 leverage ratio of 9.16%, a Tier 1 risk-based ratio of 13.31% and a total risk based capital ratio of 14.58%.

Regulatory Development

On November 25, 2009, pursuant to a Stipulation and Consent to the Issuance of a Consent Order, WaterStone Bank agreed to the issuance of a Consent Order jointly issued by the FDIC and the WDFI, the Bank's primary banking regulators. At the same time, pursuant to a Stipulation and Consent to Issuance of Order to Cease and Desist, Waterstone Financial, Inc. agreed to the issuance of an Order to Cease and Desist by the Office of Thrift Supervision ("OTS"), the Company's thrift holding company regulator at the time. Collectively, the Stipulation and Consent to the Issuance of a Consent Order which became effective on December 18, 2009 and the Stipulation and Consent to Issuance of Order to Cease and Desist which became effective on December 1, 2009 are referred to as the "Orders".

The Orders formalize a prior informal agreement entered into by the Bank, the FDIC and the WDFI in 2008. The Bank and its federal and state regulators continue working in concert to minimize the effects that the recession is having on the Bank and its borrowers. The Orders require, among other things, that the Bank (i) maintain minimum Tier 1 capital of 8.5% of total average assets and minimum total risk-based capital of 12.0% of risk-weighted assets; (ii) perform a study to confirm that the Bank is a well managed institution; (iii) manage its bad loans and real estate acquired in foreclosure; and (iv) adopt a two year capital plan. The Orders prohibit the payment of cash dividends or repurchases of common stock, and restrict the ability of the Company to incur debt, in each case without the prior regulatory non-objection. Failure to comply with the Orders could result in additional enforcement actions by the FDIC, the WDFI or the Federal Reserve Board. Compliance with the Orders may have adverse effects on the operations and financial condition of the Company and the Bank.

Dividends

Under Wisconsin law and applicable regulations, a Wisconsin savings bank that meets its regulatory capital requirement may declare dividends on capital stock based upon net profits, provided that its paid-in surplus equals its capital stock. If the paid-in surplus of the savings bank does not equal its capital stock, the board of directors may not declare a dividend unless at least 10% of the net profits of the preceding half year, in the case of quarterly or semi-annual dividends, or 10% of the net profits of the preceding year, in the case of annual dividends, has been transferred to paid-in surplus. In addition, prior WDFI approval is required before dividends exceeding 50% of profits for any calendar year may be declared and before a dividend may be declared out of retained earnings. Under WDFI regulations, a Wisconsin savings bank which has converted from mutual to stock form also is prohibited from paying a dividend on its capital stock if the payment causes the regulatory capital of the savings bank to fall below the amount required for its liquidation account. A consent order issued by state and federal regulators effective December 18, 2009 prohibits the Bank from paying dividends without the written consent of the WDFI and the FDIC.

The primary source of Waterstone Financial's cash flow, including cash flow to pay dividends on Waterstone Financial's Common Stock, is the payment of dividends to Waterstone Financial by WaterStone Bank. The Federal Deposit Insurance Corporation has the authority to prohibit WaterStone Bank from paying dividends if, in its opinion, the payment of dividends would constitute an unsafe or unsound practice in light of the financial condition of WaterStone Bank. Institutions may not pay dividends if "undercapitalized" within the meaning of the prompt corrective action regulations. In addition, since WaterStone Bank is a subsidiary of a savings and loan holding company, WaterStone Bank must file a notice with the Federal Reserve Board at least 30 days before the board declares a dividend or approves a capital distribution. A regulatory cease and desist order consistent with the consent order issued by state and federal regulators of WaterStone Bank, prohibits dividend payments without prior written approval.

Liquidity and Reserves

Wisconsin Law and Regulation. Under WDFI regulations, all Wisconsin savings banks are required to maintain a certain amount of their assets as liquid assets, consisting of cash and certain types of investments. The exact amount of assets a savings bank is required to maintain as liquid assets is set by the WDFI, but generally ranges from 4% to 15% of the saving bank's average daily balance of net withdrawable accounts plus short-term borrowings (the "Required Liquidity Ratio"). At December 31, 2011, WaterStone Bank's Required Liquidity Ratio was 8.0%, and WaterStone Bank was in compliance with this requirement. In addition, 50% of the liquid assets maintained by Wisconsin savings banks must consist of "primary liquid assets," which are defined to include securities issued by the United States government and United States government agencies. At December 31, 2011, WaterStone Bank was in compliance with this requirement.

Federal Law and Regulation. Under federal law and regulations, WaterStone Bank is required to maintain sufficient liquidity to ensure safe and sound banking practices. Regulation D, promulgated by the FRB, imposes reserve requirements on all depository institutions, including WaterStone Bank, which maintain transaction accounts or non-personal time deposits. Checking accounts, NOW accounts, Super NOW checking accounts, and certain other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits (including certain money market deposit accounts) at a savings institution. For 2011, a depository institution was required to maintain average daily reserves equal to 3% on the first $58.8 million of transaction accounts and an initial reserve of $1.4 million, plus 10% of that portion of total transaction accounts in excess of $58.8 million. The first $10.7 million of otherwise reservable balances (subject to adjustment by the FRB) are exempt from the reserve requirements. These percentages and threshold limits are subject to adjustment by the FRB. Savings institutions have authority to borrow from the Federal Reserve's "discount window," but Federal Reserve policy generally requires savings institutions to exhaust all other sources before borrowing from the Federal Reserve. As of December 31, 2011, WaterStone Bank met its Regulation D reserve requirements.

Transactions with Affiliates and Insiders

Wisconsin Law and Regulation. Under Wisconsin law, WaterStone Bank may not make a loan to a person owning 10% or more of its stock, an affiliated person, agent, or attorney of the savings bank, either individually or as an agent or partner of another, except as approved by the WDFI and regulations of the FDIC. In addition, unless the prior approval of the WDFI is obtained, WaterStone Bank may not purchase, lease or acquire a site for an office building or an interest in real estate from an affiliated person, including a shareholder owning more than 10% of its capital stock, or from any firm, corporation, entity or family in which an affiliated person or 10% shareholder has a direct or indirect interest.

Federal Law and Regulation. Sections 23A and 23B of the Federal Reserve Act govern transactions between an insured savings bank, such as WaterStone Bank, and any of its affiliates, including Waterstone Financial. The Federal Reserve Board has adopted Regulation W, which comprehensively implements and interprets Sections 23A and 23B, in part by codifying prior Federal Reserve Board interpretations under Sections 23A and 23B.

An affiliate of a bank is any company or entity that controls, is controlled by or is under common control with the bank. A subsidiary of a bank that is not also a depository institution or a "financial subsidiary" under federal law is not treated as an affiliate of the bank for the purposes of Sections 23A and 23B; however, the FDIC has the discretion to treat subsidiaries of a bank as affiliates on a case-by-case basis. Sections 23A and 23B limit the extent to which a bank or its subsidiaries may engage in "covered transactions" with any one affiliate to an amount equal to 10% of such bank's capital stock and surplus, and limit all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus. The statutory sections also require that all such transactions be on terms that are consistent with safe and sound banking practices. The term "covered transaction" includes the making of loans, purchase of assets, issuance of guarantees and other similar types of transactions. Further, most loans and other extensions of credit by a bank to any of its affiliates must be secured by collateral in amounts ranging from 100% to 130% of the loan amounts. In addition, any covered transaction by an association with an affiliate and any purchase of assets or services by an association from an affiliate must be on terms that are substantially the same, or at least as favorable, to the bank as those that would be provided to a non-affiliate.

A savings bank's loans to its executive officers, directors, any owner of more than 10% of its stock (each, an insider) and any of certain entities affiliated with any such person (an insider's related interest) are subject to the conditions and limitations imposed by Section 22(h) of the Federal Reserve Act and the FRB's Regulation O thereunder. Under these restrictions, the aggregate amount of the loans to any insider and the insider's related interests may not exceed the loans-to-one-borrower limit applicable to national banks, which is comparable to the loans-to-one-borrower limit applicable to WaterStone Bank's loans. All loans by a savings bank to all insiders and insiders' related interests in the aggregate may not exceed the bank's unimpaired capital and unimpaired surplus. With certain exceptions, loans to an executive officer, other than loans for the education of the officer's children and certain loans secured by the officer's residence, may not exceed the greater of $25,000 or 2.5% of the savings bank's unimpaired capital and unimpaired surplus, but in no event more than $100,000. Regulation O also requires that any proposed loan to an insider or a related interest of that insider be approved in advance by a majority of the board of directors of the savings bank, with any interested director not participating in the voting, if such loan, when aggregated with any existing loans to that insider and the insider's related interests, would exceed either $500,000 or the greater of $25,000 or 5% of the savings bank's unimpaired capital and surplus. Generally, such loans must be made on substantially the same terms as, and follow credit underwriting procedures that are no less stringent than, those that are prevailing at the time for comparable transactions with other persons and must not present more than a normal risk of collectibility.

An exception to this requirement is made for extensions of credit made pursuant to a benefit or compensation plan of a bank that is widely available to employees of the savings bank and that does not give any preference to insiders of the bank over other employees of the bank. Consistent with these requirements, the Bank offered employees special terms for home mortgage loans on their principal residences. Effective April 1, 2006, this program was discontinued for new loan originations. Under the terms of the discontinued program, the employee interest rate is based on the Bank's cost of funds on December 31st of the immediately preceding year and is adjusted annually. At December 31, 2011, the rate of interest on an employee rate mortgage loan was 2.16%, compared to the weighted average rate of 5.48% on all single family mortgage loans. This rate decreased to 2.06% effective March 1, 2012. Employee rate mortgage loans totaled $3.6 million, or 0.3%, of our residential mortgage loan portfolio on December 31, 2011.

Transactions between Bank Customers and Affiliates

Under Wisconsin and federal laws and regulations, Wisconsin savings banks, such as WaterStone Bank, are subject to the prohibitions on certain tying arrangements. A savings bank is prohibited, subject to certain exceptions, from extending credit to or offering any other service to a customer, or fixing or varying the consideration for such extension of credit or service, on the condition that such customer obtain some additional service from the institution or certain of its affiliates or not obtain services of a competitor of the institution.

Examinations and Assessments

WaterStone Bank is required to file periodic reports with and is subject to periodic examinations by the WDFI and FDIC. Federal regulations require annual on-site examinations for all depository institutions except certain well-capitalized and highly rated institutions with assets of less than $500 million which are examined every 18 months. Federal law also requires WaterStone Bank is required to pay examination fees and annual assessments to fund its supervision. WaterStone Bank paid an aggregate of $91,000 in assessments for the calendar year ended December 31, 2011.

Customer Privacy

Under Wisconsin and federal law and regulations, savings banks, such as WaterStone Bank, are required to develop and maintain privacy policies relating to information on its customers, restrict access to and establish procedures to protect customer data. Applicable privacy regulations further restrict the sharing of non-public customer data with non-affiliated parties if the customer requests.

Community Reinvestment Act

Under the Community Reinvestment Act ("CRA"), WaterStone Bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the Federal Deposit Insurance Corporation in connection with its examination of WaterStone Bank, to assess its record of meeting the credit needs of its community and to take that record into account in its evaluation of certain applications by WaterStone Bank. For example, the regulations specify that a bank's CRA performance will be considered in its expansion (e.g., branching) proposals and may be the basis for approving, denying or conditioning the approval of an application. As of the date of its most recent regulatory examination, WaterStone Bank was rated "satisfactory" with respect to its CRA compliance.

Federal Home Loan Bank System

The Federal Home Loan Bank System, consisting of twelve FHLBs, is under the jurisdiction of the Federal Housing Finance Board ("FHFB"). The designated duties of the FHFB are to supervise the FHLBs; ensure that the FHLBs carry out their housing finance mission; ensure that the FHLBs remain adequately capitalized and able to raise funds in the capital markets; and ensure that the FHLBs operate in a safe and sound manner.

WaterStone Bank, as a member of the FHLB of Chicago, is required to acquire and hold shares of capital stock in the FHLB of Chicago in specified amounts. WaterStone Bank is in compliance with this requirement with an investment in FHLB of Chicago stock of $21.7 million at December 31, 2011. Potential risks identified with respect to the Company's investment in FHLB of Chicago stock is addressed in Item 1A. Risk Factors.

Among other benefits, the FHLBs provide a central credit facility primarily for member institutions. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System. It makes advances to members in accordance with policies and procedures established by the FHFB and the board of directors of the FHLB of Chicago. At December 31, 2011, WaterStone Bank had $350.0 million in advances from the FHLB of Chicago.

USA PATRIOT Act

The USA PATRIOT Act of 2001 gave the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. The USA

PATRIOT Act also required the federal banking agencies to take into consideration the effectiveness of controls designed to combat money laundering activities in determining whether to approve a merger or other acquisition application of a member institution. Accordingly, if we engage in a merger or other acquisition, our controls designed to combat money laundering would be considered as part of the application process. We have established policies, procedures and systems designed to comply with these regulations.

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") is making extensive changes in the regulation of insured depository institution. Under the Dodd-Frank Act, the Office of Thrift Supervision was eliminated as of July 21, 2011. Responsibility for the supervision and regulation of federal savings banks was transferred to the Office of the Comptroller of the Currency, which is the agency that is currently primarily responsible for the regulation and supervision of national banks. At the same time, responsibility for the regulation and supervision of savings and loan holding companies, such as Lamplighter Financial and Waterstone Financial, was transferred to the Federal Reserve Board, which also supervises bank holding companies.

Additionally, the Dodd-Frank Act created a new Consumer Financial Protection Bureau as an independent bureau of the Federal Reserve Board. The Consumer Financial Protection Bureau has assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations, a function previously assigned to prudential regulators, and has authority to impose new requirements. Institutions of less than $10 billion in assets, however, such as WaterStone Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the primary enforcement authority of, their prudential regulators rather than the Consumer Financial Protection Bureau.

In addition to eliminating the Office of Thrift Supervision and creating the Consumer Financial Protection Bureau, the Dodd-Frank Act, among other things, directed changes in the way that institutions are assessed for deposit insurance, mandated the imposition of consolidated capital requirements on savings and loan holding companies, required originators of securitized loans to retain a percentage of the risk for the transferred loans, provided for regulatory rate-setting for certain debit card interchange fees, repealed restrictions on the payment of interest on commercial demand deposits and contained a number of reforms related to mortgage originations. Many of the provisions of the Dodd-Frank Act are subject to delayed effective dates and/or require the issuance of implementing regulations. Their impact on operations can not yet be fully assessed. However, there is a significant possibility that the Dodd-Frank Act will, at a minimum, result in increased regulatory burden, compliance costs and interest expense for Waterstone Bank, Lamplighter Financial and Waterstone Financial.

Regulation of Waterstone Financial

Holding Company Regulation

Wisconsin Law and Regulation. Any company that owns or controls, directly or indirectly, more than 25% of the voting securities of a state savings bank is subject to regulation as a savings bank holding company by the WDFI. Waterstone Financial and Lamplighter Financial, MHC are subject to regulation as savings bank holding companies under Wisconsin law. However, the WDFI has not issued specific regulations governing savings bank holding companies.

Federal Law and Regulation. Lamplighter Financial and Waterstone Financial are savings and loan holding companies within the meaning of the Home Owners' Loan Act. They are registered with and regulated by the Federal Reserve Board. The Federal Reserve Board succeeded the Office of Thrift Supervision as federal regulator of savings and loan holding companies in July 2011. Pursuant to applicable laws, regulations, and policies, a mutual holding company, such as Lamplighter Financial, MHC and a federally chartered mid-tier holding company, such as Waterstone Financial may engage in the following activities: (i) investing in the stock of a savings bank, (ii) acquiring a mutual savings bank through the merger of such savings bank into a savings bank subsidiary of such holding company or an interim savings bank subsidiary of such holding company, (iii) merging with or acquiring another holding company, one of whose subsidiaries is a savings bank, (iv) investing in a corporation, the capital stock of which is available for purchase by a savings bank under federal law or under the law of any state where the subsidiary savings bank or savings banks share their home offices, (v) furnishing or performing management services for a savings bank subsidiary of such company, (vi) holding, managing or liquidating assets owned or acquired from a savings subsidiary of such company, (vii) holding or managing properties used or occupied by a savings bank subsidiary of such company, (viii) acting as trustee under deeds of trust, (ix) any other activity (A) that the Federal Reserve Board, by regulation, has determined to be permissible for bank holding companies under Section 4(c) of the Bank Holding Company Act of 1956, unless the Director, by regulation, prohibits or limits any such activity for savings and loan holding companies; or (B) in which multiple savings and loan holding companies were authorized (by regulation) to directly engage on March 5, 1987, (x) any activity permissible for financial holding companies under Section 4(k) of the Bank Holding Company Act, including securities and insurance underwriting, and (xi) purchasing, holding, or disposing of stock acquired in connection with a qualified stock issuance if the purchase of such stock by such savings and loan holding company is approved by the Federal Reserve Board. If a mutual holding company acquires or merges with another holding company, the holding company acquired or the holding company resulting from such merger or acquisition may only invest in assets and engage in activities listed in (i) through (xi) above, and has a period of two years to cease any nonconforming activities and divest of any nonconforming investments.

The Home Owners' Loan Act prohibits a savings and loan holding company, including Waterstone Financial and Lamplighter Financial, MHC, directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of another savings institution or holding company thereof, without prior written approval of the Federal Reserve Board. It also prohibits the acquisition or retention of, with certain exceptions, more than 5% of a non-subsidiary company engaged in activities other than those permitted by the Home Owners' Loan Act; or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider factors such as the financial and managerial resources, future prospects of the company and institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

The Federal Reserve Board is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies, and (ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisitions.

Waivers of Dividends by Lamplighter Financial, MHC

The Dodd-Frank Act requires federally-chartered mutual holding companies to give the Federal Reserve Board notice before waiving the receipt of dividends, and provides that in the case of “grandfathered” mutual holding companies, like Lamplighter Financial, MHC, the Federal Reserve Board “may not object” to a dividend waiver if the board of directors of the mutual holding company waiving dividends determines that the waiver: (i) would not be detrimental to the safe and sound operation of the subsidiary savings bank; and (ii) is consistent with the board’s fiduciary duties to members of the mutual holding company. To qualify as a grandfathered mutual holding company, a mutual holding company must have been formed, issued stock and waived dividends prior to December 1, 2009. The Dodd-Frank Act further provides that the Federal Reserve Board may not consider waived dividends in determining an appropriate exchange ratio upon the conversion of a grandfathered mutual holding company to stock form. In September 2011, however, the Federal Reserve Board issued an interim final rule that also requires, as a condition to waiving dividends, that each mutual holding company obtain the approval of a majority of the eligible votes of its members within 12 months prior to the declaration of the dividend being waived. The Federal Reserve Board has requested comments on the interim final rule, and there can be no assurance that the rule will be amended to eliminate or modify the member vote requirement for dividend waivers by grandfathered mutual holding companies, such as Lamplighter Financial, MHC in the future, or as to what conditions the Federal Reserve Board may place on any dividend waivers. As previously noted, an existing regulatory Consent Order currently prohibits the payment of dividends by WaterStone Financial without prior regulatory consent.

Conversion of Lamplighter Financial, MHC to Stock Form

Federal Reserve Board regulations permit Lamplighter Financial, MHC to convert from the mutual form of organization to the capital stock form of organization (a “Conversion Transaction”). There can be no assurance when, if ever, a Conversion Transaction will occur, and the board of directors has no current intention or plan to undertake a Conversion Transaction. In a Conversion Transaction a new holding company would be formed as the successor to Waterstone Financial (the “New Holding Company”), Lamplighter Financial, MHC’s corporate existence would end, and certain depositors of WaterStone Bank would receive the right to subscribe for shares of the New Holding Company. In a Conversion Transaction, each share of common stock held by shareholders other than Lamplighter Financial, MHC (“Minority Shareholders”) would be automatically converted into a number of shares of common stock of the New Holding Company determined pursuant to an exchange ratio that ensures that Minority Shareholders own the same percentage of common stock in the New Holding Company as they owned in Waterstone Financial immediately prior to the Conversion Transaction subject to adjustment for any mutual holding company assets or waived dividends, as applicable. The total number of shares of common stock held by Minority

Shareholders after a Conversion Transaction also would be increased by any purchases by Minority Shareholders in the stock offering conducted as part of the Conversion Transaction.

Any Conversion Transaction would require the approval of a majority of the outstanding shares of common stock of Waterstone Financial held by Minority Shareholders and by two-thirds of the total outstanding shares of common stock of Waterstone Financial. Any Conversion Transaction also would require the approval of a majority of the eligible votes of depositors of Lamplighter Financial, MHC.

### Federal Securities Laws Regulation

Securities Exchange Act. Waterstone Financial common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. The Company is therefore subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 was adopted in response to public concerns regarding corporate accountability and oversight. The Sarbanes-Oxley Act is intended to improve corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

## Federal and State Taxation

### Federal Taxation

General. Waterstone Financial and subsidiaries and Lamplighter Financial, MHC are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. Waterstone Financial and subsidiaries constitute an affiliated group of corporations and, therefore, are eligible to report their income on a consolidated basis. Because Lamplighter Financial, MHC owns less than 80% of the common stock of Waterstone Financial, it is not a member of that affiliated group and will report its income on a separate return. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to Lamplighter Financial, MHC, Waterstone Financial or WaterStone Bank.

Method of Accounting. For federal income tax purposes, Waterstone Financial currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31 for filing its federal income tax returns.

Bad Debt Reserves. Prior to the Small Business Protection Act of 1996 (the "1996 Act"), WaterStone Bank was permitted to establish a reserve for bad debts and to make annual additions to the reserve. These additions could, within specified formula limits, be deducted in arriving at our taxable income. As a result of the 1996 Act, WaterStone Bank was required to use the specific charge-off method in computing its bad debt deduction beginning with its 1996 federal tax return. Savings institutions were required to recapture any excess reserves over those established as of

December 31, 1987 (base year reserve). At December 31, 2011, WaterStone Bank had no reserves subject to recapture in excess of its base year.

Taxable Distributions and Recapture. Prior to the 1996 Act, bad debt reserves created prior to January 1, 1988 were subject to recapture into taxable income if WaterStone Bank failed to meet certain thrift asset and definitional tests. Federal legislation has eliminated these thrift-related recapture rules. At December 31, 2011, our total federal pre-1988 base year reserve was approximately $16.7 million. However, under current law, pre-1988 base year reserves remain subject to recapture if WaterStone Bank makes certain non-dividend distributions, repurchases any of its stock, pays dividends in excess of tax earnings and profits, or ceases to maintain a bank charter.

Alternative Minimum Tax. The Internal Revenue Code of 1986, as amended (the "Code"), imposes an alternative minimum tax ("AMT") at a rate of 20% on a base of regular taxable income plus certain tax preferences which we refer to as "alternative minimum taxable income." The AMT is payable to the extent such alternative minimum taxable income is in excess of an exemption amount and the AMT exceeds the regular income tax. Net operating losses can offset no more than 90% of alternative minimum taxable income. AMT payments may be used as credits against regular tax liabilities in future years. Due to a federal net operating loss carry back generated in 2008, Waterstone Financial became subject to AMT for 2006 and 2007. At December 31, 2011, the Company had no such amounts available as credits for carryover.

Net Operating Loss Carryovers. A company may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. A 2009 federal tax law change allows for a one-time carry back of either 2008 or 2009 taxable losses for up to five years. At December 31, 2011, Waterstone Financial had net operating loss carry forwards of $2.6 million for federal income tax purposes.

Corporate Dividends-Received Deduction. Waterstone Financial may exclude from its income 100% of dividends received from WaterStone Bank as a member of the same affiliated group of corporations. The corporate dividends-received deduction is 80% in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, and corporations that own less than 20% of the stock of a corporation distributing a dividend may deduct only 70% of dividends received or accrued on their behalf.

State Taxation

Wisconsin State Taxation. Lamplighter Financial, MHC and the Company are subject to the Wisconsin corporate franchise (income) tax. Under current law, the state of Wisconsin imposes a corporate franchise tax of 7.9% on the combined taxable incomes of the members of our consolidated income tax group. Prior to January 1, 2009, the income of the Nevada subsidiary was only subject to taxation in Nevada, which currently does not impose a corporate income or franchise tax. In February 2009, the Wisconsin legislature passed legislation that requires combined state tax reporting effective January 1, 2009. This legislation results in the apportioned income of the Nevada subsidiary being subject to the Wisconsin corporate franchise tax of 7.9%.

## Item 1A. Risk Factors

The Company Operates in a Highly Regulated Environment and is Subject to Supervision, Examination and Enforcement Action by Various Regulatory Agencies.

As a savings bank holding company, the Company is regulated by the Federal Reserve Board, and the Bank is regulated separately by various federal and state banking regulators. This regulation is primarily intended to protect the Bank's depositors rather than the Company's shareholders. In addition, the Company's common stock is registered under the Securities Exchange Act and it is subject to regulation by the Securities and Exchange Commission and to public reporting requirements.

Under applicable laws, the Federal Reserve Board, the FDIC, as the Bank's primary federal regulator and deposit insurer, and the Wisconsin Department of Financial Institutions as the Bank's chartering authority, have the ability to impose sanctions, restrictions and requirements on the Company and on the Bank if they determine, the Bank or the Company has violated laws or regulations or are not operating in a safe and sound manner. Banking regulators can take actions at any time that may have an adverse impact on the Company and on the Bank. On November 25, 2009, the Bank agreed to a Consent Order issued by the WDFI and FDIC and the Company agreed to a Cease and Desist Order issued by the Office of Thrift Supervision, its regulator at the time, requiring among other things, the bank to maintain a minimum Tier I capital ratio of 8.5%, a minimum total risk based capital of 12.0%, and prohibiting dividend payments without written regulatory approval. As a result of the Consent Order, the Bank is subject to restrictions regarding the maximum interest rates that it may offer on deposits. As of December 31, 2011, the Company and the Bank were in compliance with all requirements of the regulatory orders issued. Noncompliance can result in more severe restrictions and civil money penalties. Complete copies of the regulatory orders were attached as exhibits to a Form 8-K filed with the SEC on November 27, 2009.

Challenges Posed by the Weak Economy and Distressed Real Estate Market.

The Company is operating in a difficult and uncertain economic environment characterized by high unemployment rates, a weak real estate market and a weak economy. As a result, capital raising alternatives, such as issuing common or preferred stock or borrowing funds at attractive rates are generally not available. Sales of either fixed assets or pools of loans to increase capital ratios may also have a negative impact on the Company. The economic recession and contraction of the local and national real estate markets have also resulted in higher provisions for loan losses, loan charge-offs and losses related to the write down of real estate owned, and these same trends may also cause further valuation changes and losses in our loan and investment portfolios as well as reduction in the estimated realizable value of real estate owned. These conditions have reduced our capital levels and regulatory capital ratios and may continue to do so in future periods.

Changing Interest Rates May Have a Negative Impact on Our Results of Operations.

Our earnings and cash flows are largely dependent on our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. If the interest rates paid on deposits and borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore our results of operations would be adversely affected. Similarly, mortgage banking income varies directly with movements in interest rates. Earnings would also be adversely affected if the interest rate received on our loans and other investments fall more quickly than the interest rates paid on our deposits and borrowings. Although we believe that we have implemented effective asset and liability management strategies to reduce the adverse effects of changes in market interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have an adverse effect on our financial condition and results of operations.

During 2011 We Continued to Experience High Levels of Delinquencies, Non-accrual Loans and Charge-offs.

During 2011, we continued to experience high levels of non-accrual loans and loan delinquencies. Our non-accrual loans totaled $78.2 million, or 6.43% of total loans at December 31, 2011, compared to $84.2 million, or 6.44% of total loans at December 31, 2010. Our loans past due totaled $93.4 million, or 7.7% of total loans receivable at December 31, 2011, compared to $90.7 million, or 6.9% of total loans at December 31, 2010. The continued high level of non-performing and delinquent loans has resulted in high levels of loan charge-offs. During 2011, net charge-offs totaled $18.8 million. To the extent that our loan portfolio continues to deteriorate, our financial condition and results of operations will be materially and adversely affected. Continued deterioration could also lead to additional actions by regulators that could have a direct material impact on our financial condition and results of operation.

If Our Allowance for Loan Losses is Not Sufficient to Cover Actual Loan Losses, Our Results of Operations Would be Negatively Impacted.

We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we analyze our loss and delinquency experience by loan categories and we consider the impact of existing economic conditions. If the results of our analyses are incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, which would require additions to our allowance and would decrease our net income. Although we are unaware of any specific weaknesses in our loan portfolio that would require increases in our allowance at the present time, we may need to increase our allowance further in the future due to credit deterioration, our emphasis on loan growth and on increasing our portfolio of commercial real estate loans.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities may have a material adverse effect on our results of operations and financial condition.

Deterioration of our Investment Portfolio Could Have a Negative Impact on Our Results of Operations.

The current sustained economic downturn has resulted in other than temporary impairment of securities in our overall investment portfolio, including a decline in value of mortgage related securities which are dependent upon the performance of the underlying mortgages that provide the principal and interest cash flow for the securities. Similarly, growing state and municipality budget deficits resulting from declining tax revenues will result in related declines in the value of debt securities they have issued in prior years. Continued weakness or deterioration in general economic market conditions could result in future impairment losses on these securities or other investment securities.

If Our Investment in the Federal Home Loan Bank of Chicago is Classified as Other Than Temporarily Impaired, Our Earnings and Stockholders' Equity Could Decrease.

We own common stock of the Federal Home Loan Bank of Chicago (FHLBC) in order to qualify for membership in the Federal Home Loan Bank System and to be eligible to borrow funds under the FHLBC's advance program. The fair value of our FHLBC common stock as of December 31, 2011 was $21.7 million based on its cost. There is no trading market for our FHLBC common stock.

Certain member banks of the Federal Home Loan Bank System may be subject to accounting rules and asset quality risks that could result in materially lower regulatory capital levels. In an extreme situation, it is possible that the capitalization of a Federal Home Loan Bank, including the FHLBC, could be substantially diminished or reduced to zero. Consequently, there is a risk that our investment in FHLBC common stock could be deemed other-than-temporarily impaired at some time in the future, and if this occurs, it would cause our earnings and stockholders' equity to decrease by the after-tax amount of any impairment charge.

Our Shareholders Own a Minority of Waterstone Financial Common Stock and Are Not Able to Exercise Voting Control Over Most Matters Put to a Vote of Shareholders.

Public shareholders own a minority of the outstanding shares of Waterstone Financial common stock. As a result, public shareholders are not able to exercise voting control over most matters put to a vote of shareholders. Lamplighter Financial, MHC owns a majority of Waterstone Financial's common stock and, through its Board of directors, is able to exercise voting control over most matters put to a vote of shareholders, including possible acquisitions. The same directors who govern Waterstone Financial and WaterStone Bank also govern Lamplighter Financial, MHC. The only matters over which Lamplighter Financial, MHC is not able to exercise voting control are those requiring a separate vote of shareholders other than Lamplighter Financial, MHC.

Our Non-Interest Expense Will Continue to be Negatively Impacted by Increases in FDIC Insurance Premiums

The Federal Deposit Insurance Corporation assesses premiums for deposit insurance on insured banks and savings banks. This assessment is based on the risk category of the institution, and certain specified adjustments, and currently ranges from 2.5 to 45 basis points of the institution's total assets less tangible capital. Federal law requires that the Federal Deposit Insurance Corporation takes steps as are necessary to achieve a Deposit Insurance Fund reserve ratio of 1.35% of insured deposits of September 30, 2020. The Federal Deposit Insurance Corporation has established a longer term designated reserve ratio of 2%.

Due to stress on the Deposit Insurance Fund caused by numerous bank failures, the Federal Deposit Insurance Corporation imposed a maximum 10 basis point of insured deposits special assessment that was collected on September 30, 2009. On November 12, 2009, the Federal Deposit Insurance Corporation issued a rule pursuant to which all insured depository institutions were required to prepay their estimated assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. The prepayment was due on December 31, 2009. Under the rule, the assessment rate for the fourth quarter of 2009 and for 2010 was based on each institution's total base assessment rate for the third quarter of 2009, modified to assume that the assessment rate in effect on September 30, 2009 had been in effect for the entire third quarter, and the assessment rate for 2011 and 2012 was equal to the modified third quarter assessment rate plus an additional 3 basis points. In addition, each institution's base assessment rate for each period was calculated using its third quarter assessment base, adjusted quarterly for an estimated 5% annual growth rate in the assessment base through the end of 2012. WaterStone Bank received a waiver from the Federal Deposit Insurance Corporation with respect to the 2010, 2011 and 2012 insurance prepayment.

Increased assessments significantly increased our non-interest expense for those years and may continue to increase non-interest expense in future years as long as the Federal Deposit Insurance Corporation designated reserve ratio remains low.

Financial Reform Legislation in 2010 is Expected to Increase our Costs of Operations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), has significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of depository institutions and their holding companies. The Dodd-Frank Act authorized the Federal Reserve Board to supervise and regulate all savings and loan holding companies like Waterstone Financial and Lamplighter Financial, Inc., in addition to the bank holding companies that it also regulates. The Dodd-Frank Act also instructed the Federal Reserve Board to set minimum capital levels for holding companies that are as stringent as those required for the insured depository subsidiaries, and the components of Tier 1 capital would be restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. Savings and loan holding companies are subject to a five year transition period before the holding company capital requirement will apply.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions such as the Bank, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets will be examined by their applicable bank regulators.

The legislation broadened the base for Federal Deposit Insurance Corporation insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts have unlimited deposit insurance through December 31, 2012. Further, the legislation removed restrictions on the payment of interest on commercial demand deposits, mandated that regulators issue regulations requiring originators of securitized loans retain a percentage of the risk for transferred loans, directed the Federal Reserve Board to regulate pricing of certain debit card interchange fees and contained a number of reforms related to mortgage origination.

It is difficult to predict at this time the effect that the legislation and implementing regulations will have on community banks with regard to lending and credit practices. Many of the provisions of the Dodd-Frank Act have delayed effective dates, and the legislation requires various federal agencies to promulgate numerous and extensive implementing regulations over the next several years. Although the substance and scope of all of these regulations cannot be determined at this time, it is expected that the legislation and implementing regulations, particularly those relating to the new Consumer Financial Protection Bureau, will increase our operating and compliance costs.

The Dodd-Frank Act's Elimination of the Office of Thrift Supervision may Adversely Affect the Ability of Lamplighter Financial, MHC to Waive Dividends, which could Adversely Affect our Ability to Pay Dividends and the Value of our Common Stock.

The value of Waterstone Financial's common stock is significantly affected by our ability to pay dividends to our public shareholders, which is affected by our earnings and cash resources at the holding company level and by the ability of the Bank to make capital distributions to Waterstone Financial. Moreover, our ability to pay dividends and the amount of such dividends is affected by the ability of Lamplighter, MHC, our mutual holding company, to waive the receipt of dividends declared by Waterstone Financial. If Lamplighter Financial, MHC waives its right to receive dividends on its shares of Waterstone Financial common stock, that means Waterstone Financial has more cash resources to pay dividends to our public stockholders than if Lamplighter Financial, MHC had accepted such dividends.

The Dodd-Frank Act requires federally-chartered mutual holding companies to give the Federal Reserve Board notice before waiving the receipt of dividends, and provides that in the case of "grandfathered" mutual holding companies, like Lamplighter, MHC, the Federal Reserve Board "may not object" to a dividend waiver if the board of directors of the mutual holding company waiving dividends determines that the waiver: (i) would not be detrimental to the safe and sound operation of the subsidiary savings bank; and (ii) is consistent with the board's fiduciary duties to members of the mutual holding company. To qualify as a grandfathered mutual holding company, a mutual holding company must have been formed, issued stock and waived dividends prior to December 1, 2009. The Dodd-Frank Act further provides that the Federal Reserve Board may not consider waived dividends in determining an appropriate exchange ratio upon the conversion of a grandfathered mutual holding company to stock form. In September 2011, however, the Federal Reserve Board issued an interim final rule that also requires as a condition to waiving dividends, that each mutual holding company obtain the approval of a majority of the eligible votes of its members within 12 months prior to the declaration of the dividend being waived. The Federal Reserve Board has requested comments on the interim final rule, and there can be no assurance that the rule will be amended to eliminate or modify the member vote requirement for dividend waivers by grandfathered mutual holding companies, such as Lamplighter, MHC. In the past, the Federal Reserve Board generally has not allowed dividend waivers by mutual bank holding companies and, therefore, there can be no assurance that the Federal Reserve Board will approve dividend waivers by Lamplighter, MHC in the future, or what conditions the Federal Reserve Board may place on any dividend waivers. Waterstone Financial is currently prohibited from paying dividends without prior regulatory approval due to a Consent Order entered into with the regulators.

## Item 1B. Unresolved Staff Comments

None

## Item 2. Properties

The Company and its subsidiaries conduct business from its headquarters at 11200 W. Plank Court, Wauwatosa, Wisconsin and at other offices throughout the country. In addition to its headquarters, the Bank owns eight full-service banking offices, a drive through facility and an undeveloped parcel of land for future branch expansion with net book value totaling $25.4 million excluding furniture and equipment. The mortgage banking subsidiary leases office space in 50 buildings in 11 states. Leasehold improvements total $275,000 net of depreciation. Leasehold improvements are depreciated over the remaining lease term. Leases expire at various times though 2016.

## Item 3. Legal Proceedings

We are not involved in any pending legal proceedings as a defendant other than routine legal proceedings occurring in the ordinary course of business. At December 31, 2011, we were not involved in any legal proceedings, the outcome of which would be material to our financial condition or results of operations. Other than the consent order we have entered into with the WDFI and FDIC and the cease and desist order entered into with the OTS (as administered by the FDIC and Federal Reserve), both of which are discussed under Item 1. Business and Item 1A. Risk Factors, we have no pending proceedings before any agency.

## Item 4. Submission of Matters to a Vote of Security Holders

Not applicable

Part II

## Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchase of Equity Securities

The common stock of Waterstone Financial, Inc. is traded on The NASDAQ Global Select Market® under the symbol WSBF.

As of February 29, 2012, there were 31,350,097 shares of common stock outstanding and 3,477 shareholders of record of the common stock. Waterstone Financial, Inc became a publicly-held corporation on October 4, 2005.

Waterstone Financial has never paid cash dividends on its common stock, and our board currently has no plan to pay cash dividends on the common stock. If the board considers a cash dividend in the future, the payment of dividends will depend upon a number of factors, including capital requirements, our financial condition and results of operations, tax considerations, statutory and regulatory limitations and general economic conditions and regulatory restrictions that affect our ability to pay dividends. We cannot assure you that any dividends will be paid or that, if paid, they will not be reduced or eliminated in the future. Special cash or stock dividends, to the extent permitted by applicable policy and regulation, may be paid in addition to, or in lieu of, regular cash dividends.

Our ability to pay dividends will depend, in part, upon our receipt of dividends from WaterStone Bank, because we have no significant source of income other than dividends from WaterStone Bank, earnings on our investments and interest payments on our loan to WaterStone Bank's employee stock ownership plan. Wisconsin law generally allows WaterStone Bank to pay dividends to Waterstone Financial equal to up to 50% of WaterStone Bank's net profit in the current year without prior regulatory approval and above such amount, including out of retained earnings, with prior regulatory approval. A consent order jointly issued by the WDFI and the FDIC effective December 18, 2009 prohibits the payment of a dividend without written regulatory approval.

Market Information

The high and low quarterly trading prices during fiscal 2011 and 2010 were as follows:

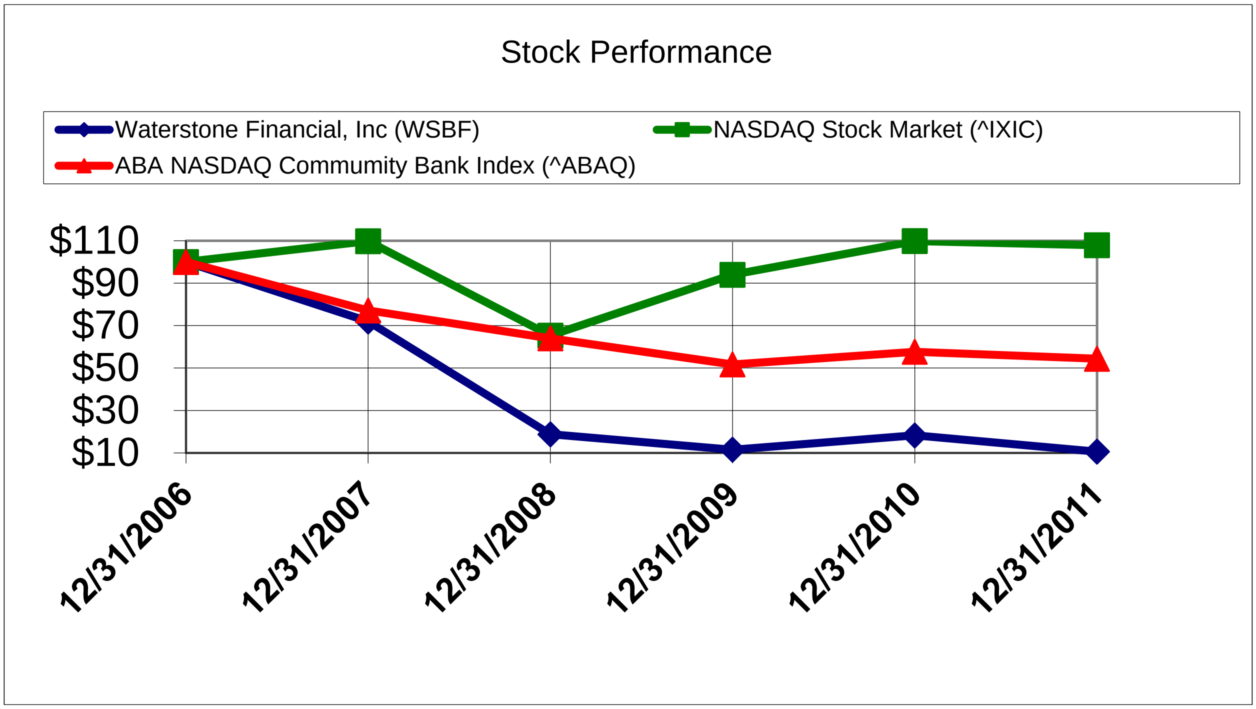
| 2011 | High | Low |
|---|---|---|
| 1st Quarter | $ 3.80 | $ 2.40 |
| 2nd Quarter | 3.22 | 2.25 |
| 3rd Quarter | 2.83 | 2.50 |
| 4th Quarter | 2.69 | 1.80 |

| 2010 | High | Low |
|---|---|---|
| 1st Quarter | $ 3.98 | $ 1.93 |
| 2nd Quarter | 4.24 | 3.34 |
| 3rd Quarter | 4.45 | 3.29 |
| 4th Quarter | 4.05 | 3.34 |

During the last two fiscal years the Company did not pay any cash dividends.

PERFORMANCE GRAPH

Set forth below is a line graph comparing the cumulative total shareholder return on Waterstone Financial common stock, based on the market price of the common stock and assuming reinvestment of cash dividends, with the cumulative total return of companies on the NASDAQ Stock Market US Index and the America's Community Bankers NASDAQ Index. The graph assumes $100 was invested on December 31, 2006, the first date of Waterstone Financial trading, in Waterstone Financial common stock and each of those indices.




| Stock/Index | 12/31/2006 | 12/31/2007 | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 |
|---|---|---|---|---|---|---|
| Waterstone Financial, Inc (WSBF) | 100.00 | 71.94 | 18.80 | 11.50 | 18.24 | 10.61 |
| NASDAQ Stock Market (^IXIC) | 100.00 | 109.81 | 65.29 | 93.95 | 109.84 | 107.86 |
| ABA NASDAQ Commumity Bank Index (^ABAQ) | 100.00 | 77.15 | 64.00 | 51.71 | 57.64 | 54.37 |

## Item 6. Selected Financial Data

### SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

The summary financial information presented below is derived in part from the Company's audited financial statements, although the table itself is not audited. The following data should be read together with the Company's consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" later in this report.

| | At or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| | (In Thousands, except per share amounts) | | | | |
| Selected Financial Condition | | | | | |
| Total assets | $ 1,712,851 | $ 1,808,966 | $ 1,868,266 | $ 1,885,432 | $ 1,710,202 |
| Securities available for sale | 206,519 | 203,166 | 205,415 | 179,887 | 172,137 |
| Federal Home Loan Bank stock | 21,653 | 21,653 | 21,653 | 21,653 | 19,289 |
| Loans receivable, net | 1,184,234 | 1,277,262 | 1,391,516 | 1,534,591 | 1,389,209 |
| Cash and cash equivalents | 80,380 | 75,331 | 71,120 | 23,849 | 17,884 |
| Deposits | 1,051,292 | 1,145,529 | 1,164,890 | 1,195,897 | 994,535 |
| Borrowings | 461,138 | 456,959 | 507,900 | 487,000 | 475,484 |
| Total shareholders' equity | 166,372 | 172,220 | 168,592 | 171,267 | 201,819 |
| Allowance for loan losses | 32,430 | 29,175 | 28,494 | 25,167 | 12,839 |
| Selected Operating Data: | | | | | |
| Interest income | $ 79,352 | $ 89,933 | $ 98,488 | $ 104,078 | $ 96,975 |
| Interest expens | 32,836 | 40,269 | 54,577 | 63,027 | 62,134 |
| Net interest income | 46,516 | 49,664 | 43,911 | 41,051 | 34,841 |
| Provision for loan losse | 22,077 | 25,832 | 26,687 | 37,629 | 11,697 |
| Net interest income after provision for loan losses | 24,439 | 23,832 | 17,224 | 3,422 | 23,144 |
| Noninterest income | 43,229 | 38,993 | 12,208 | 6,291 | 6,842 |
| Noninterest expense | 74,579 | 64,627 | 40,876 | 33,860 | 28,682 |
| Income (loss) before income taxes | (6,911) | (1,802) | (11,444) | (24,147) | 1,304 |
| Provision for income taxes (benefit) | 562 | 52 | (1,306) | 2,299 | (254) |
| Net income (loss | $ (7,473 | $ (1,854 | $ (10,138 | $ (26,446 | $ 1,558 |
| Income (loss) per share – ba | $ (0.24 | $ (0.06 | $ (0.33 | $ (0.87 | $ 0.05 |
| Income (loss) per share – dilut | $ (0.24 | $ (0.06 | $ (0.33 | $ (0.87 | $ 0.05 |

| | At or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| Selected Financial Ratios and Other Data | | | | | |
| Performance Ratios: | | | | | |
| Return (loss) on average assets | (0.43%) | (0.10%) | (0.53%) | (1.44%) | 0.09% |
| Return (loss) on average equity | (4.47) | (1.09) | (6.12) | (13.76) | 0.72 |
| Interest rate spread[(1)] | 2.67 | 2.67 | 2.21 | 1.99 | 1.74 |
| Net interest margin[(2)] | 2.82 | 2.83 | 2.41 | 2.32 | 2.19 |
| Noninterest expense to average assets | 4.27 | 3.49 | 2.14 | 1.85 | 1.73 |
| Efficiency ratio[(3)] | 83.12 | 72.90 | 72.84 | 71.52 | 68.85 |
| Average interest-earning assets to average in bearing liabilities | 107.67 | 107.11 | 106.68 | 107.85 | 111.68 |
| Capital Ratios: | | | | | |
| Equity to total assets at end of period | 9.71% | 9.52% | 9.02% | 9.08% | 11.80% |
| Average equity to average assets | 9.55 | 9.18 | 8.67 | 10.44 | 13.07 |
| Total capital to risk-weighted assets | 14.58 | 14.13 | 13.83 | 12.84 | 13.43 |
| Tier I capital to risk-weighted assets | 13.31 | 12.87 | 12.57 | 11.58 | 12.52 |
| Tier I capital to average assets | 9.16 | 8.83 | 8.77 | 8.93 | 10.08 |
| Asset Quality Ratios | | | | | |
| Allowance for loan losses as a percent of t loans | 2.67% | 2.23% | 2.01% | 1.61% | 0.92% |
| Allowance for loan losses as a percent of performing loans | 41.46 | 34.66 | 37.83 | 23.36 | 15.98 |
| Net charge-offs to average outstanding lo during the period | 1.43 | 1.75 | 1.54 | 1.67 | 0.44 |
| Non-performing loans as a percent of total loans | 6.43 | 6.44 | 5.30 | 6.91 | 5.73 |
| Non-performing assets as a percent of total assets | 7.88 | 7.85 | 6.76 | 7.02 | 5.20 |

(1) Represents the difference between the weighted average yield on average interest-earning assets and the weighted average cost of interest-bearing liabilities.
(2) Represents net interest income as a percent of average interest-earning assets.
(3) Represents non-interest expense divided by the sum of net interest income and non-interest income.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

Our profitability is highly dependent on our net interest income, mortgage banking income, the provision for loan losses and expenses related to real estate owned. Net interest income is the difference between the interest income we earn on our interest earnings assets which are loans receivable, investment securities and cash and cash equivalents and the interest we pay on deposits and other borrowings. The Bank is primarily a mortgage lender with loans secured by real estate comprising 97.3% of total loans receivable on December 31, 2011. Further, 88.5% of loans receivable are residential mortgage loans with over four-family loans comprising 44.0% of all loans on December 31, 2011. WaterStone Bank funds loan production primarily with retail deposits and Federal Home Loan Bank advances. The Bank's mortgage banking subsidiary, Waterstone Mortgage Corporation, utilizes a line of credit provided by the Bank as its primary source of funding loans held for sale. In addition, Waterstone Mortgage Corporation utilizes lines of credit with external banks as necessary. On December 31, 2011, deposits comprised 68.0% of total liabilities. Time deposits, also known as certificates of deposit, accounted for 83.6% of total deposits at December 31, 2011. Federal Home Loan Bank advances outstanding on December 31, 2011 totaled $350.0 million, or 22.6% of total liabilities. During the current prolonged period of low interest rates and economic weakness, we have determined that an investment philosophy emphasizing short-term liquid investments is prudent and positions the Company to take advantage of the investment, lending and interest rate risk management opportunities that will exist as the local and national economies recover from the recession. Our high level of time deposits, relative to total deposits, may result in an increase in our cost of funds when market interest rates begin to increase.

During the year ended December 31, 2011, our results of operations continued to be adversely affected by elevated levels of nonperforming loans and real estate owned. Weaknesses in our loan portfolio have required that we establish higher provisions for loan losses and incur significant loan charge-offs. The continued downturn in the local real estate market requires the Company to continually re-evaluate the inputs and assumptions used to determine the fair value of collateral and net present value of discounted future estimated cash flows related to loans receivable to ensure that the allowance for loan losses continues to be an accurate reflection of management's best estimate of the amount needed to provide for the probable and estimable loss on impaired loans and other incurred losses in the loan portfolio. As a result, the Company determined that a provision for loan losses of $22.1 million was necessary during the year ended December 31, 2011 in order to maintain the allowance for loan losses at an appropriate level in relation to the risks management believes are inherent and estimable in our portfolio. Additional information regarding loan quality and its impact on our financial condition and results of operations can be found in the "Asset Quality" discussion.

Our results of operations are also affected by noninterest income and noninterest expense. Noninterest income consists primarily of mortgage banking income. The increase in margins earned on the sale of mortgage loans in the secondary market yielded a $4.4 million increase in mortgage banking income during the year ended December 31, 2011 compared to the year ended December 31, 2010. Noninterest expense consists primarily of compensation and employee benefits, real estate owned expense and FDIC insurance premiums. The primary reason for the increase in noninterest expense compared to the prior year relates to the expansion of our mortgage banking operations. Of the $10.0 million increase in noninterest expense for the year ended December 31, 2011 compared to the year ended December 31, 2010, $6.1 million relates to our mortgage banking operations. Real estate owned expense increased by $5.6 million during the year ended December 31, 2011 compared to the prior year due to an increase in properties under management and an increase in write downs of asset values, which is reflective of a strategy to become more aggressive in pricing specific properties to expedite the sale process. During 2011 our noninterest expense has been and will continue to be adversely affected by elevated deposit insurance premium assessments from the FDIC. FDIC insurance premium expense totaled $3.8 million and $4.4 million during the years ended December 31, 2011 and 2010, respectively. Our results of operations are also significantly affected by general and local economic and competitive conditions, governmental policies and actions of regulatory authorities.

## Critical Accounting Policies

Critical accounting policies are those that involve significant judgments and assumptions by management and that have, or could have, a material impact on our income or the carrying value of our assets.

Allowance for Loan LossesWaterStone Bank establishes valuation allowances on loans deemed to be impaired. A loan is considered impaired when, based on current information and events, it is probable that WaterStone Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. A valuation allowance is established for an amount equal to the impairment when the carrying amount of the loan exceeds the present value of the expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral (specific component). The Company recognizes the change in present value of expected future cash flows on impaired loans attributable to the passage of time as bad debt expense. On an ongoing basis, at least quarterly for financial reporting purposes, the fair value of collateral dependent impaired loans and real estate owned is determined or reaffirmed by the following procedures:

- Obtaining updated real estate appraisals or performing updated discounted cash flow analysis;
- Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;
- Comparison of the estimated current book value to that of updated sales values experienced on similar real estate owned;
- Comparison of the estimated current book value to that of updated values seen on more current appraisals of similar properties; and
- Comparison of the estimated current book value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

WaterStone Bank also establishes valuation allowances based on an evaluation of the various risk components that are inherent in the credit portfolio (general component). The risk components that are evaluated include past loan loss experience; the level of non-performing and classified assets; current economic conditions; volume, growth, and composition of the loan portfolio; adverse situations that may affect the borrower's ability to repay; the estimated value of any underlying collateral; regulatory guidance; and other relevant factors. The allowance is increased by provisions charged to earnings and recoveries of previously charged-off loans and reduced by charge-offs. Charge-offs approximate the amount by which the outstanding principal balance exceeds the estimated net realizable value of the underlying collateral. The appropriateness of the allowance for loan losses is reviewed and approved quarterly by the WaterStone Bank board of directors. The allowance reflects management's best estimate of the amount needed to provide for the probable loss on impaired loans and other inherent losses in the loan portfolio, and is based on a risk model developed and implemented by management and approved by the WaterStone Bank board of directors.

Actual results could differ from this estimate, and future additions to the allowance may be necessary based on unforeseen changes in loan quality and economic conditions. More specifically, if our future charge-off experience increases substantially from our past experience; or if the value of underlying loan collateral, in our case real estate, declines in value by a substantial amount; or if unemployment in our primary market area increases significantly; our allowance for loan losses may be inadequate and we will incur higher provisions for loan losses and lower net income in the future.

In addition, state and federal regulators periodically review the WaterStone Bank allowance for loan losses. Such regulators have the authority to require WaterStone Bank to recognize additions to the allowance at the time of their examination.

Income Taxes. The Company and its subsidiaries file consolidated federal and combined state income tax returns. The provision for income taxes is based upon income in the consolidated financial statements, rather than amounts reported on the income tax return. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as for net operating loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, the forecasts of future income, applicable tax planning strategies, and assessments of current and future economic and business conditions. Examples of positive evidence may include the existence of taxes paid in available carry-back years as well as the probability that taxable income will be generated in future periods. Examples of negative evidence may include cumulative losses in a current year and prior two years and general business and economic trends. At both December 31, 2011 and December 31, 2010, the Company determined a valuation allowance continued to be necessary, largely based on the negative evidence represented by a cumulative loss in the most recent three-year period caused by the significant loan loss provisions recorded during those three years. In addition, general uncertainty regarding the economy and the housing market has increased the potential volatility and uncertainty of projected earnings. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly.

Positions taken in the Company's tax returns are subject to challenge by the taxing authorities upon examination. The benefit of uncertain tax positions are initially recognized in the financial statements only when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are both initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with the tax authority, assuming full knowledge of the position and all relevant facts. Interest and penalties on income tax uncertainties are classified within income tax expense in the income statement.

Management believes the Company's tax policies and practices are critical because the determination of the tax provision and current and deferred tax assets and liabilities have a material impact on our net income and the carrying value of our assets. We have no plans to change the tax recognition methodology in the future without hard evidence of sustainable earnings trends which are reliant on net interest income, mortgage banking income and significantly reduced credit losses. If the estimated valuation allowance against our deferred asset is adjusted it will affect our future net income.

Fair Value Measurements. The Company determines the fair value of its assets and liabilities in accordance with ASC 820. ASC 820 establishes a standard framework for measuring and disclosing fair value under GAAP. A number of valuation techniques are used to determine the fair value of assets and liabilities in the Company's financial statements. The valuation techniques include quoted market prices for investment securities, appraisals of real estate from independent licensed appraisers and other valuation techniques. Fair value measurements for assets and liabilities where limited or no observable market data exists are based primarily upon estimates, and are often calculated based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the valuation results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there are inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values. Significant changes in the aggregate fair value of assets and liabilities required to be measured at fair value or for impairment are recognized in the income statement under the framework established by GAAP.

Comparison of Financial Condition at December 31, 2011 and at December 31, 2010

Total Assets. Total assets decreased by $96.1 million, or 5.3%, to $1.71 billion at December 31, 2011 from $1.81 billion at December 31, 2010. The decrease in total assets reflects decreases in loans receivable of $89.8 million. Funds received upon the repayment of loans held in portfolio were utilized to pay down $95.7 million in time deposits.

Cash and Cash Equivalents. Cash and cash equivalents increased by $5.0 million, or 6.7%, to $80.4 million at December 31, 2011 from $75.3 million at December 31, 2010. The increase in cash and cash equivalents reflects the Company's decision to maintain higher than usual liquidity given the current economic environment and relatively low rates of return available on securities and other investments.

Securities Available for Sale. Securities available for sale increased by $3.4 million, or 1.7%, to $206.5 million at December 31, 2011 from $203.2 million at December 31, 2010. This increase reflects a $13.7 million increase in government sponsored enterprise bonds a $7.9 million increase in municipal securities and a $3.9 million increase in certificates of deposit, partially offset by $22.0 million decrease in mortgage-backed securities and collateralized mortgage obligations. The shift in the composition of the securities portfolio towards less volatile, shorter-term debt securities reflects a decision to increase portfolio liquidity. As of December 31, 2011, the Company holds two available for sale private label issue collateralized mortgage obligations with a total fair value of $18.5 million and an amortized cost of $19.5 million that were determined to be other than temporarily impaired. The $1.0 million unrealized loss (before taxes) is included in other comprehensive income. During the year ended December 31, 2011, $456,000 was recognized as additional other than temporary impairment with respect to one of the private label issue collateralized mortgage obligations which was charged against earnings.

Loans Held for Sale. Loans held for sale decreased by $7.8 million, or 8.2%, to $88.3 million at December 31, 2011, from $96.1 million at December 31, 2010. During the latter half of fiscal 2010, Waterstone Mortgage Corporation capitalized on its branch expansion and low interest rate environment to significantly increase its loan origination activity. This origination activity resulted in a historically high level of loans held for sale as of December 31, 2010.

Loans Receivable. Loans receivable held for investment decreased $89.8 million, or 6.9%, to $1.22 billion at December 31, 2011 from $1.31 billion at December 31, 2010. The 2011 decrease in total loans receivable was primarily attributable to an $85.2 million decrease in one- to four-family loans, a $12.0 million decrease in home equity loans and an $11.6 million decrease in construction and land loans. The decrease in one- to four-family loans reflects a decline in loan demand for variable-rate real estate mortgage loans as recent borrowers have preferred long-term fixed-rate products that the Company does not generally retain in its portfolio. The decrease in construction and land loans reflects a strategy to reduce exposure to this segment of the portfolio. Decreases in loan balances in these and other categories also reflect an overall decrease in demand due to current economic conditions combined with the Company's more stringent loan underwriting requirements. As a result of the low interest rate environment with respect to long-term fixed-rate real estate mortgage products, the Company has experienced a shift in the composition of loan originations during 2011 and 2010 from one- to four-family residential variable-rate loans to residential real estate loans collateralized by over four-family properties and commercial real estate, as these categories of borrowers displayed relatively stable levels of demand for our existing products. During the year ended December 31, 2011, $28.3 million in loans were transferred to real estate owned and $18.8 million were charged-off, net of recoveries.

Allowance for Loan Losses. The allowance for loan losses increased $3.3 million, or 11.2%, to $32.4 million at December 31, 2011 from $29.2 million at December 31, 2010. The increase in the allowance for loan loss during the year ended December 31, 2011 is attributable to a $1.5 million increase in specific loan loss reserves related to impaired loans and a $1.8 million increase in the general valuation allowance. The $1.5 million increase in specific loan loss reserves was primarily the result of collateral shortfalls pertaining to a relatively small number of lending relationships that were identified as impaired during the year ended December 31, 2011. The reserves established with respect to these loans resulted in an overall increase in specific reserves, despite a decrease in the overall level of impaired loans during the year ended December 31, 2011. The increase in the general valuation allowance resulted from an increase in loans that, while they may still be performing have been identified as having higher risk characteristics. During the year ended December 31, 2011, the increase in the amount and number of loans identified as exhibiting elevated levels of risk with respect to loss outweighed the decline in non-accrual loans. Loans with elevated risk profiles include loans internally classified as substandard. As of December 31, 2011, the allowance for loan losses to total loans receivable was 2.67% and was equal to 41.46% of non-performing loans, compared to 2.23% and 34.66%, respectively, at December 31, 2010. Of the overall $3.3 million increase in the allowance for loan losses during the year ended December 31, 2011, $1.3 million related to the one- to four-family category and an additional $1.4 million related to the over four-family category. Weakness in the residential real estate market has continued for the past four years and the risk of loss on loans secured by residential real estate remains at an elevated level. That portion of the allowance for loan losses attributable to mortgage loans secured by residential real estate has increased slightly to 85.5% of the total allowance for loan losses at December 31, 2011 compared to 83.6% at December 31, 2010.

Real Estate Owned. Total real estate owned decreased $1.1 million, or 1.9%, to $56.7 million at December 31, 2011 from $57.8 million at December 31, 2010. During the year ended December 31, 2011, $28.3 million was transferred from loans to real estate owned upon completion of foreclosure. Declines in property values evidenced by updated appraisals, responses to list prices on properties held for sale and/or deterioration in the condition of properties resulted in write downs totaling $6.8 million during the year ended December 31, 2011. During the same period, sales of real estate owned totaled $22.4 million.

Prepaid Expenses and Other Assets. Prepaid expenses and other assets declined by $3.1 million or 26.9%, to $8.4 million at December 31, 2011 from $11.4 million at December 31, 2010. The decline is primarily due to a decrease in receivables due from third parties related to the origination of loans held for sale.

Deposits. Total deposits decreased $94.2 million, or 8.2%, to $1.05 billion at December 31, 2011 from $1.15 billion at December 31, 2010. The overall reduction in deposits primarily reflects a decrease in time deposits. During calendar 2010, proceeds received from the loan principal pay downs were primarily utilized to maintain a higher than normal level of liquidity. As an adequate level of liquidity has been achieved, the Company has responded to additional reductions in the loan portfolio by allowing for strategic runoff of time deposits. Total time deposits decreased $95.7 million, or 9.8%, to $878.7 million at December 31, 2011 from $974.4 million at December 31, 2010. Time deposits originated through local retail outlets decreased $81.6 million, or 8.5%, to $878.3 million at December 31, 2011 from $960.0 million at December 31, 2010. Time deposits originated through the wholesale market decreased $14.0 million, or 97.2%, to $399,000 at December 31, 2011 from $14.4 million at December 31, 2010. Due to the consent order issued by state and federal regulators effective December 18, 2009, the Bank is prohibited from accepting or renewing brokered deposits and all other deposit interest rates are capped by the FDIC. Total money market and savings deposits increased $699,000, or 0.7%, to $104.1 million at December 31, 2011 from $103.4 million at December 31, 2010. Total demand deposits increased $722,000, or 1.1%, to $68.5 million at December 31, 2011 from $67.7 million at December 31, 2010.

Borrowings. Total borrowings increased $4.2 million, or 0.9%, to $461.1 million at December 31, 2011 from $457.0 million at December 31, 2010. The increase in borrowings relates entirely to an increase in the use of bank lines of credit to finance loans held for sale. The balance of these lines of credit increased by $4.2 million, to $27.1 million at December 31, 2011, from $23.0 million at December 31, 2010.

Shareholders' Equity.Shareholders' equity decreased by $5.8 million, or 3.4%, to $166.4 million at December 31, 2011 from $172.2 million at December 31, 2010. The decrease in stockholders' equity was primarily due to a $7.5 million decrease in retained earnings reflecting the net loss for the year ended December 31, 2011. The decrease in retained earnings was partially offset by a $940,000 increase in additional paid in capital related to stock compensation benefits and an $854,000 decrease in unearned ESOP shares and a $170,000 decrease in accumulated other comprehensive income.

## Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, average yields and costs, and certain other information for the periods indicated. No tax-equivalent yield adjustments were made, as the effect thereof was not material. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense.

| | Years Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | | 2009 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| | (Dollars in Thousands) | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans receivable and held for sale | $ 1,314,068 | $ 72,269[1] | 5.50% | $ 1,440,417 | $ 81,161[1] | 5.63% | $ 1,519,348 | $ 87,847[1] | 5.78% |
| Mortgage related securities[5] | 94,099 | 3,822 | 4.06 | 107,406 | 5,360 | 4.99 | 126,616 | 7,105 | 5.61 |
| Debt securities, federal funds sold and short-term investmetns[5] [6] | 239,400 | 3,261 | 1.36 | 206,066 | 3,412 | 1.66 | 174,593 | 3,540 | 2.03 |
| Total interest-earning assets | 1,647,567 | 79,352 | 4.82 | 1,753,889 | 89,933 | 5.13 | 1,820,557 | 98,488 | 5.41 |
| Noninterest-earning assets | 101,671 | | | 97,215 | | | 90,653 | | |
| Total assets | $ 1,749,238 | | | $ 1,851,104 | | | $ 1,911,210 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Demand accounts | 38,328 | 30 | 0.08 | 37,852 | 37 | 0.10 | 34,025 | 35 | 0.10 |
| Money market and savings accounts | 120,231 | 369 | 0.31 | 110,479 | 495 | 0.45 | 111,212 | 591 | 0.53 |
| Certificates of deposit | 925,209 | 14,890 | 1.61 | 1,007,304 | 20,457 | 2.03 | 1,047,692 | 33,858 | 3.23 |
| Total interest-bearing deposits | 1,083,768 | 15,289 | 1.41 | 1,155,635 | 20,989 | 1.82 | 1,192,929 | 34,484 | [illegible] |
| Borrowings | 446,401 | 17,547 | 3.93 | 481,808 | 19,280 | 4.00 | 513,638 | 20,093 | 3.91 |
| Total interest-bearing liabilities | 1,530,169 | 32,836 | 2.15 | 1,637,443 | 40,269 | 2.46 | 1,706,567 | 54,577 | 3.20 |
| Noninterest-bearing liabilities | | | | | | | | | |
| Non-interest bearing deposits | 23,099 | | | 26,940 | | | 22,697 | | |
| Other non-interest bearing liabilities | 28,917 | | | 16,789 | | | 16,332 | | |
| Total non-interest bearing liabilities | 52,016 | | | 43,729 | | | 39,029 | | |
| Total liabilites | 1,582,185 | | | 1,681,172 | | | 1,745,596 | | |
| Equity | 167,053 | | | 169,932 | | | 165,614 | | |
| Total liabilities and equity | $ 1,749,238 | | | $ 1,851,104 | | | $ 1,911,210 | | |
| Net interest income | | 46,516 | | | 49,664 | | | 43,911 | |
| Net interest rate spread[2] | | | 2.67% | | | 2.67% | | | 2.21% |
| Net interest-earning assets[3] | $ 117,398 | | | $ 116,440 | | | $ 113,990 | | |
| Net interest margin[4] | | | 2.82% | | | 2.83% | | | 2.41% |
| Average interest-earning assets to average interest-bearing liabilities | | | 107.67% | | | 107.11% | | | 106.68% |

(1) Includes net deferred loan fee amortization income of $636,000, $739,000 and $887,000 for the years ended December 31, 2011, 2010 and 2009, respectively.
(2) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
(3) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
(4) Net interest margin represents net interest income divided by average total interest-earning assets.
(5) Average balance of available for sale securities is based on amortized historical cost.
(6) Interest income from tax exempt securities is not significant to total interest income, therefore, interest and yield on interest earnings assets are not stated on a tax equivalent basis.

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

| | Years Ended December 31, 2011 vs. 2010 Increase (Decrease) due to | | | Years Ended December 31, 2010 vs. 2009 Increase (Decrease) due to | | |
|---|---|---|---|---|---|---|
| | Volume | Rate | Net | Volume | Rate | Net |
| | (In Thousands) | | | | | |
| Interest and dividend income: | | | | | | |
| Loans receivable and held for sale[(1)(2)] | $ (6,985) | (1,907) | (8,892) | $ (4,486) | (2,200) | (6,686) |
| Mortgage related securites | (615) | (923) | (1,538) | (1,008) | (733) | (1,741) |
| Other interest-earning assets | 505 | (656) | (151) | 580 | (708) | (128) |
| Total interest-earning assets | (7,095) | (3,486) | (10,581) | (4,914) | (3,641) | (8,555) |
| Interest expense: | | | | | | |
| Demand accounts | - | (7) | (7) | 4 | (2) | 2 |
| Money market and savings accounts | 41 | (167) | (126) | (4) | (92) | (96) |
| Certificates of deposit | (1,570) | (3,997) | (5,567) | (1,260) | (12,141) | (13,401) |
| Total interest-bearing deposits | (1,529) | (4,171) | (5,700) | (1,260) | (12,235) | (13,495) |
| Borrowings | (1,384) | (349) | (1,733) | (1,267) | 454 | (813) |
| Total interest-bearing liabilities | (2,913) | (4,520) | (7,433) | (2,527) | (11,781) | (14,308) |
| Net change in net interest inco | $ (4,182) | 1,034 | (3,148) | $ (2,387) | 8,140 | 5,753 |

(1) Includes net deferred loan fee amortization income of $636,000, $739,000 and $887,000 for the years ended December 31, 2011, 2010 and 2009, respectively.
(2) Non-accrual loans have been included in average loans receivable balance.

Comparison of Operating Results for the Years Ended December 31, 2011 and 2010

General Net loss for the year ended December 31, 2011 totaled $7.5 million, or $0.24 for both basic and diluted loss per share, compared to a net loss of $1.9 million, or $0.06 for both basic and diluted loss per share, for the year ended December 31, 2010. The year ended December 31, 2011 generated an annualized loss on average assets of 0.43% and an annualized loss on average equity of 4.47%, compared to an annualized loss on average assets of 0.10% and an annualized loss on average equity of 1.09% for the comparable period in 2010. The results of operations for the year ended December 31, 2011 as compared to the year ended December 2010 reflect a $5.5 million increase in REO expense, a $3.1 million decrease in net interest income and a $1.1 million decrease in pre-tax results of operations from our mortgage banking subsidiary partially offset by a $3.8 million reduction in the provision for loan losses.

Segment Review. As described in Note 18, “Segment Reporting,” of the notes to consolidated financial statements, the Company’s primary reportable segment is community banking. Community banking consists of lending and deposit gathering (as well as other banking-related products and services) to consumers and businesses and the support to deliver, fund, and manage such banking services. The Company’s mortgage banking segment provides residential mortgage products for the purpose of sale on the secondary market.

The Company’s results of operations are dominated by net interest income, the level of the provision for loan losses and noninterest expense of its community banking segment. The consolidated discussion, therefore, predominantly describes the community banking segment results.

Mortgage banking segment assets (which consist predominantly of loans held for sale) decreased $8.8 million, or 8.0%, to $100.2 million as of December 31, 2011 compared to $108.9 million as of December 31, 2010. Additional details are provided in the “Loans Held for Sale” section. The $4.4 million increase in mortgage banking revenues from the year ended December 31, 2010 to the year ended December 31, 2011 was attributable to increased margins on the sale of loans held for sale. The major components of mortgage banking revenues include fees and premiums associated with the sale of residential loans held for sale, which are discussed in section “Mortgage Banking Income.” The major expenses for the mortgage banking segment are compensation, payroll taxes and other employee benefits, as well as occupancy, office furniture and equipment and other expenses, which are covered generally in the consolidated discussion in section “Noninterest Expense.”

Total Interest Income. Total interest income decreased $10.6 million, or 11.8%, to $79.4 million during the year ended December 31, 2011 from $89.9 million during the year ended December 31, 2010.

Interest income on loans decreased $8.9 million, or 11.0%, to $72.3 million during the year ended December 31, 2011 from $81.2 million during the year ended December 31, 2010. The decrease in interest income was primarily due to a $126.3 million, or 8.8%, decrease in the average balance of loans outstanding to $1.31 billion during the year ended December 31, 2011 from $1.44 billion during the year ended December 31, 2010. The decrease in interest income on loans also reflects a 13 basis point decrease in the average yield on loans to 5.50% for the year ended December 31, 2011 from 5.63% for the year ended December 31, 2010.

Interest income from mortgage-related securities decreased $1.5 million, or 28.7%, to $3.8 million during the year ended December 31, 2011 from $5.4 million during the year ended December 31, 2010. The decrease in interest income was primarily due to a 93 basis point decrease in the average yield on mortgage-related securities to 4.06% for the year ended December 31, 2011 from 4.99% during the year ended December 31, 2010. The decrease in interest income from mortgage-related securities also reflects a $13.3 million, or 12.4%, decrease in the average balance of mortgage-related securities to $94.1 million for the year ended December 31, 2011 from $107.4 million during the year ended December 31, 2010. The decline in the average balance of mortgage-related securities during the year ended December 31, 2011 reflects management's decision to deemphasize investments in mortgage-related securities and emphasize more liquid, less volatile, government agency and municipal securities.

Finally, interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) decreased to $3.3 million for the year ended December 31, 2011 compared to $3.4 million for the year ended December 31, 2010. Interest income decreased due to a 30 basis point decline in the average yield on other earning assets to 1.36% for the year ended December 31, 2011 from 1.66% for the comparable period in 2010. The decline in average yield provided by these assets reflects the lower overall interest rate environment as opposed to a shift in investment strategy and product mix. The decrease in interest income due to a decline in average yield was partially offset by an increase of $33.3 million, or 16.2%, in the average balance of other earning assets to $239.4 million during the year ended December 31, 2011 from $206.1 million during the year ended December 31, 2010. The increase in average balance reflects a strategic shift towards investments which provide higher levels of liquidity. The Company intends to maintain higher than usual liquidity given the current economic environment and relatively low rates of return available on loans and mortgage related securities.

Total Interest Expense. - Total interest expense decreased by $7.4 million, or 18.5%, to $32.8 million during the year ended December 31, 2011 from $40.3 million during the year ended December 31, 2010. This decrease was the result of a decrease of 31 basis points in the average cost of funds to 2.15% for the year ended December 31, 2011 from 2.46% for the year ended December 31, 2010. The decrease in interest expense resulted from a decrease in the average cost of funds as well as a decrease of $107.3 million, or 6.6%, in average interest bearing deposits and borrowings outstanding to $1.53 billion for the year ended December 31, 2011 compared to an average balance of $1.64 billion for the year ended December 31, 2010.

Interest expense on deposits decreased $5.7 million, or 27.2%, to $15.3 million during the year ended December 31, 2011 from $21.0 million during the year ended December 31, 2010. This was due to a decrease in the cost of average deposits of 41 basis points to 1.41% for the year ended December 31, 2011 compared to 1.82% for the year ended December 31, 2010. The decrease in the cost of deposits reflects the low interest rate environment due to the Federal Reserve's low short term interest rate policy. These rates are typically used by financial institutions in pricing deposit products. The decrease in interest expense attributable to the decrease in the cost of deposits was compounded by a decrease of $71.9 million, or 6.2%, in the average balance of interest bearing deposits to $1.08 billion during the year ended December 31, 2011 from $1.16 billion during the year ended December 31, 2010. During the year ended December 31, 2011, proceeds received from the loan principal pay downs were primarily utilized to maintain a higher than normal level of liquidity. Consistent with the Bank's liquidity needs and funding obligations the Bank has reduced its level of higher cost time deposits during the year ended December 31, 2011.

Interest expense on borrowings decreased $1.7 million, or 9.0%, to $17.5 million during the year ended December 31, 2011 from $19.3 million during the comparable period in 2010. The decrease resulted from a $35.4 million, or 7.3%, decrease in average borrowings outstanding to

$446.4 million during the year ended December 31, 2011 from $481.8 million during the year ended December 31, 2010. The decrease in interest expense resulted from a decrease in the average balance as well as a decrease in the cost of borrowings of 7 basis points to 3.93% for the year ended December 31, 2011 compared to 4.00% for the year ended December 31, 2010. The decreased use of borrowings as a source of funding during the year ended December 31, 2011 reflects our decision to utilize core deposits as our primary funding source.

Net Interest Income. - Net interest income decreased by $3.1 million, or 6.3%, to $46.5 million during the year ended December 31, 2011 as compared to $49.7 million during the year ended December 31, 2010. The decrease in net interest income resulted primarily from a reduction in the loan portfolio during the year and a change in the composition of interest earning assets that became more weighted towards lower yielding other earning assets during the year ended December 31, 2011 as compared to the year ended December 31, 2010, partially offset by a decrease in time deposits and borrowings during the year ended December 31, 2011.

Provision for Loan Losses.– Our provision for loan losses decreased $3.8 million, or 14.5%, to $22.1 million during the year ended December 31, 2011, from $25.8 million during the year ended December 31, 2010. While the provision for loan losses has decreased from the prior year, it remains at high levels. These levels remain high due to continued general economic stress resulting in reduced levels of income earned by many of our borrowers combined with loan collateral values, primarily real estate, that remain at levels below those estimated at the time the loans were originally made. These factors result in higher levels of actual loss experience which when applied to the portfolio in general require higher loan loss provisions. They also result in more loans exhibiting risk characteristics that require estimated loan loss provisions in excess of our historical average experience rates. These risk characteristics include reduced borrower cash flow, reduced borrower FICO scores and known declines in collateral value even though the loan may still be performing. The provision for the year ended December 31, 2011 reflects $18.8 million of net loan charge-offs combined with continued weakness in local real estate markets which required an overall increase to the allowance for loan losses. See the Asset Quality section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions.

Noninterest Income. - Total noninterest income increased $4.2 million, or 10.9%, to $43.2 million during the year ended December 31, 2011 from $39.0 million during 2010. The increase resulted primarily from an increase in mortgage banking income.

Mortgage banking income increased $4.4 million, or 12.4%, to $39.8 million for the year ended December 31, 2011, compared to $35.5 million during the comparable period in 2010. The $4.4 million increase in mortgage banking income was primarily the result of an increase in average sales margin which was driven by the following factors: an increase in pricing on all products in all geographic markets, a change in product mix towards real estate purchase loans which yield a higher margin than loans originated for the purpose of a refinancing and change in the geographic composition of origination activity towards higher yielding geographic markets.

Despite the increase in pricing, overall loan origination volumes remained relatively consistent which reflects the continued strong demand for fixed-rate loans due in large part to historically low interest rates on these products. While the loan origination volume remained relatively consistent during the years ended December 31, 2011 and 2010, there was a shift in the mix of loan purpose toward loans originated for the purpose of a residential property purchase, which yield a higher return, as opposed to a loan originated for the purpose of refinancing an existing mortgage loan. During the year ended December 31, 2011, approximately 64% of all loans were originated for purchase and 36% were originated to refinance an existing loan. During the year ended December 31, 2010, approximately 45% of all loans were originated for purchase and 55% were originated to refinance an existing loan. In addition to the shift in product mix during the year ended December 31, 2011, there was a shift in origination volume by geographic market. Loan origination volumes increased by a combined $164.1 million during the year ended December 31, 2011 as compared to the year ended December 31, 2010 with respect to three of our higher yielding geographic markets. In addition, during the same time frame, loan origination volumes decreased by approximately $165.5 million in one of our lower yielding geographic markets. While margins increased in all markets, this shift in origination volumes by market, resulted in higher average margins during the year ended December 31, 2011.

Noninterest Expense. - Total noninterest expense increased $10. million, or 14.4%, to $74.6 million during the year ended December 31, 2011 from $64.6 million during the year ended December 31, 2010. The increase was primarily attributable to increased compensation, real estate owned expense and other noninterest expense.

Compensation, payroll taxes and other employee benefit expense increased $2.8 million, or 7.8%, to $39.2 million during the year ended December 31, 2011 compared to $36.3 million during the year ended December 31, 2010. The increase in compensation is primarily the result of an increase in commissions paid to loan originators by our mortgage banking subsidiary and correlates to the increase in mortgage banking income. Loan commissions increased by $2.9 million, or 40.0% to $10.0 million for the year ended December 31, 2011 from $7.2 million during the year ended December 31, 2010.

Real estate owned expense increased $5.6 million, or 84.4%, to $12.1 million during the year ended December 31, 2011 from $6.6 million during the comparable period in 2010. Real estate owned expense includes the net operating and carrying costs related to the properties. In addition, it includes net gain or loss recognized upon the sale of a foreclosed property, as well as write-downs recognized to maintain the properties at their estimated fair value. The increase in real estate owned expense results from an increase in properties under management and an increase in write downs of asset values, which is reflective of a strategy to become more aggressive in pricing specific properties to expedite the sale process. During the year ended December 31, 2011, net operating expense, which includes but is not limited to property taxes, maintenance and management fees, net of rental income increased $180,000, or 3.0%, to $6.1 million from $5.9 million during the year ended December 31, 2010. The increase in net operating expense compared to the prior period resulted from an increase in the number of properties owned. The average balance of real estate owned totaled $60.3 million for the year ended December 31, 2011 compared to $53.7 million for the year ended December 31, 2010. Net losses recognized on write-down of real estate owned net of net gains on sales totaled $6.1 million during the year ended December 31, 2011, compared to $675,000 during the year ended December 31, 2010.

Other noninterest expense increased $1.0 or 15.8%, to $7.4 million during the year ended

December 31, 2011 from $6.4 million during the comparable period in 2010. The increase resulted from an increase in operational costs related to the expansion of our mortgage banking operations to $5.9 million for the year ended December 31, 2011from $4.6 million during 2010.

Income Taxes. - Despite a pre-tax loss, we recorded income tax expense of $562,000 for the year ended December 31, 2011. Tax expense is comprised of current estimated expense of $1.2 million resulting from an IRS audit of tax years 2005 through 2009 which is still in progress, plus current estimated state income tax expense of $74,000 related to mortgage banking operations apportioned to states in which taxes are based on separate company operations partially offset by current income tax benefit of $736,000 for an intra-period tax allocation between other comprehensive income and loss from continuing operations, and represents an out-of-period adjustment for an error that originated beginning in 2008 that was corrected during the quarter ended June 30, 2011. The correction of the error was not material to the years ended December 31, 2011 or 2010.

Despite a pre-tax loss, we recorded income tax expense of $52,000 for the year ended December 31, 2010 primarily due to differences between prior year estimates and actual tax returns filed plus state income tax due to taxable income generated by the mortgage banking subsidiary. Due to the valuation allowance on our deferred tax assets, we were not able to record an income tax benefit related to the pre-tax loss incurred. A current income tax benefit that would normally result from a pre-tax loss was offset by additional deferred tax expense due to an increase in the required valuation allowance.

Comparison of Operating Results for the Years Ended December 31, 2010 and 2009

General. Net loss for the year ended December 31, 2010 totaled $1.9 million, or $0.06 for both basic and diluted loss per share, compared to net loss of $10.1 million, or $0.33 for both basic and diluted loss per share, for the year ended December 31, 2009. The year ended December 31, 2010 generated a loss on average assets of 0.10% and a loss on average equity of 1.09%, compared to a loss on average assets of 0.53% and a loss on average equity of 6.12% for the year ended December 31, 2009. The net loss for the year ended December 31, 2010 reflected continuing deterioration in asset quality in a weak economic environment which resulted in a $25.8 million provision for loan losses in 2010. The decrease in the net loss for the year ended December 31, 2010 reflected a $5.8 million increase in net interest income, a $2.0 million increase in pre-tax income from our mortgage banking operations, a $1.1 million decrease in other-than-temporary impairment investment loss, and $855,000 reduction in provisions for loan losses, partially offset by a $1.4 million reduction in income tax benefit. Loan charge-off activity and specific loan reserves are discussed in additional detail in the Asset Quality section. The net interest margin for the year ended December 31, 2010 was 2.83% compared to 2.41% for the year ended December 31, 2009.

Total Interest Income Total interest income decreased $8.6 million, or 8.7%, to $89.9 million during the year ended December 31, 2010 from $98.5 million during the year ended December 31, 2009.

Interest income on loans decreased $6.7 million, or 7.6%, to $81.2 million during the year ended December 31, 2010 from $87.8 million during the year ended December 31, 2009. The decrease in interest income was primarily due to a $78.9 million, or 5.2%, decrease in the average balance of loans outstanding to $1.44 billion during the year ended December 31, 2010 from $1.52 billion during the year ended December 31, 2009. The decrease in the average balance of loans reflect an overall decrease in demand due to current economic conditions combined with the Company's more stringent loan underwriting requirements. The decrease in interest income attributable to the decrease in average balance was compounded by a 15 basis point decrease in the average yield on loans to 5.63% for the year ended December 31, 2010 from 5.78% for the year ended December 31, 2009.

Interest income from mortgage-related securities decreased $1.7 million, or 24.5%, to $5.4 million during the year ended December 31, 2010 from $7.1 million during the year ended December 31, 2009. The decrease in interest income was primarily due to a $19.2 million, or 15.2%, decrease in the average balance of mortgage-related securities to $107.4 million for the year ended December 31, 2010 from $126.6 million during the year ended December 31, 2009. The decrease in interest income attributable to the decrease in average balance was compounded by a decrease in average yield. The average yield on mortgage-related securities decreased 62 basis points to 4.99% for the year ended December 31, 2010 from 5.61% for the year ended December 31, 2009. The decline in the average balance of mortgage-related securities during the year ended December 31, 2010 reflects management's decision to deemphasize investments in mortgage-related securities and emphasize more liquid, less volatile, government agency securities.

Finally, interest income from debt securities, federal funds sold and short-term investments decreased $128,000, or 3.6%, to $3.4 million during the year ended December 31, 2010 from $3.5 million during the year ended December 31, 2009. Interest income decreased due to a 37 basis point decline in the average yield on other earning assets to 1.66% for the year ended December 31, 2010 from 2.03% for the year ended December 31, 2009. The decline in average yield provided by these assets reflects the lower overall interest rate environment as opposed to a shift in investment strategy and product mix. The decrease in average rate was partially offset by an increase of $31.5 million, or 18.0%, in the average balance of other earning assets to $206.1 million during the year ended December 31, 2010 from $174.6 million during the year ended December 31, 2009. The increase in average balance reflects a strategic shift towards higher levels of liquidity. The Company intends to maintain higher than usual liquidity given the current economic environment and relatively low rates of return available on loans and mortgage related securities. The average balance of debt securities, federal funds sold and short-term investments includes FHLBC stock of $21.7 million for each of the years ended December 31, 2010 and 2009. On October 10, 2007, the FHLBC entered into a consensual cease and desist order with its regulator, the Federal Housing Finance Board. Under the terms of the order, dividend declarations are subject to the prior written approval of the Federal Housing Finance Board. On February 4, 2011, the FHLBC declared its first dividend since it entered into the cease and desist order.

Total Interest Expense. Total interest expense decreased by $14.2 million, or 26.1%, to $40.3 million during the year ended December 31, 2010 from $54.6 million during the year ended December 31, 2009. This decrease was primarily the result of a decrease of 74 basis points in the average cost of funds to 2.46% for the year ended December 31, 2010 from 3.20% for the year ended December 31, 2009. The decrease in interest expense resulted from a decrease in the average cost of funds as well as a decrease of $69.1 million, or 4.1%, in average interest bearing deposits and borrowings outstanding to $1.64 billion for the year ended December 31, 2010 compared to an average balance of $1.71 billion for the year ended December 31, 2009.

Interest expense on deposits decreased $13.5 million, or 39.1%, to $21.0 million during the year ended December 31, 2010 from $34.5 million during the year ended December 31, 2009. This was primarily due to a decrease in the average cost of deposits of 107 basis points to 1.82% for the year ended December 31, 2010 compared to 2.89% for the year ended December 31, 2009. The decrease in interest expense attributable to the decrease in the cost of deposits was compounded by a decrease of $37.3 million, or 3.1%, in the average balance of interest bearing deposits to $1.16 billion during the year ended December 31, 2010 from $1.19 billion during the year ended December 31, 2009. The decrease in the cost of deposits reflects the Federal Reserve's historically low short-term interest rate policy. These rates are typically used by financial institutions in pricing deposit products. The decrease in the average balance of interest bearing deposits was primarily due to a $45.9 million decline in average non-local or brokered deposits. The average balance of brokered deposits totaled $32.4 million for the year ended December 31, 2010 compared to $78.3 million for the year ended December 31, 2009.

Interest expense on borrowings decreased $813,000, or 4.0%, to $19.3 million during the year ended December 31, 2010 from $20.1 million during the year ended December 31, 2009. The decrease resulted from a $31.8 million, or 6.2%, decrease in average borrowings outstanding to $481.8 million during the year ended December 31, 2010 from $513.6 million during the comparable period in 2009. The decrease due to average balance was partially offset by a 9 basis point increase in the average cost of borrowings to 4.00% during the year ended December 31, 2010 from 3.91% during the comparable period in 2009. The decreased use of borrowings as a source of funding during the year ended December 31, 2010 reflects our decision to utilize core deposits as our primary funding source.

Net Interest Income. Net interest income increased by $5.8 million or 13.1%, to $49.7 million during the year ended December 31, 2010 as compared to $43.9 million during the year ended December 31, 2009. Net interest income continues to be positively affected by lower short and medium term interest rates in 2010, as compared to 2009. The increase in net interest income resulted primarily from a 46 basis point increase in our interest rate spread to 2.67% for the year ended December 31, 2010 from 2.21% for the year ended December 31, 2009. The 46 basis point increase in the interest rate spread resulted from a 74 basis point decrease in the average cost of interest bearing liabilities, which was partially offset by a 28 basis point decrease in the average yield on interest earning assets. The increase in net interest income resulting from an increase in our net interest rate spread was partially offset by a decrease in net interest income resulting from a change in the composition of interest earning assets. While net interest earning assets increased $2.5 million, or 2.2%, to $116.4 million for the year ended December 31, 2010 from $114.0 million from the year ended December 31, 2009, the composition of interest earning assets shifted from loans to debt securities and short term investments, which yield a lower return. The shift from loans towards debt securities and short term investments reflects an overall decrease in demand for loan products due to current economic conditions combined with the Company's more stringent loan underwriting requirements. The change in composition also reflects a strategic shift towards higher levels of liquidity.

Provision for Loan Losses. Our provision for loan losses decreased $855,000, or 3.2%, to $25.8 million during the year ended December 31, 2010, from $26.7 million during the year ended December 31, 2009. While the provision for loan losses has decreased from the prior year, it remained at historically high levels. These levels remain high due to continued general economic stress resulting in reduced levels of income earned by many of our borrowers combined with loan collateral values, primarily real estate, that remain at levels below those estimated at the time the loans were originally made. These factors result in higher levels of actual loss experience which when applied to the portfolio in general require higher loan loss provisions. They also result in more loans exhibiting risk characteristics that require estimated loan loss provisions in excess of our historical average experience rates. These risk characteristics include reduced borrower global cash flow, reduced borrower FICO scores and known declines in collateral value even though the loan may still be performing. The provision for the year ended December 31, 2010 was the result of $25.2 million of net loan charge-offs combined with continued weakness in local real estate markets which required an overall increase to the allowance for loan losses. See the Asset Quality section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions.

Noninterest Income. Total noninterest income increased $26.8 million to $39.0 million during the year ended December 31, 2010 from $12.2 million during the year ended December 31, 2009. The increase primarily resulted from an increase in mortgage banking income. Mortgage banking income increased $25.5 million to $35.5 million for the year ended December 31, 2010, compared to $10.0 million during the comparable period in 2009. In addition to the increase in mortgage banking activity, the increase in noninterest income compared to the prior period resulted from an $1.1 million decrease in impairment charge on securities considered to be other than temporarily impaired.

Mortgage Banking Income. Mortgage banking income increased $25.5 million to $35.5 million during the year ended December 31, 2010 from $10.0 million during the year ended December 31, 2009. The increase was the combined result of increased volume, increased sales margins, expansion of the branch network and the addition of mandatory loan delivery terms. During the year ended December 31, 2010, mortgage banking expanded from 21 to 30 branch locations outside of the Bank branch network. New branches were added in Illinois, Maryland, North Carolina, Colorado, Florida and Minnesota.

Volume and margin changes account for $16.7 million, or 65.0%, of the $25.5 million increase in mortgage banking income year over year. The volume of loans sold during 2010 increased by $352.2 million, or 49.1%, to $1.07 billion in 2010 from $716.6 million in 2009. In addition, the average sales margin increased by 81 basis points to 2.62% in 2010 from 1.82% in 2009. This combination accounted for $14.5 million, or 86.8%, of the total volume and margin change in mortgage banking income. The remaining $2.2 million increase in mortgage banking income due to volume and margin changes relates directly to the increase in processing income. The branch expansion noted above was the primary driver in the 2010 volume increase over the prior year. Volume at the new branches added during the year ended December 31, 2010 totaled $268.5 million, which represented 77.3% of the total increase in volume for the year.

Improvement in sales margins were attributable to an increase in higher margin government guaranteed loans, an increase in loans for the purchase of residential real estate and an increase in volume in higher margin markets around the country. In 2010, government guaranteed loans accounted for 36% of total mortgage banking volume, up from 34% in 2009. The average 2010 sales margin on government guaranteed loans was 158 basis points higher than that on conventional mortgage loans. Also in 2010, loans for the purchase of residential real estate accounted for 45% of total mortgage banking volume, up from 32% in 2009. The average sales margin on loans for the purchase of real estate was 113 basis points higher than that on loan refinances.

Sales margins vary from market to market around the country. There was a 206 basis point spread between the Company's highest margin branch and its lowest margin branch during the year ended December 31, 2010. During 2010 sales volumes increased at high margin branches in Minnesota, Arizona and Maryland. Branches in these three states produced 82.3% of the $352.2 million increase in volume for 2010 as compared to 2009. The Minnesota branches accounted for $198.9 million in increased volume during 2010 with a sales margin that was 22 basis points higher the Company's 2010 weighted average sales margin. The Arizona branch accounted for $54.9 million in increased volume during 2010 with a sales margin that was 109 basis points higher than the Company's 2010 weighted average sales margin. The Maryland branch accounted for $35.9 million in increased volume during 2010 with a sales margin that was 93 basis points higher than the Company's 2010 weighted average sales margin.

Branches are operated on a net branch basis whereby predetermined margins and direct expenses are paid by the branch office to the corporate office and remaining net income accrues to the branch manager. Successful branches generate higher levels of revenue and expense with an eye toward increasing branch manager net income. Branch income accounts for $6.2 million, or 24.5%, of the increase in mortgage banking income for 2010 over the prior year. This increase in mortgage banking income is offset by increases in mortgage banking expenses distributed among the noninterest expense categories of the income statement. A full 80% of this increase, or $5.0 million, is offset by branch manager payroll which increased to $6.7 million in 2010 from $1.7 million in 2009 and is included in compensation, payroll taxes, and other employee benefits expense on the consolidated statements of operations.

Prior to 2010, the Company originated loans held for sale on a “best efforts” delivery basis. Under the “best efforts” delivery method, the buyer of the loan, or investor, assumed all interest rate risk. Just prior to the end of 2009, the Company began to originate loans for sale on a “mandatory” delivery basis. Under the “mandatory” delivery method, the investor committed to buy only those loans that were originated within a specified yield to the buyer. Higher fees are paid by the investor to the originator for “mandatory” delivery as compared to “best efforts” delivery in exchange for the assumption of interest rate risk. Mortgage banking income increased by $2.7 million in 2010 over 2009 as a result of loans sold on a “mandatory” delivery method net of hedging gains and losses.

Noninterest ExpenseTotal noninterest expense increased $23.8 million, or 58.1%, to $64.6 million during the year ended December 31, 2010 from $40.9 million during the year December 31, 2009. The increase was primarily attributable to increased compensation and other operating expenses.

Compensation, payroll taxes and other employee benefit expense increased $19.0 million, or 109.5%, to $36.3 million during the year ended December 31, 2010 compared to $17.3 million during the year ended December 31, 2009. Total full-time equivalent employees increased by 77, or 14.9%, to 595 at December 31, 2010 from 518 at December 31, 2009 due to an expansion of our mortgage banking operations. Total compensation, payroll taxes and other benefits at our mortgage banking subsidiary increased $18.8 million to $23.5 million for the year ended December 31, 2010 compared to $4.6 million during the year ended December 31, 2009. This increase in expense is directly related to the 355% increase in mortgage banking income for year ended December 31, 2010 compared to December 31, 2009. The $18.8 million increase in mortgage banking compensation, payroll taxes and benefits was comprised of an $8.2 million increase in commissions paid to loan officers, a $5.0 million increase in branch manager compensation, a $4.1 million increase in administrative payroll and a $1.5 million increase in payroll taxes and benefits.

Other noninterest expense increased $3.1 million or 94.3%, to $6.4 million during the year ended December 31, 2010 from $3.3 million during the year ended December 31, 2009. The increase in other noninterest expense is a direct result of the increase in operational costs related to the expansion of our mortgage banking operations.

Income Taxes. Despite a pre-tax loss, we recorded income tax expense of $52,000 for the year ended December 31, 2010 primarily due to differences between prior year estimates and actual tax returns filed plus state income tax due to taxable income generated by the mortgage banking subsidiary. Due to the valuation allowance on our deferred tax assets, we were not able to record an income tax benefit related to the pre-tax loss incurred. A current income tax benefit that would normally result from a pre-tax loss was offset by additional deferred tax expense due to an increase in the required valuation allowance.

We recorded an income tax benefit of $1.3 million for the year ended December 31, 2009, primarily as a result of federal and Wisconsin tax law changes enacted during 2009. In the first quarter a Wisconsin state tax law change was enacted (with retroactive effect to January 1, 2009) requiring combined filing in Wisconsin. We recognized a state benefit in connection with the establishment of a Wisconsin deferred tax asset (which does not require a valuation allowance) related to the unrealized loss on securities available for sale owned by the Company's Nevada subsidiary. In addition, we recognized a federal tax benefit as a result of legislation passed in the fourth quarter of 2009 allowing for a one-time carry back of tax losses for up to five years. The effective tax rate for the year ended December, 31, 2009 was 11.4%.

Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet our liquidity needs. Our liquidity ratio averaged 6.2% and 4.8% for the years ended December 31, 2011 and 2010. The liquidity ratio is equal to average daily cash and cash equivalents for the period divided by average total assets. We adjust our liquidity levels to fund loan commitments, repay our borrowings, fund deposit outflows and pay real estate taxes on mortgage loans. We also adjust liquidity as appropriate to meet asset and liability management objectives. The operational adequacy of our liquidity position at any point in time is dependent upon the judgment of the Chief Financial Officer as supported by the full Asset/Liability Committee. Liquidity is monitored on a daily, weekly and monthly basis using a variety of measurement tools and indicators. Regulatory liquidity, as required by the Wisconsin Department of Financial Institutions, is based on current liquid assets as a percentage of the prior month's average deposits and short-term borrowings. Minimum primary liquidity is equal to 4.0% of deposits and short-term borrowings and minimum total regulatory liquidity is equal to 8.0% of deposits and short-term borrowings. The Bank's primary and total regulatory liquidity at December 31, 2011 were 16.47% and 16.93%, respectively.

Our primary sources of liquidity are deposits, repayment of loans, sales of loans held for sale, maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows, loan prepayments and the origination and sale of loans held for sale are greatly influenced by market interest rates, economic conditions, and rates offered by our competitors. However, effective March 1, 2010, our deposit rates were capped by the FDIC as a result of the consent order issued by federal and state regulators. We set the interest rates on our deposits to maintain a desired level of total deposits. In addition, we invest excess funds in short-term interest-earning assets, which provide liquidity to meet lending requirements. Additional sources of liquidity for the purpose of managing long- and short-term cash flows include advances from the FHLBC.

A portion of our liquidity consists of cash and cash equivalents, which are a product of our operating, investing and financing activities. At December 31, 2011 and 2010, $80.4 million and $75.3 million, respectively, of our assets were invested in cash and cash equivalents. Our primary sources of cash are principal repayments on loans, proceeds from the calls and maturities of debt and mortgage related securities, increases in deposit accounts, Federal funds purchased and advances from the FHLBC.

On October 10, 2007, the FHLBC entered into a consensual cease and desist order with its regulator, the Federal Housing Finance Board. Under the terms of the order, capital stock repurchases and redemptions, including redemptions upon membership withdrawal or other termination, are prohibited unless the FHLBC has received approval of the Director of the Office of Supervision of the Federal Housing Finance Board ("OS Director"). The order also provides that dividend declarations are subject to the prior written approval of the OS Director. We currently hold, at cost, $21.7 million of FHLBC stock, all of which we believe we will ultimately be able to recover. During 2011, the FHLBC received authorization to resume dividend payments to its members and received authorization to initiate an excess stock repurchase plan. Subject to a quarterly assessment of the FHLBC's capacity to repurchase, the stock repurchase plan will allow for the repurchase of member bank's excess stock that they no longer wish to hold.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our Consolidated Statements of Cash Flows included in our Consolidated Financial Statements.

During the years ended December 31, 2011, 2010 and 2009, loan repayments net of loan originations generated positive cash flows of $42.7 million, $46.6 million and $62.3 million, respectively. The decrease in loans receivable is reflective of the general decline in loan demand for variable-rate residential real estate mortgage loans combined with the Company's tightened underwriting standards given the current economic conditions. Cash received from the calls, maturities and principal repayments of debt and mortgage related securities totaled $93.5 million, $87.8 million and $58.9 million for the years ended December 31, 2011, 2010 and 2009, respectively. We purchased $100.0 million, $101.7 million and $72.4 million in debt and mortgage related securities classified as available for sale during the years ended December 31, 2011, 2010 and 2009, respectively. We sold $3.3 million, $20.7 million and $515,000 in available for sale debt and mortgage related securities during the years ended December 31, 2011, 2010 and 2009, respectively.

Deposit flows are generally affected by the level of interest rates, market conditions and products offered by local competitors and other factors. The net decrease in deposits was $94.2 million during the year ended December 31, 2011. This compares to a net decrease in deposits of $19.4 million for the year ended December 31, 2010 and $31.0 million for the year ended December 31, 2009. As a result of the consent order issued by state and federal regulators effective December 18, 2009, the Bank is prohibited from accepting or renewing brokered deposits and all other deposit rates are capped by the FDIC.

Liquidity management is both a daily and longer-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLBC, which provide an additional source of funds. At December 31, 2011, we had $350.0 million in fixed-rate advances from the FHLBC, of which none were due within 12 months, but all of which are putable at the option of the FHLBC. The weighted average rate on these advances was 3.88% as of December 31, 2011.

At December 31, 2011, we had outstanding commitments to originate loans of $14.3 million and unfunded commitments under construction loans, lines of credit and standby letters of credit of $38.4 million. At December 31, 2011, certificates of deposit scheduled to mature in less than one year totaled $787.9 million. Based on prior experience, management believes that a significant portion of such deposits will remain with us, although there can be no assurance that this will be the case. In the event a significant portion of our deposits are not retained by us, we will have to utilize other funding sources, such as FHLBC advances or the Federal Reserve Discount Window to maintain our level of assets. However, such borrowings may not be available on attractive terms, or at all, if and when needed. Alternatively, we would reduce our level of liquid assets, such as our cash and cash equivalents and securities available for sale in order to meet funding needs. In addition, the cost of such deposits may be significantly higher if market interest rates are higher or there is an increased amount of competition for deposits in our market area at the time of renewal.

Contractual Obligations, Commitments, Contingent Liabilities, and Off-balance Sheet Arrangements

WaterStone Bank has various financial obligations, including contractual obligations and commitments that may require future cash payments. The following tables present information indicating various non-deposit contractual obligations and commitments of WaterStone Bank as of December 31, 2011 and the respective maturity dates.

## Contractual Obligations

| | Total | One Year or Less | More Than One Year Through Three Years | More Than Three Years Through Five Years | Over Five Years |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| Deposits without a stated maturity (4) | $ 172,559 | $ 172,559 | $ - | $ $- | - |
| Certificates of deposit (4) | 878,733 | 787,854 | 75,272 | 15,592 | 15 |
| Bank lines of credit (4) | 27,138 | 27,138 | - | - | - |
| Federal Home Loan Bank advances (1) | 350,000 | - | - | 220,000 | 130,000 |
| Repurchase agreements (2) (4) | 84,000 | - | - | - | 84,00 |
| Operating leases (3) | 3,659 | 1,573 | 1,690 | 388 | |
| Salary continuation agreements | 935 | 170 | 340 | 340 | 8 |
| Total Contractual Obligations | $ 1,517,024 | $ 989,294 | $ 77,302 | $ 236,320 | 214,10 |

(1) Secured under a blanket security agreement on qualifying assets, principally, mortgage loans. Excludes interest that will accrue on the advances. All Federal Home Loan Bank advances with maturities exceeding five years are callable on a quarterly basis.
(2) The repurchase agreements are callable on a quarterly basis.
(3) Represents non-cancellable operating leases for offices and equipment.
(4) Excludes interest.

The following table details the amounts and expected maturities of significant off-balance sheet commitments as of December 31, 2011.

## Other Commitments

| | Total | One Year or Less | More than One Year through Three Years | More than Three Years Through Five Years | Over Five Years |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| Real estate loan commitments (1) | $ 14,259 | $ 14,259 | $ | - $ | $ |
| Unused portion of home equity lines of credit (2) | 21,403 | 21,403 | | - | - |
| Unused portion of construction loans (3) | 5,684 | 5,684 | | - | - |
| Unused portion of business lines of credit | 10,347 | 10,347 | | - | - |
| Standby letters of credit | 970 | 970 | | - | - |
| Total Other Commitmen | $ 52,66: | $ 52,66: | $ | $ | $ |

General: Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and generally have fixed expiration dates or other termination clauses.
(1) Commitments for loans are extended to customers for up to 180 days after which they expire.
(2) Unused portions of home equity loans are available to the borrower for up to 10 years.
(3) Unused portions of construction loans are available to the borrower for up to 1 year.

## Future Accounting Pronouncements

New accounting policies adopted by the Company during 2011 are discussed in Note 1, “Summary of Significant Accounting Policies,” of the notes to consolidated financial statements. The expected impact of accounting policies recently issued or proposed but not yet required to be adopted are discussed below. To the extent the adoption of new accounting standards materially affects the Company’s financial condition, results of operations, or liquidity, the impacts are discussed in the applicable sections of this financial review and the notes to consolidated financial statements.

In December 2011, the Financial Accounting Standards Board (FASB) issued amendments to require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This information will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements with certain financial instruments and derivative instruments. The amendments are effective for annual reporting periods beginning on or after January 1, 2013, with retrospective application to the disclosures of all comparative periods presented. The Company will adopt the accounting standard during 2013, as required, and is currently evaluating the impact on its results of operations, financial position, and liquidity.

In September 2011, the FASB issued amendments intended to simplify how entities test goodwill for impairment. The amendments permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. Under the guidance, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying value. The amendments are effective for interim and annual periods beginning after December 15, 2011, with early adoption permitted. The adoption of this accounting standard will not have an impact on the Company's results of operations, financial position, and liquidity.

In June 2011, the FASB issued guidance to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The amendments require that all nonowner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments are effective for interim and annual periods beginning after December 15, 2011 with retrospective application. The Company will adopt the accounting standard during 2012, as required, with no expected material impact on its results of operations, financial position, and liquidity. Subsequently, in December 2011, the FASB decided that the requirement to present items that are reclassified from other comprehensive income to net income alongside their respective components of net income and other comprehensive income will be deferred. Therefore, those requirements will not be effective for public entities for fiscal years and interim periods within those years beginning after December 15, 2011.

In May 2011, the FASB issued guidance on measuring fair value to create common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. The amendments change the wording used to describe many of the requirements for measuring fair value and for disclosing information about fair value measurements. The amendments also clarify the Board's intent about the application of existing fair value measurement and disclosure requirements. The amendments are effective for interim and annual periods beginning after December 15, 2011. The Company will adopt the accounting standard during 2012, as required, and is currently evaluating the impact on its results of operations, financial position, and liquidity.

Impact of Inflation and Changing Prices

The financial statements and accompanying notes of WaterStone Bank have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration for changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than do the effects of inflation.

Quarterly Financial Information

The following table sets forth certain unaudited quarterly data for the periods indicated:

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 3 | September 3 | December 3 |
| | (In thousands, except per share data) | | | |
| 2011 (unaudited | | | | |
| Interest income | $ 20,337 | $ 19,881 | $ 19,572 | $ 19,56 |
| Interest expense | 8,41 | 8,16 | 8,09 | 8,16 |
| Net interest income | 11,927 | 11,714 | 11,478 | 11,397 |
| Provision for loan loss | 4,87 | 5,28 | 6,00 | 5,91 |
| Net interest income after provision for loan losses | 7,052 | 6,433 | 5,472 | 5,48 |
| Total noninterest income | 6,797 | 10,177 | 13,602 | 12,653 |
| Total noninterest exper | 15,35 | 17,96 | 19,21 | 22,04 |
| Income (loss) before income taxes | (1,505) | (1,359) | (142) | (3,905) |
| Income taxes (benef | 3 | (77 | 6 | 1,23 |
| Net income (los | $ (1,544) | $ (584) | $ (206) | $ (5,139) |
| Income (loss) per share – ba | $ (0.05) | $ (0.02) | $ (0.01) | $ (0.16) |
| Income (loss) per share - dilu | $ (0.05) | $ (0.02) | $ (0.01) | $ (0.16) |
| | | | | |
| 2010 (unaudited) | | | | |
| Interest income | $ 23,049 | $ 22,026 | $ 22,465 | $ 22,39 |
| Interest expense | 10,616 | 10,051 | 9,935 | 9,667 |
| Net interest income | 12,433 | 11,975 | 12,530 | 12,726 |
| Provision for loan losses | 5,457 | 7,031 | 6,249 | 7,09 |
| loan losses | 6,976 | 4,944 | 6,281 | 5,63 |
| Total noninterest income | 4,301 | 5,830 | 11,479 | 17,383 |
| Total noninterest expense | 11,101 | 11,874 | 18,253 | 23,399 |
| Income (loss) before income taxes | 176 | (1,100) | (493) | (385) |
| Income taxes (benefit) | - | 22 | - | 3 |
| Net income (loss) | $ 176 | $ (1,122) | $ (493) | $ (415) |
| Income (loss) per share – basic | $ 0.01 | $ (0.04) | $ (0.02) | $ (0.01) |
| Income (loss) per share - diluted | $ 0.01 | $ (0.04) | $ (0.02) | $ (0.01) |

## Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Management of Market Risk

General The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, WaterStone Bank's board of directors has established an Asset/Liability Committee which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the Board of directors. Management monitors the level of interest rate risk on a regular basis and the Asset/Liability Committee meets at least weekly to review our asset/liability policies and interest rate risk position, which are evaluated quarterly.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. We have implemented the following strategies to manage our interest rate risk: (i) emphasizing variable rate loans including variable rate one- to four-family, and commercial real estate loans as well as three to five year commercial real estate balloon loans; (ii) reducing and shortening the expected average life of the investment portfolio; and (iii) whenever possible, lengthening the term structure of our deposit base and our borrowings from the FHLBC. These measures should reduce the volatility of our net interest income in different interest rate environments.

Income Simulation. Simulation analysis is an estimate of our interest rate risk exposure at a particular point in time. At least quarterly we review the potential effect changes in interest rates may have on the repayment or repricing of rate sensitive assets and funding requirements of rate sensitive liabilities. Our most recent simulation uses projected repricing of assets and liabilities at December 31, 2011 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rate assumptions may have a significant impact on interest income simulation results. Because of the large percentage of loans and mortgage-backed securities we hold, rising or falling interest rates may have a significant impact on the actual prepayment speeds of our mortgage related assets that may in turn affect our interest rate sensitivity position. When interest rates rise, prepayment speeds slow and the average expected lives of our assets would tend to lengthen more than the expected average lives of our liabilities and therefore would most likely have a negative impact on net interest income and earnings.

| | Percentage Increase (Decrease) in Estimated Net Annual Interest Income Over 12 Months |
|---|---|
| 300 basis point gradual rise in rates……………. | (0.70%) |
| 200 basis point gradual rise in rates……………. | (0.07%) |
| 100 basis point gradual rise in rates……………. | 0.64% |
| Unchanged rate scenario……………………….. | 1.49% |
| 100 basis point gradual decline in rates……….. | 2.01% |
| 200 basis point gradual decline in rates……….. | (0.32%) |
| 300 basis point gradual decline in rates……….. | (1.10%) |

WaterStone Bank's Asset/Liability policy limits projected changes in net average annual interest income to a maximum decline of 25% for various levels of interest rate changes measured over a 12-month period when compared to the flat rate scenario. In addition, projected changes in the economic value of equity are limited to a maximum decline of 35% for interest rate movements of up to 300 basis points when compared to the flat rate scenario. These limits are re-evaluated on a periodic basis and may be modified, as appropriate. At December 31, 2011, a 100 basis point gradual increase in interest rates had the effect of increasing forecast net interest income by 0.64% while a 100 basis point decrease in rates had the effect of increasing net interest income by 2.01%. At December 31, 2011, a 100 basis point gradual increase in interest rates had the effect of decreasing the economic value of equity by 0.86% while a 100 basis point decrease in rates had the effect of increasing the economic value of equity by 3.45%. While we believe the assumptions used are reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

## Item 8. Financial Statements and Supplementary Data

### Report of Independent Registered Public Accounting Firm

Board of Directors
Waterstone Financial, Inc.:

We have audited the accompanying consolidated statements of financial condition of Waterstone Financial, Inc. and subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011 in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 9, 2012 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Milwaukee, Wisconsin
March 9, 2012

# Waterstone Financial, Inc. and Subsidiaries
## Consolidated Statements of Financial Condition
## December 31, 2011 and 2010

| | | December 31 | |
|---|---|---|---|
| | | 2011 | 2010 |
| Assets | | (In Thousands, except share d | |
| Cash | $ | 72,336 | 65,900 |
| Federal funds so | | 8,044 | 9,426 |
| Interest-earning deposits in other financial instituti and other short term investme | | - | 5 |
| Cash and cash equivalents | | 80,380 | 75,331 |
| Securities available for sale (at fair val | | 206,519 | 203,166 |
| Securities held to maturity (at amortized c fair value of $2,542 in 2011 and $2,501 in 2 | | 2,648 | 2,648 |
| Loans held for sale (at fair valu | | 88,283 | 96,133 |
| Loans receivab | | 1,216,664 | 1,306,437 |
| Less: Allowance for loan loss | | 32,430 | 29,175 |
| Loans receivable, n | | 1,184,234 | 1,277,262 |
| Office properties and equipment, | | 27,356 | 28,196 |
| Federal Home Loan Bank stock (at c | | 21,653 | 21,653 |
| Cash surrender value of life insura | | 36,749 | 35,385 |
| Real estate own | | 56,670 | 57,752 |
| Prepaid expenses and other as | | 8,359 | 11,440 |
| Total assets | $ | 1,712,851 | 1,808,966 |
| Liabilities and Shareholders' Equity | | | |
| Liabilities: | | | |
| Demand deposi | $ | 68,457 | 67,735 |
| Money market and savings depo | | 104,102 | 103,403 |
| Time deposit | | 878,733 | 974,391 |
| Total deposit | | 1,051,292 | 1,145,529 |
| Short-term borrowing | | 27,138 | 22,959 |
| Long-term borrowing | | 434,000 | 434,000 |
| Advance payments by borrowers for ta | | 942 | 2,379 |
| Other liabilities | | 33,107 | 31,879 |
| Total liabilities | | 1,546,479 | 1,636,740 |
| Shareholders' equit | | | |
| Preferred stock (par value $.01 per sh Authorized - 20,000,000 shares, no shares is | | - | - |
| Common stock (par value $.01 per sh Authorized - 200,000,000 shares in 2011 and 2 Issued - 33,974,450 in 2011 and 20 Outstanding - 31,250,097 in 2011 and 2 | | 340 | 340 |
| Additional paid-in capita | | 110,894 | 109,953 |
| Retained earnin | | 101,573 | 109,046 |
| Unearned ESOP sha | | (2,562) | (3,416) |
| Accumulated other comprehensive income, net of | | 1,388 | 1,558 |
| Treasury shares (2,724,353 shares), a | | (45,261) | (45,261) |
| Total shareholders' equity | | 166,372 | 172,220 |
| Total liabilities and shareholders' equity | $ | 1,712,851 | 1,808,966 |

See accompanying notes to consolidated financial statements.

# Waterstone Financial, Inc. and Subsidiaries
## Consolidated Statements of Operations
## Years Ended December 31, 2011, 2010 and 2009

| | Years ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | (In Thousands, except per share amounts) | | |
| Interest income: | | | |
| Loans | $ 72,269 | 81,161 | 87,847 |
| Mortgage-related securities | 3,822 | 5,360 | 7,101 |
| Debt securities, federal funds sold and short-term investments | 3,261 | 3,412 | 3,540 |
| Total interest income | 79,352 | 89,933 | 98,488 |
| Interest expense: | | | |
| Deposits | 15,289 | 20,989 | 34,484 |
| Borrowings | 17,547 | 19,280 | 20,093 |
| Total interest expense | 32,836 | 40,269 | 54,577 |
| Net interest income | 46,516 | 49,664 | 43,911 |
| Provision for loan losses | 22,077 | 25,832 | 26,687 |
| Net interest income after provision for loan losses | 24,439 | 23,832 | 17,224 |
| Noninterest income: | | | |
| Service charges on loans and deposits | 1,078 | 1,093 | 1,191 |
| Increase in cash surrender value of life insurance | 1,124 | 1,138 | 1,236 |
| Total other-than-temporary investment losses | (1,479) | - | (7,255) |
| Portion of loss recognized in other comprehensive income (before tax) | 1,023 | - | 6,143 |
| Net impairment losses recognized in earnings | (456) | - | (1,112) |
| Mortgage banking income | 39,845 | 35,465 | 9,976 |
| Other | 1,638 | 1,297 | 917 |
| Total noninterest income | 43,229 | 38,993 | 12,208 |
| Noninterest expenses: | | | |
| Compensation, payroll taxes, and other employee benefits | 39,159 | 36,323 | 17,335 |
| Occupancy, office furniture, and equipment | 6,488 | 5,762 | 4,822 |
| Advertising | 1,568 | 1,259 | 876 |
| Data processing | 1,400 | 1,372 | 1,413 |
| Communications | 968 | 902 | 693 |
| Professional fees | 1,648 | 1,689 | 1,334 |
| Real estate owned | 12,140 | 6,583 | 6,434 |
| FDIC insurance premiums | 3,814 | 4,353 | 4,683 |
| Other | 7,394 | 6,384 | 3,286 |
| Total noninterest expenses | 74,579 | 64,627 | 40,876 |
| Loss before income taxes | (6,911) | (1,802) | (11,444) |
| Income tax expense (benefit) | 562 | 52 | (1,306) |
| Net loss | $ (7,473) | (1,854) | (10,138) |
| Loss per share: | | | |
| Basic | $ (0.24) | (0.06) | (0.33) |
| Diluted | $ (0.24) | (0.06) | (0.33) |
| Weighted average shares outstanding: | | | |
| Basic | 30,929,415 | 30,804,063 | 30,680,285 |
| Diluted | 30,929,415 | 30,804,063 | 30,680,285 |

See accompanying notes to consolidated financial statements.

# Waterstone Financial, Inc. and Subsidiaries
## Consolidated Statements of Changes in Shareholders’ Equity
### Years Ended December 31, 2011, 2010 and 2009

| | Common Stock | | Additional Paid-In Capital | Retained Earnings | Unearned ESOP Shares | Accumulated Other Comprehensive Income (Loss) | Treasury Shares | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | | | | | | |
| | (In Thousands) | | | | | | | |
| Balances at December 31, 2( | 31,25( | $ 340 | 107,83( | 119,92 | (5,123 | (6,449 | (45,261 | 171,26 |
| Cummulative effect adjustment related to a cha | | | | | | | | |
| in accounting principle related to available for s | — | — | — | 1,117 | — | (669) | — | 448 |
| securities, net of taxes of $4 | | | | | | | | |
| Comprehensive income (los | | | | | | | | |
| Net los | — | — | — | (10,138 | — | — | — | (10,138) |
| Other comprehensive incon | | | | | | | | |
| Net unrealized holding gains ( | | | | | | | | |
| available for sale securities arising dui | | | | | | | | |
| the period, net of taxes of $1,8 | — | — | — | — | — | 4,451 | — | 4,451 |
| Reclassification adjustment for net losses | | | | | | | | |
| available for sale securities realized in | | | | | | | | |
| income, net of taxes of $4 | — | — | — | — | — | 666 | — | 666 |
| Total comprehensive lo | | | | | | | | (4,573) |
| ESOP shares committed to be released to | | | | | | | | |
| participant | — | — | (604) | — | 854 | — | — | 250 |
| Stock based compensat | — | — | 1,648 | — | — | — | — | 1,648 |
| Balances at December 31, 2( | 31,25( | 340 | 108,88 | 110,90( | (4,269 | (2,001 | (45,261 | 168,59 |
| Comprehensive income (los | | | | | | | | |
| Net los | — | — | — | (1,854) | — | — | — | (1,854) |
| Other comprehensive incon | | | | | | | | |
| Net unrealized holding gains ( | | | | | | | | |
| available for sale securities arising dui | | | | | | | | |
| the period, net of taxes of $2,1 | — | — | — | — | — | 3,592 | — | 3,592 |
| Reclassification adjustment for net gains | | | | | | | | |
| available for sale securities realized in | | | | | | | | |
| income, net of taxes of $ | — | — | — | — | — | (33) | — | (33) |
| Total comprehensive incor | | | | | | | | 1,705 |
| ESOP shares committed to be released to | | | | | | | | |
| participant | — | — | (589) | — | 853 | — | — | 264 |
| Stock based compensat | — | — | 1,659 | — | — | — | — | 1,659 |
| Balances at December 31, 2( | 31,25( | $ 340 | 109,95 | 109,04( | (3,416 | 1,558 | (45,261 | 172,22( |

See accompanying notes to consolidated financial statements.

## Waterstone Financial, Inc. and Subsidiaries
## Consolidated Statements of Changes in Shareholders’ Equity
## Years Ended December 31, 2011, 2010 and 2009

| | Common Stock | | Additional Paid-In Capital | Retained Earnings | Unearned ESOP Shares | Accumulated Other Comprehensive Income (Loss) | Treasury Shares | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | | | | | | |
| | (In Thousands) | | | | | | | |
| Balances at December 31, 2010 | 31,250 | 340 | 109,953 | 109,046 | (3,416) | 1,558 | (45,261) | 172,220 |
| Comprehensive income (loss): | | | | | | | | |
| Net loss | — | — | — | (7,473) | — | — | — | (7,473) |
| Other comprehensive income: | | | | | | | | |
| Net unrealized holding gains on available for sale securities arising during the period, net of taxes of $1,240 | — | — | — | — | — | (201) | — | (201) |
| Reclassification adjustment for net gains on available for sale securities realized in net income, net of taxes of $22 | — | — | — | — | — | 31 | — | 31 |
| Total comprehensive loss | | | | | | | | (7,643) |
| ESOP shares committed to be released to Plan participants | — | — | (652) | — | 854 | — | — | 202 |
| Stock based compensation | — | — | 1,593 | — | — | — | — | 1,593 |
| Balances at December 31, 2011 | 31,250 | $ 340 | 110,894 | 101,573 | (2,562) | 1,388 | (45,261) | 166,372 |

See accompanying notes to consolidated financial statements.

Waterstone Financial, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended December 31, 2011, 2010 and 2009

| | | Years ended December 31, | | |
|---|---|---|---|---|
| | | 2011 | 2010 | 2009 |
| | | (In Thousands) | | |
| Operating activities: | | | | |
| Net loss | $ | (7,473) | (1,854) | (10,138) |
| Adjustments to reconcile net loss to net | | | | |
| cash provided by (used in) operating activities: | | | | |
| Provision for loan losses | | 22,077 | 25,832 | 26,687 |
| Provision for depreciation | | 1,842 | 1,859 | 1,970 |
| Deferred income taxes | | (735) | - | 479 |
| Stock based compensation | | 1,593 | 1,659 | 1,648 |
| Net amortization of premium/discount on debt and mortgage related securities | | 635 | 70 | (218) |
| Amortization of unearned ESOP shares | | 202 | 264 | 250 |
| Gain on sale of loans held for sale | | (37,667) | (35,465) | (9,477) |
| Loans originated for sale | | (1,027,346) | (1,084,362) | (739,179) |
| Proceeds on sales of loans originated for sale | | 1,072,863 | 1,068,746 | 716,596 |
| (Increase) decrease in accrued interest receivable | | 37 | 424 | (205) |
| Increase in cash surrender value of life insurance | | (1,124) | (1,138) | (1,236) |
| Decrease in accrued interest on deposits and borrowings | | (239) | (1,011) | (2,468) |
| Increase in other liabilities | | 211 | 7,565 | 1,626 |
| Increase (decrease) in accrued tax payable | | 1,282 | 5,606 | (2,732) |
| (Gain) loss on impairment or sale of securities | | 403 | (55) | 1,112 |
| Gain on sale of office properties and equipment | | (7) | (21) | (49) |
| Net realized and unrealized loss related to real estate owned | | 6,052 | 675 | 3,166 |
| Other | | 2,484 | (1,922) | 284 |
| Net cash provided by (used in) operating activities | | 35,090 | (13,128) | (11,884) |
| Investing activities: | | | | |
| Net decrease in loans receivable | | 42,692 | 46,642 | 62,316 |
| Purchases of: | | | | |
| Debt securities | | (85,802) | (66,955) | (54,731) |
| Mortgage related securities | | (14,184) | (34,700) | (17,701) |
| Premises and equipment, net | | (1,021) | (925) | (3,820) |
| Bank owned life insurance | | (240) | (306) | (306) |
| Proceeds from: | | | | |
| Principal repayments on mortgage-related securities | | 31,433 | 40,624 | 36,610 |
| Maturities of debt securities | | 62,115 | 47,202 | 14,988 |
| Sales of debt securities | | — | 14,023 | 515 |
| Sales of mortgage-related securities | | 3,230 | 6,710 | — |
| Calls of structured notes | | — | — | 7,289 |
| Sales of foreclosed properties and other assets | | 23,231 | 33,577 | 24,334 |
| Net cash provided by investing activities | | 61,454 | 85,892 | 69,494 |

See Accompanying notes to consolidated financial statements.

## Waterstone Financial, Inc. and Subsidiaries
## Consolidated Statements of Cash Flows
## Years Ended December 31, 2011, 2010 and 2009

| | Years ended December 31, | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | | (In Thousands) | |
| Financing activities: | | | |
| Net decrease in deposits | (94,237) | (19,361) | (31,007) |
| Net increase (decrease) in short-term borrowings | 4,179 | (50,941) | 20,900 |
| Net increase (decrease) in advance payments by borrowers for taxes | (1,437) | 1,749 | (232) |
| Net cash used by financing activities | (91,495) | (68,553) | (10,339) |
| Increase in cash and cash equivalents | 5,049 | 4,211 | 47,271 |
| Cash and cash equivalents at beginning of year | 75,331 | 71,120 | 23,849 |
| Cash and cash equivalents at end of year | $ 80,380 | 75,331 | 71,120 |
| Supplemental information: | | | |
| Cash paid, credited or (received) during the period for: | | | |
| Income tax payments (refunds) | 69 | (5,554) | (500) |
| Interest payments | 33,076 | 41,013 | 57,045 |
| Noncash investing activities: | | | |
| Loans receivable transferred to other real estate | 28,259 | 41,781 | 54,072 |
| Non Cash financing activities: | | | |
| Long-term FHLB advances reclassified to short-term | | | 48,900 |

See Accompanying notes to consolidated financial statements.

1) Summary of Significant Accounting Policies

a) Organization

The board of directors of WaterStone Bank (the Bank) adopted the Plan of Reorganization and related Stock Issuance Plan on May 17, 2005, as amended on June 3, 2005, under which Waterstone Financial, Inc. (the Company) was formed to become the mid-tier holding company for the Bank. In addition, Lamplighter Financial, MHC, a Federally-chartered mutual holding company, was formed to become the majority owner of Waterstone Financial, Inc. The Company's outstanding common shares are 73.8% owned by Lamplighter Financial, MHC at December 31, 2011.

b) Nature of Operations

The Company is a one-bank holding company with two operating segments – community banking and mortgage banking. The Bank is principally engaged in the business of attracting deposits from the general public and using such deposits to originate real estate, business and consumer loans.

The Bank provides a full range of financial services to customers through branch locations in southeastern Wisconsin. The Bank is subject to the regulations of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

The Bank owns a mortgage banking subsidiary that originates residential real estate loans held for sale at various branch offices across the country. Mortgage banking volume fluctuates widely given movements in interest rates. Mortgage banking income is reported as a single line item in the statements of operations while mortgage banking expense is distributed among the various noninterest expense lines. Compensation, payroll taxes and other employee benefits expense varies directly with mortgage banking income.

c) Principles of Consolidation

The consolidated financial statements include the accounts and operations of Waterstone Financial, Inc. and its wholly owned subsidiary, WaterStone Bank. The Bank has the following wholly owned subsidiaries: Wauwatosa Investments, Inc. and Waterstone Mortgage Corporation. All significant intercompany accounts and transactions have been eliminated in consolidation.

d) Use of Estimates

The preparation of the consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include: the allowance for loan losses, deferred income taxes, valuation of investments, evaluation of other than temporary impairment on investments and real estate owned. Actual results could differ from those estimates and the current economic environment has increased the degree of uncertainty inherent in those estimates and assumptions.

e) Cash and Cash Equivalents

The Company considers federal funds sold and highly liquid debt instruments with a maturity of three months or less when purchased to be cash equivalents.

f) Securities

Available for Sale Securities

At the time of purchase, investment securities are classified as available for sale, as management has the intent and ability to hold such securities for an indefinite period of time, but not necessarily to maturity. Any decision to sell investment securities available for sale would be based on various factors, including, but not limited to asset/liability management strategies, changes in interest rates or prepayment risks, liquidity needs, or regulatory capital considerations. Available for sale securities are carried at fair value, with the unrealized gains and losses, net of deferred tax, reported as a separate component of equity, accumulated other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity or, in the case of mortgage-backed securities and collateralized mortgage obligations, over the estimated life of the security. Such amortization is included in interest income from securities. Realized gains or losses on securities sales (using specific identification method) are included in other income. Declines in value judged to be other than temporary are included in investment securities gains (losses), net, in the consolidated statements of income.

Held to Maturity Securities

Debt securities that the Company has the intent and ability to hold to maturity have been designated as held to maturity. Such securities are stated at amortized cost.

Other Than Temporary Impairment

One of the significant estimates related to securities is the evaluation of investments for other than temporary impairment. The Company assesses investment securities with unrealized loss positions for other than temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other than temporary. In evaluating other than temporary impairment, management considers the length of time and extent to which the fair value has been less than cost and the expected recovery period of the security, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Declines in the fair value of investment securities below amortized cost are deemed to be other than temporary when the Company cannot assert that it will recover its amortized cost basis, including whether the present value of cash flows expected to be collected is less than the amortized cost basis of the security. If it is more likely than not that the Company will be required to sell the security before recovery or if the Company has the intent to sell, an other than temporary impairment write down is recognized in earnings equal to the difference between the security's amortized cost and its fair value. If it is not more likely than not that the Company will be required to sell the security before recovery and if the Company does not intend to sell, the other than temporary impairment write down is separated into an amount representing credit loss, which is recognized in earnings, and an amount related to other factors, which is recognized as a separate component of equity. Following the recognition of an other than temporary impairment representing credit loss, the book value of an investment less the impairment loss realized becomes the new cost basis. Because the Company's assessments are based on factual information as well as subjective information available at the time of assessment, the determination as to whether an other than temporary impairment exists and, if so, the amount considered other than temporarily impaired, or not impaired, is subjective and, therefore, the timing and amount of other than temporary impairments constitute material estimates that are subjective to significant change.

Federal Home Loan Bank Stock

Federal Home Loan Bank stock is carried at cost, which is the amount that the stock is redeemable by tendering to the FHLBC or the amount at which shares can be sold to other FHLBC members. FHLBC dividends are recognized as income on their ex-dividend date.

g) Loans Held for Sale

The origination of residential real estate loans is an integral component of the business of the Company. The Company generally sells its originations of long-term fixed interest rate mortgage loans in the secondary market. Gains and losses on the sales of these loans are determined using the specific identification method. The Company generally sells mortgage loans in the secondary market on a servicing released basis, however, servicing is retained on a limited basis when economic conditions so warrant. Mortgage loans originated for sale are generally sold within 45 days after closing.

The Company has elected to carry loans held for sale at fair value. Fair value is generally determined by estimating a gross premium or discount, which is derived from pricing currently observable in the market. The amount by which cost differs from market value is accounted for as a valuation adjustment to the carrying value of the loans. Changes in value are included in mortgage banking income in the consolidated statements of operations. The carrying value of loans held for sale included a market valuation adjustment of $3.2 million at December 31, 2011 and $1.8 million at December 31, 2010.

Costs to originate loans held for sale are expensed as incurred and are included on the appropriate noninterest expense lines of the statements of operations. Salaries, commissions and related payroll taxes are the primary costs to originate and comprise approximately 71% of total mortgage banking noninterest expense.

The value of mortgage loans held for sale and other residential mortgage loan commitments to customers are hedged by utilizing both best efforts and mandatory forward commitments to sell loans to investors in the secondary market. Such forward commitments are generally entered into at the time when applications are taken to protect the value of the mortgage loans from increases in market interest rates during the period held. The Corporation recognizes revenue associated with the expected future cash flows of servicing loans at the time a forward loan commitment is made, as required under Securities and Exchange Commission Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings.

h) Loans Receivable and Related Interest Income

Loans are classified as held for investment when management has both the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. Loans are carried at the principal amount outstanding, net of any unearned income, charge-offs and unamortized deferred fees and costs. Loan origination and commitment fees and certain direct loan origination costs are deferred and the net amount amortized as an adjustment of the related loan yield. Amortization is based on a level-yield method over the contractual life of the related loans or until the loan is paid in full.

Loan interest income is recognized on the accrual basis. Accrual of interest is generally discontinued either when reasonable doubt exists as to the full, timely collection of interest or principal, or when a loan becomes contractually past due more than 90 days with respect to interest or principal. At that time, previously accrued and uncollected interest on such loans is reversed and additional income is recorded only to the extent that payments are received and the collection of principal is reasonably assured. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

A loan is accounted for as a troubled debt restructuring if the Company, for economic reasons related to the borrower's financial condition, grants a concession to the borrower that it would not otherwise consider. A troubled debt restructuring typically involves a modification of terms such as a reduction of the stated interest rate, a deferral of principal payments or a combination of both for a temporary period of time. If the borrower was performing in accordance with the original contractual terms at the time of the restructuring, the restructured loan is accounted for on an accruing basis as long as the borrower continues to comply with the modified terms. If the loan was not accounted for on an accrual basis at the time of restructuring, the restructured loan remains in non-accrual status until the loan returns to its original contractual terms and a positive payment history is established.

i) Allowance for Loan Losses

The allowance for loan losses is presented as a reserve against loans and represents the Bank's assessment of probable loan losses inherent in the loan portfolio. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Estimated loan losses are charged against the allowance when the loan balance is confirmed to be uncollectible directly or indirectly by the borrower or upon initiation of a foreclosure action by the Bank. Subsequent recoveries, if any, are credited to the allowance.

The allowance provides for probable losses that have been identified with specific customer relationships and for probable losses believed to be inherent in the loan portfolio, but have not been specifically identified. The Bank utilizes its own loss history to estimate inherent losses on loans. Although the Bank allocates portions of the allowance to specific loans and loan types, the entire allowance is available for any loan losses that occur.

The Bank evaluates the need for specific valuation allowances on loans that are considered impaired. A loan is considered impaired when, based on current information and events, it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Within the loan portfolio, all non-accrual loans and loans modified under troubled debt restructurings have been determined by the Bank to meet the definition of an impaired loan. In addition, other one- to four-family, over four-family, construction and land, commercial real estate and commercial loans may be considered impaired loans. A valuation allowance is established for an amount equal to the impairment when the carrying amount of the loan exceeds the present value of the expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral.

The Bank also establishes valuation allowances based on an evaluation of the various risk components that are inherent in the loan portfolio. The risk components that are evaluated include past loan loss experience; the level of non-performing and classified assets; current economic conditions; volume, growth, and composition of the loan portfolio; adverse situations that may affect the borrower's ability to repay; the estimated value of any underlying collateral; regulatory guidance; and other relevant factors.

The appropriateness of the allowance for loan losses is approved quarterly by the Bank's board of directors. The allowance reflects management's best estimate of the amount needed to provide for the probable loss on impaired loans, as well as other credit risks of the Bank, and is based on a risk model developed and implemented by management and approved by the Bank's board of directors.

Actual results could differ from this estimate, and future additions to the allowance may be necessary based on unforeseen changes in economic conditions. In addition, federal regulators periodically review the Bank's allowance for loan losses. Such regulators have the authority to require the Bank to recognize additions to the allowance at the time of their examination.

j) Real Estate Owned

Real estate owned consists of properties acquired through, or in lieu of, loan foreclosure. Real estate owned is recorded at estimated fair value less anticipated selling costs based upon the property's appraised value at the date of transfer, with any difference between the fair value of the property and the net carrying value of the loan charged to the allowance for loan losses. Subsequent write-downs to reflect current fair market value, as well as gains and losses upon disposition and revenue and expenses incurred in maintaining such properties, are treated as period costs and included in real estate owned in the consolidated statements of operations.

k) Cash Surrender Value of Life Insurance

The Company purchased bank owned life insurance on the lives of certain employees. The Company is the beneficiary of the life insurance policies. The cash surrender value of life insurance is reported at the amount that would be received in cash if the polices were surrendered. Increases in the cash value of the policies and proceeds of death benefits received are recorded in non-interest income. The increase in cash surrender value of life insurance is not subject to income taxes, as long as the Company has the intent and ability to hold the policies until the death benefits are received.

l) Office Properties and Equipment

Office properties and equipment, including leasehold improvements and software, are stated at cost, net of depreciation and amortization. Depreciation and amortization are computed on the straight-line method over the estimated useful lives of the related assets. Leasehold improvements are amortized over the lease term, if shorter than the estimated useful life. Maintenance and repairs are charged to expense as incurred, while additions or major improvements are capitalized and depreciated over their estimated useful lives. Estimated useful lives of the assets are 10 to 30 years for office properties, three to 10 years for equipment, and three years for software. Rent expense related to long-term operating leases is recorded on the accrual basis.

m) Income Taxes

The Company and its subsidiaries file consolidated federal and combined state income tax returns. The provision for income taxes is based upon income in the consolidated financial statements, rather than amounts reported on the income tax returns. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as net operating loss carry fowards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date.

The Company evaluates the realizability of its deferred tax assets on a quarterly basis. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, the forecasts of future income, applicable tax planning strategies, and assessments of current and future economic and business conditions.

Positions taken in the Company's tax returns may be subject to challenge by the taxing authorities upon examination. The benefit of uncertain tax positions are initially recognized in the financial statements only when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are both initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement with the tax authority, assuming full knowledge of the position and all relevant facts. Interest and penalties on income tax uncertainties are classified within income tax expense in the income statement.

n) Earnings Per Share

Earnings per share are computed using the two-class method. Basic earnings per share is computed by dividing net income allocated to common shareholders by the weighted average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Shares of the Employee Stock Ownership Plan committed to be released are considered outstanding for both common and diluted EPS. Incentive stock compensation awards granted can result in dilution.

o) Other Comprehensive Income

Comprehensive income is the total of reported net income and all other revenues, expenses, gains and losses that under generally accepted accounting principles bypass reported net income. The Company includes unrealized gains or losses, net of tax, on securities available for sale in other comprehensive income.

p) Employee Stock Ownership Plan (ESOP)

Compensation expense under the ESOP is equal to the fair value of common shares released or committed to be released to participants in the ESOP in each respective period. Common stock purchased by the ESOP and not committed to be released to participants is included in the consolidated statements of financial condition at cost as a reduction of shareholders' equity.

q) Impact of Recent Accounting Pronouncements

In April 2011, the FASB issued ASU 2011-02, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring, providing additional guidance for creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The provisions of this standard are effective for the first interim or annual period beginning on or after June 15, 2011 or July 1, 2011 for the

Company, and should be applied retrospectively to the beginning of the annual period of adoption. The adoption of the update did not have a material effect on the Company's financial statements at the date of adoption and is discussed in detail in Footnote 3 – Loans Receivable.

2) Securities Securities Available for Sale

The amortized cost and fair values of the Company's investment in securities follow:

| | December 31, 2011 | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| | (In Thousands) | | | |
| Mortgage-backed securities | $ 33,561 | 1,857 | (1) | 35,417 |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 32,650 | 559 | (13) | 33,196 |
| Private label issued | 19,475 | 16 | (1,040) | 18,451 |
| Mortgage related securities | 85,686 | 2,432 | (1,054) | 87,064 |
| Government sponsored enterprise bonds | 71,210 | 152 | (13) | 71,349 |
| Municipal securities | 37,644 | 1,744 | (320) | 39,068 |
| Other debt securities | 5,000 | 118 | — | 5,118 |
| Debt securities | 113,854 | 2,014 | (333) | 115,535 |
| Certificates of Deposit | 3,920 | 2 | (2) | 3,920 |
| | $ 203,460 | 4,448 | (1,389) | 206,519 |

| | December 31, 2010 | | | |
|---|---|---|---|---|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
| | (In Thousands) | | | |
| Mortgage-backed securities | $ 42,607 | 1,839 | (116) | 44,330 |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 38,262 | 1,141 | (126) | 39,277 |
| Private label issued | 26,199 | 280 | (1,032) | 25,447 |
| Mortgage related securities | 107,068 | 3,260 | (1,274) | 109,054 |
| Government sponsored enterprise bonds | 57,327 | 391 | (20) | 57,698 |
| Municipal securities | 31,804 | 721 | (1,405) | 31,120 |
| Other debt securities | 5,000 | 294 | — | 5,294 |
| Debt securities | 94,131 | 1,406 | (1,425) | 94,112 |
| | $ 201,199 | 4,666 | (2,699) | 203,166 |

The majority of the Company's mortgage-backed securities and collateralized mortgage obligations issued by government sponsored enterprises are guaranteed by one of the following government sponsored enterprises: FHLB, Fannie Mae or Freddie Mac. At December 31, 2011, $46.6 million of the Company's government sponsored enterprise bonds, $56.6 million of the Company's mortgage related securities and $8.7 million of the Company's municipal securities were pledged as collateral to secure repurchase agreement obligations of the Company.

The amortized cost and fair value of securities at December 31, 2011, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because issuers or borrowers may have the right to prepay obligations with or without prepayment penalties.

| | | December 31, 2011 | |
|---|---|---|---|
| | | Amortized cost | Fair value |
| | | (In Thousands) | |
| Debt securities: | | | |
| Due within one year | $ | 8,719 | 8,736 |
| Due after one year through five years | | 89,959 | 91,053 |
| Due after five years through ten years | | 3,390 | 3,763 |
| Due after ten years | | 15,706 | 15,903 |
| Mortgage-related securities | | 85,686 | 87,064 |
| | $ | 203,460 | 206,519 |

Total proceeds and gross gains and losses from sales of investment securities available for sale for each of periods listed below.

| | | December 31, | | |
|---|---|---|---|---|
| | | 2011 | 2010 | 2009 |
| Gross gains | $ | 53 | 136 | 12 |
| Gross losses | | - | (81) | - |
| Gains on sale of investment securities, net | $ | 53 | 55 | 12 |
| | | | | |
| Proceeds from sales of investment securities | $ | 3,230 | 20,733 | 515 |

Gross unrealized losses on securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows:

| | December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| | (In Thousands) | | | | | |
| Mortgage-backed securities | 1,167 | (1) | — | — | 1,167 | (1) |
| Collateralized mortgage obligations | | | | | | |
| Government sponsored enterprise issued | 5,726 | (13) | — | — | 5,726 | (13) |
| Private-label issue | — | — | 15,408 | (1,040) | 15,408 | (1,040) |
| Government sponsored enterprise bonds | 12,487 | (13) | — | — | 12,487 | (13) |
| Municipal securities | 228 | (87) | 1,989 | (233) | 2,217 | (320) |
| Certificates of Deposit | 1,958 | (2) | — | — | 1,958 | (2) |
| | $ 21,566 | (116) | 17,397 | (1,273) | 38,963 | (1,389) |

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair value | Unrealized loss | Fair value | Unrealized loss | Fair value | Unrealized loss |
| | (In Thousands) | | | | | |
| Mortgage-backed securities | 14,215 | (116) | — | — | 14,215 | (116) |
| Collateralized mortgage obligations | | | | | | |
| Government sponsored enterprise issued | $ 13,145 | (126) | — | — | 13,145 | (126) |
| Private-label issue | — | — | 16,908 | (1,032) | 16,908 | (1,032) |
| Government sponsored enterprise bonds | 7,553 | (20) | — | — | 7,553 | (20) |
| Municipal securities | 7,206 | (545) | 3,619 | (860) | 10,825 | (1,405) |
| | $ 42,119 | (807) | 20,527 | (1,892) | 62,646 | (2,699) |

The Company reviews the investment securities portfolio on a quarterly basis to monitor its exposure to other-than-temporary impairment. In evaluating whether a security's decline in market value is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, financial condition of the issuer and the underlying obligors, quality of credit enhancements, volatility of the fair value of the security, the expected recovery period of the security and ratings agency evaluations. In addition the Company may also evaluate payment structure, whether there are defaulted payments or expected defaults, prepayment speeds and the value of any underlying collateral. For certain securities in unrealized loss positions, the Company prepares cash flow analyses to compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security.

As of December 31, 2011, the Company had four securities which had been in an unrealized loss position for twelve months or longer, including one private-label collateralized mortgage obligation security and three municipal securities. Based upon the aforementioned factors, the Company identified two collateralized mortgage obligation securities at December 31, 2011 with a combined amortized cost of $19.5 million for which a cash flow analysis was performed to determine whether an other-than-temporary impairment was warranted. This evaluation indicated that the two collateralized mortgage obligations were other-than-temporarily impaired. Estimates of discounted cash flows based on expected yield at time of original purchase, prepayment assumptions based on actual and anticipated prepayment speed, actual and anticipated default rates and estimated level of severity given the loan to value ratios, credit scores, geographic locations, vintage and levels of subordination related to the security and its underlying collateral resulted in a projected credit loss on the collateralized mortgage obligations.

During the year ended December 31, 2011, the Company's analysis resulted in an estimate of approximately $456,000 in credit losses that was charged to earnings with respect to one of these two collateralized mortgage obligations. This security had an amortized cost of $16.4 million and an estimated fair value of $15.4 million as of December 31, 2011. The analysis with respect to the second collateralized mortgage obligation indicated no additional estimated credit loss. This security had an amortized cost of $3.03 million and an estimated fair value of $3.04 million as of December 31, 2011.

The following table presents the change in other-than-temporary credit related impairment charges on collateralized mortgage obligations for which a portion of the other-than-temporary impairments related to other factors was recognized in other comprehensive loss.

| | (in thousands) |
|---|---|
| Credit related impairments on securties as of December 31, 2009 | $ 1,762 |
| Credit related impairments related to a security for which other-than-temporary impairment was not previously recognized | - |
| Reductions for increases in cash flows expected over the remaining life of the securities | (122) |
| Credit related impairments on securities as of December 31, 2010 | 1,640 |
| Credit related impairments related to a security for which other-than-temporary impairment was not previously recognized | - |
| Increase in credit related impairments related to securities for which an other-than-temporary impairment was previously recognized | 456 |
| Credit related impairments on securities as of December 31 | $ 2,096 |

Exclusive of the two aforementioned collateralized mortgage obligations, the Company has determined that the decline in fair value of the remaining securities is not attributable to credit deterioration, and as the Company does not intend to sell nor is it more likely than not that it will be required to sell these securities before recovery of the amortized cost basis, these securities are not considered other-than-temporarily impaired.

Continued deterioration of general economic market conditions could result in the recognition of future other than temporary impairment losses within the investment portfolio and such amounts could be material to our consolidated financial statements.

Securities Held to Maturity

As of December 31, 2011, the Company held one security that has been designated as held to maturity. The security has an amortized cost of $2.6 million and an estimated fair value of $2.5 million. The final maturity of this security is 2022, however, it is callable quarterly. The Company has performed an assessment to determine whether this security is other than temporarily impaired and has determined that the security is not other than temporarily impaired at December 31, 2011.

3) Loans Receivable

Loans receivable at December 31, 2011 and 2010 are summarized as follows:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| | (In Thousands) | |
| Mortgage loans: | | |
| Residential real estate: | | |
| One- to four-family | $ 498,788 | 584,014 |
| Over four-family | 552,240 | 542,602 |
| Home equity | 60,002 | 71,952 |
| Construction and land | 45,212 | 56,794 |
| Commercial real estate | 65,434 | 51,733 |
| Consumer | 109 | 154 |
| Commercial loans | 34,364 | 40,442 |
| | 1,256,149 | 1,347,691 |
| Less: | | |
| Undisbursed loan proceeds | 37,433 | 39,265 |
| Unearned loan fees | 2,052 | 1,989 |
| | $ 1,216,664 | 1,306,437 |

The Company provides several types of loans to its customers, including residential, construction, commercial and consumer loans. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to one borrower or to multiple borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. While credit risks tend to be geographically concentrated in the Company's Milwaukee metropolitan area and while 88.4% of the Company's loan portfolio involves loans that are secured by residential real estate, there are no concentrations with individual or groups of related borrowers. While the real estate collateralizing these loans is primarily residential in nature, it ranges from owner-occupied single family homes to large apartment complexes. In addition, real estate collateralizing $94.3 million or 7.5% of total mortgage loans is located outside of the state of Wisconsin.

During the year ended December 31, 2011, $1.03 billion in residential loans were originated for sale. During the same period, sales of loans held for sale totaled $1.04 billion, generating noninterest income of $39.8 million. During the year ended December 31, 2011, the Company began selectively selling loans on a servicing retained basis. The unpaid principal balance of loans serviced for others was $29.9 million and $6.3 million at December 31, 2011 and December 31, 2010, respectively. These loans are not reflected in the consolidated statements of financial condition.

Qualifying loans receivable totaling $715.7 million and $705.8 million are pledged as collateral against $350.0 million in outstanding Federal Home Loan Bank of Chicago advances under a blanket security agreement at both December 31, 2011 and December 31, 2010.

An analysis of past due loans receivable as of December 31, 2011 and 2010 follows:

| | As of December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | 1-59 Days Past Due (1) | 60-89 Days Past Due (2) | Greater Than 90 Days | Total Past Due | Current (3) | Total Loans |
| Mortgage loans: | (In Thousands) | | | | | |
| Residential real estate: | | | | | | |
| One- to four-family | $ 12,650 | 5,536 | 40,001 | 58,187 | 438,549 | 496,736 |
| Over four-family | 13,044 | 2,630 | 8,946 | 24,620 | 527,620 | 552,240 |
| Home equity | 1,982 | 131 | 290 | 2,403 | 36,196 | 38,599 |
| Construction and land | 49 | 155 | 6,790 | 6,994 | 32,534 | 39,528 |
| Commercial real estate | 70 | - | 515 | 585 | 64,849 | 65,434 |
| Consumer | 8 | - | - | 8 | 101 | 109 |
| Commercial loans | 543 | - | 70 | 613 | 23,405 | 24,018 |
| Total | $ 28,346 | 8,452 | 56,612 | 93,410 | 1,123,254 | 1,216,664 |
| | As of December 31, 2010 | | | | | |
| Mortgage loans: | | | | | | |
| Residential real estate: | | | | | | |
| One- to four-family | $ 13,220 | 7,887 | 44,055 | 65,162 | 516,864 | 582,026 |
| Over four-family | 1,639 | 2,366 | 12,307 | 16,312 | 526,290 | 542,602 |
| Home equity | 497 | 96 | 207 | 800 | 45,349 | 46,149 |
| Construction and land | 586 | 1,326 | 2,754 | 4,666 | 49,295 | 53,961 |
| Commercial real estate | 574 | 222 | 1,101 | 1,897 | 49,836 | 51,733 |
| Consumer | - | - | - | - | 154 | 154 |
| Commercial loans | 394 | - | 1,432 | 1,826 | 27,986 | 29,812 |
| Total | $ 16,910 | 11,897 | 61,856 | 90,663 | 1,215,774 | 1,306,437 |

(1) Includes $4.6 million and $3.5 million for December 31, 2011 and 2010, respectively, which are on non-accrual status.
(2) Includes $1.4 million and $3.0 million for December 31, 2011 and 2010, respectively, which are on non-accrual status.
(3) Includes $15.7 million and $15.8 million for December 31, 2011 and 2010, respectively, which are on non-accrual status.

As of December 31, 2011 and 2010, there are no loans that are 90 or more days past due and still accruing interest.

A summary of the activity for the years ended December 31, 2011, 2010 and 2009 in the allowance for loan losses follows:

| | One- to Four-Family | Over Four Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | (In Thousands) | | | | |
| Year ended December 31, 2009 | | | | | | | | |
| Balance at beginning of period | $ 14,218 | 6,844 | 1,027 | 2,137 | 445 | 39 | 457 | 25,167 |
| Provision for loan losses | 17,078 | 1,645 | 1,475 | 4,378 | 1,185 | 12 | 914 | 26,687 |
| Charge-offs | (13,602) | (3,304) | (861) | (3,957) | (910) | (9) | (1,000) | (23,643) |
| Recoveries | 181 | 23 | 1 | 77 | - | 1 | - | 283 |
| Balance at end of peri | $ 17,875 | 5,208 | 1,642 | 2,635 | 720 | 43 | 371 | 28,494 |
| Year ended December 31, 2010 | | | | | | | | |
| Balance at beginning of period | $ 17,875 | 5,208 | 1,642 | 2,635 | 720 | 43 | 371 | 28,494 |
| Provision for loan losses | 15,054 | 5,053 | 170 | 2,934 | 525 | (3) | 2,099 | 25,832 |
| Charge-offs | (16,906) | (3,439) | (619) | (2,319) | (575) | (13) | (1,470) | (25,341) |
| Recoveries | 127 | 55 | 3 | 2 | 1 | 1 | 1 | 190 |
| Balance at end of period | $ 16,150 | 6,877 | 1,196 | 3,252 | 671 | 28 | 1,001 | 29,175 |
| Year ended December 31, 2011 | | | | | | | | |
| Balance at beginning of period | $ 16,150 | 6,877 | 1,196 | 3,252 | 671 | 28 | 1,001 | 29,175 |
| Provision for loan losses | 12,567 | 5,331 | 1,429 | 1,346 | 998 | 9 | 397 | 22,077 |
| Charge-offs | (11,553) | (3,996) | (634) | (1,745) | (734) | (10) | (619) | (19,291) |
| Recoveries | 311 | 40 | 7 | 69 | 6 | 1 | 35 | 469 |
| Balance at end of period | $ 17,475 | 8,252 | 1,998 | 2,922 | 941 | 28 | 814 | 32,430 |

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of the year ended December 31, 2011 follows:

| | One- to Four Family | Over Four Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | (In Thousands) | | | | |
| Allowance related to loans individually evaluated for impairment | $ 5,707 | 3,719 | 803 | 2,077 | - | - | 269 | 12,575 |
| Allowance related to loans collectively evaluated for impairment | 11,768 | 4,533 | 1,195 | 845 | 941 | 28 | 545 | 19,855 |
| Balance at end of period | $ 17,475 | 8,252 | 1,998 | 2,922 | 941 | 28 | 814 | 32,430 |
| Loans individually evaluated for impairment | $ 68,321 | 40,783 | 2,227 | 8,436 | 515 | - | 1,115 | 121,397 |
| Loans collectively evaluated for impairment | 428,415 | 511,457 | 36,372 | 31,092 | 64,919 | 109 | 22,903 | 1,095,267 |
| Total gross loans | $ 496,736 | 552,240 | 38,599 | 39,528 | 65,434 | 109 | 24,018 | 1,216,664 |

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of the year ended December 31, 2010 follows:

| | One- to Four-Family | Over Four Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | (In Thousands) | | | | | | | |
| Allowance related to loans | | | | | | | | |
| individually evaluated for impairment | $ 5,775 | 2,548 | 311 | 2,112 | 162 | - | 185 | 11,093 |
| Allowance related to loans | | | | | | | | |
| collectively evaluated for impairment | 10,375 | 4,329 | 885 | 1,140 | 509 | 28 | 816 | 18,082 |
| Balance at end of period | $ 16,150 | 6,877 | 1,196 | 3,252 | 671 | 28 | 1,001 | 29,175 |
| Loans individually evaluated for impairm | $ 78,434 | 30,288 | 804 | 12,337 | 1,838 | - | 2,030 | 125,731 |
| Loans collectively evaluated for impairm | 503,592 | 512,314 | 45,345 | 41,624 | 49,895 | 154 | 27,782 | 1,180,706 |
| Total gross loans | $ 582,026 | 542,602 | 46,149 | 53,961 | 51,733 | 154 | 29,812 | 1,306,437 |

The following table presents information relating to the Company's internal risk ratings of its loans receivable as of December 31, 2011 and 2010:

| | One- to Four-Family | Over Four Family | Home Equity | Construction and Land | Commercial Real Estate | Consumer | Commercial | Total |
|---|---|---|---|---|---|---|---|---|
| | (In Thousands) | | | | | | | |
| At December 31, 2011 | | | | | | | | |
| Substandard | $ 68,566 | 37,502 | 3,188 | 8,436 | 1,114 | - | 1,116 | 119,922 |
| Watch | 14,341 | 16,993 | 721 | 6,199 | 1,549 | - | 1,108 | 40,911 |
| Pass | 413,829 | 497,745 | 34,690 | 24,893 | 62,771 | 109 | 21,794 | 1,055,831 |
| | $ 496,736 | 552,240 | 38,599 | 39,528 | 65,434 | 109 | 24,018 | 1,216,664 |
| At December 31, 2010 | | | | | | | | |
| Substandard | $ 72,846 | 25,071 | 1,874 | 9,569 | 1,936 | - | 2,557 | 113,853 |
| Watch | 24,343 | 30,877 | 1,401 | 14,394 | 892 | - | 706 | 72,613 |
| Pass | 484,837 | 486,654 | 42,874 | 29,998 | 48,905 | 154 | 26,549 | 1,119,971 |
| | $ 582,026 | 542,602 | 46,149 | 53,961 | 51,733 | 154 | 29,812 | 1,306,437 |

Factors that are important to managing overall credit quality include sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an allowance for loan losses, and sound non-accrual and charge-off policies. Our underwriting policies require an officers' loan committee review and approval of all loans in excess of $500,000. In addition, an independent loan review function exists for all loans. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we maintain a loan review system under which our credit management personnel review non-owner occupied one- to four-family, over four-family, construction and land, commercial real estate and commercial loans that individually, or as part of an overall borrower relationship exceed $1.0 million in potential exposure. Loans meeting these criteria are reviewed on an annual basis, or more frequently, if the loan renewal is less than one year. With respect to this review process, management has determined that pass loans include loans that exhibit acceptable financial statements, cash flow and leverage. Watch loans have potential weaknesses that deserve management's attention, and if left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit. Substandard loans are considered inadequately protected by the current net worth and paying capacity of the obligor or the collateral pledged. These loans generally have a well-defined weakness that may jeopardize liquidation of the debt and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Finally, a loan is considered to be impaired when it is probable that the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management has determined that all non-accrual loans and loans modified under troubled debt restructurings meet the definition of an impaired loan.

The Company's procedures dictate that an updated valuation must be obtained with respect to underlying collateral at the time a loan is deemed impaired. Updated valuations may also be obtained upon transfer from loans receivable to real estate owned based upon the age of the prior appraisal, changes in market conditions or known changes to the physical condition of the property.

Estimated fair values are reduced to account for sales commissions, broker fees, unpaid property taxes and additional selling expenses to arrive at an estimated net realizable value. The adjustment factor is based upon the Company's actual experience with respect to sales of real estate owned over the prior two years. In situations in which we are placing reliance on an appraisal that is more than one year old, an additional adjustment factor is applied to account for downward market pressure since the date of appraisal. The additional adjustment factor is based upon relevant sales data available for our general operating market as well as company-specific historical net realizable values as compared to the most recent appraisal prior to disposition.

With respect to over-four family income producing real estate, appraisals are reviewed and estimated collateral values are adjusted by updating significant appraisal assumptions to reflect current real estate market conditions. Significant assumptions reviewed and updated include the capitalization rate, rental income and operating expenses. These adjusted assumptions are based upon recent appraisals received on similar properties as well as on actual experience related to real estate owned and currently under Company management.

The following tables present data on impaired loans at December 31, 2011 and 2010.

| | As of or for the Year Ended December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal | Reserve | Cumulative Charge-Offs | Average Recorded Investment | Int Paid YTD |
| **Total Impaired with Reserve** | | | | | | |
| One- to four-family | $ 25,735 | 25,913 | 5,707 | 178 | 26,093 | 579 |
| Over four-family | 21,268 | 21,648 | 3,719 | 380 | 21,846 | 761 |
| Home equity | 1,428 | 1,428 | 803 | - | 1,448 | 2 |
| Construction and land | 6,543 | 6,543 | 2,077 | - | 6,543 | 113 |
| Commercial real estate | - | - | - | - | - | - |
| Commercial | 1,033 | 1,033 | 269 | - | 1,037 | 42 |
| | $ 56,007 | 56,565 | 12,575 | 558 | 56,967 | 1,497 |
| **Total Impaired with no Reserve** | | | | | | |
| One- to four-family | $ 42,586 | 48,482 | - | 5,896 | 48,552 | 1,448 |
| Over four-family | 19,515 | 21,264 | - | 1,749 | 21,535 | 780 |
| Home equity | 799 | 799 | - | - | 833 | 3 |
| Construction and land | 1,893 | 3,413 | - | 1,520 | 3,413 | 60 |
| Commercial real estate | 515 | 539 | - | 24 | 538 | 17 |
| Commercial | 82 | 100 | - | 18 | 90 | - |
| | $ 65,390 | 74,597 | - | 9,207 | 74,961 | 2,308 |
| **Total Impaired** | | | | | | |
| One- to four-family | $ 68,321 | 74,395 | 5,707 | 6,074 | 74,645 | 2,027 |
| Over four-family | 40,783 | 42,912 | 3,719 | 2,129 | 43,381 | 1,541 |
| Home equity | 2,227 | 2,227 | 803 | - | 2,281 | 5 |
| Construction and land | 8,436 | 9,956 | 2,077 | 1,520 | 9,956 | 173 |
| Commercial real estate | 515 | 539 | - | 24 | 538 | 17 |
| Commercial | 1,115 | 1,133 | 269 | 18 | 1,127 | 42 |
| | $ 121,397 | 131,162 | 12,575 | 9,765 | 131,928 | 3,805 |

The difference between a loan's recorded investment and the unpaid principal balance represents a partial charge-off resulting from a confirmed loss due to the value of the collateral securing the loan being below the loan balance and management's assessment that the full collection of the loan balance is not likely.

When a loan is considered impaired, interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

| | As of or for the Year Ended December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Pricipal | Reserve | Cumulative Charge-Offs | Average Recorded Investment | Int Paid YTD |
| Total Impaired with Reser | | | | | | |
| One- to four-family | $ 42,186 | 44,505 | 5,775 | 2,319 | 50,785 | 1,277 |
| Over four-family | 20,200 | 20,460 | 2,548 | 260 | 24,305 | 191 |
| Construction and land | 9,550 | 9,770 | 2,112 | 220 | 12,569 | 243 |
| Commercial real estate | 976 | 2,730 | 162 | 1,754 | 938 | 3 |
| Home equity | 565 | 565 | 311 | - | 628 | 19 |
| Commercial | 584 | 584 | 185 | - | 313 | 30 |
| | $ 74,061 | 78,614 | 11,093 | 4,553 | 89,538 | 1,763 |
| Total Impaired with no Reserve | | | | | | |
| One- to four-family | $ 36,248 | 43,567 | - | 7,319 | 40,598 | 1,167 |
| Over four-family | 10,088 | 13,527 | - | 3,439 | 13,947 | 481 |
| Construction and land | 2,787 | 5,859 | - | 3,072 | 1,491 | 10 |
| Commercial real estate | 862 | 1,030 | - | 168 | 2,084 | 27 |
| Home equity | 239 | 239 | - | - | 733 | 13 |
| Commercial | 1,446 | 1,446 | - | - | 2,409 | 16 |
| | $ 51,670 | 65,668 | - | 13,998 | 61,262 | 1,714 |
| Total Impaired | | | | | | |
| One- to four-family | $ 78,434 | 88,072 | 5,775 | 9,638 | 91,383 | 2,444 |
| Over four-family | 30,288 | 33,987 | 2,548 | 3,699 | 38,252 | 672 |
| Construction and land | 12,337 | 15,629 | 2,112 | 3,292 | 14,060 | 253 |
| Commercial real estate | 1,838 | 3,760 | 162 | 1,922 | 3,022 | 30 |
| Home equity | 804 | 804 | 311 | - | 1,361 | 32 |
| Commercial | 2,030 | 2,030 | 185 | - | 2,722 | 46 |
| | $ 125,731 | 144,282 | 11,093 | 18,551 | 150,800 | 3,477 |

The determination as to whether an allowance is required with respect to impaired loans is based upon an analysis of the value of the underlying collateral and/or the borrower's intent and ability to make all principal and interest payments in accordance with contractual terms. The evaluation process is subject to the use of significant estimates and actual results could differ from estimates. This analysis is primarily based upon third party appraisals and/or a discounted cash flow analysis. In those cases in which no allowance has been provided for an impaired loan, the Company has determined that the estimated value of the underlying collateral exceeds the remaining outstanding balance of the loan. Of the total $65.4 million of impaired loans as of December 31, 2011 for which no allowance has been provided, $9.2 million in charge-offs have been recorded to reduce the unpaid principal balance to an amount that is commensurate with the loan's net realizable value, using the estimated fair value of the underlying collateral. To the extent that further deterioration in property values continues, the Company may have to reevaluate the sufficiency of the collateral servicing these impaired loans resulting in additional provisions to the allowance for loans losses or charge-offs.

At December 31, 2011, total impaired loans includes $55.4 million of troubled debt restructurings. The vast majority of debt restructurings include a modification of terms to allow for an interest only payment and/or reduction in interest rate. The restructured terms are typically in place for six to twelve months. At December 31, 2010, total impaired loans included $36.5 million of troubled debt restructurings.

The following presents data on troubled debt restructurings:

| | As of December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing | | Non-accruing | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| One- to four-family | $ 8,293 | 26 | $ 26,773 | 93 | $ 35,066 | 119 |
| Over four-family | 14,845 | 13 | 2,453 | 8 | 17,298 | 21 |
| Home equity | 43 | 1 | 1,024 | 4 | 1,067 | 5 |
| Construction and land | 1,408 | 1 | 79 | 1 | 1,487 | 2 |
| Commercial real estate | - | - | 452 | 1 | 452 | 1 |
| Commercial | - | - | 42 | 2 | 42 | 2 |
| | $ 24,589 | 41 | $ 30,823 | 109 | $ 55,412 | 150 |

| | As of December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Accruing | | Non-accruing | | Total | |
| | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | |
| One- to four-family | $ 21,676 | 76 | $ 2,360 | 16 | $ 24,036 | 92 |
| Over four-family | 8,716 | 9 | - | - | 8,716 | 9 |
| Home equity | 92 | 2 | 43 | 1 | 135 | 3 |
| Construction and land | 2,847 | 5 | - | - | 2,847 | 5 |
| Commercial real estate | 261 | 1 | 476 | 1 | 737 | 2 |
| | $ 33,592 | 93 | $ 2,879 | 18 | $ 36,471 | 111 |

Troubled debt restructurings involve granting concessions to a borrower experiencing financial difficulty by modifying the terms of the loan in an effort to avoid foreclosure. Typical restructured terms include six to twelve months of principal forbearance, a reduction in interest rate or both. In no instances have the restructured terms included a reduction of outstanding principal balance. At December 31, 2011, $55.4 million in loans had been modified in troubled debt restructurings and $30.8 million of these loans were included in the non-accrual loan total. The remaining $24.6 million, while meeting the internal requirements for modification in a troubled debt restructuring, were current with respect to payments under their original loan terms at the time of the restructuring and thus, continued to be included with accruing loans. Provided these loans perform in accordance with the modified terms, they will continue to be accounted for on an accrual basis. During 2011, the Company adopted Accounting Standards Update 2011-02, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring, which provided additional guidance for creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. Based upon the provisions of this standard, the Company determined that 40 loans totaling $10.8 million not previously classified as troubled debt restructurings met the definition of a troubled debt restructuring set forth under the ASU 2011-02. In all cases, the $10.8 million in loans were modified under a legal agreement such as a bankruptcy plan or a stipulation agreement meant to prevent a foreclosure. In all cases, these loans had previously been, and continue to be classified as impaired, substandard and nonperforming. As each loan had been previously identified as impaired, an impairment review had been performed with respect to each loan and appropriate provisions for loan loss had been provided in prior periods. As such, the classification of these loans as troubled debt restructurings had no impact on the allowance for loan losses.

All loans that have been modified in a troubled debt restructuring are considered to be impaired. As such, an analysis has been performed with respect to all of these loans to determine the need for a valuation reserve. When a loan is expected to perform in accordance with the restructured terms and ultimately return to and perform under contract terms, a valuation allowance is established for an amount equal to the excess of the present value of the expected future cash flows under the original contract terms as compared with the modified terms, including an estimated default rate. When there is doubt as to the borrower's ability to perform under the restructured terms or ultimately return to and perform under market terms, a valuation allowance is established equal to the impairment when the carrying amount exceeds fair value of the underlying collateral. As a result of the impairment analysis, a $6.2 million valuation allowance has been established as of December 31, 2011 with respect to the $55.4 million in troubled debt restructurings. As of December 31, 2010, $1.4 million in valuation allowance had been established with respect to the $36.5 million in troubled debt restructurings.

After a troubled debt restructuring reverts to market terms, a minimum of six consecutive contractual payments must be received prior to consideration for a return to accrual status. If an updated credit department review indicates no other evidence of elevated credit risk, the loan is returned to accrual status at that time.

The following presents troubled debt restructurings by concession type at December 31, 2011 and 2010:

| | As of December 31, 2011 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Performing in accordance with modified terms | | | In Default | | Total | |
| | | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | | |
| Interest reduction and principal forebearance | | 22,752 | 61 | 6,564 | 22 | 29,316 | 83 |
| Principal forebearance | | 3,894 | 29 | 1,771 | 9 | 5,665 | 38 |
| Interest reduction | | 20,006 | 27 | 425 | 2 | 20,431 | 29 |
| | $ | 46,652 | 117 | 8,760 | 33 | 55,412 | 150 |

| | As of December 31, 2010 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Performing in | | | In Default | | Total | |
| | | Amount | Number | Amount | Number | Amount | Number |
| | (dollars in thousands) | | | | | | |
| Interest reduction and principal forebearance | | 15,690 | 58 | 1,753 | 10 | 17,443 | 68 |
| Principal forebearance | | 4,064 | 16 | 94 | 1 | 4,158 | 17 |
| Interest reduction | | 14,870 | 26 | - | - | 14,870 | 26 |
| | $ | 34,624 | 100 | 1,847 | 11 | 36,471 | 111 |

The following presents data on troubled debt restructurings:

| | For the Year Ended December 31, 2011 | | |
|---|---|---|---|
| | | Amount | Number |
| | (dollars in thousands) | | |
| Loans modified as a troubled debt restructure | | | |
| One- to four-family | $ | 23,049 | 86 |
| Over four-family | | 10,340 | 12 |
| Home equity | | 1,062 | 3 |
| | $ | 34,451 | 101 |
| Troubled debt restructuring modified within the past twelve months for which there was a default | | | |
| One- to four-family | $ | 702 | 6 |
| | $ | 702 | 6 |

The following table presents data on non-accrual loans:

| | As of December 31, | |
|---|---|---|
| | 2011 | 2010 |
| | (Dollars in Thousands) | |
| Non-accrual loans: | | |
| Residential | | |
| One- to four-family | $ 55,609 | 56,759 |
| Over four-family | 13,680 | 20,587 |
| Home equity | 1,334 | 712 |
| Construction and land | 6,946 | 3,013 |
| Commercial real estate | 514 | 1,577 |
| Commercial | 135 | 1,530 |
| Consumer | - | - |
| Total non-accrual loar | $ 78,21 | 84,17 |
| Total non-accrual loans to total loans, net | 6.43% | 6.44% |
| Total non-accrual loans and performing troubled debt restructurings to total loans receivable | 8.45% | 9.01% |
| Total non-accrual loans to total assets | 4.57% | 4.65% |

## 4) Office Properties and Equipment

Office properties and equipment are summarized as follows:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| | (In Thousands) | |
| Land | $ 6,959 | 6,959 |
| Office buildings and improvements | 29,583 | 29,400 |
| Furniture and equipment | 10,679 | 10,379 |
| | 47,221 | 46,738 |
| Less accumulated depreciation | (19,865) | (18,542) |
| | $ 27,356 | 28,196 |

The Company and certain subsidiaries are obligated under non-cancelable operating leases for other facilities and equipment. Rent expense totaled $2.6 million and $1.9 million for the years ended December 31, 2011 and 2010, respectively. The appropriate minimum annual commitments under all non-cancelable lease agreements as of December 31, 2011 are as follows:

| | Operating leases |
|---|---|
| | (In Thousands) |
| Within one year | $ 1,573 |
| One to two years | 997 |
| Two to three years | 693 |
| Three to four years | 255 |
| Four through five years | 133 |
| After five years | 8 |
| Total | $ 3,659 |

## 5) Real Estate Owned

Real estate owned is summarized as follows:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| | (In Thousands) | |
| One- to four-family | $ 27,449 | 28,142 |
| Over four-family | 16,231 | 14,903 |
| Construction and land | 8,796 | 9,926 |
| Commercial real estate | 4,194 | 4,781 |
| | $ 56,670 | 57,752 |

During the year ended December 31, 2011, the Company transferred $28.3 to real estate owned from the loan portfolio. During the same period the Company sold approximately $22.4 million of real estate owned. During the year ended December 31, 2010, transfers from the loan portfolio to real estate owned totaled $41.8 million and sales of real estate owned totaled $33.5 million. Declines in property values evidenced by updated appraisals, responses to list prices on properties held for sale and/or deterioration in the condition of properties resulted in write-downs totaling $6.8 million and $2.1 million, respectively during the years ended December 31, 2011 and 2010.

6) Deposits

At December 31, 2011 and 2010, time deposits with balances greater than $100,000 amounted to $232.8 million and $271.7 million, respectively. Time deposits at December 31, 2011 and 2010 also include brokered deposits of $399,000 and $14.4 million, respectively.

A summary of interest expense on deposits is as follows:

| | | Years ended December 3 | | |
|---|---|---|---|---|
| | | 2011 | 2010 | 2009 |
| | | | (In Thousands) | |
| | $ | | | |
| Interest-bearing demand deposits | | 30 | 37 | 35 |
| Money market and savings deposits | | 369 | 493 | 534 |
| Time deposits | | 14,890 | 20,459 | 33,915 |
| | $ | 15,289 | 20,989 | 34,484 |

A summary of the contractual maturities of time deposits at December 31, 2011 is as follows:

| | | (In Thousands) |
|---|---|---|
| Within one year | $ | 787,854 |
| One to two years | | 64,791 |
| Two to three years | | 10,481 |
| Three to four years | | 10,789 |
| Four through five years | | 4,803 |
| After five years | | 15 |
| | $ | 878,733 |

7) Borrowings

Borrowings consist of the following:

| | December 31, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | Balance | Weighted Average Rate | Balance | Weighted Average Rate |
| | (In Thousands) | | | |
| Bank line of credit | $ 27,138 | 4.50% | 22,959 | 4.75% |
| Federal Home Loan Bank (FHLB) advances maturing: | | | | |
| 2016 | 220,000 | 4.34% | 220,000 | 4.34% |
| 2017 | 65,000 | 3.19% | 65,000 | 3.19% |
| 2018 | 65,000 | 2.97% | 65,000 | 2.97% |
| Repurchase agreements maturing: | | | | |
| 2018 | 84,000 | 3.96% | 84,000 | 3.96% |
| | $ 461,138 | 3.93% | 456,959 | 3.94% |

The bank line of credit is the outstanding portion of a revolving line with an unrelated bank. The $50.0 million line of credit is utilized by Waterstone Mortgage Corporation to finance loans originated for sale. The line of credit is secured by the underlying loans being financed. Related interest rates are based upon the note rate associated with the loans being financed.

The $220.0 million in advances due in 2016 consist of eight advances with rates ranging from 4.01% to 4.82% callable quarterly until maturity.

The $65.0 million in advances due in 2017 consist of three advances with rates ranging from 3.09% to 3.46% callable quarterly until maturity.

The $65.0 million in advances due in 2018 consist of three advances with rates ranging from 2.73% to 3.11% callable quarterly until maturity.

The $84.0 million in repurchase agreements have rates ranging from 2.89% to 4.31% callable quarterly until maturity. The repurchase agreements are collateralized by securities available for sale with an estimated fair value of $103.3 million at December 31, 2011.

The Company selects loans that meet underwriting criteria established by the Federal Home Loan Bank Chicago (FHLBC) as collateral for outstanding advances. The Company's borrowings at the FHLBC are limited to 65% of the carrying value of unencumbered one- to four-family mortgage loans, 30% of the carrying value of home equity loans and 45% of the carrying value of over four-family loans. In addition, these advances are collateralized by FHLBC stock of $21.7 million at December 31, 2011 and 2010, respectively. In the event of prepayment, the Company is obligated to pay all remaining contractual interest on the advance.

8) Regulatory Capital

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements, or overall financial performance deemed by the regulators to be inadequate, can initiate certain mandatory and possibly additional discretionary actions by 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 must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2011, that the Bank meets all capital adequacy requirements to which it is subject. On December 18, 2009, WaterStone Bank entered into a consent order with its federal and state bank regulators whereby it has agreed to maintain a minimum Tier 1 capital ratio of 8.50% and a minimum total risk based capital ratio of 12.00%. At December 31, 2011, these higher capital requirements were satisfied. The consent order also requires that the Bank perform a study to confirm that the Bank is a well managed institution; manage its bad loans and real estate acquired in foreclosure; and adopt a two year capital plan. The consent order prohibits the payment of cash dividends or repurchases of common stock, and restricts the ability of the Company to incur debt, in each case without the prior regulatory non-objection. At December 31, 2011, the Company is in compliance with all requirements of the consent order.

As of December 31, 2011 the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as quantitatively "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios, as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's category, however, the outstanding consent order limits transactions otherwise available to "well capitalized" banks, such as acceptance of brokered deposits.

As a state-chartered savings bank, the Bank is required to meet minimum capital levels established by the state of Wisconsin in addition to federal requirements. For the state of Wisconsin, regulatory capital consists of retained income, paid-in-capital, capital stock equity and other forms of capital considered to be qualifying capital by the Federal Deposit Insurance Corporation.

The actual and required capital amounts and ratios for the Bank as of December 31, 2011 and 2010 are presented in the table below:

| | December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Capital Adequacy Purposes | | To Be Well-Capitalized Under Prompt Corrective Action Provisions | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (Dollars In Thousands) | | | | | |
| WaterStone Bank | | | | | | |
| Total capital (to risk-weighted assets) | $ 174,144 | 14.58% | 95,579 | 8.00% | 119,474 | 10.00% |
| Tier I capital (to risk-weighted assets) | 158,994 | 13.31% | 47,790 | 4.00% | 71,684 | 6.00% |
| Tier I capital (to average assets) | 158,994 | 9.16% | 69,447 | 4.00% | 86,808 | 5.00% |
| State of Wisconsin (to total assets) | 158,994 | 9.31% | 102,463 | 6.00% | N/A | N/A |
| | December 31, 2010 | | | | | |
| WaterStone Bank | | | | | | |
| Total capital (to risk-weighted assets) | $ 180,718 | 14.13% | 102,324 | 8.00% | 127,905 | 10.00% |
| Tier I capital (to risk-weighted assets) | 164,568 | 12.87% | 51,162 | 4.00% | 76,743 | 6.00% |
| Tier I capital (to average assets) | 164,568 | 8.83% | 74,567 | 4.00% | 93,208 | 5.00% |
| State of Wisconsin (to total assets) | 164,568 | 9.12% | 108,228 | 6.00% | N/A | N/A |

9) Stock Based Compensation

Stock-Based Compensation Plan

In 2006, the Company's shareholders approved the 2006 Equity Incentive Plan. All stock awards granted under these plans vest over a period of five years and are required to be settled in shares of the Company's common stock. The exercise price for all stock options granted is equal to the quoted NASDAQ market close price on the date that the awards were granted and expire ten years after the grant date, if not exercised. All restricted stock grants are issued from previously unissued shares.

Accounting for Stock-Based Compensation Plan

The fair value of stock options granted is estimated on the grant date using a Black-Scholes pricing model. The fair value of restricted shares is equal to the quoted NASDAQ market close price on the date of grant. The fair value of stock grants is recognized as compensation expense on a straight-line basis over the vesting period of the grants. Compensation expense is included in compensation, payroll taxes and other employee benefits in the consolidated statements of income.

Assumptions are used in estimating the fair value of stock options granted. The weighted average expected life of the stock options represent the period of time that the options are expected to be outstanding and is based on the SEC simplified approach to calculating expected term. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility is based on the historical volatility for a group of selected peers. The following assumptions were used in estimating the fair value of options granted in the year ended December 31, 2010 and 2009. There were no options granted during the year ended December 31, 2011.

| | 2010 | 2009 |
|---|---|---|
| Dividend Yield | 0.00% | 0.00% |
| Risk-free interest rate | 0.25% | 0.40% |
| Expected volatility | 75.67% | 31.86% |
| Weighted average expected life | 6.5 years | 6.5 years |
| Weighted average per share value of options | $ 2.54 | $ 1.51 |

The Company estimates potential forfeitures of stock grants and adjusts compensation expense recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

A summary of the Company's stock option activity for the years ended December 31, 2011, 2010 and 2009 is presented below.

| Stock Options | Shares | Weighted Average Exercise Price | Weighted Average Years Remaining in Contractual Term | Aggregate Instrinsic Value (000's) |
|---|---|---|---|---|
| Outstanding December 31, 2( | 767,50( | 17.5ç | 8.0ɜ | - |
| Options exercisable at December 31, 2008 | 152,500 | 17.63 | 8.02 | - |
| Granted | 10,000 | $ 4.65 | | - |
| Excercised | - | | | - |
| Forfeited | (20,000) | 17.67 | | - |
| Outstanding December 31, 2009 | 757,500 | 17.41 | 7.07 | - |
| Options exercisable at December 31, 2009 | 298,000 | 17.60 | 7.03 | - |
| Granted | 50,000 | $ 3.80 | | - |
| Excercised | - | | | - |
| Forfeited | (5,000) | 17.67 | | - |
| Outstanding December 31, 2( | 802,50( | 16.4⁄ | 6.34 | - |
| Options exercisable at December 31, 2010 | 446,500 | 17.54 | 6.04 | - |
| Granted | - | | | - |
| Excercised | - | | | - |
| Forfeited | (10,000) | 17.16 | | - |
| Outstanding December 31, 2( | 792,50( | 16.3ž | 5.37 | - |
| Options exercisable at December 31, 2011 | 599,000 | 17.28 | 5.12 | - |

The following table summarizes information about the Company's nonvested stock option activity for the years ended December 31, 2011 and 2010:

| Stock Options | Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Nonvested at December 31, 2009 | 459,500 | $ 6.13 |
| Granted | 50,000 | 2.54 |
| Vested | (150,500) | 6.17 |
| Forfeited | (3,000) | 6.27 |
| Nonvested at December 31, 2010 | 356,000 | 5.60 |
| | | |
| Nonvested at December 31, 2010 | 356,000 | $ 5.60 |
| Granted | - | |
| Vested | (160,500) | 5.79 |
| Forfeited | (2,000) | 6.04 |
| Nonvested at December 31, 2011 | 193,500 | 5.31 |

The Company amortizes the expense related to stock options as compensation expense over the vesting period. During the year ended December 31, 2011, 10,000 were forfeited, of which 8,000 had vested in prior years. During the year ended December 31, 2010, 50,000 options were granted and 5,000 were forfeited, of which 2,000 had vested in prior years. During the year ended December 31, 2009, 10,000 options were granted and 20,000 were forfeited, of which 4,000 had vested in the prior year. Expense for the stock options granted of $745,000, $810,000 and $804,000 was recognized during the years ended December 31, 2011, 2010 and 2009, respectively. At December 31, 2011, the Company had $133,000 in estimated unrecognized compensation costs related to outstanding stock options that is expected to be recognized over a weighted average period of 35 months.

The following table summarizes information about the Company's restricted stock shares activity for the years ended December 31, 2011 and 2010:

| Restricted Stock | Shares | | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| Nonvested at December 31, 2009 | 150,600 | $ | 17.02 |
| Granted | - | | - |
| Vested | (49,200) | | 17.24 |
| Forfeited | - | | - |
| Nonvested at December 31, 2( | 101,40( | | 16.91 |
| Nonvested at December 31, 2010 | 101,400 | $ | 16.91 |
| Granted | - | | - |
| Vested | (49,200) | | 17.24 |
| Forfeited | - | | - |
| Nonvested at December 31, 2( | 52,20( | | 16.61 |

The Company amortizes the expense related to restricted stock awards as compensation expense over the vesting period. During the years ended December 31, 2011 and 2010, no shares of restricted stock were awarded and no shares were forfeited. During the year ended December 31, 2009, 5,000 shares of restricted stock were awarded and 4,800 were forfeited. Expense for the restricted stock awards of $848,000, $848,000 and $845,000 was recorded for the years ended December 31, 2011, 2010 and 2009, respectively. At December 31, 2011, the Company had $29,000 of unrecognized compensation expense related to restricted stock shares that is expected to be recognized over a weighted average period 25 months.

10) Employee Benefit Plans

The Company has two 401(k) profit sharing plans and trusts covering substantially all employees. WaterStone Bank employees over 18 years of age are immediately eligible to participate in the Bank's Plan. Waterstone Mortgage employees over 21 years of age are eligible to participate in its Plan as of the first of the month following their date of employment. Participating employees may annually contribute pretax compensation in accordance with IRS limits. The Company made no contributions to the Plans during the years ended December 31, 2011, 2010 and 2009.

The Company has a nonqualified salary continuation plan for one former employee. This agreement provides for payments of specific amounts over a 10-year period subsequent to the employee's retirement. The deferred compensation liability was accrued ratably to the employee's respective normal retirement date. Payments made to the retired employee reduce the liability. As of December 31, 2011 and 2010, approximately $826,000 and $960,000 was accrued related to this plan. This agreement is funded by a life insurance policy with a death benefit of $6.1 million and a cash surrender value of $2.9 million and $2.6 million at December 31, 2011 and 2010, respectively. The former employee has no interest in this policy. There was no expense for compensation under this agreement during the years ended December 31, 2011, 2010 and 2009.

## 11) Employee Stock Ownership Plan

All employees are eligible to participate in the WaterStone Bank Employee Stock Ownership Plan (the “Plan”) after they attain twenty-one years of age and complete twelve consecutive months of service in which they work at least 1,000 hours of service. The Plan borrowed $8.5 million from the Company and purchased 761,515 shares of common stock of the Company in the open market. The Plan debt is secured by shares of the Company. The Company has committed to make annual contributions to the Plan necessary to repay the loan, including interest. The loan is scheduled to be repaid in ten annual installments. While the shares are not released and allocated to Plan participants until the loan payment is made, the shares are deemed to be earned and are therefore, committed to be released throughout the service period. As such, one-tenth of the shares are scheduled to be released annually as shares are earned over a period of ten years, beginning with the period ended December 31, 2005. As the debt is repaid, shares are released from collateral and allocated to active participant accounts. The shares pledged as collateral are reported as unearned ESOP shares in the consolidated statement of financial condition. As shares are committed to be released from collateral, the Company reports compensation expense equal to the average fair market price of the shares, and the shares become outstanding for earnings per share computations. Compensation expense attributed to the ESOP was $202,000, $264,000 and $250,000, respectively for the years ended December 31, 2011, 2010 and 2009.

The aggregate activity in the number of unearned ESOP shares, considering the allocation of those shares committed to be released as of December 31, is as follows:

| | | 2011 | 2010 |
|---|---|---|---|
| Beginning ESOP shares | | 304,605 | 380,757 |
| Shares committed to be released | | (76,152) | (76,152) |
| Unreleased shar | | 228,453 | 304,605 |
| | | | |
| Fair value of unreleased shares (in thousands) | $ | 432 | 990 |

12) Income Taxes

The provision (benefit) for income taxes for the year ended December 31, 2011, 2010 and 2009 consists of the following:

| | Years ended December 31, 2011 | 2010 (In Thousands) | 2009 |
|---|---|---|---|
| Current: | | | |
| Federal | $ 1,216 | 30 | (1,319) |
| State | 81 | 22 | (466) |
| | 1,297 | 52 | (1,785) |
| Deferred: | | | |
| Federal | (590) | — | 812 |
| State | (145) | — | (333) |
| | (735) | — | 479 |
| Total | $ 562 | 52 | (1,306) |

The income tax provisions differ from that computed at the Federal statutory corporate tax rate for the years ended December 31, 2011, 2010 and 2009 as follows:

| | Years ended December 31, 2011 | 2010 (Dollars In Thousands) | 2009 |
|---|---|---|---|
| Loss before income taxes | $ (6,911) | (1,802) | (11,444 |
| Tax at Federal statutory rate (35%) | (2,419) | (631) | (4,005) |
| Add (deduct) effect of: | | | |
| State income taxes net of Federal income tax benefit (expense) | (41) | 14 | (519) |
| Cash surrender value of life insurance | (393) | (398) | (433) |
| Non-deductible ESOP and stock option expense | 119 | 168 | 151 |
| Tax-exempt interest income | (254) | (294) | (439) |
| Change in valuation allowance on deferred taxes | 2,921 | 1,281 | 3,983 |
| Intra-period tax allocation between other comprehensive income and loss from operations | (591) | - | - |
| Increase in tax exposure reserve | 1,216 | - | - |
| Other | 4 | (88) | (44) |
| Income tax provision (benef | 562 | 52 | (1,306) |
| Effective tax rate | (8.1%) | (2.9%) | 11.4% |

The increase in the required valuation allowance was largely due to an increase in the Company's net deferred tax assets, partly offset by a reduction related to changes in the beginning of the year valuation allowance solely attributable to identifiable events recorded in other comprehensive income, primarily changes in unrealized gains on the available-for-sale investment portfolio, the tax effects of which were therefore allocated to other comprehensive income.

The current year income tax expense includes a federal and state benefit of $736,000 due to an intra-period tax allocation between other comprehensive income and loss from continuing operations representing an out-of-period adjustment for an error that originated beginning in 2008 that was corrected during the quarter ended June 30, 2011. The correction of the error was not material to the year ended December 31, 2011. The impact of this error to all prior periods was not deemed to be material.

Estimated tax expense related to the IRS audit of the Company's 2005 through 2009 tax returns is primarily due to temporary differences between book and tax expenses related to real estate owned, loan loss charge-offs and fixed and determinable expenses paid prior to filing the tax returns. The current expense related to these items was offset by deferred tax benefit to be realized in future periods. However, the related deferred tax assets are fully off-set by deferred tax asset valuation allowances thus no deferred tax benefit has been recognized.

The significant components of the Company's net deferred tax assets (liabilities) included in prepaid expenses and other assets are as follows at December 31, 2011 and 2010:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| | (In Thousands) | |
| Gross deferred tax assets: | | |
| Excess book depreciation | $ 617 | 903 |
| Compensation agreements | 335 | 374 |
| Restricted stock and stock options | 1,252 | 1,047 |
| Allowance for loan losses | 13,113 | 11,292 |
| Real estate owned write-downs | 4,826 | 2,037 |
| Interest recognized for tax but not books | 1,169 | 1,330 |
| Federal NOL carryforward | 915 | 705 |
| State NOL carryforward | 1,563 | 1,132 |
| Unrealized loss on impaired securities | 841 | 635 |
| Other | 213 | 275 |
| Total gross deferred tax assets | 24,844 | 19,730 |
| Valuation allowance | (21,270) | (15,990) |
| Deferred tax assets | 3,574 | 3,740 |
| Gross deferred tax liabilities: | | |
| Unrealized gain on securities available for sale, net | (1,228) | (789) |
| FHLB stock dividends | (931) | (898) |
| Deferred loan fees | (859) | (971) |
| Deferred liabilities | (3,018) | (2,658) |
| Net deferred tax assets | $ 556 | 1,082 |

The Company has a Federal NOL carry forward of $2.6 million at December 31, 2011 which will begin to expire in 2030. The Company has a Wisconsin NOL carry forward of $30.4 million at December 31, 2011, which will begin to expire in 2028.

All of the deferred tax assets related to these NOLs are fully offset by valuation allowances. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, the forecasts of future income, applicable tax planning strategies, and assessments of current and future economic and business conditions. Examples of positive evidence may include the existence of taxes paid in available carry back years as well as the probability that taxable income will be generated in future periods, while examples of negative evidence may include the cumulative losses in the current year and prior two years and general business and economic trends. At both December 31, 2011 and 2010, the Company determined a valuation allowance was necessary, largely based on the negative evidence represented by a cumulative loss in the most recent three-year period caused by the significant loan loss provisions recorded during the past three years. In addition, general uncertainty surrounding future economic and business conditions have increased the potential volatility and uncertainty of projected earnings. Management is required to re-evaluate the deferred tax asset and the related valuation allowance quarterly.

Under the Internal Revenue Code and Wisconsin Statutes, the Company was permitted to deduct, for tax years beginning before 1988, an annual addition to a reserve for bad debts. This amount differs from the provision for loan losses recorded for financial accounting purposes. Under prior law, bad debt deductions for income tax purposes were included in taxable income of later years only if the bad debt reserves were used for purposes other than to absorb bad debt losses. Because the Company did not intend to use the reserve for purposes other than to absorb losses, no deferred income taxes were provided. Retained earnings at December 31, 2011 include approximately $16.7 million for which no deferred Federal or state income taxes were provided. Deferred income taxes have been provided on certain additions to the tax reserve for bad debts.

The Company and its subsidiaries file consolidated federal and state tax returns. One subsidiary also files separate state income tax returns in certain states. The Company is no longer subject to federal or state income tax examinations by tax authorities for years before 2005.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | 2011 | 2010 |
|---|---|---|
| | (In Thousands) | |
| Balance at January 1 | $ - | 15 |
| Increases related to prior year tax positions | 1,526 | - |
| Increases related to current year tax positions | 478 | |
| Decreases related to prior year tax positions | - | (15) |
| Balance at December | $ 2,004 | - |

The Internal Revenue Service (IRS) commenced an examination of the Company's income tax returns for 2005 through 2009 in the first quarter of 2010. In the fourth quarter of 2011, the IRS proposed significant adjustments related to the Company's deduction of expenses related to real estate owned and acquired through foreclosure, loan loss charge-offs and state tax deductions. All of these significant proposed adjustments are timing differences which resulted in current tax expense offset by deferred tax benefit to be realized in future periods. However, as deferred assets are fully off-set by deferred tax asset valuation allowances thus no deferred tax benefit was recognized.

Management is currently evaluating the IRS proposed adjustments and expects a settlement sometime during 2012. As such, it is reasonably possible that $1.2 million of the increases related to prior year tax positions will be reported either as settlements or decreases related to prior year tax positions within the next 12 months.

The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. During the year ended December 31, 2011, the Company recognized $241,000 in in interest which was accrued for as of December 31, 2011. The Company recognized no interest or penalties during the years ended December 31, 2010 and 2009. The Company had no accrual for the payment of interest and penalties at December 31, 2010 and 2009.

13) Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| | (In Thousands) | |
| Financial instruments whose contract amounts represent potential credit risk: | | |
| Commitments to extend credit under first mortgage loans | $ 14,259 | 14,681 |
| Commitments to extend credit under home equity lines of credit | 21,403 | 25,803 |
| Unused portion of construction loans | 5,684 | 2,832 |
| Unused portion of business lines of credit | 10,347 | 10,630 |
| Standby letters of credit | 970 | 991 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements of the Company. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral obtained generally consists of mortgages on the underlying real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds mortgages on the underlying real estate as collateral supporting those commitments for which collateral is deemed necessary.

The Company has determined that there are no probable losses related to commitments to extend credit or the standby letters of credit as of December 31, 2011 and 2010.

14) Derivative Financial Instruments

In connection with its mortgage banking activities, the Company enters into derivative financial instruments as part of its strategy to manage its exposure to changes in interest rates. Mortgage banking derivatives include interest rate lock commitments provided to customers to fund mortgage loans to be sold in the secondary market and forward commitments for the future delivery of such loans. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of future changes in interest rates on its commitments to fund the loans as well as on its portfolio of mortgage loans held-for-sale. The Company's mortgage banking derivatives have not been designated as being in hedge relationships. These instruments are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements of ASC 815. Changes in the fair value of derivatives not designated in hedging relationships are recorded directly in earnings. The Company does not use derivatives for speculative purposes.

Forward commitments to sell mortgage loans represent commitments obtained by the Company from a secondary market agency to purchase mortgages from the Company at specified interest rates and within specified periods of time. Commitments to sell loans are made to mitigate interest rate risk on interest rate lock commitments to originate loans and loans held for sale. At December 31, 2011, the Company had forward commitments to sell mortgage loans with an aggregate notional amount of approximately $118.0 million and interest rate lock commitments with an aggregate notional amount of approximately $119.0 million. The fair value of the mortgage derivatives at December 31, 2011 included a net gain of $924,000 on interest rate lock commitments to originate residential mortgage loans held for sale to individuals and a net loss of $397,000 on forward commitments to sell residential mortgage loans to various investors. .

In determining the fair value of its derivative loan commitments, the Company considers the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. That value includes the price that the loan is expected to be sold for in the secondary mortgage market. The fair value of these commitments is recorded on the consolidated statements of financial condition with the changes in fair value recorded as a component of mortgage banking income.

## 15) Fair Values Measurements

The FASB issued an accounting standard (subsequently codified into ASC Topic 820, "Fair Value Measurements and Disclosures") which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This accounting standard applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements. The standard also emphasizes that fair value (i.e., the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date), among other things, is based on exit price versus entry price, should include assumptions about risk such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. When considering the assumptions that market participants would use in pricing the asset or liability, this accounting standard establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The fair value hierarchy prioritizes inputs used to measure fair value into three broad levels.

Level 1 inputs - In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2 inputs - Fair values determined by Level 2 inputs use inputs other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets where there are few transactions and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Level 3 inputs are unobservable inputs for the asset or liability and include situations where there is little, if any, market activity for the asset or liability.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a recurring basis as of December 31, 2011 and December 31, 2010, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

| | December 31, 2011 | Fair Value Measurements Using Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | (In Thousands) | | | |
| Assets: | | | | |
| Available for sale securities | | | | |
| Mortgage-backed securities | $ 35,417 | - | 35,417 | - |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 33,196 | - | 33,196 | - |
| Private-label issue | 18,451 | - | - | 18,451 |
| Government sponsored enterprise bonds | 71,349 | - | 71,349 | - |
| Municipal securities | 39,068 | - | 39,068 | - |
| Other debt securities | 5,118 | 5,118 | - | - |
| Certificates of deposit | 3,920 | - | 3,920 | - |
| Loans held for sale | 88,283 | - | 88,283 | |
| Mortgage banking derivative assets | 924 | - | - | 924 |
| Liabilities: | | | | |
| Mortgage banking derivative liabilities | 397 | - | - | 397 |

| | December 31, 2010 | Fair Value Measurements Using Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | (In Thousands) | | | |
| Assets: | | | | |
| Available for sale securities | | | | |
| Mortgage-backed securities | $ 44,330 | - | 44,330 | - |
| Collateralized mortgage obligations | | | | |
| Government sponsored enterprise issued | 39,277 | - | 39,277 | - |
| Private-label issue | 25,447 | - | 5,146 | 20,301 |
| Government sponsored enterprise bonds | 57,698 | - | 57,698 | - |
| Municipal securities | 31,120 | - | 31,120 | - |
| Other debt securities | 5,294 | 5,294 | - | - |
| Loans held for sale | 96,133 | - | 96,133 | - |
| Mortgage banking derivative assets | 470 | - | - | 470 |
| Liabilities: | | | | |
| Mortgage banking derivative liabilities | 63 | - | - | 63 |

The following summarizes the valuation techniques for assets recorded in our consolidated statements of financial condition at their fair value on a recurring basis:

Available for sale securities – The Company's investment securities classified as available for sale include: mortgage-backed securities, collateralized mortgage obligations, government sponsored enterprise bonds, municipal securities and other debt securities. The fair value of mortgage-backed securities, collateralized mortgage obligations and government sponsored enterprise bonds are determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities, prepayment models and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. These model and matrix measurements are classified as Level 2 and Level 3 in the fair value hierarchy. The fair value of municipal securities is determined by a third party valuation source using observable market data utilizing a multi-dimensional relational pricing model. Standard inputs to this model include observable market data such as benchmark yields, reported trades, broker quotes, rating updates and issuer spreads. These model measurements are classified as Level 2 in the fair value hierarchy. The fair value of other debt securities, which includes a trust preferred security issued by a financial institution, is determined through quoted prices in active markets and is classified as Level 1 in the fair value hierarchy.

Loans held for sale –The Company accounts for loans held for sale at fair value under the fair value option model. Fair value is generally determined by estimating a gross premium or discount, which is derived from pricing currently observable in the secondary market, principally from observable prices for forward sale commitments. At December 31, 2011 and December 31, 2010, loans held-for-sale totaled $88.3 million and $96.1 million, respectively. Loans held-for-sale are considered to be Level 2 in the fair value hierarchy of valuation techniques.

Mortgage banking derivatives - Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company utilizes a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment and then multiplying by quoted investor prices. The Company also utilizes a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. While there are Level 2 and 3 inputs used in the valuation models, the Company has determined that one or more of the inputs significant in the valuation of both of the mortgage banking derivatives fall within Level 3 of the fair value hierarchy.

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2011 and 2010.

| | Available for sale securities | Mortgage banking derivatives |
|---|---|---|
| | (In Thousands) | |
| Balance at December 31, 2009 | $ 15,799 | 41 |
| Transfer into level 3 | - | - |
| Unrealized holding gains arising during the period: | | |
| Included in other comprehensive income | 5,261 | - |
| Other than temporary impairment included in net loss | - | - |
| Principal repayments | (881) | - |
| Net accretion of discount/amortization of premium | 122 | - |
| Cummulative-effect adjustment | - | - |
| Mortgage derivative gain, net | - | 366 |
| Balance at December 31, 2010 | 20,301 | 407 |
| Transfer into level 3 | - | - |
| Unrealized holding losses arising during the period: | | |
| Included in other comprehensive income | (142) | - |
| Other than temporary impairment included in net loss | (456) | - |
| Principal repayments | (1,252) | - |
| Net accretion of discount/amortization of premium | - | - |
| Cummulative-effect adjustment | - | - |
| Mortgage derivative gain, net | - | 120 |
| Balance at December 31, 2( | $ 18,451 | 527 |

Level 3 available-for-sale securities includes two corporate collateralized mortgage obligations. The market for these securities was not active as of December 31, 2011. As such, the Company valued this security based on the present value of estimated future cash flows Additional impairment may be incurred in future periods if estimated future cash flows are less than the cost basis of the securities. There were no transfers in or out of Level 1 or Level 2 measurements during the periods.

Assets Recorded at Fair Value on a Non-recurring Basis

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a non-recurring basis as of December 31, 2011 and December 31, 2010, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

| | December 31, 2011 | Fair Value Measurements Using Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | (In Thousands) | | | |
| Loans(1) | $ 43,432 | - | - | 43,432 |
| Real estate owned | 56,670 | - | - | 56,670 |

| | December 31, 2010 | Fair Value Measurements Using Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | (In Thousands) | | | |
| Loans(1) | $ 62,968 | - | - | 62,968 |
| Real estate owned | 57,752 | - | - | 57,752 |

(1) Represents collateral-dependent impaired loans, net, which are included in loans.

Loans – We do not record loans at fair value on a recurring basis, other than loans held for sale. On a non-recurring basis, loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at net realizable value of the underlying collateral. Fair value is determined based on third party appraisals or based upon an analysis of the present value of the expected future cash flows under the original contract terms as compared to the modified terms in the case of certain troubled debt restructurings. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of impaired loans, loans that have been deemed to be impaired are considered to be Level 3 in the fair value hierarchy of valuation techniques. At December 31, 2011, loans determined to be impaired with an outstanding balance of $56.0 million were carried net of specific reserves of $12.6 million for a fair value of $43.4 million. At December 31, 2010, loans determined to be impaired with an outstanding balance of $74.1 million were carried net of specific reserves of $11.1 million for a fair value of $63.0 million.

Real estate owned – On a non-recurring basis, real estate owned, is recorded in our consolidated statements of financial condition at the lower of cost or fair value. Fair value is determined based on third party appraisals obtained at the time the Company takes title to the property and, if less than the carrying value of the loan, the carrying value of the loan is adjusted to the fair value. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of the properties, real estate owned is considered to be Level 3 in the fair value hierarchy of valuation techniques. Changes in the value of real estate owned totaled $6.8 million and $2.1 million during the years ended December 31, 2011 and 2010, respectively and are recorded in real estate owned expense. At December 31, 2011 and December 31, 2010, real estate owned totaled $56.7

million and $57.8 million, respectively.

Fair value information about financial instruments follows, whether or not recognized in the consolidated statements of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company’s financial instruments consist of the following at December 31, 2011 and 2010:

| | December 31, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| | (In Thousands) | | | |
| Financial Assets | | | | |
| Cash and cash equivalents | $ 80,380 | 80,380 | 74,945 | 74,945 |
| Securities available-for-sale | 206,519 | 206,519 | 203,166 | 203,166 |
| Securities held-to-maturity | 2,648 | 2,542 | 2,648 | 2,501 |
| Loans held for sale | 88,283 | 88,283 | 96,133 | 96,133 |
| Loans receivable | 1,216,664 | 1,225,141 | 1,306,437 | 1,313,854 |
| FHLB stock | 21,653 | 21,653 | 21,653 | 21,653 |
| Cash surrender value of life insurance | 36,749 | 36,749 | 35,385 | 35,385 |
| Accrued interest receivable | 4,064 | 4,064 | 4,101 | 4,101 |
| Mortgage banking derivative assets | 924 | 924 | 470 | 470 |
| Financial Liabilities | | | | |
| Deposits | 1,051,292 | 1,052,663 | 1,145,529 | 1,153,065 |
| Advance payments by borrowers for taxes | 942 | 942 | 2,379 | 2,379 |
| Borrowings | 461,138 | 517,624 | 456,959 | 482,933 |
| Accrued interest payable | 2,087 | 2,087 | 2,326 | 2,326 |
| Mortgage banking derivative liabilities | 397 | 397 | 63 | 63 |
| Other Financial Instruments | | | | |
| Stand-by letters of credit | 6 | 6 | 5 | 5 |

The following methods and assumptions were used by the Company in determining its fair value disclosures for financial instruments.

Cash and Cash Equivalents

The carrying amount reported in the consolidated statements of financial condition for cash and cash equivalents is a reasonable estimate of fair value.

Securities

The fair value of securities is determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. Prepayment models are used for mortgage related securities with prepayment features.

Loans Held for Sale

Fair value is estimated using the prices of the Company's existing commitments to sell such loans and/or the quoted market price for commitments to sell similar loans.

Loans Receivable

Loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at fair value. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. With respect to loans that are not considered to be impaired, fair value is estimated by discounting the future contractual cash flows using discount rates that that reflect a current rate offered to borrowers of similar credit standing for the remaining term to maturity. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820-10 and generally produces a higher fair value.

FHLB Stock

For FHLB stock, the carrying amount is the amount at which shares can be redeemed with the FHLB and is a reasonable estimate of fair value.

Cash Surrender Value of Life Insurance

The carrying amounts reported in the consolidated statements of financial condition for the cash surrender value of life insurance approximate those assets' fair values.

Deposits and Advance Payments by Borrowers for Taxes

The fair values for interest-bearing and noninterest-bearing negotiable order of withdrawal accounts, savings accounts, and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates of similar remaining maturities to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit. The advance payments by borrowers for taxes are equal to their carrying amounts at the reporting date.

Borrowings

Fair values for borrowings are estimated using a discounted cash flow calculation that applies current interest rates to estimated future cash flows of the borrowings.

Accrued Interest Payable and Accrued Interest Receivable

For accrued interest payable and accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would be generally established at market rates at the time of the draw. Fair values for the Company's commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the counterparty's credit standing, and discounted cash flow analyses. The fair value of the Company's commitments to extend credit is not material at December 31, 2011 and 2010.

Mortgage Banking Derivative Assets and Liabilities

Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company utilizes a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment, and then multiplying by quoted investor prices. The Company also utilizes a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. On the Company's Consolidated Statements of Condition, instruments that have a positive fair value are included in prepaid expenses and other assets, and those instruments that have a negative fair value are included in other liabilities.

16) Earnings (loss) per share

Earnings per share are computed using the two-class method. Basic earnings (loss) per share is computed by dividing net income (loss) allocated to common shares by the weighted average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities have the right to receive dividends at the same rate as holders of the Company's common stock. Diluted earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares. Unvested restricted stock and stock options are considered outstanding for diluted earnings per share only. Unvested restricted stock and stock options totaling 52,200 and 193,500 shares for the year ended December 31, 2011 and 101,400 and 356,000 shares for the year ended December 31, 2010 and 150,600 and 459,500 shares for the year ended December 31, 2009 are antidilutive and are excluded from the loss per share calculation. Presented below are the calculations for basic and diluted earnings loss per share.

| | | For the year ended December 31, | | |
|---|---|---|---|---|
| | | 2011 | 2010 | 2009 |
| | | (In Thousands, except per share amounts) | | |
| Net loss | $ | (7,473) | (1,854) | (10,138) |
| Weighted average shares outstanding | | 30,929 | 30,804 | 30,680 |
| Effect of dilutive potential common shares | | - | - | - |
| Diluted weighted average shares outstanding | | 30,929 | 30,804 | 30,680 |
| Basic loss per share | $ | (0.24) | (0.06) | (0.33) |
| Diluted loss per share | $ | (0.24) | (0.06) | (0.33) |

## 17) Condensed Parent Company Only Statements

### Statements of Financial Condition

| | | December 31, | |
|---|---|---|---|
| | | 2011 | 2010 |
| | | (In Thousands) | |
| Assets | | | |
| Cash and cash equivalents | $ | 521 | 557 |
| Securities available for sale (at fair value) | | 5,118 | 5,294 |
| Investment in subsidiaries | | 160,933 | 166,555 |
| Other assets | | 21 | 21 |
| Total Assets | $ | 166,593 | 172,427 |
| Liabilities and shareholders' equity | | | |
| Liabilities: | | | |
| Other liabilities | | 221 | 207 |
| Shareholders' equity | | | |
| Preferred Stock (par value $.01 per share) | | - | - |
| Authorized - 20,000,000 shares, no shares issued | | | |
| Common stock (par value $.01 per share) | | 340 | 340 |
| Authorized - 200,000,000 shares in 2011 and 2010 | | | |
| Issued - 33,974,450 in 2011 and 2010 | | | |
| Outstanding - 31,250,097 in 2011 and 2010 | | | |
| Additional paid-in-capital | | 110,894 | 109,953 |
| Retained earnings | | 101,573 | 109,046 |
| Unearned ESOP shares | | (2,562) | (3,416) |
| Treasury stock (2,724,353 shares), at cost | | (45,261) | (45,261) |
| Accumulated other comprehensive loss (net of taxes) | | 1,388 | 1,558 |
| Total shareholders' equity | | 166,372 | 172,220 |
| Total liabilities and shareholders' equity | $ | 166,593 | 172,427 |

Statements of Operations

| | For the year ended December 31, 2011 | 2010 | 2009 |
|---|---|---|---|
| | | (In Thousands) | |
| Interest income | $ 669 | 715 | 766 |
| Equity in loss of subsidiaries | (8,250) | (2,790) | (11,201) |
| Total loss | (7,581) | (2,075) | (10,435) |
| Compensation | (605) | (541) | (557) |
| Professional fees | 57 | 40 | 51 |
| Other expense | 440 | 280 | 131 |
| Total expense | (108) | (221) | (375) |
| Loss before income tax | (7,473) | (1,854) | (10,060) |
| Income tax expense | - | - | 78 |
| Net loss | $ (7,473) | (1,854) | (10,138) |

Statements of Cash Flows

| | For the year ended December 31, 2011 | 2010 | 2009 |
|---|---|---|---|
| | | (In Thousands) | |
| Cash flows from operating activities | | | |
| Net loss | $ (7,473) | (1,854) | (10,138) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | |
| Amortization of unearned ESOP | 202 | 264 | 250 |
| Stock based compensation | 1,593 | 1,659 | 1,648 |
| Deferred income taxes | (71) | 319 | (8) |
| Equity in earnings of subsidiaries | 8,250 | 2,790 | 11,201 |
| Change in other assets and liabilities | (1,537) | (2,067) | (562) |
| Net cash provided by operating actitivies | 964 | 1,111 | 2,391 |
| Cash flows from investing activities: | | | |
| Capital contributions to subsidiary | (1,000) | (1,000) | (3,000) |
| Net cash used in investing activities | (1,000) | (1,000) | (3,000) |
| Net cash provided by (used in) financing activities | - | - | - |
| Net increase (decrease) in cash | (36) | 111 | (609) |
| Cash and cash equivalents at beginning of year | 557 | 446 | 1,055 |
| Cash and cash equivalents at end of year | $ 521 | 557 | 446 |

## 18) Segments and Related Information

During the year ended December 31, 2011, the Company determined that it has two reportable segments: community banking and mortgage banking. During this period, the Company realigned its operations to allow for all mortgage banking activities to be managed exclusively within its mortgage banking subsidiary. Based upon this realignment, the Company determined that the mortgage banking subsidiary represents a segment that is distinct from the operations of the core community banking function. Prior to the year ended December 31, 2011, the Company's operations were aligned such that it had one reportable segment. All segment data related to the years ended December 31, 2010 and 2009 reflect the Company's operations in the same manner as they were aligned during the year ended December 31, 2011. The Company's operating segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Company and therefore, the financial results of the Company's business segments are not necessarily comparable with similar information for other financial institutions.

### Community Banking

The Community Banking segment provides consumer and business banking products and services to customers primarily within Southeastern Wisconsin. Consumer products include loan and deposit products: mortgage, home equity loans and lines, personal term loans, demand deposit accounts, interest bearing transaction accounts and time deposits. Business banking products include secured and unsecured lines and term loans for working capital, inventory and general corporate use, commercial real estate construction loans, demand deposit accounts, interest bearing transaction accounts and time deposits.

### Mortgage Banking

The Mortgage Banking segment provides residential mortgage loans for the purpose of sale on the secondary market. Mortgage banking products and services are provided by offices in: Wisconsin, Arizona, Florida, Idaho, Indiana, Illinois, Iowa, Maryland, Minnesota, Ohio and Pennsylvania.

# Waterstone Financial, Inc. and Subsidiaries
## Notes to Consolidated Financial Statements
## Years Ended December 31, 2011, 2010 and 2009

| | As of or for the Year ended December 31, 2011 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (in thousands) | | | |
| Net interest income | $ 45,611 | 406 | 499 | 46,516 |
| Provision for loan losses | 21,960 | 117 | - | 22,077 |
| Net interest income after provision for loan losses | 23,651 | 289 | 499 | 24,439 |
| Noninterest income: | 2,431 | 40,798 | - | 43,229 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 13,006 | 26,929 | (776) | 39,159 |
| Occupancy, office furniture and equipment | 3,262 | 3,226 | - | 6,488 |
| FDIC insurance premiums | 3,814 | - | - | 3,814 |
| Real estate owned | 12,140 | - | - | 12,140 |
| Other | 4,598 | 7,883 | 497 | 12,978 |
| Total noninterest expenses | 36,820 | 38,038 | (279) | 74,579 |
| Income (loss) before income taxes (benefit) | (10,738) | 3,049 | 778 | (6,911) |
| Income taxes (benefit) | (833) | 1,395 | | 562 |
| Net income (loss) | $ (9,905) | 1,654 | 778 | (7,473) |
| Total Assets | $ 1,669,231 | 100,177 | (56,557) | 1,712,851 |

| | As of or for the Year ended December 31, 2010 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (in thousands) | | | |
| Net interest income | 48,521 | 641 | 502 | 49,664 |
| Provision for loan losses | 25,553 | 279 | - | 25,832 |
| Net interest income after provision for loan losses | 22,968 | 362 | 502 | 23,832 |
| Noninterest income: | 3,295 | 35,698 | - | 38,993 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 13,600 | 23,478 | (755) | 36,323 |
| Occupancy, office furniture and equipment | 3,313 | 2,449 | - | 5,762 |
| FDIC insurance premiums | 4,353 | - | - | 4,353 |
| Real estate owned | 6,583 | - | - | 6,583 |
| Other | 5,251 | 6,034 | 321 | 11,606 |
| Total noninterest expenses | 33,100 | 31,961 | (434) | 64,627 |
| Income (loss) before income taxes (benefit) | (6,837) | 4,099 | 936 | (1,802) |
| Income taxes (benefit) | (1,554) | 1,606 | | 52 |
| Net income (loss) | (5,283) | 2,493 | 936 | (1,854) |
| Total Assets | $ 1,770,912 | 108,928 | (70,874) | 1,808,966 |

| | As of or for the Year ended December 31, 2009 | | | |
|---|---|---|---|---|
| | Community Banking | Mortgage Banking | Holding Company and Other | Consolidated |
| | (in thousands) | | | |
| Net interest income | 42,911 | 490 | 510 | 43,911 |
| Provision for loan losses | 26,687 | - | - | 26,687 |
| Net interest income after provision for loan losses | 16,224 | 490 | 510 | 17,224 |
| Noninterest income: | 2,284 | 9,942 | (18) | 12,208 |
| Noninterest expenses: | | | | |
| Compensation, payroll taxes, and other employee benefits | 13,511 | 4,637 | (813) | 17,335 |
| Occupancy, office furniture and equipment | 3,616 | 1,206 | - | 4,822 |
| FDIC insurance premiums | 4,683 | - | - | 4,683 |
| Real estate owned | 6,643 | - | (209) | 6,434 |
| Other | 4,749 | 2,461 | 392 | 7,602 |
| Total noninterest expenses | 33,202 | 8,304 | (630) | 40,876 |
| Income (loss) before income taxes (benefit) | (14,694) | 2,128 | 1,122 | (11,444) |
| Income taxes (benefit) | (2,223) | 838 | | (1,306) |
| Net income (loss) | $ (12,471) | 1,290 | 1,043 | (10,138) |
| Total Assets | $ 1,861,595 | 50,927 | (44,256) | 1,868,266 |

## Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

## Item 9A. Controls and Procedures

Disclosure Controls and Procedures: Waterstone Financial management, with the participation of Waterstone Financial's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of Waterstone Financial's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, Waterstone Financial's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, Waterstone Financial's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by Waterstone Financial in the reports that it files or submits under the Exchange Act.

Change in Internal Control Over Financial Reporting: There have not been any changes in Waterstone Financial's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the final fiscal quarter of the period to which this report relates that have materially affected, or are reasonably likely to materially affect, Waterstone Financial's internal control over financial reporting.

Management's Annual Report on Internal Control Over Financial Reporting

Management of Waterstone Financial Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

As of December 31, 2011, management assessed the effectiveness of the Company's internal control over financial reporting based on criteria for effective internal control over financial reporting established in "Internal Control—Integrated Framework," issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2011 is effective.

KPMG LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued a report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2011. The report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2011, is included below under the heading "Report of Independent Registered Public Accounting Firm."

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Waterstone Financial, Inc.:

We have audited Waterstone Financial, Inc's internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Waterstone Financial, Inc's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Waterstone Financial, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Waterstone Financial, Inc and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011 and our report dated March 9, 2012 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Milwaukee, Wisconsin
March 9, 2012

Item 9B. Other Information.

None

## Part III

Item 10. Directors, Executive Officers and Corporate Governance

The information in the Company's definitive Proxy Statement, prepared for the 2012 Annual Meeting of Shareholders, which contains information concerning directors of the Company under the caption "Election of Directors" and compliance with Section 16 reporting requirements under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" and information concerning executive officers of the Company under the caption "Executive Officers of Waterstone Financial" and information concerning corporate governance under the caption "Other Board and Corporate Governance Matters" in Part I hereof is incorporated herein by reference.

Executive Officers of the Registrant

The table below sets forth certain information regarding the persons who have been determined, by our board of directors, to be executive officers of the Company. The executive officers of the Company are elected annually and hold office until their respective successors have been elected or until death, resignation, retirement or removal by the Board of directors.

| Name and Age | Offices and Positions with Waterstone Financial and Subsidiaries* | Executive Officer Since |
|---|---|---|
| Douglas S. Gordon, 54 | Chief Executive Officer and President of Waterstone Financial and of WaterStone Bank | 2005 |
| Richard C. Larson, 54 | Chief Financial Officer and Senior Vice President of Waterstone Financial and of WaterStone Bank | 1990(1) |
| William F. Bruss, 42 | General Counsel, Senior Vice President and Secretary of Waterstone Financial and of WaterStone Bank | 2005 |
| Rebecca M. Arndt, 44 | Vice President – Retail Operations of WaterStone Bank | 2006 |
| Eric J. Egenhoefer, 36 | President of Waterstone Mortgage Corporation | 2008 |

* Excluding directorships and excluding positions with Bank subsidiary which do not constitute a substantial part of the officers' duties.

(1) Indicates date when individual first held an executive officer position with the Bank. This individual became an executive officer of Waterstone Financial upon its organization.

Item 11. Executive Compensation

The information in the Company's definitive Proxy Statement, prepared for the 2012 Annual Meeting of Shareholders, which contains information concerning this item under the captions "Executive Compensation," "Director Compensation," "Compensation Committee Interlocks and Insider Participation," and "Compensation Discussion and Analysis" is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information in the Company's definitive Proxy Statement, prepared for the 2012 Annual Meeting of Shareholders, which contains information concerning this item under the caption "Stock Ownership of Certain Beneficial Owners" is incorporated herein by reference.

Compensation Plans

Set forth below is information as of December 31, 2011 regarding equity compensation plans that have been approved by shareholders. The Company has no equity based benefit plans, other than its employee stock ownership plan, that were not approved by shareholders.

| Plan | Number of shares to be issued upon exercise of outstanding options and rights | Weighted average option exercise price | Number of securities remaining available for issuance under plan |
|---|---|---|---|
| 2006 Equity Incentive Plan | 1,494,298[(1)] | $16.32 | 446,098 |

(1) Consists of 1,067,356 shares reserved for grants of stock options and 426,942 shares reserved for grants of restricted stock. On December 31, 2011, 792,500 options were outstanding with a weighted average exercise price of $16.32 of which 599,000 were exercisable as of that date.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information in the Company's definitive Proxy Statement, prepared for the 2012 Annual Meeting of Shareholders, which contains information concerning this item under the captions "Certain Transactions with the Company" and "Board Meetings and Committee" is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

The information in the Company's definitive Proxy Statement, prepared for the 2012 Annual Meeting of Shareholders, which contains information concerning this item under the caption "Independent Registered Public Accounting Firm," is incorporated herein by reference.

Part IV

Item 15. Exhibits and Financial Statement Schedules

(a) Documents filed as part of the Report:
1. and 2. Financial Statements and Financial Statement Schedules.

The following consolidated financial statements of Waterstone Financial, Inc. and subsidiaries are filed as part of this report under Item 8, "Financial Statements and Supplementary Data":

Consolidated Statements of Financial Condition – December 31, 2011 and 2010.

Consolidated Statements of Operations – Years ended December 31, 2011, 2010 and 2009.

Consolidated Statements of Changes in Shareholders' Equity – Years ended December 31, 2011, 2010 and 2009.

Consolidated Statements of Cash Flows – Years ended December 31, 2011, 2010 and 2009.

Notes to Consolidated Financial Statements.

Report of KPMG LLP, Independent Registered Public Accounting Firm, on consolidated financial statements.

All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

(b). Exhibits. See Exhibit Index following the signature page of this report, which is incorporated herein by reference. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this report is identified in the Exhibit Index by an asterisk following its exhibit number.

## SIGNATURES

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

WATERSTONE FINANCIAL, INC.

March 9, 2012

By: /s/Douglas S. Gordon
Douglas S. Gordon
Chief Executive Officer

## POWER OF ATTORNEY

Each person whose signature appears below hereby authorizes Douglas S. Gordon, Richard C. Larson and William F. Bruss, or any of them, as attorneys-in-fact with full power of substitution, to execute in the name and on behalf of such person, individually, and in each capacity stated below or otherwise, and to file, any and all amendments to this report.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.*

Signature and Title

| | |
|---|---|
| /s/Douglas S. Gordo<br>DouglasS. Gordon<br>Chief Executive Officer and Direct<br>(Principal Executive Office | /s/Patrick S. Lawtc<br>Patrick S. LawtonChairman an Director |
| /s/Richard C. Larsc<br>Richard C. LarsorSenior Vice Preside<br>Chief Financial Office<br>(Principal Financial and Accounting Officer) | /s/Thomas E. Dalu<br>Thomas E. Dalun Director |
| | /s/Michael L. Hanse<br>Michael L. HansenDirector |
| | /s/Stephen J. Schm<br>Stephen J. SchmicDirector |

*Each of the above signatures is affixed as of March 9, 2012.

WATERSTONE FINANCIAL, INC
(“Waterstone Financial” or the “Company”)
Commission File No. 000-51507

EXHIBIT INDEX
TO
2011 REPORT ON FORM 10-K

The following exhibits are filed with, or incorporated by reference in, this Annual Report on Form 10-K for the year ended December 31, 2011:

| Exhibit | Description | Incorporated Herein By Reference To | Filed Herewith |
|---|---|---|---|
| 2.1 | Plan of Reorganization from Mutual Savings Bank to Mutual Holding Company of Wauwatosa Savings Bank (the “Bank”), as adopted on May 17,2005 and amended on June 3, 2005 (the “Plan”) | Exhibit 2.1 to the Company’s Registration Statement on Form S-1, Registration No. 333-125715 (the “2005 S-1”) | |
| 3.1 | Articles of Incorporation of the Company | Exhibit 3.1 to 2005 S-1 | |
| 3.2 | Proposed Bylaws of the Company | Exhibit 3.1 to 2005 S-1 | |
| 10.4* | Stock Compensation Plans | Exhibit 10.1 to the company’s Current Report on Form 8-K filed on May 22, 2006 | |
| 11.1 | Statement re: Computation of Per Share Earnings | See Note 16 in Part II Item 8 | |
| 21.1 | List of Subsidiaries | | X |
| 23.1 | Consent of Independent Registered Public Accounting Firm | | X |
| 24.1 | Powers of Attorney | Signature Page | |
| 31.1 | Sarbanes-Oxley Act Section 302 Certification signed by the Chief Executive Officer of Waterstone Financial | | X |
| 31.2 | Sarbanes-Oxley Act Section 302 Certification signed by the Chief Financial Officer of Waterstone Financial | | X |
| 32.1 | Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer of Waterstone Financial | | X |

| Exhibit | Description | Incorporated Herein By Reference To | Filed Herewith |
|---|---|---|---|
| 32.2 | Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer of Waterstone Financial | | X |

* Designates management or compensatory agreements, plans or arrangements required to be filed as exhibits pursuant to Item 15(b) of Form 10-K.

Exhibit 21.1

The following table sets forth the name and jurisdiction of incorporation/charter of the Company's subsidiaries as of December 31, 2011. Inactive subsidiaries are not listed. All of the subsidiaries are 100% owned except as noted.

| Name of Subsidiary | Jurisdiction of Incorporation/Charter |
|---|---|
| WaterStone Bank, SSB (1) | Wisconsin |
| Wauwatosa Investments, Inc. (2) | Nevada |
| Waterstone Mortgage Corporation (2) | Wisconsin |

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(1) Direct subsidiary of Waterstone Financial, Inc.
(2) Direct subsidiary of WaterStone Bank

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Waterstone Financial, Inc

We consent to the incorporation by reference in the Registration Statement (No. 333-125715) on Form S-8 of Waterstone Financial, Inc. of our reports dated March 9, 2012, with respect to the consolidated statements of financial condition of Waterstone Financial, Inc. and Subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011, and the effectiveness of internal control over financial reporting as of December 31, 2011, which reports appear in the December 31, 2011 annual report on Form 10-K of Waterstone Financial, Inc.

/s/ KPMG LLP

Milwaukee, Wisconsin
March 9, 2012

Exhibit 31.1

CERTIFICATION

I, Douglas S. Gordon, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2011 of Waterstone Financial, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 9, 2012

/s/ Douglas S. Gordon
Douglas S. Gordon,
Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Richard C. Larson, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2011 of Waterstone Financial, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 9, 2012

/s/ Richard C. Larson

Richard C. Larson,
Chief Financial Officer

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Waterstone Financial, Inc. (the “Company”) on Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Douglas S. Gordon, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Douglas S. Gordon
Douglas S. Gordon
Chief Executive Officer
March 9, 2012

Exhibit 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Waterstone Financial, Inc. (the “Company”) on Form 10-K for the year ended December 31, 2011 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Richard C. Larson, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Richard C. Larson
Richard C. Larson
Chief Financial Officer
March 9, 2012

## WATERSTONE FINANCIAL, INC. -DIRECTORS

PATRICK S. LAWTON
Chairman of the Board

THOMAS E. DALUM

DOUGLAS S. GORDON

MICHAEL L. HANSEN

STEPHEN J. SCHMIDT

## WATERSTONE FINANCIAL, INC. -OFFICERS

DOUGLAS S. GORDON
Chief Executive Officer & President

WILLIAM F. BRUSS
General Counsel, Secretary & Senior Vice President

RICHARD C. LARSON
Chief Financial Officer, Treasurer & Senior Vice President

AS OF MARCH 2012

## WATERSTONE BANK SSB -OFFICERS

DOUGLAS S. GORDON
Chief Executive Officer & President

WILLIAM F. BRUSS
General Counsel, Secretary & Senior Vice President

RICHARD C. LARSON
Chief Financial Officer, Treasurer & Senior Vice President

DON BRAY
Chief Information Officer & Vice President

DAVE PROVANCHER
Chief Credit Officer & Vice President

KURT ANDRAE
Vice President

REBECCA M. ARNDT
Vice President

ANDREW BOARIO
Vice President

JAMES CROWLEY
Vice President

TODD M. CRUCIANI
Vice President

MICHAEL GRIEBEL
Vice President

KENNETH A. SNYDER
Vice President

JULIE FAY-KRIVITZ
Assistant Vice President

JUDY L. GEBHARD
Assistant Vice President

MARK R. GERKE
Corporate Controller

MARGARET HAAGENSEN
Assistant Vice President

KIM IGIELSKI
Assistant Vice President

JODI L. JOHNSON
Assistant Vice President

JACK KAHL
Assistant Vice President

COLLETTE M. KENDZIERSKI
Assistant Vice President

MEGAN MCCOY
Assistant Vice President

SALLY MCFADDEN
Assistant Vice President

BRYAN J. OLEN
Assistant Vice President

THERESE M. PEKAR
Assistant Vice President

MARK VAP
Assistant Vice President

JUDY M. WAGNER
Assistant Controller

## WATERSTONE MORTGAGE CORPORATION -OFFICERS

ERIC J. EGENHOEFER
President

KPMG, LLP
Auditors

LUSE GORMAN POMERENK & SCHICK, P.C.
Special Counsel

Waterstone