## BANNER CORP

Form 10-K
March 14, 2013

## UNITED STATES

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2012

## OR

$\qquad$ to $\qquad$

Commission File Number 0-26584
BANNER CORPORATION
(Exact name of registrant as specified in its charter)
Washington
(State or other jurisdiction of incorporation
or organization)
10 South First Avenue, Walla Walla, Washington 99362
(Address of principal executive offices and zip code)
Registrant's telephone number, including area code: (509) 527-3636
Securities registered pursuant to Section 12(b) of the Act:
Common Stock, par value $\$ .01$ per share
(Title of Each Class)

Securities registered pursuant to section 12(g) of the Act:
None.
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes $\qquad$ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes __No X

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T ( $\$ 232.405$ of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes X No $\qquad$

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulations S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. $\qquad$
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer $\qquad$ Accelerated filer X

Non-accelerated filer $\qquad$ Smaller reporting company $\qquad$
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes $\qquad$ No X The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant based on the closing sales price
of the registrant's common stock quoted on The NASDAQ Stock Market on June 30, 2012, was:
Common Stock - \$402,237,057
(The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the Registrant
that such person is an affiliate of the Registrant.)
The number of shares outstanding of the registrant's classes of common stock as of February 28, 2013:
Common Stock, $\$ .01$ par value - 19,455,023 shares
Documents Incorporated by Reference
Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 23, 2013 are incorporated by reference into Part III.

## BANNER CORPORATION AND SUBSIDIARIES

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## Forward-Looking Statements

Certain matters in this Form $10-\mathrm{K}$ constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, liquidity, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions o conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance and projections of financial items. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated or implied by our forward-looking statements, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates and the relative differences between short and long-term interest rates, loan and deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute a formal or informal enforcement action against us or any of the Banks which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds, or maintain or increase deposits, or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the implementing regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets and liabilities, which estimates may prove to be incorrect and result in significant changes in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; the failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common stock and interest or principal payments on our junior subordinated debentures; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities
and Exchange Commission, including this report on Form 10-K. Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to update any forward-looking statements included in this report or the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. These risks could cause our actual results to differ materially from those expressed in any forward-looking statements by, or on behalf of, us. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur, and you should not put undue reliance on any forward-looking statements.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Banner Corporation and its consolidate subsidiaries, unless the context otherwise requires. All references to "Banner" refer to Banner Corporation and those to "the Banks" refer to its wholly-owned subsidiaries, Banner Bank and Islanders Bank, collectively.

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## PART 1

Item 1 - Business

## General

Banner Corporation (the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly-owned subsidiaries, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2012, its 85 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks (the DFI) and the Federal Deposit Insurance Corporation (the FDIC). As of December 31, 2012, we had total consolidated assets of $\$ 4.3$ billion, net loans of $\$ 3.2$ billion, total deposits of $\$ 3.6$ billion and total stockholders' equity of $\$ 507$ million.

Banner Bank is a regional bank which offers a wide variety of commercial banking services and financial products to individuals, businesses and public sector entities in its primary market areas. Islanders Bank is a community bank which offers similar banking services to individuals, businesses and public entities located primarily in the San Juan Islands. Our primary business is that of traditional banking institutions, accepting deposits and originating loans in locations surrounding our offices in portions of Washington, Oregon and Idaho. Banner Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans. Lending activities include commercial business and commercial real estate loans, agriculture business loans, construction and land development loans, one- to four-family residential loans and consumer loans. A portion of Banner Bank's construction and mortgage lending activities are conducted through its subsidiary, Community Financial Corporation (CFC), which is located in the Lake Oswego area of Portland, Oregon. Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol "BANR."

Since becoming a public company in 1995, we have invested significantly in expanding our branch and distribution systems with a primary emphasis on strengthening our market presence in our five primary markets in the Northwest. Those markets include the four largest metropolitan areas in the Northwest: the Puget Sound region of Washington and the greater Boise, Idaho, Portland, Oregon, and Spokane, Washington markets, as well as our historical base in the vibrant agricultural communities in the Columbia Basin region of Washington and Oregon. Our aggressive franchise expansion during this period included the acquisition and consolidation of eight commercial banks, as well as the opening of 28 new branches and relocating ten others. Over the past ten years, we also invested heavily in advertising campaigns designed to significantly increase the brand awareness for Banner Bank. These investments, which have been significant elements in our strategies to grow loans, deposits and customer relationships, have increased our presence within desirable marketplaces and allow us to better serve existing and future customers. This emphasis on growth and development resulted in an elevated level of operating expenses during much of this period; however, we believe that the expanded branch network and heightened brand awareness have created a franchise that we believe is well positioned to allow us to successfully execute on our super community bank model. That strategy is focused on delivering customers, including middle market and small businesses, business owners, their families and employees, a compelling value proposition by providing the financial sophistication and breadth of products of a regional bank while retaining the appeal and superior service level of a community bank.

Despite weak economic conditions and ongoing strains in the financial and housing markets, Banner Corporation's successful execution of its strategic turnaround plan and operating initiatives, which resulted in our return to profitability in 2011, continued in 2012 and delivered noteworthy results as evidenced by our solid profitability for the
year ended December 31, 2012. We achieved substantial progress on our goal to position the Company with a moderate risk profile and to maintain that profile and earnings momentum going forward. Highlights for the year included further improvement in our asset quality, additional customer account growth, significantly increased non-interest-bearing deposit balances and strong revenues from mortgage banking operations. As a result, substantially reduced credit costs, significant improvement in our net interest margin and strong non-interest revenues all contributed to meaningfully increased profitability in 2012. Also notable during the year was the repurchase and retirement of all of our Series A Preferred Stock. We realized gains of $\$ 2.5$ million on these repurchase transactions. For the year ended December 31, 2012, we had net income of $\$ 64.9$ million which, after providing for the preferred stock dividend, related discount accretion and gains on repurchases of preferred stock, resulted in a net income available to common shareholders of $\$ 59.1$ million, or $\$ 3.16$ per diluted share, compared to a net income of $\$ 5.5$ million which, after providing for the preferred stock dividend and related discount accretion, resulted in a net loss to common shareholders of $\$ 2.4$ million, or ( $\$ 0.15$ ) per diluted share for the year ended December 31, 2011.

Our return to consistent profitability was punctuated in 2012 by management's decision to reverse the valuation allowance against our deferred tax assets. For the year ended December 31, 2012, the elimination of the deferred tax asset valuation allowance, combined with the Company's pre-tax income, resulted in a net tax benefit of $\$ 24.8$ million which significantly added to our net income for the year. The decision to reverse the valuation allowance reflects our confidence in the sustainability of our future profitability. Further, as a result of our return to profitability, including the recovery of our deferred tax asset, our improved asset quality and operating trends, strong capital position and our expectation for sustainable profitability for the foreseeable future, we also significantly reduced the credit portion of the discount rate utilized to estimate the fair value of the junior subordinated debentures issued by the Company. As a result, the estimated fair value of our junior subordinated debentures increased by $\$ 23.1$ million during the year, accounting for most of the $\$ 16.5$ million net charge before taxes for fair value adjustments for the year ended December 31, 2012. Changes in these two significant accounting estimates, while substantial, represent non-cash valuation adjustments that have no effect on our liquidity or our ability to fund our operations.

Although economic conditions have improved from the depths of the recession resulting in a material decrease in credit costs in recent periods, the pace of recovery has been modest and uneven and ongoing stress in the economy, reflected in high unemployment, tepid consumer spending, modest loan demand and very low interest rates, will likely continue to create a challenging operating environment going forward. Nonetheless, over the past two years we have significantly improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in lower credit costs and stronger revenues, and which we believe will lead to further improved operating results in future periods.

Our provision for loan losses was $\$ 13.0$ million for the year ended December 31, 2012, compared to $\$ 35.0$ million in 2011 and $\$ 70$ million in 2010. The decrease from a year earlier reflects significant progress in reducing the levels of delinquencies, non-performing loans and net charge-offs, particularly for loans for the construction of one- to four-family homes and for acquisition and development of land for residential properties. From 2008 through 2011, higher than historical provision for loan losses was the most significant factor adversely affecting our operating results; however, the substantial decrease in non-performing assets resulted in much lower provisioning in 2012 and the expectation of more normal levels going forward. (See Note 6, Loans Receivable and the Allowance for Loan Losses, as well as "Asset Quality" below in this Form 10-K.)

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits and borrowings. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. Our net interest income before provision for loan losses increased to $\$ 167.6$ million for the year ended December 31, 2012, compared to $\$ 164.6$ million for the same prior year, primarily as a result of expansion of our net interest spread and net interest margin due to a lower cost of funds and a reduction in the adverse impact of non-performing assets. The continuing trend to lower funding costs primarily reflects a further decline in interest expense on deposits driven by significant changes in our deposit mix and pricing. This decrease in deposit costs coupled with the reduction in the adverse impact of non-performing assets represent important improvements in our core operating fundamentals. The increase in net interest income occurred despite a modest decline in average earning assets compared to a year ago, as we continued to focus on reducing our non-performing loans and make changes in our mix of assets and liabilities designed to reduce our risk profile and produce more sustainable earnings.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 22 of the Notes to the Consolidated Financial Statements.) For the year ended December 31, 2012, we recorded a net loss of $\$ 16.5$ million in fair value adjustments and $\$ 409,000$ of OTTI charges. In comparison, we recorded a net fair value loss of $\$ 624,000$ for the year ended December 31, 2011, which was more than offset by a $\$ 3.0$ million OTTI recovery. The current year fair value loss was primarily related to the increased valuation of our junior subordinated debentures, which was partially offset by similar adjustments to the fair value estimates for certain investment securities also carried at fair value.

Reflecting the large adverse fair value adjustment, our other operating income for the year ended December 31, 2012 decreased to $\$ 26.9$ million, compared to $\$ 34.0$ million for the year ended December 31, 2011. As a result, our total revenues (net interest income before the provision for loan losses plus other operating income) for 2012 decreased $\$ 4.0$ million, to $\$ 194.6$ million, compared to $\$ 198.6$ million for 2011 . However, as a result of exceptionally strong mortgage banking revenues and growth in core deposits, our revenues, excluding fair value and OTTI adjustments,
which we believe are more indicative of our core operations, increased by $\$ 15.2$ million, or $8 \%$, to $\$ 211.4$ million for the year ended December 31, 2012, compared to $\$ 196.2$ million for the year ended December 31, 2011.

Our other operating expenses decreased to $\$ 141.5$ million for the year ended December 31, 2012, compared to $\$ 158.1$ million for the year ended December 31, 2011, largely as a result of decreased costs related to real estate owned, FDIC deposit insurance costs and professional services, which were partially offset by increased compensation expenses. While significantly lower in 2012 than in 2011, both years' expenses reflect significant costs associated with problem loan collection activities including professional services and valuation charges related to real estate owned, which should decline in future periods as a result of the continuing reduction in non-performing assets.

Other operating income, revenues and other earnings information excluding fair value adjustments and OTTI losses are financial measures not made in conformity with U.S. generally acceptable accounting principles (GAAP). Management has presented these and other non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. Where applicable, we have also presented comparable earnings information using GAAP financial measures.

See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for more detailed information about our financial performance, critical accounting policies and reconciliations of these non-GAAP financial measures.

## Recent Developments and Significant Events

Regulatory Actions: On March 19, 2012, the Memorandum of Understanding (MOU) by and between Banner Bank and the FDIC and Washington DFI (originally effective March 29, 2010) was terminated. On April 10, 2012, the MOU by and between the Company and the Federal Reserve Bank of San Francisco (originally effective March 23, 2010) was also terminated.

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Income Tax Reporting and Accounting:
Amended Federal Income Tax Returns: On October 25, 2011, the Company filed amended federal income tax returns for tax years 2005, 2006, 2008 and 2009. The amended tax returns, which are under review by the Internal Revenue Service (IRS), significantly affect the timing for recognition of credit losses within previously filed income tax returns and, if approved, would result in the refund of up to $\$ 13.6$ million of previously paid taxes from the utilization of net operating loss carryback claims into prior tax years. The outcome of the anticipated IRS review is inherently uncertain and since there can be no assurance of approval of some or all of the tax carryback claims, no asset has been recognized to reflect the possible results of these amendments as of December 31, 2012. Accordingly, the Company does not anticipate recognizing any tax benefit until the results of the IRS review have been determined. We expect this review to be completed and the issue resolved during 2013.

Deferred Tax Asset Valuation Allowance: The Company and the Banks file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP, a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of our deferred tax assets will not be realized. While realization of the deferred tax asset is ultimately dependent on sustained profitability, the guidance reflected in the accounting standard is significantly influenced by consideration of recent historical operating results. During 2010, the Company evaluated its net deferred tax asset and determined it was prudent to establish a valuation allowance against the entire asset. As a result, we recorded an $\$ 18.0$ million income tax expense for the year ended December 31, 2010. No tax benefit or expense was recognized during 2011. During the year ended December 31, 2012, management analyzed the Company's performance and trends, focusing on trends in asset quality, loan loss provisioning, capital position, net interest margin, core operating income and net income and the likelihood of continued profitability. Based on this analysis, management determined that a full valuation allowance was no longer appropriate and reversed all of the valuation allowance during the year ended December 31, 2012. See Note 13 of the Notes to the Consolidated Financial Statements for more information.

Stockholder Equity Transactions:
Preferred Stock: On March 29, 2012, the Company's $\$ 124$ million of Series A Preferred Stock with a liquidation value of $\$ 1,000$ per share, originally issued to the U.S. Treasury (Treasury) as part of its Capital Purchase Program, was sold by the Treasury as part of its efforts to manage and recover its investments under the Troubled Asset Relief Program (TARP). While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrants to purchase up to $\$ 18.6$ million in Banner common stock. Subsequently, during 2012, the Company repurchased or redeemed its Series A Preferred Stock, realizing gains aggregating $\$ 2.5$ million, which partially offset the accelerated amortization of a portion of the initial discount recorded at the issuance of the Series A Preferred Stock. In addition, dividends paid in 2012 on the Series A Preferred Stock were reduced by the retirement of the repurchased shares.

## Lending Activities

General: All of our lending activities are conducted through Banner Bank, its subsidiary, Community Financial Corporation, and Islanders Bank. We offer a wide range of loan products to meet the demands of our customers and our loan portfolio is very diversified by product type, borrower and geographic location within our market area. We originate loans for our own loan portfolio and for sale in the secondary market. Management's strategy has been to
maintain a well diversified portfolio with a significant percentage of assets in the loan portfolio having more frequent interest rate repricing terms or shorter maturities than traditional long-term fixed-rate mortgage loans. As part of this effort, we have developed a variety of floating or adjustable interest rate products that correlate more closely with our cost of funds, particularly loans for commercial business and real estate, agricultural business, and construction and development purposes. However, in response to customer demand, we continue to originate fixed-rate loans, including fixed interest rate mortgage loans with terms of up to 30 years. The relative amount of fixed-rate loans and adjustable-rate loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

Historically, our lending activities have been primarily directed toward the origination of real estate and commercial loans. Prior to 2008, real estate lending activities were significantly focused on residential construction and land development and first mortgages on owner-occupied, one- to four-family residential properties; however, over the subsequent four years our origination of construction and land development loans declined materially and the proportion of the portfolio invested in these types of loans has declined substantially. During 2011 and particularly in 2012, we experienced more demand for one- to four-family construction loans and outstanding balances have increased modestly. Our residential mortgage loan originations also decreased during the earlier years of this cycle, although less significantly than the decline in construction and land development lending as exceptionally low interest rates supported demand for loans to refinance existing debt as well as loans to finance home purchases. Refinancing activity was particularly significant during 2012, which resulted in a meaningful increase in residential mortgage originations compared to the same period a year earlier. Despite the recent increase in these loan originations, our outstanding balances for residential mortgages have continued to decline, as most of the new originations have been sold in the secondary market while existing residential loans have been repaying at an accelerated pace. Our real estate lending activities also include the origination of multifamily and commercial real estate loans. While reduced from periods prior to the economic slowdown, our level of activity and investment in these types of loans has been relatively stable in recent periods. Our commercial business lending is directed toward meeting the credit and related deposit needs of various small to medium-sized business and agribusiness borrowers operating in our primary market areas. Reflecting the weak economy, in recent periods demand for these types of commercial business loans has been modest and, aside from seasonal variations, total outstanding balances have not significantly increased or decreased. Our consumer lending activity is primarily directed at meeting demand from

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our existing deposit customers and, while we have increased our emphasis on consumer lending in recent years, demand for consumer loans also has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt. At December 31, 2012, our net loan portfolio totaled $\$ 3.158$ billion compared to $\$ 3.213$ billion at December 31, 2011.

For additional information concerning our loan portfolio, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Loans and Lending" including Tables 7 and 8, which sets forth the composition and geographic concentration of our loan portfolio, and Tables 9 and 10 , which contain information regarding the loans maturing in our portfolio.

One- to Four-Family Residential Real Estate Lending: At both Banner Bank and Islanders Bank, we originate loans secured by first mortgages on one- to four-family residences in the Northwest communities where we have offices. While we offer a wide range of products, we have not engaged in any sub-prime lending programs, which we define as loans to borrowers with poor credit histories or undocumented repayment capabilities and with excessive reliance on the collateral as the source of repayment. However, in recent years we have experienced a modest increase in delinquencies on our residential loans in response to the weakened housing market conditions. At December 31, 2012, $\$ 582$ million, or $18 \%$ of our loan portfolio, consisted of permanent loans on one- to four-family residences.

We offer fixed- and adjustable-rate mortgages (ARMs) at rates and terms competitive with market conditions, primarily with the intent of selling these loans into the secondary market. Fixed-rate loans generally are offered on a fully amortizing basis for terms ranging from 10 to 30 years at interest rates and fees that reflect current secondary market pricing. Most ARM products offered adjust annually after an initial period ranging from one to five years, subject to a limitation on the annual change of $1.0 \%$ to $2.0 \%$ and a lifetime limitation of $5.0 \%$ to $6.0 \%$. For a small portion of the portfolio, where the initial period exceeds one year, the first rate change may exceed the annual limitation on subsequent rate changes. Our ARM products most frequently adjust based upon the average yield on Treasury securities adjusted to a constant maturity of one year or certain London Interbank Offered Rate (LIBOR) indices plus a margin or spread above the index. ARM loans held in our portfolio may allow for interest-only payments for an initial period up to five years but do not provide for negative amortization of principal and carry no prepayment restrictions. The retention of ARM loans in our loan portfolio can help reduce our exposure to changes in interest rates. However, borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. In recent years, borrower demand for ARM loans has been limited and we have chosen not to aggressively pursue ARM loans by offering minimally profitable, deeply discounted teaser rates or option-payment ARM products. As a result, ARM loans have represented only a small portion of our loans originated during this period and of our portfolio.

Our residential loans are generally underwritten and documented in accordance with the guidelines established by the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) and the Federal National Mortgage Association (Fannie Mae or FNMA). Government insured loans are underwritten and documented in accordance with the guidelines established by the Department of Housing and Urban Development (HUD) and the Veterans Administration (VA). In the loan approval process, we assess the borrower's ability to repay the loan, the adequacy of the proposed security, the employment stability of the borrower and the creditworthiness of the borrower. For ARM loans, our standard practice provides for underwriting based upon fully indexed interest rates and payments. Generally, we will lend up to $95 \%$ of the lesser of the appraised value or purchase price of the property on conventional loans, although higher loan-to-value ratios are available on certain government insured programs. We require private mortgage insurance on conventional residential loans with a loan-to-value ratio at origination exceeding $80 \%$. For the past four years, particularly in 2009 and 2010, a number of exceptions to these general underwriting guidelines were granted in connection with the sale or refinance of properties, particularly new

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construction, for which we were already providing financing. These exceptions most commonly relate to loan-to-value and mortgage insurance requirements and not to credit underwriting or loan documentation standards. Such exceptions, while less frequent in recent periods, will likely continue in the near term to facilitate troubled loan resolution and may result in loans having performance characteristics different from the rest of our one-to-four-family loan portfolio.

Through our mortgage banking activities, we sell residential loans on either a servicing-retained or servicing-released basis. During the past three years, we have sold a significant portion of our conventional residential mortgage originations and nearly all of our government insured loans in the secondary market.

Construction and Land Lending: Historically, we have invested a significant portion of our loan portfolio in residential construction and land loans to professional home builders and developers; however, as housing markets weakened the amount of this investment was substantially reduced in recent years. In years prior to 2008, residential construction and land development lending was an area of major emphasis at Banner Bank and the primary focus of its subsidiary, CFC. To a lesser extent, we also originate construction loans for commercial and multifamily real estate. More recently, in response to improvement in certain sub-markets, our construction and development lending increased in 2011 and 2012 and made a meaningful contribution to increased revenues and profitability in those years. Although well diversified with respect to sub-markets, price ranges and borrowers, our construction and land loans are significantly concentrated in the greater Puget Sound region of Washington State and the Portland, Oregon market area. At December 31, 2012, construction and land loans totaled $\$ 305$ million, or $9 \%$ of total loans of the Company, consisting of $\$ 161$ million of one- to four-family construction loans, $\$ 77$ million of residential land or land development loans, $\$ 53$ million of commercial and multifamily real estate construction loans and $\$ 14$ million of commercial land or land development loans.

Construction and land lending affords us the opportunity to achieve higher interest rates and fees with shorter terms to maturity than are usually available on other types of lending. Construction and land lending, however, involves a higher degree of risk than other lending opportunities because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity
of the loan with a project the value of which is insufficient to assure full repayment. Disagreements between borrowers and builders and the failure of builders to pay subcontractors may also jeopardize projects. Loans to builders to construct homes for which no purchaser has been identified carry additional risk because the payoff for the loan is dependent on the builder's ability to sell the property before the construction loan is due. We attempt to address these risks by adhering to strict underwriting policies, disbursement procedures and monitoring practices.

Construction loans made by us include those with a sales contract or permanent loan in place for the finished homes and those for which purchasers for the finished homes may be identified either during or following the construction period. We actively monitor the number of unsold homes in our construction loan portfolio and local housing markets to attempt to maintain an appropriate balance between home sales and new loan originations. The maximum number of speculative loans (loans that are not pre-sold) approved for each builder is based on a combination of factors, including the financial capacity of the builder, the market demand for the finished product and the ratio of sold to unsold inventory the builder maintains. We have attempted to diversify the risk associated with speculative construction lending by doing business with a large number of small and mid-sized builders spread over a relatively large geographic region with numerous sub-markets within our three-state service area.

Loans for the construction of one- to four-family residences are generally made for a term of twelve to eighteen months. Our loan policies include maximum loan-to-value ratios of up to $80 \%$ for speculative loans. Individual speculative loan requests are supported by an independent appraisal of the property, a set of plans, a cost breakdown and a completed specifications form. Underwriting is focused on the borrowers' financial strength, credit history and demonstrated ability to produce a quality product and effectively market and manage their operations. All speculative construction loans must be approved by senior loan officers.

Historically, we have also made land loans to developers, builders and individuals to finance the acquisition and/or development of improved lots or unimproved land, although over the past five years we generally have not originated this type of loan. In making land loans, we follow underwriting policies and disbursement and monitoring procedures similar to those for construction loans. The initial term on land loans is typically one to three years with interest only payments, payable monthly, and provisions for principal reduction as lots are sold and released from the lien of the mortgage.

We regularly monitor the construction and land loan portfolios and the economic conditions and housing inventory in each of our markets and increase or decrease this type of lending as we observe market conditions change. Housing markets in most areas of the Pacific Northwest significantly deteriorated beginning in 2008 and our origination of new construction loans declined sharply as a result; however, our level of construction lending has increased in the past two years as certain sub-markets have improved. We believe that the underwriting policies and internal monitoring systems we have in place have helped to mitigate some of the risks inherent in construction and land lending; however, weak housing market conditions nonetheless resulted in material delinquencies and charge-offs in our construction and land loan portfolios in recent years. While construction and land loans, including residential, commercial and multifamily, have been meaningfully reduced, they still represent $9 \%$ of our portfolio. Reducing the amount of non-performing construction and land development loans and related real estate acquired through foreclosure was the most critical issue that we needed to resolve to return to acceptable levels of profitability and we have made substantial progress during the past three years in this regard, as reflected in the decline in non-performing construction and land loans to $12 \%$ of non-performing loans at December 31, 2012 from $52 \%$ of non-performing loans at December 31, 2010. The most significant risk in this portfolio relates to the land development loans in a few areas where demand for building lots remains weak. (See "Asset Quality" below and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality.")

Commercial and Multifamily Real Estate Lending: We originate loans secured by multifamily and commercial real estate including, as noted above, loans for construction of multifamily and commercial real estate
projects. Commercial real estate loans are made for both owner-occupied and investor properties. At December 31, 2012, our loan portfolio included $\$ 138$ million in multifamily and $\$ 1.073$ billion in commercial real estate loans, including $\$ 489$ million in owner-occupied commercial real estate loans and $\$ 584$ million in non-owner-occupied commercial real estate loans, which in aggregate comprised $37 \%$ of our total loans. Multifamily and commercial real estate lending affords us an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multifamily and commercial properties are generally greater in amount, more difficult to evaluate and monitor and, therefore, potentially riskier than one- to four-family residential mortgage loans. Because payments on loans secured by multifamily and commercial properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. In originating multifamily and commercial real estate loans, we consider the location, marketability and overall attractiveness of the properties. Our underwriting guidelines for multifamily and commercial real estate loans require an appraisal from a qualified independent appraiser and an economic analysis of each property with regard to the annual revenue and expenses, debt service coverage and fair value to determine the maximum loan amount. In the approval process we assess the borrowers' willingness and ability to manage the property and repay the loan and the adequacy of the collateral in relation to the loan amount.

Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Most of our multifamily and commercial real estate loans are linked to various Federal Home Loan Bank (FHLB) advance rates, certain prime rates or other market rate indices. Rates on these adjustable-rate loans generally adjust with a frequency of one to five years after an initial fixed-rate period ranging from one to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no large concentrations by property type, location or borrower. At December 31, 2012, the average size of our commercial real estate loans was $\$ 659,000$ and the largest commercial real estate loan in our portfolio was approximately $\$ 15$ million.

Commercial Business Lending: We are active in small- to medium-sized business lending and are engaged to a lesser extent in agricultural lending primarily by providing crop production loans. Our commercial bankers are focused on local markets and devote a great deal of effort to developing customer relationships and the ability to serve these types of borrowers with a full array of products and services delivered in a thorough and responsive manner. While also strengthening our commitment to small business lending, in recent years we have added experienced officers and staff focused on corporate lending opportunities for borrowers with credit needs generally in a $\$ 3$ million to $\$ 15$ million range. In addition to providing earning assets, this type of lending has helped us increase our deposit base. Expanding commercial lending and related commercial banking services is currently an area of significant focus, including recent reorganization and additions to staffing in the areas of business development, credit administration, Small Business Administration (SBA) lending, and loan and deposit operations.

Commercial business loans may entail greater risk than other types of loans. Commercial business loans may be unsecured or secured by special purpose or rapidly depreciating assets, such as equipment, inventory and receivables, which may not provide an adequate source of repayment on defaulted loans. In addition, commercial business loans are dependent on the borrower's continuing financial strength and management ability, as well as market conditions for various products, services and commodities. For these reasons, commercial business loans generally provide higher yields or related revenue opportunities than many other types of loans but also require more administrative and management attention. Loan terms, including the fixed or adjustable interest rate, the loan maturity and the collateral considerations, vary significantly and are negotiated on an individual loan basis.

We underwrite our commercial business loans on the basis of the borrower's cash flow and ability to service the debt from earnings rather than on the basis of the underlying collateral value. We seek to structure these loans so that they have more than one source of repayment. The borrower is required to provide us with sufficient information to allow us to make a prudent lending determination. In most instances, this information consists of at least three years of financial statements, tax returns, a statement of projected cash flows, current financial information on any guarantor and information about the collateral. Loans to closely held businesses typically require personal guarantees by the principals. Our commercial business loan portfolio is geographically dispersed across the market areas serviced by our branch network and there are no significant concentrations by industry or products.

Our commercial business loans may be structured as term loans or as lines of credit. Commercial business term loans are generally made to finance the purchase of fixed assets and have maturities of five years or less. Commercial business lines of credit are typically made for the purpose of providing working capital and are usually approved with a term of one year. Adjustable- or floating-rate loans are primarily tied to various prime rate or LIBOR indices. At December 31, 2012, commercial business loans totaled $\$ 618$ million, or $19 \%$ of our total loans.

Agricultural Lending: Agriculture is a major industry in many parts of our service areas. While agricultural loans are not a large part of our portfolio, we intend to continue to make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operations of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile. At December 31, 2012, agricultural business loans, including collateral secured loans to purchase farm land and equipment, totaled $\$ 230$ million, or $7 \%$ of our loan portfolio.

Agricultural operating loans generally are made as a percentage of the borrower's anticipated income to support budgeted operating expenses. These loans are secured by a blanket lien on all crops, livestock, equipment, accounts and products and proceeds thereof. In the case of crops, consideration is given to projected yields and prices from each commodity. The interest rate is normally floating based on the prime rate or a LIBOR index plus a negotiated margin. Because these loans are made to finance a farm or ranch's annual operations, they are usually written on a
one-year review and renewable basis. The renewal is dependent upon the prior year's performance and the forthcoming year's projections as well as the overall financial strength of the borrower. We carefully monitor these loans and related variance reports on income and expenses compared to budget estimates. To meet the seasonal operating needs of a farm, borrowers may qualify for single payment notes, revolving lines of credit and/or non-revolving lines of credit.

In underwriting agricultural operating loans, we consider the cash flow of the borrower based upon the expected operating results as well as the value of collateral used to secure the loans. Collateral generally consists of cash crops produced by the farm, such as milk, grains, fruit, grass seed, peas, sugar beets, mint, onions, potatoes, corn and alfalfa or livestock. In addition to considering cash flow and obtaining a blanket security interest in the farm's cash crop, we may also collateralize an operating loan with the farm's operating equipment, breeding stock, real estate and federal agricultural program payments to the borrower.

We also originate loans to finance the purchase of farm equipment. Loans to purchase farm equipment are made for terms of up to seven years. On occasion, we also originate agricultural real estate loans secured primarily by first liens on farmland and improvements thereon located in our market areas, although generally only to service the needs of our existing customers. Loans are written in amounts ranging from $50 \%$ to $75 \%$ of the tax assessed or appraised value of the property for terms of five to 20 years. These loans generally have interest rates that adjust at least every five years based upon a Treasury index or FHLB advance rate plus a negotiated margin. Fixed-rate loans are granted on terms usually not to exceed five years. In originating agricultural real estate loans, we consider the debt service coverage of the borrower's cash flow, the appraised value of the underlying property, the experience and knowledge of the borrower, and the borrower's past performance with us and/or the market area. These loans normally are not made to start-up businesses and are reserved for existing customers with substantial equity and a proven history.

Among the more common risks to agricultural lending can be weather conditions and disease. These risks may be mitigated through multi-peril crop insurance. Commodity prices also present a risk, which may be reduced by the use of set price contracts. Normally, required beginning
and projected operating margins provide for reasonable reserves to offset unexpected yield and price deficiencies. In addition to these risks, we also consider management succession, life insurance and business continuation plans when evaluating agricultural loans.

Consumer and Other Lending: We originate a variety of consumer loans, including home equity lines of credit, automobile, boat and recreational vehicle loans and loans secured by deposit accounts. While consumer lending has traditionally been a small part of our business, with loans made primarily to accommodate our existing customer base, it has received consistent emphasis in recent years. Part of this emphasis has been the reintroduction of a Banner Bank-funded credit card program which we began marketing in 2005. Similar to other consumer loan programs, we focus this credit card program on our existing customer base to add to the depth of our customer relationships. In addition to earning balances, credit card accounts produce non-interest revenues through interchange fees and other activity-based revenues. Our underwriting of consumer loans is focused on the borrower's credit history and ability to repay the debt as evidenced by documented sources of income. At December 31, 2012, we had $\$ 291$ million, or $9 \%$ of our loans receivable, in consumer related loans, including \$170 million, or 5\% of our loans receivable, in consumer loans secured by one- to four-family residences.

Similar to commercial business loans, our other consumer loans often entail greater risk than residential mortgage loans. Home equity lines of credit generally entail greater risk than do one- to four-family residential mortgage loans where we are in the first lien position. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. In the case of consumer loans which are unsecured or secured by rapidly depreciating assets such as automobiles, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. These loans may also give rise to claims and defenses by a consumer loan borrower against an assignee of such loans such as us, and a borrower may be able to assert against the assignee claims and defenses that it has against the seller of the underlying collateral.

Loan Solicitation and Processing: We originate real estate loans in our market areas by direct solicitation of real estate brokers, builders, depositors, walk-in customers and visitors to our Internet website. Loan applications are taken by our mortgage loan officers or through our Internet website and are processed in branch or regional locations. Most underwriting and loan administration functions for our real estate loans are performed by loan personnel at central locations. We do not make loans originated by independent third-party loan brokers or any similar wholesale loan origination channels.

Our commercial bankers solicit commercial and agricultural business loans through call programs focused on local businesses and farmers. While commercial bankers are delegated reasonable commitment authority based upon their qualifications, credit decisions on significant commercial and agricultural loans are made by senior loan officers or in certain instances by the Board of Directors of Banner Bank and Islanders Bank.

We originate consumer loans through various marketing efforts directed primarily toward our existing deposit and loan customers. Consumer loan applications are primarily underwritten and documented by centralized administrative personnel.

Loan Originations, Sales and Purchases

While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. For the years ended December 31, 2012, 2011 and 2010, we originated loans, net of repayments, of $\$ 460$ million, $\$ 270$ million, and $\$ 114$ million, respectively. The increase in net originations for 2012 reflects a significant increase in production of one- to four-family residential loans, as well as increased new commercial business and agricultural business loans and commercial real estate loans, and a reduction in charge-offs on problem loans. The lower level of originations, net of repayments and charge-offs, during 2010 was significantly impacted by reduced demand from creditworthy borrowers due to weak economic conditions, a substantial amount of loan repayments, and significant charge-offs.

We sell many of our newly originated one- to four-family residential mortgage loans to secondary market purchasers as part of our interest rate risk management strategy. Originations of one- to four-family residential loans for sale increased to $\$ 504$ million for the year ended December 31, 2012 from $\$ 279$ million during 2011. Proceeds from sales of loans for the years ended December 31, 2012, 2011 and 2010, totaled $\$ 505$ million, $\$ 282$ million, and $\$ 351$ million, respectively. Sales of loans generally are beneficial to us because these sales may generate income at the time of sale, provide funds for additional lending and other investments, increase liquidity or reduce interest rate risk. We sell loans on both a servicing-retained and a servicing-released basis. All loans are sold without recourse. The decision to hold or sell loans is based on asset liability management goals, strategies and policies and on market conditions. See "Loan Servicing." At December 31, 2012, we had $\$ 12$ million in loans held for sale.

We periodically purchase whole loans and loan participation interests primarily during periods of reduced loan demand in our primary market area and at times to support our Community Reinvestment Act lending activities. Any such purchases are made generally consistent with our underwriting standards; however, the loans may be located outside of our normal lending area. During the years ended December 31, 2012, 2011 and 2010, we purchased $\$ 18$ million, $\$ 5$ million and $\$ 341,000$, respectively, of loans and loan participation interests.

## Loan Servicing

We receive fees from a variety of institutional owners in return for performing the traditional services of collecting individual payments and managing portfolios of sold loans. At December 31, 2012, we were servicing $\$ 1.031$ billion of loans for others. Loan servicing includes processing payments, accounting for loan funds and collecting and paying real estate taxes, hazard insurance and other loan-related items such as private mortgage insurance. In addition to earning fee income, we retain certain amounts in escrow for the benefit of the lender for which we incur no interest expense but are able to invest the funds into earning assets. At December 31, 2012, we held $\$ 5.0$ million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2012 was composed of $\$ 687$ million of Freddie Mac residential mortgage loans, $\$ 212$ million of Fannie Mae residential mortgage loans and $\$ 132$ million of both residential and non-residential mortgage loans serviced for a variety of private investors. The portfolio included loans secured by property located primarily in the states of Washington, Oregon and Idaho. For the year ended December 31, 2012, we recognized a $\$ 872,000$ gain from loan servicing in our results of operations, which was net of $\$ 2.6$ million of servicing rights amortization and a $\$ 400,000$ impairment charge for a valuation adjustment to mortgage servicing rights.

Mortgage Servicing Rights: We record mortgage servicing rights (MSRs) with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. For the years ended December 31, 2012, 2011 and 2010, we capitalized $\$ 3.7$ million, $\$ 1.9$ million, and $\$ 1.7$ million, respectively, of MSRs relating to loans sold with servicing retained. No MSRs were purchased in those periods. Amortization of MSRs for the years ended December 31, 2012, 2011 and 2010, was $\$ 2.6$ million, $\$ 1.8$ million, and $\$ 2.0$ million, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. These carrying values are adjusted when the valuation indicates the carrying value is impaired. During 2012, we recorded a $\$ 400,000$ impairment charge to reduce the carrying value of our MSRs. MSRs generally are adversely affected by higher levels of current or anticipated prepayments resulting from decreasing interest rates. At December 31, 2012, our MSRs were carried at a value of $\$ 6.2$ million, net of amortization.

## Asset Quality

Classified Assets: State and federal regulations require that the Banks review and classify their problem assets on a regular basis. In addition, in connection with examinations of insured institutions, state and federal examiners have authority to identify problem assets and, if appropriate, require them to be classified. Historically, we have not had any meaningful differences of opinion with the examiners with respect to asset classification. Banner Bank's Credit Policy Division reviews detailed information with respect to the composition and performance of the loan portfolios, including information on risk concentrations, delinquencies and classified assets for both Banner Bank and Islanders Bank. The Credit Policy Division approves all recommendations for new classified loans or, in the case of smaller-balance homogeneous loans including residential real estate and consumer loans, it has approved policies governing such classifications, or changes in classifications, and develops and monitors action plans to resolve the problems associated with the assets. The Credit Policy Division also approves recommendations for establishing the appropriate level of the allowance for loan losses. Significant problem loans are transferred to Banner Bank's Special Assets Department for resolution or collection activities. The Banks' and Banner Corporation's Boards of Directors are given a detailed report on classified assets and asset quality at least quarterly. For additional information regarding asset quality and non-performing loans, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Asset Quality," and Tables 15, 16 and 17 contained therein.

Allowance for Loan Losses: In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the

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term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. As a result, we maintain an allowance for loan losses consistent with GAAP guidelines. We increase our allowance for loan losses by charging provisions for possible loan losses against our income. The allowance for losses on loans is maintained at a level which, in management's judgment, is sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon continuing analysis of the factors underlying the quality of the loan portfolio. At December 31, 2012, we had an allowance for loan losses of $\$ 77$ million, which represented $2.39 \%$ of loans and $225 \%$ of non-performing loans compared to $2.52 \%$ and $110 \%$, respectively, at December 31, 2011. For additional information concerning our allowance for loan losses, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011—Provision and Allowance for Loan Losses," and Tables 21 and 22 contained therein.

Real Estate Owned: Real estate owned (REO) is property acquired by foreclosure or receiving a deed in lieu of foreclosure, and is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying amount of the defaulted loan. Development and improvement costs relating to the property are capitalized to the extent they add value to the property. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are credited or charged to operations in the period in which they are realized. The amounts we will ultimately recover from REO may differ substantially from the carrying value of the assets because of market factors beyond our control or because of changes in our strategies for recovering the investment. If the book value of the REO is determined to be in excess of the fair market value, a valuation allowance is recognized against earnings. At December 31, 2012, we had REO of $\$ 16$ million, compared to $\$ 43$ million at December 31, 2011. Valuation allowances recognized during 2012 were $\$ 5.2$ million and for both 2011 and 2010 valuation charges were $\$ 15.1$ million. For additional information on REO, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Asset Quality" and Table 18 contained therein and Note 7 of the Notes to the Consolidated Financial Statements.

## Investment Activities

Under Washington state law, banks are permitted to invest in various types of marketable securities. Authorized securities include but are not limited to Treasury obligations, securities of various federal agencies (including government-sponsored enterprises), mortgage-backed and asset-backed securities, certain certificates of deposit of insured banks and savings institutions, bankers' acceptances, repurchase agreements, federal funds, commercial paper, corporate debt and equity securities and obligations of states and their political subdivisions. Our investment policies are designed to provide and maintain adequate liquidity and to generate favorable rates of return without incurring undue interest rate or credit risk. Our policies generally limit investments to U.S. Government and agency (including government-sponsored entities) securities, municipal bonds, certificates of deposit, corporate debt obligations and mortgage-backed securities. Investment in mortgage-backed securities may include those issued or guaranteed by Freddie Mac, Fannie Mae, Government National Mortgage Association (Ginnie Mae or GNMA) and privately-issued mortgage-backed securities that have an AA credit rating or higher at the time of purchase, as well as collateralized mortgage obligations (CMOs). A high credit rating indicates only that the rating agency believes there is a low risk of loss or default. To the best of our knowledge, we do not have any investments in mortgage-backed securities, collateralized debt obligations or structured investment vehicles that have a material exposure to sub-prime mortgages. However, we do have investments in single-issuer trust preferred securities and collateralized debt obligations secured by pooled trust preferred securities that have been materially adversely impacted by concerns related to the banking and insurance industries as well as payment deferrals and defaults by certain issuers. Further, all of our investment securities, including those that have high credit ratings, are subject to market risk in so far as a change in market rates of interest or other conditions may cause a change in an investment's earnings performance and/or market value.

At December 31, 2012, our consolidated investment portfolio totaled $\$ 631$ million and consisted principally of U.S. Government agency obligations, mortgage-backed securities, municipal bonds, corporate debt obligations, and asset-backed securities secured by student loans issued or guaranteed by the Student Loan Marketing Association. From time to time, investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in loan originations, deposits and other activities. During the year ended December 31, 2012, holdings of mortgage-backed securities increased $\$ 176$ million to $\$ 306$ million, while Treasury and agency obligations decreased $\$ 243$ million to $\$ 99$ million, corporate securities including equities increased $\$ 6$ million to $\$ 49$ million, municipal bonds increased $\$ 28$ million to $\$ 135$ million, and new investments in asset-backed securities were $\$ 43$ million.

For detailed information on our investment securities, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Investments," and Tables 1 to 6 contained therein.

Off-Balance-Sheet Derivatives: Derivatives include "off-balance-sheet" financial products, the value of which is dependent on the value of underlying financial assets, such as stock, bonds, foreign currency, or a reference rate or index. Such derivatives include "forwards," "futures," "options" or "swaps." As a result of the 2007 acquisition of F\&M Bank, we became a party to approximately $\$ 23$ million ( $\$ 16$ million as of December 31, 2012) in notional amounts of interest rate swaps. These swaps serve as hedges to an equal amount of fixed-rate loans which include market value prepayment penalties that mirror the provision of the specifically matched interest rate swaps. In addition, in 2011 we began actively marketing interest rate swaps to certain loan customers in connection with longer-term floating rate loans, allowing them to effectively fix their loan interest rates. These customer swaps are matched with third party swaps with qualified broker/dealers or banks to offset the risk. As of December 31, 2012, we had $\$ 95$ million in notional amounts of these customer interest rate swaps outstanding, with an equal amount of offsetting third party swaps also in place. The fair value adjustments for these swaps and the related loans are reflected in other assets or other liabilities as appropriate, and in the carrying value of the hedged loans. Also, as a part of mortgage banking
activities, we issue "rate lock" commitments to borrowers and obtain offsetting "best efforts" delivery commitments from purchasers of loans. While not providing any trading or net settlement mechanisms, these off-balance-sheet commitments do have many of the prescribed characteristics of derivatives and as a result are accounted for as such. Accordingly, on December 31, 2012, we recorded an asset of $\$ 74,000$ and a liability of $\$ 74,000$, representing the estimated market value of those commitments. Further, in 2012 we began using forward contracts for the sale of mortgage-backed securities and mandatory delivery commitments for the sale of loans to partially hedge "rate lock" commitments and closed loans to borrowers in our mortgage banking activities. On December 31, 2012, we recorded an asset of $\$ 436,000$ and a liability of $\$ 121,000$, representing the estimated market value of those commitments. These forward contracts and mandatory delivery commitments, as well as the related "rate lock" commitments and loans, are accounted for in the Consolidated Financial Statements at fair value with changes in fair value recognized in earnings. On December 31, 2012, we had no other investment related off-balance-sheet derivatives.

## Deposit Activities and Other Sources of Funds

General: Deposits, FHLB advances (or other borrowings) and loan repayments are our major sources of funds for lending and other investment purposes. Scheduled loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced by general economic, interest rate and money market conditions and may vary significantly. Borrowings may be used on a short-term basis to compensate for reductions in the availability of funds from other sources. Borrowings may also be used on a longer-term basis for general business purposes, including funding loans and investments.

We compete with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction balances and savings deposits from commercial banks, credit unions and non-bank corporations, such as securities brokerage companies, mutual funds and other diversified companies, some of which have nationwide networks of offices. Much of the focus of our branch expansion, relocations and renovation and advertising and marketing campaigns has been directed toward attracting additional deposit customer relationships and balances. In addition, our electronic banking activities including debit card and automated teller machine (ATM) programs, on-line Internet banking services and, most recently, customer remote deposit and mobile banking capabilities are all directed at providing products and services
that enhance customer relationships and result in growing deposit balances. Growing core deposits (transaction and savings accounts) is a fundamental element of our business strategy.

Deposit Accounts: We generally attract deposits from within our primary market areas by offering a broad selection of deposit instruments, including demand checking accounts, interest-bearing checking accounts, money market deposit accounts, regular savings accounts, certificates of deposit, cash management services and retirement savings plans. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of deposit accounts, we consider current market interest rates, profitability to us, matching deposit and loan products and customer preferences and concerns. At December 31, 2012, we had $\$ 3.558$ billion of deposits, including $\$ 2.529$ billion of transaction and savings accounts and $\$ 1.029$ billion in time deposits. For additional information concerning our deposit accounts, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Deposit Accounts." See also Table 11 contained therein, which sets forth the balances of deposits in the various types of accounts, and Table 12, which sets forth the amount of our certificates of deposit greater than $\$ 100,000$ by time remaining until maturity as of December 31, 2012. In addition, see Note 9 of the Notes to the Consolidated Financial Statements.

Borrowings: While deposits are the primary source of funds for our lending and investment activities and for general business purposes, we also use borrowings to supplement our supply of lendable funds, to meet deposit withdrawal requirements and to more efficiently leverage our capital position. The FHLB-Seattle serves as our primary borrowing source, although in recent years we have significantly reduced our use of FHLB advances. The FHLB-Seattle provides credit for member financial institutions such as Banner Bank and Islanders Bank. As members, the Banks are required to own capital stock in the FHLB-Seattle and are authorized to apply for advances on the security of that stock and certain of their mortgage loans and securities provided certain credit worthiness standards have been met. Limitations on the amount of advances are based on the financial condition of the member institution, the adequacy of collateral pledged to secure the credit, and FHLB stock ownership requirements. At December 31, 2012, we had $\$ 10$ million of borrowings from the FHLB-Seattle. At that date, Banner Bank had been authorized by the FHLB-Seattle to borrow up to $\$ 889$ million under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to $\$ 26$ million under a similar agreement. The Federal Reserve Bank also serves as an important source of borrowing capacity. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB-Seattle. At December 31, 2012, based upon our available unencumbered collateral, Banner Bank was eligible to borrow $\$ 595$ million from the Federal Reserve Bank, although at that date we had no funds borrowed under this arrangement. Although eligible to participate, Islanders Bank has not applied for approval to borrow from the Federal Reserve Bank. For additional information concerning our borrowings, see Item 7, "Management's Discussion and Analysis of Financial Condition-Comparison of Financial Condition at December 31, 2012 and 2011—Borrowings," Table 14 contained therein, and Notes 10 and 11 of the Notes to the Consolidated Financial Statements.

We issue retail repurchase agreements, generally due within 90 days, as an additional source of funds, primarily in connection with cash management services provided to our larger deposit customers. At December 31, 2012, we had issued retail repurchase agreements totaling $\$ 77$ million, which were secured by a pledge of certain U.S. Government and agency notes and mortgage-backed securities with a market value of $\$ 109$ million. We also may borrow funds through the use of secured wholesale repurchase agreements with securities brokers; however, during the three years ended December 31, 2012, we did not have any wholesale repurchase borrowings.

On March 31, 2009, Banner Bank completed an offering of $\$ 50$ million of qualifying senior bank notes that were guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP). This debt, which was issued to strengthen our overall liquidity position as we adjusted to a lower level of public funds deposits, matured and was repaid on March 31, 2012.

We have also issued $\$ 120$ million of junior subordinated debentures in connection with the sale of trust preferred securities (TPS). The TPS were issued from 2002 through 2007 by special purpose business trusts formed by Banner Corporation and were sold in private offerings to pooled investment vehicles. The junior subordinated debentures associated with the TPS have been recorded as liabilities and are reported at fair value on our Consolidated Statements of Financial Condition. All of the debentures issued to the Trusts, measured at their fair value, less the common stock of the Trusts, qualified as Tier I capital as of December 31, 2012, under guidance issued by the Board of Governors of the Federal Reserve System. We have invested substantially all of the proceeds from the issuance of the TPS as additional paid in capital at Banner Bank. For additional information about deposits and other sources of funds, see Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources," and Notes 9, 10, 11 and 12 of the Notes to the Consolidated Financial Statements.

Personnel

As of December 31, 2012, we had 1,074 full-time and 99 part-time employees. Banner Corporation has no employees except for those who are also employees of Banner Bank, its subsidiaries, and Islanders Bank. The employees are not represented by a collective bargaining unit. We believe our relationship with our employees is good.

## Taxation

Federal Taxation

General: For tax reporting purposes, we report our income on a calendar year basis using the accrual method of accounting on a consolidated basis. We are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the reserve for bad debts. Reference is made to Note 13 of the Notes to the Consolidated Financial Statements for additional information concerning the income taxes payable by us.

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## State Taxation

Washington Taxation: We are subject to a Business and Occupation (B\&O) tax which is imposed under Washington law at the rate of $1.80 \%$ of gross receipts. For many years, this rate had been $1.50 \%$. However, on April 12, 2010, the Washington State Legislature passed a law that temporarily increased this rate to $1.80 \%$. This new higher rate will be in effect for the period May 1, 2010 through June 30, 2013. Interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities is not subject to this tax. Our $\mathrm{B} \& \mathrm{O}$ tax expense was $\$ 2.3$ million, $\$ 2.2$ million, and $\$ 2.3$ million for the years ended December 31, 2012, 2011 and 2010, respectively.

Oregon and Idaho Taxation: Corporations with nexus in the states of Oregon and Idaho are subject to a corporate level income tax. Our operations in those states resulted in corporate income taxes of approximately $\$ 540,000, \$ 30,000$, and $\$ 60,000$ for the years ended December 31, 2012, 2011 and 2010, respectively. As our operations in these states increase, the state income tax provision will have an increasing effect on our effective tax rate and results of operations.

## Competition

We encounter significant competition both in attracting deposits and in originating loans. Our most direct competition for deposits comes from other commercial and savings banks, savings associations and credit unions with offices in our market areas. We also experience competition from securities firms, insurance companies, money market and mutual funds, and other investment vehicles. We expect continued strong competition from such financial institutions and investment vehicles in the foreseeable future, including competition from on-line Internet banking competitors. Our ability to attract and retain deposits depends on our ability to provide transaction services and investment opportunities that satisfy the requirements of depositors. We compete for deposits by offering a variety of accounts and financial services, including robust electronic banking capabilities, with competitive rates and terms, at convenient locations and business hours, and delivered with a high level of personal service and expertise.

Competition for loans comes principally from other commercial banks, loan brokers, mortgage banking companies, savings banks and credit unions and for agricultural loans from the Farm Credit Administration. The competition for loans is intense as a result of the large number of institutions competing in our market areas. We compete for loans primarily by offering competitive rates and fees and providing timely decisions and excellent service to borrowers.

## Regulation

Banner Bank and Islanders Bank
General: As state-chartered, federally insured commercial banks, Banner Bank and Islanders Bank (the Banks) are subject to extensive regulation and must comply with various statutory and regulatory requirements, including prescribed minimum capital standards. The Banks are regularly examined by the FDIC and state banking regulators and file periodic reports concerning their activities and financial condition with these banking regulators. The Banks' relationship with depositors and borrowers also is regulated to a great extent by both federal and state law, especially in such matters as the ownership of deposit accounts and the form and content of mortgage and other loan documents.

Federal and state banking laws and regulations govern all areas of the operation of the Banks, including reserves, loans, investments, deposits, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state bank regulatory agencies also have the general authority to limit the dividends paid by insured banks and bank holding companies if such payments should be deemed to constitute an unsafe and unsound practice. The respective primary federal regulators of Banner Corporation, Banner Bank and Islanders Bank have authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks
from engaging in unsafe or unsound practices.
State Regulation and Supervision: As a Washington state-chartered commercial bank with branches in the States of Washington, Oregon and Idaho, Banner Bank is subject to the applicable provisions of Washington, Oregon and Idaho law and regulations. State law and regulations govern Banner Bank's ability to take deposits and pay interest thereon, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers and to establish branch offices. In a similar fashion, Washington State laws and regulations for state-chartered commercial banks also apply to Islanders Bank.

Deposit Insurance: The Deposit Insurance Fund ("DIF") of the FDIC insures deposit accounts of the Banks up to $\$ 250,000$ per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. Banner Bank's and Islanders Bank's deposit insurance premiums expense for the year ended December 31, 2012, were $\$ 3.5$ million and $\$ 195,000$, respectively.

As a result of a decline in the reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) and concerns about expected failure costs and available liquid assets in the DIF, the FDIC adopted a rule requiring each insured institution to prepay on December 30, 2009 the estimated amount of its quarterly assessments for the fourth quarter of 2009 and all quarters through the end of 2012 (in addition to the regular quarterly assessment for the third quarter which was due on December 30, 2009). The prepaid amount is recorded as an asset with a zero risk weight and the institution will continue to record quarterly expenses for deposit insurance. For purposes of calculating the prepaid amount, assessments were measured at the institution's assessment rate as of September 30, 2009, with a uniform increase of three basis points effective January 1, 2011, and were based on the institution's assessment base for the third quarter of 2009, with growth assumed quarterly at annual rate of $5 \%$. If events cause actual assessments during the prepayment period to vary from the prepaid amount, institutions will pay excess
assessments in cash or receive a rebate of prepaid amounts not exhausted after collection of assessments due on June 30, 2013, as applicable. Collection of the prepayment does not preclude the FDIC from changing assessment rates or revising the risk-based assessment system in the future. The balance of our prepaid assessment was $\$ 12.4$ million at December 31, 2012.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules, effective as of the second quarter of 2011, which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals $1.15 \%$. Once the FDIC's reserve ratio reaches $1.15 \%$ and the reserve ratio for the immediately prior assessment period is less than $2.0 \%$, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than $2.0 \%$ and less than $2.5 \%$, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than $2.5 \%$, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.
The FDIC conducts examinations of and requires reporting by state non-member banks, such as the Banks. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the deposit insurance fund.

The FDIC may terminate the deposit insurance of any insured depository institution if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is not aware of any existing circumstances which would result in termination of the deposit insurance of either Banner Bank or Islanders Bank.

Prompt Corrective Action: Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is $10 \%$ or more, its ratio of core capital to risk-weighted assets is $6 \%$ or more, its ratio of core capital to total assets (leverage ratio) is $5 \%$ or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than $8 \%$, a core capital to risk-weighted assets ratio of not less than $4 \%$, and a leverage ratio of not less than $4 \%$. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by either Banner Bank and Islanders Bank to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment

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of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At December 31, 2012, both Banner Bank and Islanders Bank were categorized as "well capitalized" under the prompt corrective action regulations of the FDIC. For additional information, see Note 18 of the Notes to Consolidated Financial Statements.

Standards for Safety and Soundness: The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to internal controls, information systems and internal audit systems; loan documentation; credit underwriting; interest rate risk exposure; asset growth; asset quality; earnings; and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Capital Requirements: Federally insured financial institutions, such as Banner Bank and Islanders Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common stockholders' equity, qualifying restricted core capital elements (other than cumulative perpetual preferred
stock), less deductions for disallowed intangibles and disallowed deferred tax assets. Tier 2 capital, which recognizes up to $100 \%$ of Tier 1 capital for risk-based capital purposes includes such items as qualifying general loan loss reserves (up to $1.25 \%$ of risk-weighted assets), qualified subordinated debt, redeemable preferred stock, other restricted core capital elements, cumulative perpetual preferred stock, and net unrealized holding gains on equity securities (subject to certain limitations); provided, however, the amount of term subordinated debt and intermediate term preferred stock that may be included in Tier 2 capital for risk-based capital purposes is limited to $50 \%$ of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least $3 \%$ to $4 \%$ of total assets. At December 31, 2012, Banner Bank and Islanders Bank had Tier 1 leverage capital ratios of $12.29 \%$ and $13.02 \%$, respectively. The FDIC retains the right to require an institution to maintain a higher capital level based on an institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of the category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least $8 \%$, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4\%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At December 31, 2012, Banner Bank and Islanders Bank had Tier 1 risk-based capital ratios of $15.12 \%$ and $16.28 \%$, respectively, and total risk-based capital ratios of $16.38 \%$ and $17.53 \%$, respectively.

FDIC capital requirements are designated as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The FDIC capital regulations state that, where the FDIC determines that the financial history or condition, including off-balance-sheet risk, managerial resources and/or the future earnings prospects of a bank are not adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of capital for the bank is greater than the minimum standards established in the regulation.

We believe that, under the current regulations, Banner Bank and Islanders Bank exceed their minimum capital requirements. However, events beyond the control of the Banks, such as weak or depressed economic conditions in areas where they have most of their loans, could adversely affect future earnings and, consequently, the ability of the Banks to meet their capital requirements. For additional information concerning Banner Bank's and Islanders Bank's capital, see Note 18 of the Notes to the Consolidated Financial Statements.

New Proposed Capital Rules. In June 2012, the Federal Reserve, FDIC and the Office of the Comptroller of the Currency (OCC) approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to various documents released by the Basel Committee on Banking Supervision. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

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The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to Banner Corporation and the Banks under the proposals would be: (i) a new common equity Tier 1 capital ratio of $4.5 \%$; (ii) a Tier 1 capital ratio of $6 \%$ (increased from 4\%); (iii) a total capital ratio of $8 \%$ (unchanged from current rules); and (iv) a Tier 1 leverage ratio of $4 \%$. The proposed rules would also establish a "capital conservation buffer" of $2.5 \%$ above each of the new regulatory minimum capital ratios which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of $7.0 \%$, (ii) a Tier 1 capital ratio of $8.5 \%$, and (iii) a total capital ratio of $10.5 \%$. The new capital conservation buffer requirement would be phased in beginning in January 2016 at $0.625 \%$ of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Banks, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as "well capitalized": (i) a new common equity Tier 1 risk-based capital ratio of $6.5 \%$; (ii) a Tier 1 risk-based capital ratio of $8 \%$ (increased from $6 \%$ ); (iii) a total risk-based capital ratio of $10 \%$ (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5\% (unchanged from the current rules).

The proposed rules set forth certain changes for the calculation of risk-weighted assets and utilize an increased number of credit risk and other exposure categories and risk weights. In addition, the proposed rules also address: (i) a proposed alternative standard of creditworthiness
consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; and (iv) revised capital treatment for derivatives and repurchase-style transactions.

In particular, the proposed rules would expand the risk-weighting categories from the current four categories ( $0 \%$, $20 \%, 50 \%$ and $100 \%$ ) to a much larger and more risk-sensitive number of categories, generally ranging from $0 \%$ for U.S. government and agency securities, to $600 \%$ for certain equity exposures. Higher risk weights would apply to a variety of exposure categories. Specifics include, among others:

Applying a $150 \%$ risk weight instead of a $100 \%$ risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

For residential mortgage exposures, the current approach of a $50 \%$ risk weight for high-quality seasoned mortgages and a $100 \%$ risk-weight for all other mortgages is replaced with a risk weight of between $35 \%$ and $200 \%$ depending upon the mortgage's loan-to-value ratio and whether the mortgage is a "category 1 " or "category 2 " residential mortgage exposure (based on eight criteria that include, among others, the term, seniority of the lien, use of negative amortization, balloon payments and certain rate increases).

Assigning a $150 \%$ risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.
Providing for a $20 \%$ credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at $0 \%$ ).

Providing for a $100 \%$ risk weight for claims on securities firms.
Eliminating the current $50 \%$ cap on the risk weight for OTC derivatives.
The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. The following discussion summarizes significant aspects of the Dodd-Frank Act that may affect the Banks and Banner Corporation. For certain of these changes, implementing regulations have not been promulgated, so we cannot determine the full impact of the Dodd-Frank Act on our business and operations at this time.
The following aspects of the Dodd-Frank Act are related to the operations of the Banks:
The Consumer Financial Protection Bureau ("CFPB"), an independent consumer compliance regulatory agency within the Federal Reserve has been established. The CFPB is empowered to exercise broad regulatory, supervisory and enforcement authority over financial institutions with total assets of over $\$ 10$ billion with respect to both new and existing consumer financial protection laws. Financial institutions with assets of less than $\$ 10$ billion, like the Banks, will continue to be subject to supervision and enforcement by their primary federal banking regulator with respect to federal consumer financial protection laws. The CFPB also has authority to promulgate new consumer financial protection regulations and amend existing consumer financial protection regulations;
The Federal Deposit Insurance Act was amended to direct federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries;
The prohibition on payment of interest on demand deposits was repealed, effective July 21, 2011;
Deposit insurance is permanently increased to $\$ 250,000$;
The deposit insurance assessment base for FDIC insurance is the depository institution's average consolidated total assets less the average tangible equity during the assessment period; and

The minimum reserve ratio of the FDIC's DIF increased to 1.35 percent of estimated annual insured deposits or the comparable percentage of the assessment base; however, the FDIC is directed to "offset the effect" of the increased reserve ratio for insured depository institutions with total consolidated assets of less than $\$ 10$ billion. Pursuant to the Dodd-Frank Act, the FDIC recently issued a rule setting a designated reserve ratio at $2.0 \%$ of insured deposits. The following aspects of the Dodd-Frank Act are related to the operations of Banner Corporation:
Tier 1 capital treatment for "hybrid" capital items like trust preferred securities is eliminated subject to various grandfathering and transition rules. The federal banking agencies must promulgate new rules on regulatory capital within 18 months from July 21, 2010, for both depository institutions and their holding companies, to include leverage capital and risk-based capital measures at least as stringent as those now applicable to the Banks under the prompt corrective action regulations;
Public companies are required to provide their shareholders with a non-binding vote: (i) at least once every three years on the compensation paid to executive officers, and (ii) at least once every six years on whether they should have a "say on pay" vote every one, two or three years;

A separate, non-binding shareholder vote is required regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments;
Securities exchanges are required to prohibit brokers from using their own discretion to vote shares not beneficially owned by them for certain "significant" matters, which include votes on the election of directors, executive compensation matters, and any other matter determined to be significant;
Stock exchanges are prohibited from listing the securities of any issuer that does not have a policy providing for (i) disclosure of its policy on incentive compensation payable on the basis of financial information reportable under the securities laws, and (ii) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid erroneously during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information;
Disclosure in annual proxy materials is required concerning the relationship between the executive compensation paid and the financial performance of the issuer;
Item 402 of Regulation S-K is amended to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees; and
Smaller reporting companies are exempt from complying with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act.

Commercial Real Estate Lending Concentrations: The federal banking agencies have issued guidance on sound risk management practices for concentrations in commercial real estate lending. The particular focus is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be sensitive to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is not to limit a bank's commercial real estate lending but to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance directs the FDIC and other bank regulatory agencies to focus their supervisory resources on institutions that may have significant commercial real estate loan concentration risk. A bank that has experienced rapid growth in commercial real estate lending, has notable exposure to a specific type of commercial real estate loan, or is approaching or exceeding the following supervisory criteria may be identified for further supervisory analysis with respect to real estate concentration risk:

Total reported loans for construction, land development and other land represent $100 \%$ or more of the bank's capital; or

Total commercial real estate loans (as defined in the guidance) represent $300 \%$ or more of the bank's total capital or the outstanding balance of the bank's commercial real estate loan portfolio has increased $50 \%$ or more during the prior 36 months.

The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory guidance on evaluation of capital adequacy. As of December 31, 2012, Banner Bank's and Islanders Bank's aggregate loans for construction, land development and land loans were $92 \%$ and $51 \%$ of total capital, respectively. In addition, at December 31, 2012 Banner Bank's and Islanders Bank's loans on commercial real estate were $227 \%$ and $213 \%$ of total capital, respectively.

Activities and Investments of Insured State-Chartered Financial Institutions: Federal law generally limits the activities and equity investments of FDIC insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (1) acquiring or retaining a majority interest in a subsidiary, (2) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such
limited partnership investments may not exceed $2 \%$ of the bank's total assets, (3) acquiring up to $10 \%$ of the voting stock of a company that solely provides or re-insures directors', trustees' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (4) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

Washington State has enacted a law regarding financial institution parity. Primarily, the law affords
Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of the Washington Department of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered commercial banks may exercise any of the powers that the Federal Reserve has determined to be closely related to the business of banking and the powers of national banks, subject to the approval of the Director in certain situations. The law also provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

Environmental Issues Associated With Real Estate Lending: The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) is a federal statute that generally imposes strict liability on all prior and present "owners and operators" of sites containing hazardous waste. However, Congress asked to protect secured creditors by providing that the term "owner and operator" excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this "secured creditor exemption" has been the
subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including Banner Bank and Islanders Bank, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System: The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Interest-bearing checking accounts and 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 at a bank. At December 31, 2012, the Banks' deposits with the Federal Reserve Bank and vault cash exceeded their reserve requirements.

Affiliate Transactions: Banner Corporation, Banner Bank and Islanders Bank are separate and distinct legal entities. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates, including their bank holding companies. Transactions deemed to be a "covered transaction" under Section 23A of the Federal Reserve Act and between a subsidiary bank and its parent company or any non-bank subsidiary of the bank holding company are limited to $10 \%$ of the subsidiary bank's capital and surplus and, with respect to the parent company and all such non-bank subsidiaries, to an aggregate of $20 \%$ of the subsidiary bank's capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

Community Reinvestment Act: Banner Bank and Islanders Bank are subject to the provisions of the Community Reinvestment Act of 1977 (CRA), which requires the appropriate federal bank regulatory agency to assess a bank's performance under the CRA in meeting the credit needs of the community serviced by the bank, including low and moderate income neighborhoods. The regulatory agency's assessment of the bank's record is made available to the public. Further, a bank's CRA performance rating must be considered in connection with a bank's application to, among other things, to establish a new branch office that will accept deposits, relocate an existing office or merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. Both Banner Bank and Islanders Bank received a "satisfactory" rating during their most recent CRA examinations.

Dividends: The amount of dividends payable by the Banks to the Company will depend upon their earnings and capital position, and is limited by federal and state laws, regulations and policies. Federal law further provides that no insured depository institution may make any capital distribution (which includes a cash dividend) if, after making the distribution, the institution would be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe and unsound practice.

Privacy Standards: The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA) modernized the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers. Banner Bank and Islanders Bank are subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require the Banks to disclose their privacy policy, including informing consumers of their information sharing practices and informing consumers of their rights to opt out of certain practices.

Anti-Money Laundering and Customer Identification: In response to the terrorist events of September 11, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act
of 2001 (USA Patriot Act) was signed into law on October 26, 2001. The USA Patriot Act gives 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. Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications. Banner Bank's and Islanders Bank's policies and procedures comply with the requirements of the USA Patriot Act.

Other Consumer Protection Laws and Regulations: The Banks are subject to a broad array of federal and state consumer protection laws and regulations that govern almost every aspect of its business relationships with consumers. While the list set forth below is not exhaustive, these include the Truth-in-Lending Act, the Truth in Savings Act, the Electronic Fund Transfers Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Right to Financial Privacy Act, the Home Ownership and Equity Protection Act, the Fair Credit Billing Act, the Homeowners Protection Act, the Check Clearing for the 21st Century Act, laws governing flood insurance, laws governing consumer protections in connection with the sale of insurance, federal and state laws prohibiting unfair and deceptive business practices, and various regulations that implement some or all of the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans, and providing other services. Failure to comply with these laws and regulations can subject the Banks to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

## Banner Corporation

General: Banner Corporation, as sole shareholder of Banner Bank and Islanders Bank, is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended, or the BHCA, and the regulations of the Federal Reserve. We are required to file quarterly reports with the Federal Reserve
and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and charge us for the cost of the examination. The Federal Reserve also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. Banner Corporation is also required to file certain reports with, and otherwise comply with the rules and regulations of the Securities and Exchange Commission.

The Bank Holding Company Act: Under the BHCA, we are supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd-Frank Act and earlier Federal Reserve policy provide that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial distress to the banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. The Dodd-Frank Act requires new regulations to be promulgated concerning the source of strength. Banner Corporation and any subsidiaries that it may control are considered "affiliates" within the meaning of the Federal Reserve Act, and transactions between Banner Bank and affiliates are subject to numerous restrictions. With some exceptions, Banner Corporation, and its subsidiaries, are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by Banner Corporation, or by its affiliates.

Acquisitions: The BHCA prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than $5 \%$ of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. Under the BHCA, the Federal Reserve may approve the ownership of shares by a bank holding company in any company, the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. These activities include: operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

Federal Securities Laws: Banner Corporation's common stock is registered with the Securities and Exchange Commission under Section 12(b) of the Securities Exchange Act of 1934, as amended. We are subject to information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934 (the Exchange Act).

Sarbanes-Oxley Act of 2002: The Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act was signed into law on July 30, 2002 in response to public concerns regarding corporate accountability in connection with several accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase 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. The Sarbanes-Oxley Act generally applies to all companies, such as Banner Corporation, that file or are required to file periodic reports with the Securities and Exchange Commission (SEC), under the Exchange Act.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and corporate governance rules and requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC and the Comptroller General. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Interstate Banking and Branching: The Federal Reserve must approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the statutory law of the host state. Nor may the Federal Reserve approve an application if the applicant (and its depository institution affiliates) controls or would control more than $10 \%$ of the insured deposits in the United States or $30 \%$ or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state which may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the $30 \%$ state-wide concentration limit contained in the federal law.

The federal banking agencies are authorized to approve interstate merger transactions without regard to whether the transaction is prohibited by the law of any state, unless the home state of one of the banks adopted a law prior to June 1, 1997 which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions will also be subject to the nationwide and statewide insured deposit concentration amounts described above. Under the Dodd-Frank Act, the federal banking agencies may generally approve interstate de novo branching.

Dividends: The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses its view that although there are no specific regulations restricting dividend payments by bank holding companies other than state corporate laws, a bank holding company must maintain an adequate capital position and generally should not pay cash dividends unless the company's net
income for the past year is sufficient to fully fund the cash dividends and that the prospective rate of earnings appears consistent with the company's capital needs, asset quality, and overall financial condition. The Federal Reserve policy statement also indicates that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends.

Capital Requirements: The Federal Reserve has established capital adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Banks, although the Federal Reserve regulations provide for the inclusion of certain trust preferred securities for up to $25 \%$ of Tier 1 capital in determining compliance with the guidelines. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with $\$ 500$ million or more in total consolidated assets. The guidelines require that a company's total risk-based capital must equal $8 \%$ of risk-weighted assets and one half of the $8 \%$ ( $4 \%$ ) must consist of Tier 1 (core) capital. As of December 31, 2012, Banner Corporation's total risk-based capital was $16.96 \%$ of risk-weighted assets and its Tier 1 (core) capital was $15.70 \%$ of risk-weighted assets. The Dodd-Frank Act required new capital regulations to be adopted in final form 18 months after the July 21, 2010 enactment date of the Dodd-Frank Act. In June 2012, the Federal Reserve, FDIC and the OCC approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Stock Repurchases: A bank holding company, except for certain "well-capitalized" and highly rated bank holding companies, is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding twelve months, is equal to $10 \%$ or more of its consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order or any condition imposed by, or written agreement with, the Federal Reserve. We did not repurchase any shares of common stock during the 2012 fiscal year.

Management Personnel
Executive Officers

The following table sets forth information with respect to the executive officers of Banner Corporation and Banner Bank as of December 31, 2012:

| Name | Age | Position with Banner Corporation <br> President, Chief Executive Officer, <br> Director <br> Executive Vice President, <br> Chief Financial Officer |
| :--- | :--- | :--- |
| Lloyd W. Baker | 64 | Position with Banner Bank <br> President, Chief Executive Officer, <br> Director |
| Cynthia D. Purcell | 55 | Executive Vice President, <br> Chief Financial Officer |
| Richard B. Barton | 69 | Executive Vice President, <br> Retail Banking and Administration |
| Steven W. Rust | 65 | Executive Vice President, <br> Chief Lending Officer |
| Douglas M. Bennett | 60 | Executive Vice President, <br> Chief Information Officer <br> Executive Vice President, |
| Tyrone J. Bliss | 55 | Real Estate Lending Operations <br> Executive Vice President, <br> Risk Management and Compliance |
|  |  | Officer |


| Gary W. Wagers | 52 | Executive Vice President, <br> Retail Products and Services <br> Executive Vice President, |
| :--- | :---: | :--- |
| John T. Wagner | 62 | Corporate Administration <br> Senior Vice President, |
| James T. Reed, Jr. | 50 | Commercial Banking |
| M. Kirk Quillin | 50 | Senior Vice President, <br> Commercial Banking |

Biographical Information
Set forth below is certain information regarding the executive officers of Banner Corporation and Banner Bank. There are no family relationships among or between the directors or executive officers.

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Mark J. Grescovich is President and Chief Executive Officer, and a director, of Banner Corporation and Banner Bank. Mr. Grescovich joined the Bank in April 2010 and became Chief Executive Officer in August 2010 following an extensive banking career specializing in finance, credit administration and risk management. Prior to joining the Bank, Mr. Grescovich was the Executive Vice President and Chief Corporate Banking Officer for Akron, Ohio-based FirstMerit Corporation and FirstMerit Bank N.A., a commercial bank with $\$ 14.5$ billion in assets and over 200 branch offices in three states. He assumed the role and responsibility for FirstMerit's commercial and regional line of business in 2007, having served since 1994 in various commercial and corporate banking positions, including that of Chief Credit Officer. Prior to joining FirstMerit, Mr. Grescovich was a Managing Partner in corporate finance with Sequoia Financial Group, Inc. of Akron, Ohio and a commercial and corporate lending officer and credit analyst with Society National Bank of Cleveland, Ohio.

Lloyd W. Baker joined First Savings Bank of Washington (now Banner Bank) in 1995 as Asset/Liability Manager, has been a member of the executive management committee since 1998 and has served as the Chief Financial Officer of Banner Corporation and Banner Bank since 2000. His banking career began in 1972.

Cynthia D. Purcell was formerly the Chief Financial Officer of Inland Empire Bank (now Banner Bank), which she joined in 1981, and has served in her current position as Executive Vice President since 2000. Ms. Purcell is responsible for Retail Banking and Administration.

Richard B. Barton joined Banner Bank in 2002 as Chief Credit Officer. Mr. Barton's banking career began in 1972 with Seafirst Bank and Bank of America, where he served in a variety of commercial lending and credit risk management positions. In his last positions at Bank of America before joining Banner Bank, he served as the senior real estate risk management executive for the Pacific Northwest and as the credit risk management executive for the west coast home builder division. Mr. Barton was named Chief Lending Officer in 2008.

Steven W. Rust joined Banner Bank in October 2005. Mr. Rust has over 34 years of relevant industry experience prior to joining Banner Bank and was founder and President of InfoSoft Technology, through which he worked for nine years as a technology consultant and interim Chief Information Officer for banks and insurance companies. He worked 19 years with US Bank/West One Bancorp as Senior Vice President \& Manager of Information Systems.

Douglas M. Bennett, who joined First Federal Savings and Loan (now Banner Bank) in 1974, has over 36 years of experience in real estate lending. He has served as a member of Banner Bank's executive management committee since 2004.

Tyrone J. Bliss joined Banner Bank in 2002. Mr. Bliss is a Certified Regulatory Compliance Manager with more than 33 years of commercial banking experience. Prior to joining Banner Bank, his career included senior risk management and compliance positions with Bank of America's Consumer Finance Group, Barnett Banks, Inc., and Florida-based community banks.

Gary W. Wagers joined Banner Bank as Senior Vice President, Consumer Lending Administration in 2002 and was named to his current position in Retail Products and Services in January 2008. Mr. Wagers began his banking career in 1982 at Idaho First National Bank. Prior to joining Banner Bank, his career included senior management positions in retail lending and branch banking operations with West One Bank and US Bank.

John T. Wagner began his banking career in 1972 with Norwest Bank. He worked for Seafirst Bank and Bank of America from 1977 to 2003, concluding his career there as Market President for Eastern Washington and Idaho. He joined F\&M Bank in October, 2003 as President and Chief Operating Officer. Currently, Mr. Wagner serves as Executive Vice President at Banner Bank. He is a graduate of the University of Montana with a bachelor's degree in

Finance. He is a 1986 graduate of the Pacific Coast Banking School and has completed the Executive Management Program at Duke University.

James T. Reed, Jr. joined Towne Bank (now Banner Bank) as a Vice President and Commercial Branch Manager in July 1995 and was named to his current position as the West Region Commercial Banking Executive in July 2012. He is responsible for Commercial Banking in Western Washington and Western Oregon as well as Specialty Banking. Mr. Reed began his banking career with Rainier Bank which later became Security Pacific Bank and later still West One Bank. He earned a Bachelor of Arts in Interdisciplinary Arts and Sciences from the University of Washington, and earned certificates from Pacific Coast Banking School, Northwest Intermediate Banking School and Northwest Intermediate Commercial Lending School. Currently, Mr. Reed sits on the University of Washington Bothell Advisory Board and the University of Washington Foundation Board.
M. Kirk Quillin joined Banner Bank's commercial banking group in 2002 as a Senior Vice President and commercial loan manager and was named to his current position as the East Region Commercial Banking Executive in July 2012. He is responsible for commercial and specialty banking for all locations in Eastern Washington, Eastern Oregon and Idaho. Mr. Quillin began his career in the banking industry in 1984 with Idaho First National Bank, which is now U.S. Bank. His career also included management positions in commercial lending with Washington Mutual. He earned a B.S. in Finance and Economics from Boise State University and was certified by the Pacific Coast Banking School and Northwest Intermediate Commercial Lending School.

## Corporate Information

Our principal executive offices are located at 10 South First Avenue, Walla Walla, Washington 99362. Our telephone number is (509) 527-3636. We maintain a website with the address www.bannerbank.com. The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form $10-\mathrm{K}$. Other than an investor's own Internet access charges, we make available
free of charge through our website our Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form $8-\mathrm{K}$, and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to, the Securities and Exchange Commission.

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## Item 1A - Risk Factors

An investment in our common stock is subject to risks inherent in our business. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included in this report. In addition to the risks and uncertainties described below, other risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition, capital levels, cash flows, liquidity, results of operations and prospects. The market price of our common stock could decline significantly due to any of these identified or other risks, and you could lose some or all of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements. This report is qualified in its entirety by these risk factors.

## Risks Factors Related to Our Business

Our business may continue to be adversely affected by downturns in the national economy and the regional economies on which we depend.

Our operations are significantly affected by national and regional economic conditions. Weakness in the national economy or the economies of the markets in which we operate could have a material adverse effect on our financial condition, results of operations and prospects. Substantially all of our loans are to businesses and individuals in the states of Washington, Oregon and Idaho. All of our branches and most of our deposit customers are also located in these three states. Beginning in 2008, Washington, Oregon and Idaho have experienced significant home price declines, increased foreclosures and high unemployment rates, and each state continues to face fiscal challenges, which may have adverse long term effects on economic conditions in those states. As a result of the high concentration of our customer base in the Puget Sound area of Washington State, the deterioration of businesses in the Puget Sound area, or one or more businesses with a large employee base in that area, could have a material adverse effect on our business, financial condition, liquidity, results of operations and prospects. In addition, weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade.

A further deterioration in economic conditions or a prolonged delay in economic recovery in the market areas we serve, in particular the Puget Sound area of Washington State, the Portland, Oregon metropolitan area, Spokane, Washington, Boise, Idaho and the agricultural regions of the Columbia Basin, could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, liquidity and results of operations:
demand for our products and services may decline;
toan delinquencies, problem assets and foreclosures may increase;
collateral for loans, especially real estate, may decline further in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans; and
the amount of our low-cost or non-interest-bearing deposits may decrease.
A return of recessionary conditions could result in increases in our level of non-performing loans and/or reduce demand for our products and services, which could have adverse effect on our results of operations.

The ongoing debate in Congress regarding the national debt ceiling and federal budget deficit and concerns over the United States' credit rating (which was downgraded by Standard \& Poor's), the European sovereign debt crisis, the overall weakness in the economy and continued high unemployment in the United States, among other economic indicators, have contributed to increased volatility in the capital markets and diminished expectations for the
economy.
A return of recessionary conditions and/or continued negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. Further declines in real estate values and sales volumes and continued high unemployment levels may result in higher than expected loan delinquencies and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect our capital, liquidity, and financial condition.
Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. If the Federal Reserve increases the federal funds rate, overall interest rates will likely rise, which may negatively impact the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

Declines in property value have increased the loan-to-value ratios on a significant portion of our residential mortgage loan portfolio, which exposes us to greater risk of loss.

Many of our residential mortgage loans are secured by liens on mortgage properties in which the borrowers have little or no equity because either we originated the loan with a relatively high combined loan-to-value ratio or because of the decline in home values in our market areas. Residential loans with high combined loan-to-value ratios will be more sensitive to declining property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. In addition, if the borrowers
sell their homes, such borrowers may be unable to repay their loans in full from the sale proceeds. As a result, these loans may experience higher rates of delinquencies, defaults and losses.

Our loan portfolio includes loans with a higher risk of loss.
We originate construction and land loans, commercial and multifamily mortgage loans, commercial business loans, consumer loans, agricultural mortgage loans and agricultural loans primarily within our market areas. We had $\$ 2.42$ billion outstanding in these types of higher risk loans at December 31, 2012 compared to $\$ 2.65$ billion at December 31, 2011. These loans typically present different risks to us for a number of reasons, including those discussed below:

Construction and Land Loans. At December 31, 2012, construction and land loans were $\$ 305$ million or $9 \%$ of our total loan portfolio. This type of lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Loans on land under development or held for future construction also pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand conditions. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to independently repay principal and interest. While our origination of these types of loans has decreased significantly in the last five years, we continue to have significant levels of construction and land loan balances. At December 31, 2012, construction and land loans that were non-performing were $\$ 4$ million, or $11 \%$ of our total non-performing loans.

Commercial and Multifamily Real Estate Loans. At December 31, 2012, commercial and multifamily real estate loans were $\$ 1.211$ billion, or $37 \%$ of our total loan portfolio. These loans typically involve higher principal amounts than other types of loans. Repayment is dependent upon income being generated from the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. This risk is exacerbated in the current economic environment. At December 31, 2012, commercial and multifamily real estate loans that were non-performing were $\$ 7$ million, or $19 \%$ of our total non-performing loans.

Commercial Business Loans. At December 31, 2012, commercial business loans were $\$ 618$ million, or $19 \%$ of our total loan portfolio. Our commercial loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise, may be illiquid and may fluctuate in value based on the success of the business. At December 31, 2012, commercial business loans that were non-performing were $\$ 5$ million, or $14 \%$ of our total non-performing loans.

Agricultural Loans. At December 31, 2012, agricultural loans were $\$ 230$ million, or $7 \%$ of our total loan portfolio. Repayment is dependent upon the successful operation of the business, which is greatly dependent on many things outside the control of either us or the borrowers. These factors include weather, commodity prices, and interest rates among others. Collateral securing these loans may be difficult to evaluate, manage or liquidate and may not provide an adequate source of repayment. At December 31, 2012, there were no agricultural loans that were non-performing .

Consumer Loans. At December 31, 2012, consumer loans were $\$ 291$ million, or $9 \%$ of our total loan portfolio. Consumer loans (such as personal lines of credit) are collateralized, if at all, with assets that may not provide an adequate source of payment of the loan due to depreciation, damage, or loss. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. At December 31, 2012, consumer loans that were non-performing were $\$ 4$ million, or $10 \%$ of our total non-performing loans.

If our allowance for loan losses is not adequate, we may be required to make further increases in our provisions for loan losses and to charge off additional loans in the future, which could adversely affect our financial condition, liquidity and results of operations.

For the year ended December 31, 2012, we recorded a provision for loan losses of $\$ 13.0$ million, compared to $\$ 35.0$ million for the year ended December 31, 2011. We also recorded net loan charge-offs of $\$ 18.4$ million for the year ended December 31, 2012, compared to $\$ 49.5$ million for the year ended December 31, 2011. Despite the decrease from the prior year, we are still experiencing elevated levels of loan delinquencies and credit losses by historical standards. At December 31, 2012, our total non-performing loans had decreased to $\$ 34.4$ million compared to $\$ 75.3$ million at December 31, 2011. If current weak conditions in the housing and real estate markets continue, we expect that we will continue
to experience higher than normal delinquencies and credit losses. Moreover, if weak economic conditions in our market areas persist, we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could materially adversely affect our financial condition and results of operations.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio which would cause our results of operations, liquidity and financial condition to be adversely affected.

Lending money is a substantial part of our business and each loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:
cash flow of the borrower and/or the project being financed;
in the case of a collateralized loan, the changes and uncertainties as to the future value of the collateral; *he duration of the loan;
the character and creditworthiness of a particular borrower; and
changes in economic and industry conditions.
We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through periodic reviews and consideration of several factors, including, but not limited to:
our general reserve, based on our historical default and loss experience, certain macroeconomic factors, and management's expectations of future events; our specific reserve, based on our evaluation of non-performing loans and their underlying collateral; and an unallocated reserve to provide for other credit losses inherent in our portfolio that may not have been contemplated in the other loss factors.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability 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 review our loans and loss and delinquency experience, and evaluate economic conditions and make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for additions to our allowance through an increase in the provision for loan losses. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. Our allowance for loan losses was $2.39 \%$ of total loans outstanding and $225 \%$ of non-performing loans at December 31, 2012. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and capital.

If our non-performing assets increase, our earnings will be adversely affected.

At December 31, 2012 and 2011, our non-performing assets (which consist of nonaccruing loans, accruing loans 90 days or more past due, non-performing investment securities, and real estate owned (REO)) were $\$ 50.2$ million and $\$ 118.9$ million, respectively, or $1.18 \%$ and $2.79 \%$ of total assets, respectively. Our non-performing assets adversely affect our net income in various ways:

We do not record interest income on nonaccrual loans, non-performing investment securities, or REO.
We must provide for probable loan losses through a current period charge to the provision for loan losses. Non-interest expense increases when we must write down the value of properties in our REO portfolio to reflect changing market values or recognize other-than-temporary impairment on non-performing investment securities. There are legal fees associated with the resolution of problem assets, as well as carrying costs, such as taxes, insurance, and maintenance fees related to our REO.
The resolution of non-performing assets requires the active involvement of management, which can distract them from more profitable activity.

If additional borrowers become delinquent and do not pay their loans and we are unable to successfully manage our non-performing assets, our losses and troubled assets could increase significantly, which could have a material adverse effect on our financial condition, liquidity and results of operations.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

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

We may have significant variation in our annual and quarterly results.
We reported net income of $\$ 59.1$ million available to common shareholders during the year ended December 31, 2012 compared to a net loss of $\$ 2.4$ million during the year ended December 31, 2011. Our operating results in recent periods have been significantly influenced by the relatively high, although declining, levels of delinquencies, non-performing loans, and related provision for loan losses, net loan charge-offs and charges related to REO. In addition, several other factors affecting our business can cause significant variations in our quarterly results of operations. In particular, variations in the volume of our loan originations and sales, the differences between our cost of funds and the average interest rate earned on investments, special FDIC insurance charges, significant changes in real estate valuations and the fair valuation of our junior subordinated debentures or our investment securities portfolio could have a material adverse effect on our results of operations, financial condition and liquidity.

If our investments in real estate are not properly valued or sufficiently reserved to cover actual losses, or if we are required to increase our valuation reserves, our earnings could be reduced.

We obtain updated valuations in the form of appraisals and broker price opinions when a loan has been foreclosed and the property taken in as REO and at certain other times during the assets holding period. Our net book value (NBV) in the loan at the time of foreclosure and thereafter is compared to the updated market value of the foreclosed property less estimated selling costs (fair value). A charge-off is recorded for any excess in the asset's NBV over its fair value. If our valuation process is incorrect, or if property values decline, the fair value of the investments in real estate may not be sufficient to recover our carrying value in such assets, resulting in the need for additional charge-offs. Significant charge-offs to our investments in real estate could have a material adverse effect on our financial condition, liquidity and results of operations.

In addition, bank regulators periodically review our REO and may require us to recognize further charge-offs. Any increase in our charge-offs, as required by the bank regulators, may have a material adverse effect on our financial condition, liquidity and results of operations.

The value of securities in our investment securities portfolio may be negatively affected by disruptions in securities markets.

The market for some of the investment securities held in our portfolio has been generally disrupted, uncertain and inefficient in recent years. These market conditions have affected and may further detrimentally affect the value of these securities, such as through reduced valuations because of the perception of heightened credit and liquidity risks. There can be no assurance that the declines in market value associated with this disruption and lack of activity will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

An increase in interest rates, change in the programs offered by secondary market purchasers or our ability to qualify for their programs may reduce our mortgage banking revenues, which would negatively impact our non-interest income.

Our mortgage banking operations provide a significant portion of our non-interest income. We generate mortgage revenues primarily from gains on the sale of single-family mortgage loans pursuant to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae and non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. Any future changes in these programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Mortgage banking is generally considered a volatile source of income because it depends largely on the level of loan volume which, in turn, depends largely on prevailing market interest rates. In a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations. In addition, although we sell loans into the secondary market without recourse, we are required to give customary representations and warranties about the loans to the buyers. If we breach those representations and warranties, the buyers may require us to repurchase the loans and we may incur a loss on the repurchase.

Our results of operations, liquidity and cash flows are subject to interest rate risk.
Our earnings and cash flows are largely dependent upon 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. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also

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be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. In addition, a substantial amount of our loans have adjustable interest rates. As a result, these loans may experience a higher rate of default in a rising interest rate environment. Further, a significant portion of our adjustable rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately $64 \%$ of our loan portfolio was comprised of adjustable or floating-rate loans at December 31, 2012, and approximately $\$ 1.5$ billion, or $72 \%$, of those loans contained interest rate floors, below which the loans' contractual interest rate may not adjust. At December 31, 2012, the weighted average floor interest rate of these loans was $5.08 \%$. At that date, approximately $\$ 1.3$ billion, or $86 \%$, of these loans were at their floor interest rate. The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates, although this result is subject to the risks that borrowers may refinance these loans during periods of declining interest rates. Also, when loans are at their floors, there is a further risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates which could have a material adverse effect on our results of operations.

Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition, liquidity and results of operations. Further, a prolonged period of exceptionally low market interest rates, such as we are currently experiencing, could have an adverse effect on our results of operations as a result of substantially reduced asset yields. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results.

Historically low interest rates may adversely affect our net interest income and profitability.
During the last four years, it has been the policy of the Board of Governors of the Federal Reserve System (the "Federal Reserve") to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. As a result, yields on securities we have purchased, and market rates on the loans we have originated, have been at levels lower than were available prior to 2008. Consequently, the average yield on our interest-earning assets has decreased during the recent low interest rate environment. As a general matter, our interest-bearing liabilities re-price or mature more quickly than our interest-earning assets, which has contributed to increases in net interest income in the short term. However, our ability to lower our interest expense is limited at these interest rate levels, while the average yield on our interest-earning assets may continue to decrease. The Federal Reserve has indicated its intention to maintain low interest rates in the near future. Accordingly, our net interest income may decrease, which may have an adverse affect on our profitability. For information with respect to changes in interest rates, see "Risk Factors- Our results of operations, liquidity and cash flows are subject to interest rate risk."

If our investment in the Federal Home Loan Bank of Seattle becomes impaired, our earnings and shareholders' equity could decrease.

At December 31, 2012, the Company had recorded $\$ 36.7$ million in FHLB stock, compared to $\$ 37.4$ million at December 31, 2011. The Banks' investments in FHLB stock are generally viewed as a long-term investment and are carried at par value ( $\$ 100$ per share), which reasonably approximates its fair value. It does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions and can only be purchased and redeemed at par. As members of the FHLB system, the Banks are required to maintain a minimum level of investment in FHLB stock based on specific percentages of their outstanding FHLB advances. For the years ended December 31, 2012, 2011 and 2010, the Banks did not receive any dividend income on FHLB stock.

Management periodically evaluates FHLB stock for impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is
influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

The Seattle FHLB announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the FHFA), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. The FHLB of Seattle announced September 7, 2012 that the FHFA now considers the FHLB of Seattle to be adequately capitalized. Dividends on, or repurchases of, the FHLB of Seattle stock continue to require consent of the FHFA. The FHFA subsequently approved the repurchase of portions of FHLB of Seattle stock, and as of December 31, 2012, the FHLB had repurchased $\$ 665,900$ of the Banks' stock. The Company will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of Banner's investment. Based on the above, the Company has determined there is not any impairment on the FHLB stock investment as of December 31, 2012.

The Dodd-Frank Wall Street Reform and Consumer Protection Act has, among other things, tightened capital standards, created a new Consumer Financial Protection Bureau and will result in new laws and regulations that are expected to increase our costs of operations.
The Banks are subject to extensive examination, supervision and comprehensive regulation by the FDIC and the Washington DFI, and Banner Corporation is subject to examination and supervision by the Federal Reserve. The FDIC, Washington DFI and the Federal Reserve govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution's
operations, reclassify assets, determine the adequacy of an institution's allowance for loan losses and determine the level of deposit insurance premiums assessed.
Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has significantly changed the bank regulatory structure and has affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.
Certain provisions of the Dodd-Frank Act are expected to have a near term impact on us. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.
The Dodd-Frank Act also broadens the base for FDIC 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.
The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.
The Dodd-Frank Act 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, 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. Financial institutions such as the Banks with $\$ 10$ billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.
It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Any additional changes in our regulation and oversight, whether in the form of new laws, rules or regulations, could make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

In June 2012, the Federal Reserve, FDIC and the OCC proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Various provisions of the Dodd-Frank Act increase the capital requirements of bank holding companies, such as Banner Corporation. The leverage and risk-based capital ratios of these entities may not be lower than the leverage and risk-based capital ratios for insured depository institutions. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to Banner Corporation and the Banks under the proposals would be: (i) a new common equity Tier 1 capital ratio of $4.5 \%$; (ii) a Tier 1 capital ratio of $6 \%$ (increased from $4 \%$ ); (iii) a total capital ratio of $8 \%$ (unchanged from current rules); and (iv) a Tier 1 leverage ratio of $4 \%$ for all institutions. The proposed rules would also establish a

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"capital conservation buffer" of $2.5 \%$ above the new regulatory minimum capital ratios, and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of $7.0 \%$, (ii) a Tier 1 capital ratio of $8.5 \%$, and (iii) a total capital ratio of $10.5 \%$. The new capital conservation buffer requirement would be phased in beginning in January 2016 at $0.625 \%$ of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to Banner Corporation and the Banks.

In addition, in the current economic and regulatory environment, regulators of banks and bank holding companies have become more likely to impose capital requirements on bank holding companies and banks that are more stringent than those required by applicable existing regulations.

The application of more stringent capital requirements for Banner Corporation and the Banks could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

Increases in deposit insurance premiums and special FDIC assessments will negatively impact our earnings.

The Dodd-Frank Act established $1.35 \%$ of total insured deposits as the minimum reserve ratio. The FDIC has adopted a plan under which it will meet this ratio by the statutory deadline of September 30, 2020. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $\$ 10$ billion of the increase in the minimum reserve ratio to $1.35 \%$ from the former minimum of $1.15 \%$. The FDIC has not announced how it will implement this offset. In addition to the statutory minimum ratio, the FDIC must set a designated reserve ratio or DRR, which may exceed the statutory minimum. The FDIC has set $2.0 \%$ as the DRR.

As required by the Dodd-Frank Act, the FDIC has adopted final regulations under which insurance premiums are based on an institution's total assets minus its tangible equity instead of its deposits. While our FDIC insurance premiums initially have been reduced by these regulations, it is possible that our future insurance premiums will increase under the final regulations.

Failure to manage our growth may adversely affect our performance.

Our financial performance and profitability depend on our ability to manage past and possible future growth. Future acquisitions and growth may present operating, integration and other issues that could have a material adverse effect on our business, financial condition, liquidity or results of operations.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business and the inability to obtain adequate funding may negatively affect growth and, consequently, our earnings capability and capital levels. An inability to raise funds through deposits, borrowings, the sale of loans or investment securities and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the Washington, Oregon or Idaho markets in which our loans are concentrated, negative operating results or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued uncertainty in credit markets. In particular, our liquidity position could be significantly constrained if we are unable to access funds from the Federal Home Loan Bank of Seattle, the Federal Reserve Bank of San Francisco or other wholesale funding sources or if adequate financing is not available at acceptable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources, our revenues may not increase proportionately to cover our costs. In this case, our results of operations and financial condition would be negatively affected. In addition, changes in recent years in the collateralization requirements and other provisions of the Washington and Oregon public funds deposit programs have changed the economic benefit associated with accepting public funds deposits, which may affect our need to utilize alternative sources of liquidity.

We may engage in FDIC-assisted transactions, which could present additional risks to our business.
We may have opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions, including transactions in the states of Washington, Oregon and Idaho. Although these FDIC-assisted transactions typically provide for FDIC assistance to an acquirer to mitigate certain risks, such as sharing exposure to loan losses and providing indemnification against certain liabilities of the failed institution, we are (and would be in future transactions) subject to many of the same risks we would face in acquiring another bank in a negotiated transaction,
including risks associated with maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the time frames we expect. In addition, because these acquisitions are structured in a manner that would not allow us the time and access to information normally associated with preparing for and evaluating a negotiated acquisition, we may face additional risks in FDIC-assisted transactions, including additional strain on management resources, management of problem loans, problems related to integration of personnel and operating systems and impact to our capital resources requiring us to raise additional capital. We cannot provide assurance that we would be successful in overcoming these risks or any other problems encountered in connection with FDIC-assisted transactions. Our inability to overcome these risks could have a material adverse effect on our business, financial condition and results of operations.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit our shareholders. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. The significant federal and state banking regulations that affect us are described in this report under the heading "Item 1. Business-Regulation." These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and
products, among other things. For example, regulatory changes to the rules for overdraft fees for debit transactions and interchange fees have the potential to reduce our fee income which would result in a reduction of our non-interest income. Further, legislative proposals limiting our rights as a creditor could result in credit losses or increased expense in pursuing our remedies as a creditor. If proposals such as these, or other proposals limiting our rights as a creditor, were to be implemented, we could experience increased credit losses on our loans, or increased expense in pursuing our remedies as a creditor. Our failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, which could have a material adverse effect on our business, financial condition, liquidity and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

Our litigation-related costs might continue to increase.
The Banks are subject to a variety of legal proceedings that have arisen in the ordinary course of the Banks' business. In the current economic environment, the Banks' involvement in litigation has increased significantly, primarily as a result of defaulted borrowers asserting claims to defeat or delay foreclosure proceedings. There can be no assurance that our loan workout and other activities will not expose us to additional legal actions, including lender liability or environmental claims. The Banks believe that they have meritorious defenses in legal actions where they have been named as defendants and are vigorously defending these suits. Although management, based on discussion with litigation counsel, believes that such proceedings will not have a material adverse effect on the financial condition, liquidity and results of operations of the Banks, there can be no assurance that a resolution of any pending or future legal matter will not result in significant liability to the Banks nor have a material adverse impact on their financial condition, liquidity and results of operations or the Banks' ability to meet applicable regulatory requirements. Moreover, the expenses of any legal proceedings will adversely affect the Banks' results of operations until they are resolved.

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

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where the Banks conduct their business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President, and certain other employees. In addition, our success has been and continues to be highly dependent upon the services of our directors, many of whom are at or nearing retirement age, and we may not be able to identify and attract suitable candidates to replace such directors.

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.
Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur.

Managing reputational risk is important to attracting and maintaining customers, investors and employees.

Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. We have policies and procedures in place to protect our reputation and promote ethical conduct, but these policies and procedures may not be fully effective. Negative publicity regarding our business, employees, or customers, with or without merit, may result in the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

We operate in a highly competitive industry and market areas.
The Banks face substantial competition in all phases of their operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. To date, the Banks have been competitive by focusing on their business lines in their market areas and emphasizing the high level of service and responsiveness desired by their customers. We compete for loans, deposits and other financial services with other commercial banks, thrifts, credit unions, brokerage houses, mutual funds, insurance companies and specialized finance companies. Many of our competitors offer products and services which we do not offer, and many have substantially greater resources and lending limits, name recognition and market presence that benefit them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than the Banks do, and newer competitors may also be more aggressive in terms of pricing loan and deposit products than we are in order to obtain a share of the market. Some of the financial institutions and financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies, federally insured state-chartered banks and national banks and federal savings banks. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services.

Our ability to compete successfully depends on a number of factors including the following:
the ability to develop, maintain and build upon long-term customer relationships based on top-quality service, high ethical standards and safe, sound assets;
the ability to expand our market position;
the scope, relevance and pricing of products and services offered to meet customer needs and demands;
the rate at which we introduce new products and services relative to our competitors;
customer satisfaction with our level of service; and
industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition, liquidity and results of operations.

We rely on communications, information, operating and financial control systems technology from third-party service providers, and we may suffer an interruption in those systems.

We rely heavily on third-party service providers for much of our communications, information, operating and financial control systems technology, including our Internet banking services and data processing systems. Any failure or interruption of these services or systems or breaches in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems. The occurrence of any failures or interruptions may require us to identify alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all.

Item 1B - Unresolved Staff Comments

None.

Item 2 - Properties

Banner Corporation maintains its administrative offices and main branch office, which is owned by us, in Walla Walla, Washington. In total, as of December 31, 2012, we have 88 branch offices located in Washington, Oregon and Idaho. Three of those 88 are Islanders Bank branches and 85 are Banner Bank branches. Sixty-four branches are located in Washington, fifteen in Oregon and nine in Idaho. Of those offices, approximately half are owned and the other half are leased facilities. We also have seven leased locations for loan production offices spread throughout the same three-state area. The lease terms for our branch and loan production offices are not individually material. Lease expirations range from one to 25 years. Administrative support offices are primarily in Washington, where we have eight facilities, of which we own four and lease four. Additionally, we have one leased administrative support office in Idaho and own one located in Oregon. In the opinion of management, all properties are adequately covered by insurance, are in a good state of repair and are appropriately designed for their present and future use.

## Item 3 - Legal Proceedings

In the normal course of business, we have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. These claims and counter-claims typically arise during the course of collection efforts on problem loans or with respect to action to enforce liens on properties in which we hold a security interest. We are not a party to any pending legal proceedings that we believe would have a material adverse effect on our financial condition or operations.

Item 4 - Mine Safety Disclosures

Not applicable.

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## PART II

Item 5 - Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Price Range of Common Stock and Dividend Information
Our common stock is traded on the NASDAQ Global Select Market under the symbol "BANR." Shareholders of record as of December 31, 2012 totaled 1,604 based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or "street" name through various brokerage firms. The following tables show the reported high and low sale prices of our common stock for the periods presented, adjusted for the one-for-seven reverse stock split of June 2011, as well as the cash dividends declared per share of common stock for each of those periods.

| Year Ended December 31, 2012 | High | Low | Cash Dividend <br> Declared |
| :--- | :--- | :--- | :--- |
| First quarter | $\$ 22.97$ | $\$ 17.13$ | $\$ 0.01$ |
| Second quarter | 22.80 | 18.05 | 0.01 |
| Third quarter | 27.41 | 20.04 | 0.01 |
| Fourth quarter | 31.32 | 26.49 | 0.01 |
| Year Ended December 31, 2011 | High | Low | Cash Dividend |
| First quarter | $\$ 18.48$ | $\$ 14.00$ | Declared |
| Second quarter | 20.23 | 15.56 | 0.07 |
| Third quarter | 19.25 | 12.37 | 0.01 |
| Fourth quarter | 18.45 | 11.67 | 0.01 |

The timing and amount of cash dividends paid on our common stock depends on our earnings, capital requirements, financial condition and other relevant factors and is subject to the discretion of our board of directors. After consideration of these factors, beginning in the third quarter of 2008, we reduced our dividend payout to preserve our capital and further reduced our dividend in the first quarter of 2009. Our aggregate dividend payments were also reduced by our one-for-seven reverse stock split effective June 1, 2011. There can be no assurance that we will pay dividends on our common stock in the future.

Our ability to pay dividends on our common stock depends primarily on dividends we receive from Banner Bank and Islanders Bank. Under federal regulations, the dollar amount of dividends the Banks may pay depends upon their capital position and recent net income. Generally, if a bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. In addition, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the conversion. Banner Bank, our primary subsidiary, converted to a stock form of ownership and is therefore subject to the limitation described in the preceding sentence. The Washington DFI has the power to require any bank to suspend the payment of any and all dividends. In addition, under Washington law, no bank may declare or pay any dividend in an amount greater than its retained earnings without the prior approval of the Washington DFI.

Further, under Washington law, Banner Corporation is prohibited from paying a dividend if, after making such dividend payment, it would be unable to pay its debts as they become due in the usual course of business, or if its total liabilities, plus the amount that would be needed, in the event Banner Corporation were to be dissolved at the time of the dividend payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right
of payment to the capital stock on which the applicable distribution is to be made, exceed our total assets.
In addition to the foregoing regulatory considerations, there are numerous governmental requirements and regulations that affect our business activities. A change in applicable statutes, regulations or regulatory policy may have a material effect on our business and on our ability to pay dividends on our common stock.

Payments of the distributions on our trust preferred securities from the special purpose subsidiary trusts we sponsored are fully and unconditionally guaranteed by us. The junior subordinated debentures that we have issued to our subsidiary trusts are ranked senior to our shares of common stock. We must make required payments on the junior subordinated debentures before any dividends can be paid on our TPS and our common stock and, in the event of our bankruptcy, dissolution or liquidation, the interest and principal obligations under the junior subordinated debentures must be satisfied before any distributions can be made on our common stock. We may defer the payment of interest on each of the junior subordinated debentures for a period not to exceed 20 consecutive quarters, provided that the deferral period does not extend beyond the stated maturity. During such deferral period, distributions on the corresponding trust preferred securities will also be deferred and we may not pay cash dividends to the holders of shares of our common stock. At December 31, 2012, we are current on all interest payments.

Issuer Purchases of Equity Securities
We did not repurchase any of our common stock during 2012.

## Equity Compensation Plan Information

The equity compensation plan information presented under Part III, Item 12 of this report is incorporated herein by reference.

Performance Graph. The following graph compares the cumulative total shareholder return on Banner Corporation common stock with the cumulative total return on the NASDAQ (U.S. Stock) Index, a peer group of the SNL $\$ 1$ Billion to $\$ 5$ Billion Asset Bank Index and a peer group of the SNL NASDAQ Bank Index. Total return assumes the reinvestment of all dividends.

|  | Period Ended |  |  |  |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :---: | :---: | :---: | :---: | :---: |
| Index | $12 / 31 / 07$ | $12 / 31 / 08$ | $12 / 31 / 09$ | $12 / 31 / 10$ | $12 / 31 / 11$ | $12 / 31 / 12$ |  |  |  |  |  |
| Banner Corporation | 100.00 | 34.08 | 9.80 | 8.61 | 9.19 | 16.49 |  |  |  |  |  |
| NASDAQ Composite | 100.00 | 60.02 | 87.24 | 103.08 | 102.26 | 120.42 |  |  |  |  |  |
| SNL Bank \$1B-\$5B | 100.00 | 82.94 | 59.45 | 67.39 | 61.46 | 75.78 |  |  |  |  |  |
| SNL Bank NASDAQ | 100.00 | 72.62 | 58.91 | 69.51 | 61.67 | 73.51 |  |  |  |  |  |

*Assumes $\$ 100$ invested in Banner Corporation common stock and each index at the close of business on December 31, 2007 and that all dividends were reinvested. Information for the graph was provided by SNL Financial L.C. © 2013.

## Item 6 - Selected Financial Data

The following condensed consolidated statements of financial condition and operations and selected performance ratios as of December 31, 2012, 2011, 2010, 2009, and 2008 and for the years then ended have been derived from our audited consolidated financial statements. Certain information for prior years has been restated in accordance with the U.S. Securities and Exchange Commission Staff Accounting Bulletin No. 108 which addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements.

The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8, Financial Statement and Supplementary Data."
FINANCIAL CONDITION DATA:
(In thousands)
Total assets
Loans receivable, net
Cash and securities ${ }^{(1)}$
Deposits
Borrowings
Common stockholders' equity
Total stockholders' equity
Shares outstanding
Shares outstanding excluding unearned, restricted shares held in ESOP

OPERATING DATA:
(In thousands)
Interest income
Interest expense
Net interest income before provision for loan
losses
Provision for loan losses
Net interest income
Deposit fees and other service charges
Mortgage banking operations revenue
Other-than-temporary impairment recoveries (losses)
Net change in valuation of financial instruments carried at fair value
All other operating income
Total other operating income
Goodwill write-off
REO operations
All other operating expenses
Total other operating expense

| December 31 |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| 2012 | 2011 | 2010 | 2009 | 2008 |
| $\$ 4,265,564$ | $\$ 4,257,312$ | $\$ 4,406,082$ | $\$ 4,722,221$ | $\$ 4,584,368$ |
| $3,158,223$ | $3,213,426$ | $3,305,716$ | $3,694,852$ | $3,886,211$ |
| 811,902 | 754,396 | 729,345 | 640,657 | 419,718 |
| $3,557,804$ | $3,475,654$ | $3,591,198$ | $3,865,550$ | $3,778,850$ |
| 160,000 | 212,649 | 267,761 | 414,315 | 318,421 |
| 506,919 | 411,748 | 392,472 | 287,721 | 317,433 |
| 506,919 | 532,450 | 511,472 | 405,128 | 433,348 |
| 19,455 | 17,553 | 16,165 | 3,077 | 2,450 |
|  |  |  |  |  |
| 19,421 | 17,519 | 16,130 | 3,042 | 2,416 |


| For the Year Ended December 31 |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| 2012 | 2011 | 2010 | 2009 | 2008 |
| $\$ 187,162$ | $\$ 197,563$ | $\$ 218,082$ | $\$ 237,370$ | $\$ 273,158$ |
| 19,514 | 32,992 | 60,312 | 92,797 | 125,345 |
| 167,648 | 164,571 | 157,770 | 144,573 | 147,813 |
| 13,000 | 35,000 | 70,000 | 109,000 | 62,500 |
| 154,648 | 129,571 | 87,770 | 35,573 | 85,313 |
| 25,266 | 22,962 | 22,009 | 21,394 | 21,540 |
| 12,940 | 5,068 | 6,370 | 8,893 | 6,045 |
| $(409$ | $)$ | 3,000 | $(4,231$ | $)$ |
|  |  |  | $(1,511$ | - |
| $(16,515$ | $)$ | $(624$ | $)$ | 1,747 |
| 12,529 | 9,156 |  |  |  |
| 5,620 | 3,584 | 3,253 | 2,385 | 2,888 |
| 26,902 | 33,990 | 29,148 | 43,690 | 39,629 |
| - | - | - | - | 121,121 |
| 3,354 | 22,262 | 26,025 | 7,147 | 2,283 |
| 138,099 | 135,842 | 134,776 | 134,933 | 136,616 |
| 141,453 | 158,104 | 160,801 | 142,080 | 260,020 |
| 40,097 | 5,457 | $(43,883$ | $)(62,817$ | $(135,078$ |$)$

Income (loss) before provision for income tax expense (benefit)
$\left.\begin{array}{lllllll}\text { Provision for income tax expense (benefit) } & (24,785 & ) & - & 18,013 & (27,053 & ) \\ \text { Net income (loss) } & \$ 64,882 & \$ 5,457 & \$(61,896 & \text { ) } & \$(35,764 & ) \\ \$(127,993\end{array}\right)$
(footnotes follow)
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PER COMMON SHARE DATA:


OTHER DATA:

|  | As of December 31 |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 | 2009 | 2008 |
| Full time equivalent employees | 1,074 | 1,078 | 1,060 | 1,060 | 1,095 |
| Number of branches | 88 | 89 | 89 | 89 | 86 |

KEY FINANCIAL RATIOS:

|  | At or For the Years Ended December 31 |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2012 |  | 2011 |  | 2010 |  | 2009 |  | 2008 |  |
| Performance Ratios: |  |  |  |  |  |  |  |  |  |  |
| Return on average assets ${ }^{(3)}$ | 1.54 | \% | 0.13 | \% | (1.36 | )\% | (0.78 | )\% | (2.78 | )\% |
| Return on average common equity ${ }^{(4)}$ | 14.03 |  | 1.37 |  | (17.19 | ) | (11.69 | ) | (30.90 | ) |
| Average common equity to average assets | 10.96 |  | 9.31 |  | 7.90 |  | 6.71 |  | 8.99 |  |
| Interest rate spread (5) | 4.13 |  | 3.99 |  | 3.61 |  | 3.23 |  | 3.36 |  |
| Net interest margin ${ }^{(6)}$ | 4.17 |  | 4.05 |  | 3.67 |  | 3.33 |  | 3.45 |  |
| Non-interest income to average assets | 0.64 |  | 0.79 |  | 0.64 |  | 0.96 |  | 0.86 |  |
| Non-interest expense to average assets | 3.35 |  | 3.69 |  | 3.53 |  | 3.12 |  | 5.65 |  |
| Efficiency ratio ${ }^{(7)}$ | 72.71 |  | 79.62 |  | 86.03 |  | 75.47 |  | 138.72 |  |
| Average interest-earning assets to interestbearing liabilities | 109.1 |  | 106.90 |  | 104.32 |  | 104.55 |  | 103.21 |  |
| Selected Financial Ratios: |  |  |  |  |  |  |  |  |  |  |
| Allowance for loan losses as a percent of total loans at end of period | 2.39 |  | 2.52 |  | 2.86 |  | 2.51 |  | 1.90 |  |
| Net charge-offs as a percent of average outstanding loans during the period | 0.57 |  | 1.50 |  | 1.88 |  | 2.28 |  | 0.84 |  |
| Non-performing assets as a percent of total assets | 1.18 |  | 2.79 |  | 5.77 |  | 6.27 |  | 4.56 |  |
| Allowance for loan losses as a percent of non-performing loans ${ }^{(8)}$ | 225.33 |  | 110.09 |  | 64.30 |  | 44.55 |  | 40.14 |  |
| Common stockholders' tangible equity to tangible assets ${ }^{(9)}$ | 11.80 |  | 9.54 |  | 8.73 |  | 5.87 |  | 6.64 |  |
| Consolidated Capital Ratios: |  |  |  |  |  |  |  |  |  |  |
| Total capital to risk-weighted assets | 16.96 |  | 18.07 |  | 16.92 |  | 12.73 |  | 13.11 |  |
| Tier 1 capital to risk-weighted assets | 15.70 |  | 16.80 |  | 15.65 |  | 11.47 |  | 11.86 |  |
| Tier 1 leverage capital to average assets | 12.74 |  | 13.44 |  | 12.24 |  | 9.62 |  | 10.32 |  |

${ }^{(1)}$ Includes securities available-for-sale and held-to-maturity.
(2) Calculated using shares outstanding excluding unearned restricted shares held in ESOP and adjusted for 1-for-7 reverse stock split.
${ }^{(3)}$ Net income divided by average assets.
${ }^{(4)}$ Net income divided by average common equity.
${ }^{(5)}$ Difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
${ }^{(6)}$ Net interest income before provision for loan losses as a percent of average interest-earning assets.
${ }_{\text {(7) }}$ Other operating expenses divided by the total of net interest income before loan losses and other operating income (non-interest income).
${ }^{(8)}$ Non-performing loans consist of nonaccrual and 90 days past due loans.
Common stockholders' tangible equity per share and the ratio of tangible common stockholders' equity to tangible assets are non-GAAP financial measures. We calculate tangible common equity by excluding the balance of goodwill, other intangible assets and preferred equity from stockholders' equity. We calculate tangible assets by excluding the balance of goodwill and other intangible assets from total assets. We believe that this is consistent with the treatment by our bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. In addition, excluding preferred equity, the level of which may vary from
(9) company to company, allows investors to more easily compare our capital adequacy to other companies in the industry that also use this measure. Management believes that these non-GAAP financial measures provide information to investors that is useful in understanding the basis of our capital position. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Because not all companies use the same calculation of tangible common equity and tangible assets, this presentation may not be comparable to other similarly titled measures as calculated by other companies. For a reconciliation of these non-GAAP measures, see Item 7, "Management's Discussion and Analysis of Financial Condition-Executive Overview."

Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations
Management's discussion and analysis of results of operations is intended to assist in understanding our financial condition and results of operations. The information contained in this section should be read in conjunction with the Consolidated Financial Statements and accompanying Notes to the Consolidated Financial Statements of this Form 10-K.

## Executive Overview

We are a bank holding company incorporated in the State of Washington and own two subsidiary banks, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2012, its 85 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank and conducts its business from three locations in San Juan County, Washington. As of December 31, 2012, we had total consolidated assets of $\$ 4.3$ billion, net loans of $\$ 3.2$ billion, total deposits of $\$ 3.6$ billion and total stockholders' equity of $\$ 507$ million.

Banner Bank is a regional bank which offers a wide variety of commercial banking services and financial products to individuals, businesses and public sector entities in its primary market areas. Islanders Bank is a community bank which offers similar banking services to individuals, businesses and public entities located in the San Juan Islands. The Banks' primary business is that of traditional banking institutions, accepting deposits and originating loans in locations surrounding their offices in portions of Washington, Oregon and Idaho. Banner Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans.

Banner Corporation experienced marked improvement in asset quality and operating results 2011, which continued and accelerated throughout 2012. Highlights for the year included further improvement in our asset quality metrics, additional customer account growth, significantly increased non-interest-bearing deposit balances, exceptional mortgage banking activity and record revenues from core operations. As a result, substantially reduced credit costs, significant improvement in our net interest margin and strong non-interest revenues all contributed to meaningfully increased profitability in 2012. For the year ended December 31, 2012, we had net income of $\$ 64.9$ million which, after providing for the preferred stock dividend, related discount accretion and gains on repurchases of preferred stock, resulted in a net income available to common shareholders of $\$ 59.1$ million, or $\$ 3.16$ per diluted share. This compares to a net income of $\$ 5.5$ million, but a net loss to common shareholders of $\$ 2.4$ million, or $(\$ 0.15)$ per diluted share, for the year ended December 31, 2011. Also notable during 2012 was the repurchase and retirement of all of our Series A Preferred Stock. As a result of these repurchase transactions, we realized gains of $\$ 2.5$ million.

Although there continue to be indications that economic conditions are improving from the recent recessionary downturn, the pace of recovery has been modest and uneven and ongoing stress in the economy will likely continue to be challenging going forward. As a result, our future operating results and financial performance will be significantly affected by the course of recovery. However, over the past four years we have significantly improved our risk profile by aggressively managing and reducing our problem assets which contributed substantially to our return to profitability in 2012 and 2011 and which we believe provide the foundation for sustainable improvement to our operating results in future periods.

Our provision for loan losses was $\$ 13.0$ million for the year ended December 31, 2012, compared to $\$ 35.0$ million in 2011 and $\$ 70$ million in 2010. The decrease from a year earlier reflects significant progress in reducing the levels of delinquencies, non-performing loans and net charge-offs, particularly for loans for the construction of one- to four-family homes and for acquisition and development of land for residential properties. From 2008 through 2011,
higher than historical provision for loan losses was the most significant factor adversely affecting our operating results. Looking forward, we anticipate that our continuing efforts to decrease non-performing loans should result in a return to more normal levels of loan loss provisioning in future periods. (See Note 6 of the Notes to the Consolidated Financial Statements, as well as "Asset Quality" below.)

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income. As more fully explained below, our net interest income before provision for loan losses increased $\$ 3.1$ million, or $2 \%$, for the year ended December 31, 2012 to $\$ 167.6$ million, which followed an increase of $\$ 6.8$ million for the prior year, primarily as a result of an expansion of our net interest spread and net interest margin due to a lower cost of funds and a reduction in the adverse impact of non-performing assets. The trend to lower funding costs and the resulting increase in the net interest margin was driven by rapidly declining interest expense on deposits and represents an important improvement in our core operating fundamentals. The increase in net interest income occurred despite a modest decline in average earning assets in 2012, as we continued to make changes in our mix of assets and liabilities designed to reduce our risk profile and produce more sustainable earnings.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 22 of the Notes to the Consolidated Financial Statements.) For the year ended December 31, 2012, we recorded a net charge of $\$ 16.5$ million in fair value adjustments compared to a net charge of $\$ 624,000$ for the year ended December 31, 2011. Also, for the year ended December 31, 2012, our net income included a $\$ 409,000$ net OTTI charge. By comparison, for the year ended December 31, 2011, we had a net OTTI recovery of $\$ 3.0$ million as a result of the full cash repayment on a security that had been written off as an OTTI charge in 2010.

Our other operating income for the year ended December 31, 2012 was $\$ 26.9$ million, compared to $\$ 34.0$ million for the year ended December 31, 2011. However, other operating income, excluding fair value and OTTI adjustments, was $\$ 43.8$ million for the year ended December 31, 2012, an increase of $\$ 12.2$ million compared to a year earlier. Our total revenues (net interest income before the provision for loan losses plus other

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operating income) for 2012 were $\$ 194.6$ million compared to $\$ 198.6$ million for 2011. Our revenues excluding fair value and OTTI adjustments, which we believe is more indicative of our core operations, increased $\$ 15.2$ million, or $8 \%$, to $\$ 211.4$ million for the year ended December 31, 2012, compared to $\$ 196.2$ million for the year ended December 31, 2011. This growth in core revenues was the result of the meaningful increases in our net interest income, and deposit fees and service charges, as well as a substantial increase in revenues from mortgage banking activities.

Our other operating expenses decreased to $\$ 141.5$ million for the year ended December 31, 2012, compared to $\$ 158.1$ million for the year ended December 31, 2011, largely as a result of decreased costs related to REO operations, FDIC deposit insurance and professional services, which were partially offset by increased compensation expenses. While much lower in 2012 than in 2011, both years' expenses reflect significant costs associated with problem loan collection activities, including professional services and valuation charges related to REO, which we believe will decline further in future periods provided reductions in non-performing assets continue.

In addition, reflecting our return to profitability and expectation of sustainable profitability in future periods, during 2012, we reversed all of the valuation allowance against our net deferred tax assets and significantly adjusted the fair value estimate for our junior subordinated debentures. The substantial changes to both of these significant accounting estimates were directly linked to our improved performance and profitability. For the year ended December 31, 2012, the elimination of the deferred tax asset valuation allowance, combined with the Company's pre-tax income, resulted in a net tax benefit of $\$ 24.8$ million, which substantially added to our net income for the year.

As noted above, for the years ended December 31, 2012 and 2011, our net income included significant adjustments related to the valuation of selected financial assets and liabilities we record at fair value, as well as OTTI losses in 2012 and an OTTI recovery in 2011. However, for comparison purposes we often present information excluding these fair value and OTTI adjustments. Revenues and other earnings information excluding the change in valuation of financial instruments carried at fair value and OTTI recoveries or losses represent non-GAAP financial measures. Management has presented these non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP measures, see the tables below, as well as the discussion related to tangible common stockholders' equity per share and the ratio of common stockholders' tangible equity to tangible assets in footnote number 9 to the Key Financial Ratios tables. These non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Because not all companies use the same calculations, our presentation may not be comparable to other similarly titled measures as calculated by other companies. See "Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011" for more detailed information about our financial performance.

The following tables set forth reconciliations of non-GAAP financial measures discussed in this report (dollars in thousands):

|  | For the Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Total other operating income | $\$ 26,902$ | $\$ 33,990$ | $\$ 29,148$ |
| Exclude other-than-temporary impairment losses (recoveries) | 409 | $(3,000$ | 4,231 |
| Exclude change in valuation of financial instruments carried at fair value 16,515 | 624 | $(1,747$ |  |
| Total other operating income, excluding fair value adjustments and | $\$ 43,826$ | $\$ 31,614$ | $\$ 31,632$ |
| OTTI | $\$ 167,648$ | $\$ 164,571$ | $\$ 157,770$ |
| Net interest income before provision for loan losses | 26,902 | 33,990 | 29,148 |
| Total other operating income | 194,550 | 198,561 | 186,918 |
| Total revenue |  |  |  |

$\left.\begin{array}{lllll}\text { Exclude other-than-temporary impairment losses (recoveries) } & 409 & (3,000 & ) & 4,231 \\ \text { Exclude change in valuation of financial instruments carried at fair value } 16,515 & 624 & (1,747 & \\ \text { Total revenue, excluding fair value adjustments and OTTI } & \$ 211,474 & \$ 196,185 & \$ 189,402 & \\ \text { Net income (loss) } & \$ 64,882 & \$ 5,457 & \$(61,896 & \text { ) } \\ \text { Exclude other-than-temporary impairment losses (recoveries) } & 409 & (3,000 & ) & 4,231 \\ \text { Exclude change in valuation of financial instruments carried at fair value } 16,515 & 624 & (1,747 & \\ \text { Exclude related tax expense } & (5,923 & ) & 855 & (869\end{array}\right)$

Stockholders' equity
Other intangible assets, net
Tangible equity
Preferred equity
Tangible common stockholders’ equity
Total assets
Other intangible assets, net
Tangible assets
Tangible common stockholders' equity to tangible assets Common stockholders' equity per share-GAAP
Adjustment for other intangibles, net, per share
Common stockholders' tangible equity per share

December 31

| 2012 | 2011 | 2010 |  |
| :--- | :--- | :--- | :--- |
| $\$ 506,919$ | $\$ 532,450$ | $\$ 511,472$ |  |
| 4,230 | 6,331 | 8,609 |  |
| 502,689 | 526,119 | 502,863 |  |
| - | 120,702 | 119,000 |  |
| $\$ 502,689$ | $\$ 405,417$ | $\$ 383,863$ |  |
| $\$ 4,265,564$ | $\$ 4,257,312$ | $\$ 4,406,082$ |  |
| 4,230 | 6,331 | 8,609 |  |
| $\$ 4,261,334$ | $\$ 4,250,981$ | $\$ 4,397,473$ |  |
| 11.80 | $\%$ | 9.54 | $\%$ |
| $\$ 26.10$ | $\$ 23.50$ |  | $\$ 24.33$ |
| 0.22 | 0.36 |  | 0.47 |
| $\$ 25.88$ | $\$ 23.14$ | $\$ 23.80$ |  |

We offer a wide range of loan products to meet the demands of our customers. Our lending activities are primarily directed toward the origination of real estate and commercial loans. Until recent periods, real estate lending activities were significantly focused on residential construction and first mortgages on owner-occupied, one- to four-family residential properties; however, over the previous four years our origination of construction and land development loans declined materially and the proportion of the portfolio invested in these types of loans has declined substantially. More recently, we have experienced increased demand for one- to four-family construction loans and outstanding balances have increased modestly. Our residential mortgage loan originations also decreased during the earlier years of this cycle, although less significantly than the decline in construction and land development lending as exceptionally low interest rates supported demand for loans to refinance existing debt as well as loans to finance home purchases. Refinancing activity was particularly significant in 2012, leading to a meaningful increase in residential mortgage originations compared to the same period a year earlier. Despite the recent increase in these loan originations, our outstanding balances for residential mortgages have continued to decline, as most of the new originations have been sold in the secondary market while existing residential loans have been repaying at an accelerated pace. Our real estate lending activities also include the origination of multifamily and commercial real estate loans. While reduced from periods prior to the economic slowdown, our level of activity and investment in these types of loans has been relatively stable in recent periods. Our commercial business lending is directed toward meeting the credit and related deposit needs of various small to medium-sized business and agribusiness borrowers operating in our primary market areas. Reflecting the weak economy, in recent periods demand for these types of commercial business loans has been modest and, aside from seasonal variations, total outstanding balances have remained relatively unchanged. Our consumer loan activity is primarily directed at meeting demand from our existing deposit customers and, while we have increased our emphasis on consumer lending in recent years, demand for consumer loans also has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt. At December 31, 2012, our net loan portfolio totaled $\$ 3.158$ billion compared to $\$ 3.213$ billion at December 31, 2011.

Deposits, customer retail repurchase agreements and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits and we generally attract deposits within our primary market areas. Much of the focus of our earlier branch expansion and current marketing efforts have been directed toward attracting additional deposit customer relationships and balances. The long-term success of our deposit gathering activities is reflected not only in the growth of deposit balances, but also in increases in the level of deposit fees, service charges and other payment processing revenues compared to periods prior to that expansion. For the two years ended December 31, 2012, we have had a meaningful increase of transaction and savings accounts (checking, savings and money market accounts) and related fees and payment processing revenues, as we have remained focused on growing these core deposits. Total deposits at

December 31, 2012 increased $\$ 82$ million to $\$ 3.558$ billion, compared to $\$ 3.476$ billion a year earlier. However, the mix of our deposits significantly changed as certificates of deposit decreased $\$ 221$ million, while core deposits increased $\$ 303$ million, with particularly strong growth in non-interest-bearing checking accounts, which increased $\$ 203$ million for the year.

Critical Accounting Policies
In the opinion of management, the accompanying Consolidated Statements of Financial Condition and related Consolidated Statements of Operations, Comprehensive Income, Changes in Stockholders' Equity and Cash Flows reflect all adjustments (which include reclassification and normal recurring adjustments) that are necessary for a fair presentation in conformity with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements.

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including OTTI losses, (iv) the valuation of intangibles, such as core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale and (vi) the valuation of or recognition of deferred tax assets and liabilities. These policies and judgments, estimates and assumptions are described in greater detail below. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and our financial condition and operating results in future periods. There have been no significant changes in our application of accounting policies since December 31, 2011. For additional information concerning critical accounting policies, see Notes 1, 6, 13, 21 and 22 of the Notes to the Consolidated Financial Statements and the following:

Interest Income: (Notes 1 and 6) Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the amounts owed, principal or interest, may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.

Provision and Allowance for Loan Losses: (Notes 1 and 6) The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. We maintain an allowance for loan losses consistent in all material respects with the GAAP guidelines outlined in ASC 450, Contingencies. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and value impaired loans consistent with the accounting guidelines outlined in ASC 310, Receivables.

The allowance for losses on loans is maintained at a level sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon our continuing analysis of the factors underlying the quality of the loan portfolio. These factors include, among others, changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loans. Realized losses related to specific assets are applied as a reduction of the carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by us at the time financial statements are prepared. Although we use the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond our control. The adequacy of general and specific reserves is based on our continuing evaluation of the pertinent factors underlying the quality of the loan portfolio as well as individual review of certain large balance
loans. Loans are considered impaired when, based on current information and events, we determine that it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment.

Our methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, an allocated formula allowance and an unallocated allowance. Losses on specific loans are provided for when the losses are probable and estimable. General loan loss reserves are established to provide for inherent loan portfolio risks not specifically provided for. The level of general reserves is based on analysis of potential exposures existing in our loan portfolio including evaluation of historical trends, current market conditions and other relevant factors identified by us at the time the financial statements are prepared. The formula allowance is calculated by applying loss factors to outstanding loans, excluding those loans that are subject to individual analysis for specific allowances. Loss factors are based on our historical loss experience adjusted for significant environmental considerations, including the experience of other banking organizations, which in our judgment affect the collectability of the portfolio as of the evaluation date. The unallocated allowance is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. This methodology may result in losses or recoveries differing significantly from those provided in the Consolidated Financial Statements.

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition
and results of operations. In addition, the determination of the amount of the Banks' allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Fair Value Accounting and Measurement: (Notes 1 and 22) We use fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. We include in the Notes to the Consolidated Financial Statements information about the extent to which fair value is used to measure financial assets and liabilities, the valuation methodologies used and the impact on our results of operations and financial condition. Additionally, for financial instruments not recorded at fair value we disclose, where appropriate, our estimate of their fair value. For more information regarding fair value accounting, please refer to Note 22 in the Notes to the Consolidated Financial Statements.

Other Intangible Assets: (Notes 1 and 21) Other intangible assets consists primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

Mortgage Servicing Rights: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of the servicing right is estimated and capitalized. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized servicing rights are reported in other assets and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Real Estate Held for Sale: (Notes 1 and 7) Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Development and improvement costs relating to the property may be capitalized, while other holding costs are expensed. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts the Banks will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of market factors beyond the Banks' control or because of changes in the Banks' strategies for recovering the investment.

Income Taxes and Deferred Taxes: (Note 13) The Company and its wholly-owned subsidiaries file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP (ASC 740), a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of our deferred tax assets will not be realized.

Accounting Standards Recently Adopted or Issued

## Accounting Standards Recently Adopted

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. This guidance is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance has been applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The amendments remove the transferor's ability criterion from the consideration of effective control for repurchase and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. The adoption of this ASU has not had a material effect on the Company's Consolidated Financial Statements.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurement - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the first interim or annual period beginning on or after December 15, 2011 and did not have a significant impact on the Company's Consolidated Financial Statements.

In June 2011, FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The amendments in this ASU is required to be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The FASB decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, the amendments require the consecutive presentation of the statement of net income and other comprehensive income and require the presentation of reclassification
adjustments on the face of the financial statements from other comprehensive income to net income. See also ASU No. 2011-12. The adoption of this ASU has not had a material effect on the Company's Consolidated Financial Statements.

In December 2011, FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. This update was made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. The amendments in this Update are effective at the same time as the amendments in Update 2011-05 so that entities were not required to comply with the presentation requirements in Update 2011-05 until this ASU becomes effective. The adoption of this ASU has not had a material effect on the Company's Consolidated Financial Statements.

Comparison of Financial Condition at December 31, 2012 and 2011
General. Total assets in aggregate were nearly unchanged at $\$ 4.266$ billion at December 31, 2012, compared to $\$ 4.257$ billion at December 31, 2011. However, net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) decreased $\$ 55$ million, or $2 \%$, to $\$ 3.158$ billion at December 31, 2012, from $\$ 3.213$ billion at December 31, 2011. The contraction in net loans primarily reflects decreases in residential and non-owner occupied commercial real estate loans, as continued refinancing activity resulted in significant levels of loan prepayments. One- to four-family residential real estate loans decreased $\$ 61$ million during 2012, while non-owner occupied commercial real estate loans decreased $\$ 38$ million. In addition, residential and commercial land and land development loans, in aggregate, decreased $\$ 22$ million during 2012 and commercial construction loans decreased $\$ 12$ million. These decreases were partially offset by increases in commercial loans, including owner-occupied commercial real estate, and commercial and agricultural business loans. During 2012, owner-occupied commercial real estate loans increased $\$ 20$ million, while commercial business loans increased $\$ 17$ million and agricultural business loans increased by $\$ 12$ million. The net decrease in loans was partially offset by a reduction of $\$ 5$ million in the allowance for loan losses, as net charge-offs modestly exceeded the provision for loan losses during the year ended December 31, 2012. The decrease in aggregate loan balances for the year in part also reflects our efforts to reduce our exposure to certain weaker credits as we continued to aggressively manage problem assets. While demand for consumer loans remained weak and utilization of existing credit lines for consumer and commercial borrowers was low, our production of new commercial real estate and commercial and agricultural business loans was again encouraging. Importantly, the change in total assets also reflects a $\$ 27$ million decrease in REO which was more than offset by a $\$ 35$ million increase in deferred tax assets primarily as the result of the elimination of the valuation allowance for those assets.

Securities increased to $\$ 631$ million at December 31, 2012, from $\$ 622$ million at December 31, 2011, and the aggregate total of securities and interest-bearing deposits increased $\$ 54$ million, or $8 \%$, to $\$ 746$ million at December 31, 2012, compared to $\$ 692$ million a year earlier. Securities acquired during the year generally have expected maturities ranging from six months to six years and were purchased to generate a modest increase in yield compared to interest-bearing cash balances. With the exception of certain trust preferred securities, aggregate fair value adjustments to the securities portfolio were modest during the first nine months of 2012. At December 31, 2012, the fair value of our trading securities was $\$ 19$ million less than their amortized cost. The reduction reflected in the fair value of these securities compared to their amortized cost primarily was centered in single-issuer trust preferred securities and collateralized debt obligations secured by pools of trust preferred securities issued by bank holding companies and insurance companies, partially offset by modest gains in all other trading securities. (See Note 4 of the Notes to the Consolidated Financial Statements.) Our available-for-sale portfolio grew during the year, as purchases of primarily U.S. Government and agency mortgage-related and asset-backed securities exceeded net repayments, sales and maturities of other securities by $\$ 7$ million. Periodically, we also acquire securities (primarily municipal
bonds) which are generally designated as held-to-maturity and this portfolio increased by $\$ 11$ million from the prior year-end balances.

REO decreased $\$ 27$ million, to $\$ 16$ million at December 31, 2012 compared to $\$ 43$ million at December 31, 2011, continuing the improving trend with respect to these non-earning assets. The December 31, 2012 total included $\$ 10$ million in land or land development projects, $\$ 1$ million in commercial real estate and $\$ 5$ million in single-family homes and related residential construction. During the year ended December 31, 2012, we transferred $\$ 14$ million of loans into REO, capitalized additional investments of $\$ 300,000$ in acquired properties, disposed of approximately $\$ 41$ million of properties and recognized $\$ 452,000$ of charges against current earnings for valuation adjustments for REO properties net of gains related to properties sold. (See "Asset Quality" discussion below.)

Deposits increased $\$ 82$ million, or $2 \%$, to $\$ 3.558$ billion at December 31, 2012, from $\$ 3.476$ billion at December 31, 2011. Non-interest-bearing deposits increased by $\$ 203$ million, or $26 \%$, to $\$ 981$ million from $\$ 778$ million, and interest-bearing transaction and savings accounts increased by $\$ 99$ million, or $7 \%$, to $\$ 1.547$ billion at December 31, 2012 from $\$ 1.448$ billion at December 31, 2011. Offsetting these increases, certificates of deposit decreased $\$ 221$ million, or $18 \%$, to $\$ 1.029$ billion at December 31, 2012 from $\$ 1.250$ billion at December 31, 2011. The growth in non-interest-bearing deposits and other transaction and savings accounts was particularly notable and significantly contributed to our improved net interest margin and deposit fee revenues. A portion of the decrease in certificates of deposit was in brokered certificates which decreased $\$ 33$ million from the prior year-end balance; however, much of the decrease reflects management's pricing decisions designed to allow maturing higher priced retail certificates to migrate off the balance sheet or into core deposits.

FHLB advances decreased $\$ 229,000$, to $\$ 10.3$ million at December 31, 2012 from $\$ 10.5$ million at December 31, 2011, while other borrowings decreased $\$ 75$ million to $\$ 77$ million at December 31, 2012. The modest decrease in FHLB advances reflects a limited amount of maturities and no additional borrowing as a part of our short-term cash management activities. Other borrowings at December 31, 2012 were comprised of $\$ 77$ million of retail repurchase agreements that are primarily related to customer cash management accounts as compared to $\$ 102$ million at December 31, 2011. Retail repurchase agreement balances decreased during the year as many customers elected to keep more of their funds in the related non-interest-bearing transaction accounts to receive earnings credit to offset the service fees associated with those accounts or utilized funds for alternative purposes including paying down credit lines. Included in other borrowings at December 31, 2011 was $\$ 50$ million
of qualifying senior bank notes covered by the FDIC Temporary Liquidity Guarantee Program (TLGP) with a fixed interest rate of $2.625 \%$. This debt, which was issued in March 2009 to strengthen our overall liquidity position as we adjusted to a lower level of public funds deposits, was repaid on March 31, 2012. No additional junior subordinated debentures were issued or matured during the year; however, the estimated fair value of these instruments increased to $\$ 73$ million from $\$ 50$ million a year ago as a result of a significant change in the discount rate used to estimate fair value of these financial instruments. For more information, see Notes 10,11 and 12 of the Notes to the Consolidated Financial Statements.

Total stockholders' equity decreased $\$ 25$ million to $\$ 507$ million at December 31, 2012 compared to $\$ 532$ million at December 31, 2011, primarily due to the redemption of the $\$ 124$ million of Series A Preferred Stock, which was partially offset by capital raised through our Dividend Reinvestment and Stock Purchase and Sale Plan (DRIP) and retained earnings from operations. During the year ended December 31, 2012, we issued 1,901,493 additional shares of common stock for $\$ 37$ million at an average net per share price of $\$ 19.33$ through our DRIP. The increase in paid in capital from stock issuances, as well as additions to retained earnings as a result of net income from operations and changes in accumulated other comprehensive income, were reduced by the accrual and payment of preferred and common stock dividends and the redemption of the Series A Preferred Stock, resulting in the net $\$ 25$ million decrease in total stockholders' equity. Tangible common stockholders' equity, which excludes the Series A Preferred Stock and intangible assets, increased $\$ 97$ million to $\$ 503$ million, or $11.80 \%$ of tangible assets at December 31, 2012. During the year ended December 31, 2012, we did not repurchase any shares of Banner Corporation common stock.

Investments: At December 31, 2012, our consolidated investment portfolio totaled $\$ 631$ million and consisted principally of U.S. Government and agency obligations, mortgage-backed and mortgage-related securities, municipal bonds, corporate debt obligations, and asset-backed securities. From time to time, our investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in our loan origination, deposit and other activities. During the year ended December 31, 2012, our aggregate investment in securities increased $\$ 9$ million. Holdings of mortgage-backed securities increased $\$ 176$ million, municipal bonds increased $\$ 28$ million, and corporate bonds increased $\$ 6$ million while asset-backed securities, which were all purchased during the year, increased $\$ 43$ million. Partially offsetting these increases was a net decrease in U.S. Government and agency obligations of $\$ 243$ million.
U.S. Government and Agency Obligations: Our portfolio of U.S. Government and agency obligations had a carrying value of $\$ 99$ million ( $\$ 98$ million at amortized cost, with a fair value adjustment of $\$ 1$ million) at December 31, 2012, a weighted average contractual maturity of 4.1 years and a weighted average coupon rate of $1.22 \%$. Most of the U.S. Government and agency obligations we own include call features which allow the issuing agency the right to call the securities at various dates prior to the final maturity. Certain agency obligations also include step-up provisions which provide for periodic increases in the coupon rate if the call options are not exercised.

Mortgage-Backed Obligations: At December 31, 2012, our mortgage-backed and mortgage-related securities had a carrying value of $\$ 306$ million ( $\$ 301$ million at amortized cost, with a fair value adjustment of $\$ 5$ million). The weighted average coupon rate of these securities was $3.23 \%$ and the weighted average contractual maturity was 11.7 years, although we receive principal payments on these securities each period resulting in a much shorter expected average life. As of December 31, 2012, $97 \%$ of the mortgage-backed and mortgage-related securities pay interest at a fixed rate and 3\% pay at an adjustable-interest rate. We do not believe that any of our mortgage-backed obligations had a meaningful exposure to sub-prime mortgages.

Municipal Bonds: The carrying value of our tax-exempt bonds at December 31, 2012 was $\$ 104$ million (also with an amortized cost of $\$ 104$ million), and was comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by revenues from the specific project being financed) issued by cities and counties and various housing authorities, and hospital, school, water and sanitation districts located in the states of

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Washington, Oregon and Idaho, our primary service area. We also had taxable bonds in our municipal bond portfolio, which at December 31, 2012 had a carrying value of $\$ 31$ million (also $\$ 31$ million at amortized cost). Many of our qualifying municipal bonds are not rated by a nationally recognized credit rating agency due to the smaller size of the total issuance and a portion of these bonds have been acquired through direct private placement by the issuers. We have not experienced any defaults or payment deferrals on our municipal bonds. At December 31, 2012, our municipal bond portfolio, including taxable and tax-exempt, had a weighted average maturity of approximately 8.8 years and a weighted average coupon rate of $3.86 \%$.

Corporate Bonds: Our corporate bond portfolio, which had a carrying value of $\$ 49$ million ( $\$ 70$ million at amortized cost) at December 31, 2012, was comprised principally of long-term adjustable-rate capital securities issued by financial institutions, including single issuers, trust preferred securities and collateralized debt obligations secured by pools of trust preferred securities issued by bank holding companies and insurance companies. The market for these capital securities deteriorated significantly in 2008 and 2009 and in our opinion is still not currently functioning in a meaningful manner. As a result, the fair value estimates for many of these securities are more subjective than in periods before 2008 when they were acquired. Nonetheless, it is apparent that the values have declined appreciably since purchase, which is reflected in our financial statements and results of operations. In addition to the disruption in the market for these securities, the decline in value also reflects deterioration in the financial condition of some of the issuing financial institutions and payment deferrals and defaults by certain institutions. (See "Critical Accounting Policies" above and Note 22 of the Notes to the Consolidated Financial Statements.) At December 31, 2012, the portfolio had a weighted average maturity of 19.4 years and a weighted average coupon rate of $2.40 \%$.

Asset-Backed Securities: At December 31, 2012, our asset-backed securities portfolio had a carrying value of \$43 million ( $\$ 42$ million at amortized cost), and was comprised primarily of securitized pools of student loans issued or guaranteed by the Student Loan Marketing Association (SLMA). The weighted average coupon rate of these adjustable-rate securities was $1.40 \%$, the adjustments are tied to changes in three-month LIBOR and the weighted average contractual maturity was 9.5 years.

The following tables set forth certain information regarding carrying values and percentage of total carrying values of our portfolio of securities-trading and securities-available-for-sale, both carried at estimated fair market value, and securities-held-to-maturity, carried at amortized cost as of December 31, 2012, 2011 and 2010 (dollars in thousands):

Table 1: Securities—Trading
As of December 31,

|  | 2012 <br> Carrying <br> Value | Percent of Total |  | 2011 <br> Carrying <br> Value | Percent of Total |  | 2010 <br> Carrying <br> Value | Percent of Total |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| U.S. Government and agency obligations | \$1,637 | 2.3 | \% | \$2,635 | 3.3 | \% | \$4,379 | 4.6 | \% |
| Municipal bonds: |  |  |  |  |  |  |  |  |  |
| Taxable | - | - |  | 420 | 0.5 |  | 693 | 0.7 |  |
| Tax exempt | 5,684 | 8.0 |  | 5,542 | 6.9 |  | 5,705 | 6.0 |  |
| Total municipal bonds | 5,684 | 8.0 |  | 5,962 | 7.4 |  | 6,398 | 6.7 |  |
| Corporate bonds | 35,741 | 50.2 |  | 35,055 | 43.4 |  | 34,724 | 36.4 |  |
| Mortgage-backed or related securities: |  |  |  |  |  |  |  |  |  |
| 1-4 residential agency guaranteed | 28,107 | 39.4 |  | 36,673 | 45.4 |  | 49,688 | 52.1 |  |
| Total mortgage-backed or related securities | 28,107 | 39.4 |  | 36,673 | 45.4 |  | 49,688 | 52.1 |  |
| Equity securities | 63 | 0.1 |  | 402 | 0.5 |  | 190 | 0.2 |  |
| Total securities-trading | \$71,232 | 100.0 | \% | \$80,727 | 100.0 | \% | \$95,379 | 100.0 | \% |

Table 2: Securities—Available-for-Sale
As of December 31,
$\left.\begin{array}{lllllll}2012 & & 2011 & & 2010 & \\ \text { Carrying } & \text { Percent of } & \begin{array}{l}\text { Carrying } \\ \text { Value }\end{array} & \text { Total } & \text { Value } & \begin{array}{l}\text { Percent of }\end{array} & \begin{array}{l}\text { Carrying } \\ \text { Value }\end{array}\end{array} \begin{array}{l}\text { Percent of }\end{array} \quad \begin{array}{l}\text { Total }\end{array}\right]$ obligations
Municipal bonds:
Taxable
21,153 4

10,581 2.3
$2.3 \quad 775$
Tax exempt
Total municipal bonds
23,785 5
$44,938 \quad 9.5$
16,729 3.6
$775 \quad 0.4$

Corporate bonds
10,729 2.3
27,310
5.9

6,260 $\quad 1.3$
Mortgage-backed or related securities:


Table 3: Securities—Held-to-Maturity
$\left.\begin{array}{llllllllll} & \begin{array}{ll}\text { As of December 31, } \\ 2012\end{array} & & 2011 & & 2010\end{array}\right)$

The following table shows the maturity or period to repricing of our consolidated portfolio of securities-trading at fair value as of December 31, 2012 (dollars in thousands):

Table 4: Securities-Trading Maturity/Repricing and Rates
Securities—Trading at December 31, 2012


|  | Weighted | ighted | ighted |  | ghted | Weigh |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Carrying | Average Carrying | Average Carryi | erage Carryi | verage Carryi | Average ${ }^{\text {carry }}$ |  |
| Value | Yield Value | Yield Value | Yield Value | Yield | Yield | Yield |

U.S. Government and agency
obligations:

| Fixed-rate | $\$-$ | - | $\$-$ | - | $\%$ | $\$ 180$ | $6.00 \%$ | $\$ 1,457$ | $5.19 \%$ | $\$-$ | - | $\%$ | $\$ 1,637$ | $5.30 \%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
|  | - | - | - | - | 180 | 6.00 | 1,457 | 5.19 | - | - | 1,637 | 5.30 |  |  |

Mortgage-backed or
related securities:

| Fixed-rate | - | - | 3,100 | 5.33 | 11,786 | 4.48 | 4,854 | 5.36 | 3,091 | 4.73 | 22,831 | 4.82 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Adjustable-rate | 5,276 | 4.04 | - | - | - | - | - | - | - | - | 5,276 | 4.04 |
|  | 5,276 | 4.04 | 3,100 | 5.33 | 11,786 | 4.48 | 4,854 | 5.36 | 3,091 | 4.73 | 28,107 | 4.67 |
| Equity securities | 63 | - | - | - | - | - | - | - | - | - | 63 | - |

Total securities—trading—carryi\$86,248 $2.43 \begin{array}{lllllllll} & \$ 9,699 & 3.43 & \$ 15,535 & 4.78 & \$ 6,311 & 5.32 & \$ 3,439 & 4.51\end{array} \quad \$ 71,2323.17$ value
Total securities-trading—amort\$₹6,771 $\quad \$ 10,496 \quad \$ 14,251 \quad \$ 5,629 \quad \$ 3,192 \quad \$ 90,339$
cost
${ }^{(1)}$ Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

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The following table shows the maturity or period to repricing of our consolidated portfolio of securities-available-for-sale at fair value as of December 31, 2012 (dollars in thousands):

Table 5: Securities-Available-for-Sale Maturity/Repricing and Rates
Securities—Available-for-Sale at December 31, 2012

U.S. Government and agency obligations:
Fixed-rate
Adjustable-rate
Municipal bonds:
$\begin{array}{llllllllllll}\text { Fixed rate taxable } & 590 & 0.39 & 18,579 & 1.46 & 1,497 & 0.77 & 487 & 2.20 & - & - & 21\end{array}$
Fixed rate tax exemp

| $\$ 10,005$ | $0.80 \%$ | $\$ 61,182$ | $0.93 \%$ | $\$ 23,508$ | $0.59 \%$ | $\$ 576$ | $1.47 \%$ | $\$-$ | - | $\% 9$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 1,709 | 0.63 | - | - | - | - | - | - | - | - | 1, |
| 11,714 | 0.78 | 61,182 | 0.93 | 23,508 | 0.59 | 576 | 1.47 | - | - | 96 |
|  |  |  |  |  |  |  |  |  |  |  |
| 590 | 0.39 | 18,579 | 1.46 | 1,497 | 0.77 | 487 | 2.20 | - | - | 21 |
| 3,777 | 1.09 | 17,110 | 1.35 | 2,898 | 1.66 | - | - | - | - | 23 |
| 4,367 | 0.99 | 35,689 | 1.41 | 4,395 | 1.36 | 487 | 2.20 | - | - | 44 |
|  |  |  |  |  |  |  |  |  |  |  |
| 2,021 | 1.11 | 8,708 | 0.98 | - | - | - | - | - | - | 10 |
| 2,021 | 1.11 | 8,708 | 0.98 | - | - | - | - | - | - | 10 |

Mortgage-backed or related securities:
$\begin{array}{llllllllllll}\text { Fixed-rate } & - & - & 101,568 & 1.06 & 78,389 & 1.19 & 21,861 & 2.12 & 72,559 & 2.55 & 27 \\ \text { Adjustable-rate } & 3,380 & 2.86 & - & - & - & - & - & - & - & - & 3, \\ & 3,380 & 2.86 & 101,568 & 1.06 & 78,389 & 1.19 & 21,861 & 2.12 & 72,559 & 2.55 & 27 \\ \text { Asset-backed securities: } & & & & & & & & & & & \\ \text { Fixed-rate } & - & - & - & - & 10,042 & 1.65 & - & - & - & - & 10 \\ \text { Adjustable-rate } & 32,474 & 1.04 & - & - & - & - & - & - & - & - & 32 \\ & 32,474 & 1.04 & - & - & 10,042 & 1.65 & - & - & - & - & 42\end{array}$
Total
securities—available-for-sale—carryisiz, 956 1.09 \$207,147 1.08 \$116,334 1.12 \$22,924 $2.10 \quad \$ 72,5592.55 \quad \$ 4$
value
Total securities-available-for sale amortized cost
\$53,753
\$205,913 \$115,289
\$23,084
\$71,611
${ }^{(1)}$ Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

The following table shows the maturity or period to repricing of our consolidated portfolio of securities held-to-maturity as of December 31, 2012 (dollars in thousands):

Table 6: Securities-Held-to-Maturity Maturity/Repricing and Rates
Securities-Held-to-Maturity at December 31, 2012

| One Year or | Over One to | Over Five to | Over Ten to | Over Twenty |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Less | Five Years | Ten Years | Twenty | Years | Years |



Municipal bonds:
Fixed rate taxable
Fixed rate tax exempt

| $\$ 100$ | $6.25 \%$ | $\$ 4,098$ | $4.07 \%$ | $\$ 3,330$ | $4.30 \%$ | $\$ 2,768$ | $4.59 \%$ | $\$ 30$ | $5.78 \%$ | $\$ 10,326$ | $4.31 \%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 2,973 | 3.46 | 8,543 | 3.63 | 9,165 | 2.80 | 50,263 | 4.34 | 3,132 | 4.08 | 74,076 | 4.02 |
| 3,073 | 3.55 | 12,641 | 3.78 | 12,495 | 3.20 | 53,031 | 4.36 | 3,162 | 4.10 | 84,402 | 4.06 |
|  |  |  |  |  |  |  |  |  |  |  |  |
| 250 | 2.00 | 1,000 | 3.00 | 800 | 4.00 | - | - | - | - | 2,050 | 3.27 |
| 250 | 2.00 | 1,000 | 3.00 | 800 | 4.00 | - | - | - | - | 2,050 | 3.27 |

Total securities
held-to-maturity—carrying $\$ 3,3233.44 \quad \$ 13,6413.72 \quad \$ 13,2953.25 \quad \$ 53,0314.36$
value
Total securities
held-to-maturity—estimate\$13,410 \$14,335 \$13,452 $\$ 57,868 \quad \$ 3,393 \quad \$ 92,458$
market value
${ }^{(1)}$ Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

Loans and Lending. Our loan portfolio decreased $\$ 61$ million, or 2\%, during the year ended December 31, 2012, compared to a decrease of $\$ 107$ million, or $3 \%$, during the year ended December 31, 2011. While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. Reflecting the recession in 2008 and 2009 and subsequent modest pace of recovery, loan demand, other than for lower rate refinancing of real estate loans, has been weak for most of the past five years as consumers and businesses have been cautious in their use of credit. However, we have implemented strategies designed to capture more market share and achieve increases in targeted loans and our loan originations increased meaningfully in 2011 and 2012. Nonetheless, looking forward, new loan originations and portfolio balances will continue to be significantly affected by the course of the recovery from the current sluggish economic environment. For the years ended December 31, 2012, 2011 and 2010, we originated loans, net of repayments and charge-offs, of $\$ 460$ million, $\$ 270$ million and $\$ 114$ million, respectively. The level of net originations during all three years was significantly impacted by a substantial amount of loan repayments and charge-offs. We generally sell a significant portion of our newly originated one- to four-family residential mortgage loans to secondary market purchasers. Proceeds from sales of loans for the years ended December 31, 2012, 2011 and 2010 totaled $\$ 505$ million, $\$ 282$ million and $\$ 351$ million, respectively. See "Loan Servicing Portfolio" below. Loans held for sale increased to $\$ 12.0$ million at December 31, 2012, compared to $\$ 3$ million at December 31, 2011.

At various times, we also purchase whole loans and participation interests in loans. During the years ended December 31, 2012, 2011 and 2010, we purchased $\$ 15$ million, $\$ 5$ million and $\$ 341,000$, respectively, of loans and loan participation interests.

One- to Four-Family Residential Real Estate Lending: At December 31, 2012, $\$ 582$ million, or 18\%, of our loan portfolio, consisted of permanent loans on one- to four-family residences. We are active originators of one- to four-family residential loans in communities where we have established offices in Washington, Oregon and Idaho. Our originations of one- to four-family residential loans were particularly strong in 2012; however, since most of these new loans were sold in the secondary market and principal repayments on existing loans were substantial, we had a $\$ 61$ million decrease in the balance of loans on one- to four-family residences compared to the prior year. Our one- to four-family loan originations totaled $\$ 538$ million for the year ended December 31, 2012, compared to $\$ 358$ million and $\$ 468$ million for the years ended December 31, 2011 and 2010, respectively.

Construction and Land Lending: Historically, we invested a significant proportion of our loan portfolio in residential construction loans, as well as land loans and loans for the construction of commercial and multifamily real estate. However, as housing markets weakened in 2008, we significantly reduced our origination of new construction and land development loans. The slower pace of originations coupled with repayments as a result of home sales and restructuring opportunities as well as charge-off and foreclosure actions caused our portfolio of one- to four-family construction loans to decrease substantially through 2011. Reversing this trend during the year ended December 31, 2012, one- to four-family construction loans increased by $\$ 17$ million to $\$ 161$ million. Land development loans (both residential and commercial) decreased by $\$ 22$ million to $\$ 91$ million at December 31, 2012. Although significantly below our production levels prior to the beginning of the housing downturn, our construction loan originations have increased for each of the past three years as builders have adjusted to new price levels and certain sub-markets have become more active. Our construction and land development loan originations totaled $\$ 492$ million for the year ended December 31, 2012, compared to $\$ 376$ million for the year ended December 31, 2011, and $\$ 295$ million in 2010. At December 31, 2012, construction and land loans totaled $\$ 305$ million (including $\$ 161$ million of one- to four-family construction loans, $\$ 77$ million of residential land or land development loans, $\$ 53$ million of commercial and multifamily real estate construction loans and $\$ 14$ million of commercial land or land development loans), or $9 \%$ of total loans, compared to $\$ 319$ million, or $10 \%$, at December 31, 2011. The geographic distribution of our construction and land development loans is approximately $36 \%$ in the greater Puget Sound market and $42 \%$ in the greater Portland, Oregon market, with the remaining $22 \%$ in the various eastern Washington, eastern Oregon and western Idaho markets we serve. While delinquencies and defaults in residential construction and land development loans had a
material adverse effect on our results of operations for much of the recent economic cycle, at December 31, 2012, only $\$ 4$ million were classified as non-performing loans. For the year ended December 31, 2012, performing construction loans made an important contribution to our net interest income and profitability.

Commercial and Multifamily Real Estate Lending: We also originate loans secured by multifamily and commercial real estate. Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no significant concentrations by property type, borrowers or locations. We experienced reasonable demand for both multifamily and commercial real estate loans in 2012, though total balances in these categories decreased $\$ 20$ million or $2 \%$ from the prior year end. At December 31, 2012, our loan portfolio included $\$ 1.073$ billion of commercial real estate loans, or $33 \%$ of the total loan portfolio. Our portfolio of multifamily loans was much smaller, at $\$ 138$ million, or $4 \%$ of total loans.

Commercial Business Lending: We are active in small- to medium-sized business lending. In addition to providing earning assets, this type of lending has helped increase our deposit base. Reflecting the relatively weak economic environment, demand for new loans remained modest and line utilizations continued to be low in 2012; however, our production levels for targeted loans were encouraging and resulted in a $\$ 17$ million, or $3 \%$, increase in commercial business loan balances for the year. This growth occurred despite our successful efforts to reduce our exposure to certain weak or non-performing borrowers. At December 31, 2012, commercial business loans totaled $\$ 618$ million, or $19 \%$ of total loans, compared to $\$ 601$ million, or $18 \%$, at December 31, 2011.

Agricultural Lending: Agriculture is a major industry in many Washington, Oregon and Idaho locations in our service area. While agricultural loans are not a large part of our portfolio, we routinely make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operation of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile at times. Generally, in recent years, weather conditions, production levels and market prices have been good for most of our agricultural borrowers. Our 2012 production levels for agricultural loans
were consistent with recent years and at December 31, 2012, agricultural loans totaled $\$ 230$ million, or $7 \%$ of the loan portfolio, compared to $\$ 218$ million, or $7 \%$, at December 31, 2011.

Consumer and Other Lending: We originate a variety of consumer loans, including home equity lines of credit, automobile, recreational vehicle and boat loans, credit cards and loans secured by deposit accounts. Consumer lending has traditionally been a modest part of our business with loans made primarily to accommodate our existing customer base. In recent years, including 2012, demand for consumer loans has been restrained and outstanding balances have decreased modestly. During the fourth quarter of 2012, we purchased approximately $\$ 13$ million of consumer loans originated by another northwest financial institution that are secured by recreational boats. At December 31, 2012, we had $\$ 291$ million, or $9 \%$ of our loan portfolio, in consumer loans, compared to $\$ 284$ million, or $9 \%$, at December 31, 2011. As of December 31, 2012, $59 \%$ of our consumer loans were secured by one- to four-family real estate, including home equity lines of credit. Credit card balances totaled $\$ 21$ million at December 31, 2012 compared to $\$ 20$ million a year earlier.

Loan Servicing Portfolio: At December 31, 2012, we were servicing $\$ 1.031$ billion of loans for others and held $\$ 5.0$ million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2012 was composed of $\$ 687$ million of Freddie Mac residential mortgage loans, $\$ 212$ million of Fannie Mae residential mortgage loans and $\$ 132$ million of both residential and non-residential mortgage loans serviced for a variety of private investors. The portfolio included loans secured by property located primarily in the states of Washington, Oregon and Idaho. For the year ended December 31, 2012, we recognized $\$ 872,000$ of loan servicing fees in our results of operations, which were net of $\$ 2.6$ million of amortization for mortgage servicing rights (MSRs) and a $\$ 400,000$ impairment charge for a valuation adjustment to MSRs.

Mortgage Servicing Rights: We record MSRs with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. For the years ended December 31, 2012, 2011 and 2010, we capitalized $\$ 3.7$ million, $\$ 1.9$ million, and $\$ 1.7$ million, respectively, of MSRs relating to loans sold with servicing retained. No MSRs were purchased in those periods. Amortization of MSRs for the years ended December 31, 2012, 2011 and 2010 was $\$ 2.6$ million, $\$ 1.8$ million, and $\$ 2.0$ million, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. These carrying values are adjusted when the valuation indicates the carrying value is impaired. At December 31, 2012, our MSRs were carried at a value of $\$ 6.2$ million, net of amortization, compared to $\$ 5.6$ million at December 31, 2011.

Table 7: Loan Portfolio Analysis
The following table sets forth the composition of the Company's loan portfolio, including loans held for sale, by type of loan as of the dates indicated (dollars in thousands):

December 31


Commercial real
estate
Owner-occupied $\$ 489,581$ Investment 583,641
15.1 \% \$469,806
14.2 \% \$515,093
15.1 \% \$509,464 13.4 \% \$459,446
11.6
properties
Multifamily real
estate
Commercial construction Multifamily construction
One- to $\begin{array}{lllllllllll}\text { four-family } & 160,815 & 5.0 & 144,177 & 4.4 & 153,383 & 4.5 & 239,135 & 6.3 & 420,673 & 10.6\end{array}$ construction Land and land development

| Residential | 77,010 | 2.4 | 97,491 | 3.0 | 167,764 | 4.9 | 284,331 | 7.5 | 401,129 | 10.1 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |


| Commercial | 13,982 | 0.4 | 15,197 | 0.5 | 32,386 | 1.0 | 43,743 | 1.2 | 62,128 | 1.6 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |


| Commercial | 618,049 | 19.1 | 601,440 | 18.2 | 585,457 | 17.2 | 637,823 | 16.8 | 679,867 | 17.2 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Agricultural business,

| including | 230,031 | 7.1 | 218,171 | 6.6 | 204,968 | 6.0 | 205,307 | 5.4 | 204,142 | 5.2 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | secured by farmland

One- to $\begin{array}{lllllllllll}\text { four-family real } & 581,670 & 18.0 & 642,501 & 19.5 & 682,924 & 20.1 & 703,277 & 18.6 & 599,169 & 15.1\end{array}$ estate Consumer

| secured by one- <br> to four-family | 170,123 | 5.3 | 181,049 | 5.5 | 186,036 | 5.5 | 191,454 | 5.1 | 175,646 | 4.5 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

real estate

| Consumer—othet 20,498 | 3.7 | 103,347 | 3.1 | 99,761 | 2.9 | 110,937 | 2.9 | 115,515 | 2.9 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |



Less allowance
for loan losses
Net loans
$(77,491) \quad(82,912)$
(97,401 )
(95,269 ) (75,197 )
\$3,158,223
\$3,213,426
\$3,305,716
\$3,694,852
\$3,886,211

Table 8: Loans by Geographic Concentration
The following table sets forth the Company's loans by geographic concentration at December 31, 2012 (dollars in thousands):


The following table sets forth certain information at December 31, 2012 regarding the dollar amount of loans maturing in our portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances are net of unamortized premiums and discounts, include loans held for sale and exclude the allowance for loan losses (in thousands):

Table 9: Loans by Maturity

|  | Maturing <br> Within One Year | Maturing <br> After One to Three Years | Maturing <br> After Three <br> to Five <br> Years | Maturing <br> After Five to Ten Years | Maturing <br> After Ten <br> Years | Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial real estate |  |  |  |  |  |  |
| Owner-occupied | \$28,135 | \$34,120 | \$56,595 | \$263,008 | \$ 107,723 | \$489,581 |
| Investment properties | 70,302 | 75,891 | 94,839 | 288,431 | 54,178 | 583,641 |
| Multifamily real estate | 13,042 | 16,911 | 8,400 | 56,985 | 42,166 | 137,504 |
| Commercial construction | 14,121 | 7,347 | - | 6,477 | 2,284 | 30,229 |
| Multifamily construction | 10,671 | 10,198 | 718 | 994 | - | 22,581 |
| One- to four-family construction | 92,270 | 52,508 | 929 | 170 | 14,938 | 160,815 |
| Land and land development |  |  |  |  |  |  |
| Residential | 28,617 | 47,529 | 560 | 53 | 251 | 77,010 |
| Commercial | 7,291 | 1,191 | 3,777 | 1,155 | 568 | 13,982 |
| Commercial business | 241,193 | 126,924 | 113,069 | 103,793 | 33,070 | 618,049 |
| Agricultural business, including secured by farmland | 90,844 | 51,263 | 25,341 | 52,114 | 10,469 | 230,031 |


| One- to four-family real estate | 22,258 | 20,589 | 13,384 | 26,288 | 499,151 | 581,670 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Consumer secured by one- to | 1,323 | 3,785 | 1,361 | 11,349 | 152,305 | 170,123 |
| four-family real estate | 14,662 | 10,649 | 15,202 | 21,309 | 58,676 | 120,498 |
| Consumer-other | $\$ 634,729$ | $\$ 458,905$ | $\$ 334,175$ | $\$ 832,126$ | $\$ 975,779$ | $\$ 3,235,714$ |

Contractual maturities of loans do not necessarily reflect the actual life of such assets. The average life of loans typically is substantially less than their contractual maturities because of principal repayments and prepayments. In addition, due-on-sale clauses on certain mortgage loans generally give us the right to declare loans immediately due and payable in the event that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase; however, when current mortgage loan market rates
are substantially higher than rates on existing mortgage loans and, conversely, decreases when rates on existing mortgage loans are substantially higher than current mortgage loan market rates.

The following table sets forth the dollar amount of all loans maturing after December 31, 2012 which have fixed interest rates and floating or adjustable interest rates (in thousands):

Table 10: Loans Maturing after One Year

|  | Fixed Rates | Floating or <br> Adjustable <br> Rates | Total |
| :--- | :--- | :--- | :--- |
| Commercial real estate | $\$ 57,424$ | $\$ 404,023$ | $\$ 461,447$ |
| Owner-occupied 121,659 | 391,679 | 513,338 |  |
| Investment properties | 44,649 | 79,813 | 124,462 |
| Multifamily real estate | 7,945 | 8,163 | 16,108 |
| Commercial construction | 994 | 10,916 | 11,910 |
| Multifamily construction | 17,690 | 50,856 | 68,546 |
| One- to four-family construction |  |  |  |
| Land and land development | 13,317 | 35,077 | 48,394 |
| Residential | 478 | 6,212 | 6,690 |
| Commercial | 168,208 | 208,649 | 376,857 |
| Commercial business | 37,698 | 101,489 | 139,187 |
| Agricultural business, including secured by farmland | 431,615 | 127,796 | 559,411 |
| One- to four-family real estate | 12,005 | 156,794 | 168,799 |
| Consumer secured by one- to four-family real estate | 91,718 | 14,118 | 105,836 |
| Consumer-other | $\$ 1,005,400$ | $\$ 1,595,585$ | $\$ 2,600,985$ |

Deposits: We made further progress in 2012 implementing our strategies to strengthen our franchise by remixing our deposits away from high cost certificates of deposit and emphasizing core deposit activity in non-interest-bearing and other transaction and savings accounts. Increasing core deposits (transaction and savings accounts) is a fundamental element of our business strategy. This strategy continues to improve our cost of funds and increase the opportunity for deposit fee revenues, while stabilizing our funding base. Total deposits increased $\$ 82$ million, to $\$ 3.558$ billion at December 31, 2012 from $\$ 3.476$ billion at December 31, 2011, non-interest-bearing deposits increased by $\$ 203$ million, or $26 \%$, to $\$ 981$ million at year end from $\$ 778$ million at December 31, 2011, and interest-bearing transaction and savings accounts increased by $\$ 100$ million, or $7 \%$, to $\$ 1.547$ billion at December 31, 2012 compared to $\$ 1.448$ billion a year earlier. This core deposit growth augmented similarly strong results in 2011 and coupled with significantly better pricing was primarily responsible for the much improved net interest margin we experienced in 2012. Offsetting these increases, certificates of deposit decreased $\$ 221$ million, or $18 \%$, to $\$ 1.029$ billion at December 31, 2012 from $\$ 1.250$ billion at December 31, 2011. A portion of the decrease in certificates of deposit was in brokered certificates, which decreased $\$ 33$ million from the prior year-end balances; however, much of the decrease reflects a reduction in retail certificates as a result of management's pricing decisions designed to allow maturing higher priced certificates to migrate off the balance sheet or into core deposit accounts.

The following table sets forth the balances of deposits in the various types of accounts offered by the Banks at the dates indicated (dollars in thousands):

Table 11: Deposits
December 31


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The following table indicates the amount of the Banks' certificates of deposit with balances equal to or greater than $\$ 100,000$ by time remaining until maturity as of December 31, 2012 (in thousands):

Table 12: Maturity Period- $\$ 100,000$ or greater CDs
$\left.\begin{array}{ll} & \begin{array}{l}\text { Certificates of } \\ \text { Deposit } \$ 100,000\end{array} \\ \text { or Greater }\end{array}\right\}$

Table 13: Geographic Concentration of Deposits
The following table provides additional detail on geographic concentrations of our deposits at December 31, 2012 (in thousands):

|  | Washington | Oregon | Idaho | Total |
| :--- | :--- | :--- | :--- | :--- |
| Deposits by State | $\$ 2,718,396$ | $\$ 600,179$ | $\$ 239,229$ | $\$ 3,557,804$ |

Borrowings: The FHLB-Seattle serves as our primary borrowing source. To access funds, we are required to own a sufficient level of capital stock in the FHLB-Seattle and may apply for advances on the security of such stock and certain of our mortgage loans and securities provided that certain creditworthiness standards have been met. At December 31, 2012, we had $\$ 10$ million of borrowings from the FHLB-Seattle (at fair value) at a weighted average rate of $2.45 \%$, a decrease of $\$ 229,000$ compared to a year earlier. Also at December 31, 2012, we had an investment of $\$ 37$ million in FHLB-Seattle capital stock. At that date, Banner Bank was authorized by the FHLB-Seattle to borrow up to $\$ 889$ million under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to $\$ 26$ million under a similar agreement.

Table 14: FHLB Advances Outstanding
The following table provides additional detail on our FHLB advances as of December 31, 2012 and 2011 (dollars in thousands):

\left.|  | December 31 |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | 2012 |  |  |  |  |$\right)$

At certain times the Federal Reserve Bank has also served as an important source of borrowings. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB-Seattle. At December 31, 2012, based upon our available unencumbered collateral, Banner Bank was eligible to borrow $\$ 595$ million from the Federal Reserve Bank; however, at that date we had no funds borrowed
under this arrangement.
We also issue retail repurchase agreements to customers that are primarily related to customer cash management accounts and in the past have borrowed funds through the use of secured wholesale repurchase agreements with securities brokers. In each case, the repurchase agreements are generally due within 90 days. At December 31, 2012, retail repurchase agreements totaling $\$ 77$ million, with a weighted average rate of $0.30 \%$, were secured by a pledge of certain mortgage-backed securities and agency securities with a market value of $\$ 109$ million. Retail repurchase agreement balances, which are primarily associated with sweep account arrangements, decreased $\$ 25$ million, or $25 \%$, from the 2011 year-end balance. We had no outstanding borrowings under wholesale repurchase agreements at December 31, 2012 or 2011.

We have issued an aggregate of $\$ 120$ million, net of repayments, of trust preferred securities (TPS) since 2002. The junior subordinated debentures associated with the TPS have been recorded as liabilities on our Consolidated Statements of Financial Condition, although portions of the TPS qualify as Tier 1 or Tier II capital for regulatory capital purposes. The junior subordinated debentures are carried at fair value on our Consolidated Statements of Financial Condition and have an estimated fair value of $\$ 73$ million at December 31, 2012. At December 31, 2012, the TPS had a weighted average rate of $2.42 \%$. See Notes 1 and 12 of the Notes to the Consolidated Financial Statements for additional information with respect to the TPS.

Asset Quality: While non-performing assets declined substantially in 2012 and 2011, beginning in the third quarter of 2008 and continuing throughout 2009 and 2010, housing markets deteriorated in many of our primary service areas and we experienced significantly higher levels of delinquencies and non-performing assets, primarily in our construction and land development loan portfolios. During this period, home and lot sales activity was exceptionally slow, causing stress on builders' and developers' cash flows and their ability to service debt, which was reflected in our increased non-performing asset totals. Further, property values generally declined, reducing the value of the collateral securing loans. In addition, other non-housing-related segments of the loan portfolio developed signs of stress and increasing levels of non-performing loans as the effects of the recessionary economy became more evident and the pace of the recovery remained slow. As a result, our provision for loan losses was significantly higher than historical levels and our normal expectations. This higher than normal level of delinquencies and non-accruals also had a material adverse effect on operating income as a result of foregone interest revenues, increased loan collection costs and carrying costs and valuation adjustments for real estate acquired through foreclosure. While our non-performing assets have been significantly reduced, resulting in materially reduced credit costs in 2012, and we are actively engaged with our borrowers in resolving remaining problem assets, our future results will continue to be meaningfully influenced by the course of recovery from the economic recession. However, our reserve levels are substantial and, as a result of our impairment analysis and charge-off actions, reflect current appraisals and valuation estimates as well as recent regulatory examination results.

Non-performing assets decreased to $\$ 50$ million, or $1.18 \%$ of total assets, at December 31, 2012, from $\$ 119$ million, or $2.79 \%$ of total assets, at December 31, 2011, and $\$ 254$ million, or $5.77 \%$ of total assets, at December 31, 2010. Construction and land development loans, including related REO, represented approximately $27 \%$ of our non-performing assets at December 31, 2012. Reflecting lingering weakness in the economy and property values which now have generally stabilized but are lower than when many of the related loans were originated, we continued to provide for loan losses at a relatively high level during 2012 and maintained a substantial allowance for loan losses at year end even though non-performing loans and total loans outstanding declined. At December 31, 2012, our allowance for loan losses was $\$ 77$ million, or $2.39 \%$ of total loans and $225 \%$ of non-performing loans, compared to $\$ 83$ million, or $2.52 \%$ of total loans and $110 \%$ of non-performing loans at December 31, 2011. Included in our allowance at December 31, 2012 was an unallocated portion of $\$ 12$ million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. We continue to believe our level of non-performing loans and assets, which declined significantly during the past two years, is manageable and we believe that we have sufficient capital and human resources to manage the collection of our non-performing assets in an orderly fashion.

The primary components of the $\$ 50$ million in non-performing assets are $\$ 31$ million in nonaccrual loans and $\$ 16$ million in REO and other repossessed assets. The geographic distribution of non-performing assets included approximately $\$ 18$ million, or $35 \%$, in the Puget Sound region, $\$ 17$ million, or $33 \%$, in the greater Portland market area, $\$ 2$ million, or $5 \%$, in the greater Boise market area, and $\$ 14$ million, or $27 \%$, in other areas of Washington, Oregon and Idaho.

Loans are reported as restructured when we grant concessions to a borrower experiencing financial difficulties that we would not otherwise consider. As a result of these concessions, restructured loans are impaired as the Banks will not

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collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. If any restructured loan becomes delinquent or other matters call into question the borrower's ability to repay full interest and principal in accordance with the restructured terms, the restructured loan(s) would be reclassified as nonaccrual. At December 31, 2012, we had $\$ 57$ million of restructured loans currently performing under their restructured terms.

The following table sets forth information with respect to our non-performing assets and restructured loans, at the dates indicated (dollars in thousands):

Table 15: Non-Performing Assets

|  | December 31 |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2012 |  | 2011 |  | 2010 |  | 2009 |  | 2008 |  |
| Nonaccrual loans: ${ }^{(1)}$ |  |  |  |  |  |  |  |  |  |  |
| Secured by real estate: |  |  |  |  |  |  |  |  |  |  |
| Commercial | \$6,579 |  | \$9,226 |  | \$24,727 |  | \$7,300 |  | \$ 12,879 |  |
| Multifamily | - |  | 362 |  | 1,889 |  | 383 |  | - |  |
| Construction/land | 3,672 |  | 27,731 |  | 75,734 |  | 159,264 |  | 154,823 |  |
| One- to four-family | 12,964 |  | 17,408 |  | 16,869 |  | 14,614 |  | 8,649 |  |
| Commercial business | 4,750 |  | 13,460 |  | 21,100 |  | 21,640 |  | 8,617 |  |
| Agricultural business, including secured by farmland | - |  | 1,896 |  | 5,853 |  | 6,277 |  | 1,880 |  |
| Consumer | 3,396 |  | 2,905 |  | 2,332 |  | 3,923 |  | 130 |  |
|  | 31,361 |  | 72,988 |  | 148,504 |  | 213,401 |  | 186,978 |  |
| Loans more than 90 days delinquent, still on accrual: |  |  |  |  |  |  |  |  |  |  |
| Secured by real estate: |  |  |  |  |  |  |  |  |  |  |
| One- to four-family | 2,877 |  | 2,147 |  | 2,955 |  | 358 |  | 124 |  |
| Commercial business | - |  | 4 |  | - |  | - |  | - |  |
| Consumer | 152 |  | 173 |  | 30 |  | 91 |  | 243 |  |
|  | 3,029 |  | 2,324 |  | 2,985 |  | 449 |  | 367 |  |
| Total non-performing loans | 34,390 |  | 75,312 |  | 151,489 |  | 213,850 |  | 187,345 |  |
| Securities on nonaccrual | - |  | 500 |  | 1,896 |  | 4,232 |  | - |  |
| REO assets held for sale, net ${ }^{(2)}$ | 15,778 |  | 42,965 |  | 100,872 |  | 77,743 |  | 21,782 |  |
| Other repossessed assets held for sale, net | 75 |  | 74 |  | 73 |  | 59 |  | 104 |  |
| Total non-performing assets | \$50,243 |  | \$ 118,851 |  | \$254,330 |  | \$295,884 |  | \$209,231 |  |
| Total non-performing loans to net loans before allowance for loan losses | 1.06 | \% | 2.28 | \% | 4.45 | \% | 5.64 | \% | 4.73 | \% |
| Total non-performing loans to total assets | 0.81 | \% | 1.77 | \% | 3.44 | \% | 4.53 | \% | 4.09 | \% |
| Total non-performing assets to total assets | 1.18 | \% | 2.79 | \% | 5.77 | \% | 6.27 | \% | 4.56 | \% |
| Restructured loans ${ }^{(3)}$ | \$57,462 |  | \$54,533 |  | \$60,115 |  | \$43,683 |  | \$23,635 |  |
| Loans 30-89 days past due and on accrual | \$11,685 |  | \$9,962 |  | \$28,847 |  | \$34,156 |  | \$61,124 |  |

Includes $\$ 8.0$ million of non-accrual restructured loans. For the year ended December 31, 2012, \$3.2 million in
${ }^{(1)}$ interest income would have been recorded had nonaccrual loans been current, and no interest income on these loans was included in net income for this period.
Real estate acquired by us as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate held for sale until it is sold. When property is acquired, it is recorded at the lower of the estimated fair value of the
(2) property, less expected selling costs, or the carrying value of the defaulted loan. Subsequent to foreclosure, the property is carried at the lower of the foreclosed amount or net realizable value. Upon receipt of a new appraisal and market analysis, the carrying value is written down through the establishment of a specific reserve to the anticipated sales price, less selling and holding costs.
(3) These loans are performing under their restructured terms.

In addition to the non-performing loans noted in Table 15, as of December 31, 2012, we had classified loans with an aggregate outstanding balance of $\$ 100$ million that are not on nonaccrual status, with respect to which known

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information concerning possible credit problems with the borrowers or the cash flows of the properties securing the respective loans has caused management to be concerned about the ability of the borrowers to comply with present loan repayment terms. This may result in the future inclusion of such loans in the nonaccrual loan category.

The following table provides additional detail and geographic concentration of non-performing assets at December 31, 2012 (dollars in thousands):

Table 16: Non-Performing Assets by Geographic Concentration

|  | Washington | Oregon | Idaho | Total |
| :---: | :---: | :---: | :---: | :---: |
| Secured by real estate: |  |  |  |  |
| Commercial | \$5,814 | \$- | \$765 | \$6,579 |
| Construction and land |  |  |  |  |
| One- to four-family construction | 1,565 | - | - | 1,565 |
| Residential land acquisition \& development | - | 1,422 | - | 1,422 |
| Residential land improved lots | 119 | 276 | - | 395 |
| Residential land unimproved | 245 | - | - | 245 |
| Commercial land improved | 46 | - | - | 46 |
| Total construction and land | 1,975 | 1,698 | - | 3,673 |
| One- to four-family | 11,932 | 2,487 | 1,422 | 15,841 |
| Commercial business | 4,676 | 74 | - | 4,750 |
| Consumer | 2,623 | 423 | 501 | 3,547 |
| Total non-performing loans | 27,020 | 4,682 | 2,688 | 34,390 |
| REO and repossessed assets | 5,850 | 9,557 | 446 | 15,853 |
| Total non-performing assets at end of the period | \$32,870 | \$14,239 | \$3,134 | \$50,243 |
| Percent of non-performing assets | 65.5 | \% 28.3 | \% 6.2 | \% 100.0 |

Table 17: Non-Performing Loan Summary
Within our non-performing loans, we have a total of six nonaccrual lending relationships, each with aggregate loan exposures in excess of $\$ 1$ million that collectively comprise $\$ 8$ million, or $24 \%$ of our total non-performing loans as of December 31, 2012, and the single largest relationship totaled $\$ 1.8$ million at that date. The most significant of our non-performing loan exposures at December 31, 2012 are included in the following table (dollars in thousands):

| Amount | Percent of Total Non-Performing Loans | Collateral Securing the Indebtedness | Geographic Location |
| :---: | :---: | :---: | :---: |
| \$1,819 | 5.3 \% | Accounts receivable and inventory | Greater Seattle-Puget Sound area |
| 1,432 | 4.2 | Commercial building | Central Washington |
| 1,405 | 4.1 | Business assets, accounts receivable, and vehicles | Greater Spokane, WA area |
| 1,306 | 3.8 | Seven single family residences | Greater Portland, OR area |
| 1,190 | 3.5 | Seven single family residences | Greater Seattle-Puget Sound area |
| 1,086 | 3.1 | Four commercial lots and one commercial acreage lot | Greater Portland, OR area |
| 26,152 | 76.0 | Relationships under \$1 million; various collateral | Sum of 164 loans spread throughout the franchise |
| \$34,390 | 100.0 \% | Total non-performing loans |  |

Table 18: Real Estate Owned Summary
At December 31, 2012, we had $\$ 15.8$ million of REO, the most significant component of which is a subdivision in the greater Portland, Oregon area consisting of 13 residential buildable lots and 33.2 acres of undeveloped land with a book value of $\$ 2.1$ million. The second largest REO holding is 5.9 acres of undeveloped land in the greater Portland, Oregon area with a book value $\$ 1.7$ million. The third largest holding is 20.5 acres of undeveloped residential land in the greater Portland, Oregon area with a book value of $\$ 1.1$ million. All other REO holdings have individual book values of less than $\$ 586,000$. The table below summarizes our REO by geographic location and property type (dollars in thousands):

| Amount | Percent of <br> Total REO | REO Description | Geographic Location |
| :---: | :---: | :---: | :---: |
| \$ 10,594 | 67.2 | $\begin{aligned} & 13 \text { single family residences } \\ & \text { \% residential lots } \\ & 83 \text { acres undeveloped buildable residential land } \end{aligned}$ | Greater Portland, OR area |
| 1,658 | 10.5 | Five single family residences <br> One residential lot <br> Three parcels of undeveloped residential land One acre of buildable residential land | Greater Seattle-Puget Sound area |
| 819 | 5.2 | One single family residences 21 residential lots One parcel of residential land Three commercial office buildings 63 acres of forest land One parcel of undeveloped waterfront land One single family residence 53 residential lots | Greater Spokane, WA area |
| 445 | 2.8 | Three commercial lots One commercial office building | Greater Boise, ID area |
| 2,194 | 13.9 | Three single family residences <br> 21 residential lots <br> One single family residence under construction 13 acres of undeveloped land One residence with 31 acres of agricultural land One parcel of bare land One 79 acre farm | Other Washington locations |
| 68 | 0.4 | One single family residence | Other Oregon locations |
| \$15,778 | 100.0 | \% |  |

Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011
Following three difficult years and despite a still challenging economy, Banner Corporation returned to profitability in 2011 and achieved significantly increased profitability in 2012. While this return to profitability largely resulted from a material decrease in credit costs, particularly our provision for loan losses, it also reflected strong revenue generation
from our core operations. The decrease in credit costs reflects a substantially reduced level of non-performing assets while the increase in revenues was driven by improvement in our net interest income and deposit fees and other service charges fueled by growth in core deposits and, in 2012, significantly increased revenues from mortgage banking operations and a substantial net benefit from income taxes. For the year ended December 31, 2012, we had net income of $\$ 64.9$ million, which, after providing for the preferred stock dividend of $\$ 4.9$ million, the related discount accretion of $\$ 3.3$ million, and including a $\$ 2.5$ million gain on repurchase and retirement of preferred stock, resulted in net income to common shareholders of $\$ 59.1$ million, or $\$ 3.16$ per diluted share. This compares to net income of $\$ 5.5$ million, which, after providing for the preferred stock dividend of $\$ 6.2$ million and related discount accretion of $\$ 1.7$ million, resulted in a net loss to common shareholders of $\$ 2.4$ million, or $(\$ 0.15)$ per diluted share, for the year ended December 31, 2011. Our provision for loan losses was $\$ 13.0$ million for the year ended December 31, 2012, compared to $\$ 35.0$ million for the prior year. For the year ending December 31, 2012, our results also include a net tax benefit of $\$ 24.8$ million, primarily the result of a reversal of a full valuation allowance for our net deferred tax assets.

Aside from credit costs, our operating results depend largely on our net interest income which, as explained below, increased by $\$ 3.1$ million to $\$ 167.7$ million, primarily because of a significant reduction in deposit costs and a reduction in the adverse effect of non-performing assets. Our operating results for the year ended December 31, 2012 also reflected a decrease in other operating income, which was particularly influenced by a net charge of $\$ 16.5$ million as a result of changes in the valuation of financial instruments carried at fair value that was only partially offset by increases in deposit fees and service charges, revenues from mortgage banking operations and miscellaneous other operating income. By comparison, for the year ended December 31, 2011, we recorded a $\$ 3$ million recovery of a previous OTTI charge, which was partially offset by $\$ 624,000$ in net fair value losses. Excluding these fair value and OTTI adjustments, our other operating income increased by $\$ 12.2$ million
to $\$ 43.8$ million for the year ended December 31,2012 compared to $\$ 31.6$ million the preceding year, due primarily to a $\$ 7.9$ million increase in mortgage banking revenue, a $\$ 2.3$ million increase in deposit fees and service charges and a $\$ 2.2$ million increase in miscellaneous other operating income. Other operating expenses decreased to $\$ 141.5$ million for the year ended December 31, 2012, a decrease of $11 \%$ from the prior year, largely as a result of decreased costs related to REO and FDIC deposit insurance.

Net Interest Income. Net interest income before provision for loan losses increased by $\$ 3.1$ million, or $2 \%$, to $\$ 167.7$ million for the year ended December 31, 2012, compared to $\$ 164.6$ million one year earlier, primarily as a result of an increase in the net interest margin and despite a modest decrease in average interest-earning assets. The net interest margin of $4.17 \%$ for the year ended December 31, 2012 increased 12 basis points from the prior year, largely as a result of the effect of a much lower cost of deposits which more than offset a further decrease in asset yields. While less severe than in the preceding year as a result of the significant reduction in problem assets, our net interest margin continued to be adversely affected by the level of nonaccrual loans and other non-performing assets. However, nonaccruing loans reduced the margin by just eight basis points during the year ended December 31, 2012, a meaningful improvement compared to a 22 basis point reduction for the prior year. In addition, the mix of earning assets changed to include fewer loans and more securities and interest-bearing deposits as our on-balance-sheet liquidity remained high. This continued shift in the mix during the still very low interest rate environment had a further adverse effect on earning asset yields. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on earning assets for the year ended December 31, 2012 decreased by 20 basis points compared to the prior year. Importantly, however, funding costs were also significantly lower, especially deposit costs which decreased 31 basis points to $0.44 \%$ from $0.75 \%$ a year earlier, more than offsetting the decline in asset yields. As a result, the net interest spread expanded to $4.13 \%$ for the year ended December 31, 2012 compared to $3.99 \%$ for the prior year and was only partially offset by the $1 \%$ decline in average interest-earning assets.

Interest Income. Interest income for the year ended December 31, 2012 was $\$ 187.2$ million, compared to $\$ 197.6$ million for the prior year, a decrease of $\$ 10.4$ million, or $5 \%$. The decrease in interest income occurred as a result of a $\$ 46$ million decrease in the average balance of interest-earning assets, as well as a 20 basis point decrease in the average yield on those assets. The yield on average interest-earning assets decreased to $4.66 \%$ for the year ended December 31, 2012, compared to $4.86 \%$ one year earlier, largely as a result of changes in the mix of assets and the impact of lower market rates on the loan and securities portfolios. The Federal Reserve continued monetary policy actions during the year designed to maintain short-term market interest rates at the extremely low levels of the past four years and initiated further actions to move intermediate- and longer-term rates even lower in 2012. Despite the pressure from lower market interest rates, our loan yields were only modestly lower at $5.41 \%$ for the year ended December 31, 2012 compared to $5.59 \%$ in the preceding year largely because of a decrease in the amount of non-performing loans. Looking forward, loan yields will likely continue to decline in the current interest rate environment as refinance activity will be reflective of market rates that are below the average portfolio yield and opportunities to further reduce the impact of non-performing loans have diminished. Average loans receivable for the year ended December 31, 2012 decreased $\$ 74$ million, or $2 \%$, to $\$ 3.224$ billion, compared to $\$ 3.298$ billion for the prior year. Interest income on loans decreased by $\$ 10.1$ million, or $5 \%$, to $\$ 174.3$ million for the year from $\$ 184.4$ million for the year ended December 31, 2011, reflecting the decreased average balance and the lower average yield on loans.

The combined average balance of mortgage-backed securities, investment securities, daily interest-bearing deposits and FHLB stock increased by $\$ 28$ million (excluding the effect of fair value adjustments) for the year ended December 31, 2012; however the interest and dividend income from those investments decreased by $\$ 366,000$ compared to the prior year. The effect of the increased average balance was offset as the average yield on the securities portfolio and cash equivalents decreased to $1.61 \%$ for the year ended December 31, 2012, from $1.72 \%$ one year earlier. The adverse impact of lower market rates on the combined yield on these investments was partially offset by changes in the mix to include lower balances of daily interest-bearing deposits and more investment securities;
however, yields on this portfolio should continue to decline in future periods given continuation of the currently low interest rate environment.

Interest Expense. Interest expense for the year ended December 31, 2012 was $\$ 19.5$ million, compared to $\$ 33.0$ million for the prior year, a decrease of $\$ 13.5$ million, or $41 \%$. The sharp decline in interest expense occurred as a result of a 34 basis point decrease in the average cost of all interest-bearing liabilities to $0.53 \%$ for the year ended December 31, 2012, from $0.87 \%$ one year earlier, and a $\$ 119$ million, or $3 \%$, decrease in average interest-bearing liabilities. The decrease in average interest-bearing balances reflects a substantial decrease in the average balance of certificates of deposit, as well as decreases in FHLB advances and other borrowings, which were only partially offset by increases in transaction and savings accounts. The growth in non-interest-bearing deposits and other transaction and savings accounts during the past two years has significantly contributed to our improved net interest margin in 2012.

Deposit interest expense decreased $\$ 11.1$ million, or $42 \%$, to $\$ 15.1$ million for the year ended December 31, 2012 compared to $\$ 26.2$ million for the prior year as a result of a 31 basis point decrease in the cost of deposits and a $\$ 62$ million decrease in the average balance of deposits. Average deposit balances decreased to $\$ 3.448$ billion for the year ended December 31, 2012, from $\$ 3.510$ billion for the year ended December 31, 2011, while the average rate paid on deposit balances decreased to $0.44 \%$ in the current year from $0.75 \%$ for the prior year. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits frequently tend to lag changes in market interest rates as evidenced by the continuing decline in our deposit costs despite relatively stable short-term market interest rates over the past twelve months.

While we do not anticipate further reductions in market interest rates, we do expect additional modest declines in deposits costs over the near term as maturities of certificates of deposit will present further repricing opportunities and competitive pricing should remain restrained in response to modest loan demand in the current economic environment. Further, continuing changes in our deposit mix, especially growth in lower cost transaction and savings accounts, in particular non-interest-bearing deposits, have meaningfully contributed to the decrease in our funding costs compared to earlier periods, and should also result in lower deposit costs going forward.

Average FHLB advances (excluding the effect of fair value adjustments) decreased to $\$ 10$ million for the year ended December 31, 2012, compared to $\$ 15$ million for the prior year. The decline in outstanding FHLB advances was almost entirely responsible for the $\$ 116,000$ decrease in the related interest expense as the average rate paid on FHLB advances remained nearly unchanged for the years ended December 31, 2012 and 2011 at $2.49 \%$ and $2.52 \%$, respectively.

Other borrowings consist of retail repurchase agreements with customers secured by certain investment securities and, prior to March 31, 2012, the $\$ 50$ million of senior bank notes issued under the TLGP. The senior bank notes had a fixed rate of $2.625 \%$, plus a $1.00 \%$ guarantee fee, and matured on March 31, 2012. Repaying these notes resulted in a significant reduction in the cost of borrowings for 2012. Primarily as a result of repaying the senior bank notes, the average balance for other borrowings decreased $\$ 52$ million to $\$ 102$ million at December 31, 2012 compared to $\$ 154$ million a year earlier. The rate on these other borrowings likewise decreased to $0.74 \%$ from $1.47 \%$ a year earlier and the related interest expense for other borrowings decreased by $\$ 1.5$ million to $\$ 758,000$ for the year ended December 31, 2012, from $\$ 2.3$ million one year earlier.

Junior subordinated debentures which were issued in connection with our trust preferred securities had an average balance (excluding the effect of fair value adjustments) of $\$ 124$ million for both the years ended December 31, 2012 and 2011. These junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index. During 2012, the average rate decreased to $2.72 \%$ compared to $3.39 \%$ for 2011. The lower average cost of the junior subordinated debentures in the current year was primarily the result of the expiration on February 29, 2012 of a five-year fixed-rate period on one debenture and its repricing from a fixed rate of $6.56 \%$ to an adjustable rate of LIBOR plus $1.62 \%$, or $1.99 \%$ at December 31, 2012.

Table 19, Analysis of Net Interest Spread, presents, for the periods indicated, our condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets and interest expense and rates paid on average interest-bearing liabilities. Average balances are computed using daily average balances. (See the footnotes to the tables for more information on average balances.)

The following table provides an analysis of our net interest spread for the last three years (dollars in thousands):
Table 19: Analysis of Net Interest Spread
Year Ended December 31, 2012 Year Ended December 31, 2011 Year Ended December 31, 2010

| Average | Interest | and | Yield/ | Average | Interest | Yield/ | Average | Interest |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| and | Yield/ |  |  |  |  |  |  |  |
| Balance |  and | Dividends | Cost ${ }^{(4)}$ | Balance |  | Dividends | Cost ${ }^{(4)}$ | Balance | | Dividends | Cost ${ }^{(4)}$ |
| :--- | :--- |

Interest-earning assets:
$\left.\begin{array}{llllllllll}\text { Mortgage loans } & \$ 2,380,308 & \$ 131,523 & 5.53 & \% & \$ 2,464,462 & \$ 139,102 & 5.64 & \% & \$ 2,735,285\end{array}\right) \$ 152,2705.57$

Interest-bearing
liabilities:

| Savings accounts <br> Checking and <br> interest-bearing <br> checking accounts (2) <br> Money market accounts 411,453 | $1,203,991$ | 491 | 1,825 | 0.27 | $\$ 648,262$ | 3,119 | 0.48 | $\$ 591,886$ | 5,153 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | 0.87

Other interest-bearing
liabilities:

| FHLB advances | 10,215 | 254 | 2.49 | 14,699 | 370 | 2.52 | 51,411 | 1,318 | 2.56 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Other borrowings | 102,193 | 758 | 0.74 | 154,140 | 2,265 | 1.47 | 175,509 | 2,448 | 1.39 |
| Junior subordinated debentures | 123,716 | 3,395 | 2.74 | 123,716 | 4,193 | 3.39 | 123,716 | 4,226 | 3.42 |
| Total borrowings | 236,124 | 4,407 | 1.87 | 292,555 | 6,828 | 2.33 | 350,636 | 7,992 | 2.28 |
| Total interest-bearing liabilities | 3,684,029 | 19,514 | 0.53 | 3,802,829 | 32,992 | 0.87 | 4,119,384 | 60,312 | 1.46 |
| Non-interest-bearing liabilities ${ }^{(3)}$ | (22,757 |  |  | (40,266 |  |  | (37,378 |  |  |
| Total liabilities Stockholders' equity | $\begin{aligned} & 3,661,272 \\ & 557,894 \end{aligned}$ |  |  | $\begin{aligned} & 3,762,563 \\ & 518,204 \end{aligned}$ |  |  | $\begin{aligned} & 4,082,006 \\ & 478,298 \end{aligned}$ |  |  |


(footnotes follow)
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(1) Average balances include loans accounted for on a nonaccrual basis and loans 90 days or more past due. Amortization of net deferred loan fees/costs is included with interest on loans.
${ }^{(2)}$ Average balances include non-interest-bearing deposits.
(3) Average non-interest-bearing liabilities include fair value adjustments related to FHLB advances and junior subordinated debentures.
${ }^{(4)}$ Yields and costs have not been adjusted for the effect of tax-exempt interest.
The following table sets forth the effects of changing rates and volumes on our net interest income during the periods shown (in thousands). Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate) and (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume). Effects on interest income attributable to changes in rate and volume (changes in rate multiplied by changes in volume) have been allocated between changes in rate and changes in volume (in thousands):

Table 20: Rate/Volume Analysis

Interest-earning assets:
Mortgage loans
Commercial/agricultural loans
Consumer and other loans
Total loans ${ }^{(1)}$
Mortgage-backed securities
Other securities
Interest-bearing deposits with banks
FHLB stock
Total investment securities

| Year Ended December 31, 2012 |  |  | Year Ended December 31, 2011 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Compared to Year Ended |  |  | Compared to Year Ended |  |  |
| December 31, 2011 |  |  | December 31, 2010 |  |  |
| Increase (Decrease) in |  |  | Increase (Decrease) in |  |  |
| Income/E | Expense Due |  | Income/E | Expense Due to |  |
| Rate | Volume | Net | Rate | Volume | Net |
| \$(2,891 | ) $\$(4,688$ | ) $\$(7,579$ | \$2,092 | \$(15,260) | ) $\$(13,168)$ |
| (2,658 | ) 367 | (2,291 | (5,816 | ) (2,109 ) | (7,925 |
| (383 | ) 218 | (165 | (162 | ) (172 | (334 |
| (5,932 | ) $(4,103$ | ) $(10,035$ | (3,886 | ) $(17,541$ | (21,427 |
| (2,005 | ) 2,726 | 721 | (508 | ) (82 | (590 |
| (1,088 | ) 171 | (917 | ) $(1,869$ | ) 3,568 | 1,699 |
| 26 | (196 | (170 | ) (31 | ) (170 | (201 |
| - | - | - | - | - | - |
| (3,067 | ) 2,701 | (366 | (2,408 | ) 3,316 | 908 |
| - 8,999 | ) $(1,402$ | (10,401 | (6,294 | ) (14,225 ) | ) $(20,519$ |
| (8,159 | ) $(2,898$ | ) $(11,057$ | ) $(18,832$ | ) (7,324 ) | (26,156 |
| (4 | ) (112 | ) (116 | ) (24 | ) (924 ) | (948 |
| (897 | ) (610 | ) $(1,507$ | 126 | (309 ) | (183 |
| (798 | ) - | (798 | ) (33 | ) - | (33 |
| (1,699 | ) (722 | ) $(2,421$ | 69 | (1,233 ) | (1,164 |
| (9,858 | ) $(3,620$ | ) $(13,478$ | ) $(18,763$ | ) $(8,557$ | (27,320 |
| \$859 | \$2,218 | \$3,077 | \$12,469 | \$(5,668 ) | ) $\$ 6,801$ |

[^0]Provision and Allowance for Loan Losses. During the year ended December 31, 2012, the provision for loan losses was $\$ 13$ million, compared to $\$ 35$ million for the year ended December 31, 2011. As discussed in the "Summary of

Critical Accounting Policies" section above and in Note 1 of the Notes to the Consolidated Financial Statements, the provision and allowance for loan losses is one of the most critical accounting estimates included in our Consolidated Financial Statements. The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves, trends in delinquencies and net charge-offs and current economic conditions.

Our provision for loan losses was substantially less in the year ended December 31, 2012 than in 2011. Nonetheless, it remained elevated in relation to historical loss rates prior to the economic downturn, particularly during the first half of 2012, in response to still high levels of delinquencies, non-performing assets and net charge-offs as well as diminished property values and uncertain economic conditions. However,
all of our asset quality indicators improved significantly throughout the years 2011 and 2012, allowing us to decrease the level of provisioning as each year progressed.

Reflecting lingering weakness in the economy and lower property values, during 2012, we continued to provide for loan losses at a relatively high level and maintained a substantial allowance for loan losses at December 31, 2012 even though non-performing loans and total loans outstanding declined. Although the allowance for loan losses at December 31, 2012 continued to reflect material levels of delinquencies and net charge-offs for land and land development loans, our exposure to these types of loans was further reduced during the year as additional problem asset resolutions occurred. The allowance for loan losses also continues to reflect our concerns that the significant number of distressed sellers in the market and additional expected lender foreclosures may further disrupt certain housing markets and adversely affect home prices and the demand for building lots. These concerns have remained elevated during the past four years as price declines for housing and related lot and land markets have occurred in most areas of the Puget Sound and Portland regions where a significant portion of our one- to four-family residential and construction and development loans are located. Nonetheless, more recently we have been encouraged by evidence of stabilization or modest improvement in certain markets in our service areas. Aside from housing-related construction and development loans, non-performing loans often reflect unique operating difficulties for the individual borrower; however, the weak pace of general economic activity and declining commercial real estate values have been significant contributing factors to more recent late-cycle defaults in other non-housing-related segments of the portfolio.

We recorded net charge-offs of $\$ 18$ million for the year ended December 31, 2012, compared to $\$ 49$ million for the prior year, and non-performing loans decreased by $\$ 41$ million during the year to $\$ 34$ million at December 31, 2012, compared to $\$ 75$ million at December 31, 2011. A comparison of the allowance for loan losses at December 31, 2012 and 2011 reflects a decrease of $\$ 6$ million, or $7 \%$, to $\$ 77$ million at December 31, 2012, from $\$ 83$ million at December 31, 2011. Included in our allowance at December 31, 2012 was an unallocated portion of $\$ 12$ million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) decreased to $2.39 \%$ at December 31, 2012, compared to $2.52 \%$ at December 31, 2011. However, as a result of the reduction in problem loans, the allowance as a percentage of non-performing loans increased to $225 \%$ at December 31, 2012, compared to $110 \%$ a year earlier.

As of December 31, 2012, we had identified $\$ 92$ million of impaired loans. Impaired loans are comprised of loans on nonaccrual, TDRs that are performing under their restructured terms and loans that are 90 days or more past due, but are still on accrual. Impaired loans may be evaluated for reserve purposes using either a specific impairment analysis or collectively evaluated as part of homogeneous pools. For more information on these impaired loans, refer to Note 6 and 22 of the Notes to the Consolidated Financial Statements.

We believe that the allowance for loan losses as of December 31, 2012 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

The following table sets forth an analysis of our allowance for loan losses for the periods indicated (dollars in thousands):

Table 21: Changes in Allowance for Loan Losses

|  | Years En |  | ecember |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2012 |  | 2011 |  | 2010 |  | 2009 |  | 2008 |  |
| Balance, beginning of period | \$82,912 |  | \$97,401 |  | \$95,269 |  | \$75,197 |  | \$45,827 |  |
| Provision | 13,000 |  | 35,000 |  | 70,000 |  | 109,000 |  | 62,500 |  |
| Recoveries of loans previously charged off: |  |  |  |  |  |  |  |  |  |  |
| Commercial real estate | 921 |  | 53 |  | - |  | - |  | 1,530 |  |
| Construction and land | 2,954 |  | 1,602 |  | 897 |  | 715 |  | 192 |  |
| Commercial business | 2,425 |  | 1,082 |  | 2,865 |  | 545 |  | 471 |  |
| Agricultural business, including secured by farmland | 49 |  | 20 |  | 45 |  | 38 |  | 1,048 |  |
| One- to four-family real estate | 586 |  | 356 |  | 136 |  | 138 |  | 45 |  |
| Consumer | 531 |  | 304 |  | 284 |  | 275 |  | 185 |  |
|  | 7,466 |  | 3,417 |  | 4,227 |  | 1,711 |  | 3,471 |  |
| Loans charged off: |  |  |  |  |  |  |  |  |  |  |
| Commercial real estate | (4,065 | ) | (6,079 | ) | (1,668 | ) | (1 | ) | (7 | ) |
| Multifamily real estate | - |  | (682 | ) | - |  | - |  | - |  |
| Construction and land | (6,546 | ) | (26,328 | ) | (43,592 | ) | (64,456 | ) | (27,020 | ) |
| Commercial business | (6,485 | ) | (8,396 | ) | $(15,244$ | ) | (11,541 | ) | (7,323 | ) |
| Agricultural business, including secured by farmland | (456 | ) | (477 | ) | (1,940 | ) | (3,877 | ) | (60 | ) |
| One- to four-family real estate | (5,328 | ) | (9,910 | ) | (7,860 | ) | (8,795 | ) | (934 | ) |
| Consumer | (3,007 | ) | (1,034 | ) | (1,791 | ) | (1,969 | ) | (1,257 | ) |
|  | (25,887 | ) | (52,906 | ) | (72,095 | ) | (90,639 | ) | (36,601 | ) |
| Net charge-offs | (18,421 | ) | (49,489 | ) | (67,868 | ) | (88,928 | ) | (33,130 | ) |
| Balance, end of period | \$77,491 |  | \$82,912 |  | \$97,401 |  | \$95,269 |  | \$75,197 |  |
| Allowance for loan losses as a percent of total loans | 2.39 | \% | 2.52 | \% | 2.86 | \% | 2.51 | \% | 1.90 | \% |
| Net loan charge-offs as a percent of average outstanding loans during the period | $0.57$ | \% | 1.50 | \% | 1.88 | \% | 2.28 | \% | 0.84 | \% |
| Allowance for loan losses as a percent of non-performing loans | 225 | \% | 110 | \% | 64 | \% | 45 | \% | 40 | \% |

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated (dollars in thousands):

Table 22: Allocation of Allowance for Loan Losses
December 31

| 2012 |  | 2011 |  | 2010 |  | 2009 |  | 2008 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Percent of |  | Percent of |  | Percent of |  | Percent of |  | Percent |
|  | Loans |  | Loans |  | Loans |  | Loans |  | of Loans in Each |
| Amount | in Each | Amount | in Each | Amount | in Each | Amount | in Each | Amount | Category |
|  | to Total |  | to Total |  | to Total |  | to Total |  | to Total |
|  | Loans |  | Loans |  | Loans |  | Loans |  | Loans |

Specific or allocated loss allowances ${ }^{(1)}$ :
Commercial real estate Multifamily real estate
Construction and land Commercial business
Agricultural

| business, includin secured by farmland | 2,295 | 7.1 | 1,548 | 6.6 | 1,846 | 6.0 | 919 | 5.4 | 530 | 5.2 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| One- to four-family real estate | 16,475 | 18.0 | 12,299 | 19.5 | 5,829 | 20.1 | 2,912 | 18.6 | 752 | 15.1 |
| Consumer | 1,348 | 9.0 | 1,253 | 8.6 | 1,794 | 8.4 | 1,809 | 8.0 | 1,730 | 7.4 |
| Total allocated | 64,894 |  | 68,852 |  | 82,877 |  | 81,271 |  | 62,084 |  |

Estimated

| allowance for | 758 | $\mathrm{n} / \mathrm{a}$ | 678 | $\mathrm{n} / \mathrm{a}$ | 1,426 | $\mathrm{n} / \mathrm{a}$ | 1,594 | $\mathrm{n} / \mathrm{a}$ | 1,108 | $\mathrm{n} / \mathrm{a}$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | undisbursed commitments Unallocated ${ }^{(1)} \quad 11,839 \mathrm{n} / \mathrm{a} \quad 13,382 \mathrm{n} / \mathrm{a} \quad 13,098 \quad \mathrm{n} / \mathrm{a} \quad 12,404 \quad \mathrm{n} / \mathrm{a} \quad 12,005 \mathrm{n} / \mathrm{a}$ $\begin{array}{llllllllllll}\begin{array}{l}\text { Total allowance for } \\ \text { loan losses }\end{array} & \$ 77,491 & 100.0 & \% & \$ 82,912 & 100.0 & \% & \$ 97,401 & 100.0 & \% & \$ 95,269 & 100.0\end{array}$

We establish specific loss allowances when individual loans are identified that present a possibility of loss (i.e.,
${ }^{(1)}$ that full collectability is not reasonably assured). The remainder of the allocated and unallocated allowance for loan losses is established for the purpose of providing for estimated losses which are inherent in the loan portfolio.

Other Operating Income. Other operating income, which includes changes in the valuation of financial instruments carried at fair value as well as non-interest revenues from core operations, decreased $\$ 7.0$ million to $\$ 26.9$ million for the year ended December 31, 2012, compared to $\$ 34.0$ million for the year ended December 31, 2011. This decrease was primarily due to a $\$ 15.9$ million unfavorable variance in net fair value adjustments compared to the prior year. Excluding fair value and OTTI adjustments and, in the current year, a small gain on sale of securities, other operating income from core operations increased $\$ 12.2$ million to $\$ 43.8$ million for the year ended December 31, 2012 compared to $\$ 31.6$ million at December 31, 2011, largely as a result of significantly increased revenues from mortgage banking. Mortgage banking revenues increased by $\$ 7.9$ million as increased production and sales of loans were supported by high levels of refinancing in the very low interest rate environment. Loan sales for the year ended December 31, 2012 totaled $\$ 505$ million, compared to $\$ 282$ million for the year ended December 31, 2011. Importantly, and primarily as a result of growth in our customer base, income from deposit fees and other service charges increased by $\$ 2.3$ million, or approximately $10 \%$, to $\$ 25.3$ million for the year ended December 31, 2012, compared to $\$ 23.0$ million for the prior year. By contrast, loan servicing fee income decreased $\$ 206,000$ compared to the prior year, primarily reflecting a $\$ 400,000$ impairment charge on our MSRs. Miscellaneous revenues also increased significantly, largely as a result of increased fees associated with interest rate swaps and income on bank-owned life insurance.

For the year ended December 31, 2012, we recorded a net charge of $\$ 16.5$ million for changes in the valuation of financial instruments carried at fair value, compared to a net charge of $\$ 624,000$ for the year ended December 31, 2011. The adjustments in 2012 primarily reflect changes in the valuation of the junior subordinated debentures we have issued, which resulted in $\$ 23.1$ million in charges that were partially offset by net gains in the value of certain investment securities. The net fair value loss in 2011 was also largely a result of changes in the valuation of the junior subordinated debentures, which resulted in $\$ 1.6$ million in charges that were partially offset by net gains in the values of certain investment securities. Additionally, in 2011, we had a $\$ 3.0$ million recovery as a result of the full cash repayment of a trust preferred security issued by a commercial bank that had been written off as an OTTI charge in 2010. As discussed more thoroughly in Note 22 of the Notes to the Consolidated Financial Statements, the valuation for many of these financial instruments has become very difficult and more subjective in recent periods as current and reliable observable transaction data does not exist.

Other Operating Expenses. Other operating expenses for the year ended December 31, 2012 totaled $\$ 141.5$ million compared to $\$ 158.1$ million in 2011, a decrease of $\$ 16.6$ million, or $11 \%$, compared to the prior year, largely as a result of decreased costs related to REO and FDIC deposit insurance which were partially offset by increased compensation expenses. While lower in 2012 than in 2011, both years' expenses reflect significant costs associated with problem loan collection activities including professional services and valuation charges related to REO, which we expect will decline in future periods as a result of the continuing reduction in non-performing assets. Total REO expenses were $\$ 3.4$ million, including only $\$ 451,000$ of net losses and valuation adjustments, for the year ended December 31, 2012, compared to $\$ 22.3$ million, including $\$ 16.4$ million of losses and valuation adjustments, for the year ended December 31, 2011. Importantly, our total REO was reduced by nearly $\$ 27$ million during 2012 to $\$ 16$ million at December 31, 2012, compared to $\$ 43$ million a year earlier. The cost of FDIC insurance decreased by $\$ 2.3$ million compared to the prior year, largely as a result of the decrease in average deposit balances, leading to a decrease in average assets, and a reduction in the premium assessment rate. Compensation expense increased $\$ 6.2$ million to $\$ 78.7$ million for the year ended December 31, 2012 from $\$ 72.5$ million for the year ended December 31, 2011, primarily reflecting salary and wage adjustments, increased mortgage banking activity and higher health insurance costs. The increase in compensation costs was partially offset by an $\$ 2.4$ million increase in the amount of the credit for capitalized loan origination costs as a result of increased new loan originations and a $\$ 1.6$ million reduction in professional fees largely due to decreased legal expenses associated with problem loan resolution. Payment and card processing expenses increased by $\$ 730,000$, reflecting the increased number of transaction accounts and increased customer usage of debit and credit cards. All other expenses were only modestly changed from the prior year.

Income Taxes: Our normal, expected statutory income tax rate is $36.5 \%$, representing a blend of the statutory federal income tax rate of $35.0 \%$ and apportioned effects of the $7.6 \%$ Oregon and Idaho income tax rates. However, during 2010, we evaluated our net deferred tax asset and determined it was prudent to establish a valuation allowance against the entire asset. While the full valuation allowance remained in effect, we did not recognize any tax expense or benefit in our Consolidated Statements of Operations. As a result, we did not recognize any tax expense or benefit for the year ended December 31, 2011, although our pre-tax net income was $\$ 5.5$ million. During 2012, we determined that maintaining the full valuation allowance was no longer appropriate and reversed all of the valuation allowance resulting in a substantial tax benefit for the year. The reversal of the valuation allowance, net of adjustments to tax expense/(benefits), resulted in a net benefit from income taxes for the year ended December 31, 2012 of $\$ 24.8$ million. Beginning with the first quarter of 2013, we expect to recognize income tax expense based upon the statutory rate noted above, although certain tax-exempt income and tax credits likely will result in a slightly lower effective rate in future periods. For more information on income taxes and deferred taxes, see Note 13 of the Notes to the Consolidated Financial Statements.

Comparison of Results of Operations for the Years Ended December 31, 2011 and 2010
Following three difficult years and despite a still challenging economy, Banner Corporation returned to profitability in 2011. While this return to profitability largely resulted from a material decrease in credit costs, particularly our provision for loan losses, it also reflected increased revenue generation from our core operations. The decrease in credit costs reflected a substantially reduced level of non-performing assets, while the increase in revenues was driven by significant improvement in our net interest income and deposit fees and other service charges fueled by growth in core deposits. For the year ended December 31, 2011, we had net income of $\$ 5.5$ million, which, after providing for the preferred stock dividend of $\$ 6.2$ million and related discount accretion of $\$ 1.7$ million, resulted in a net loss to common shareholders of $\$ 2.4$ million, or ( $\$ 0.15$ ) per diluted share. This compared to a net loss to common shareholders of $\$ 69.7$ million, or ( $\$ 7.21$ ) per diluted share, for the year ended December 31, 2010. Our provision for loan losses was $\$ 35.0$ million for the year ended December 31, 2011, compared to $\$ 70.0$ million for the prior year. Our results for 2010 also included an $\$ 18.0$ million provision for income taxes, despite a pre-tax loss, as we recorded a full valuation allowance for our net deferred tax assets. By contrast, for the year ended December 31, 2011, we had pre-tax net income of $\$ 5.5$ million, with the resulting provision for income taxes offset by an adjustment to the deferred tax assets valuation allowance.

Aside from credit costs, our operating results depend largely on our net interest income which increased by $\$ 6.8$ million to $\$ 164.6$ million, primarily because of a significant reduction in deposit costs and a reduction in the adverse effect of non-performing assets, and was the most important component of our growth in revenues from core operations in 2011. Our operating results for the year ended December 31, 2011 also included an increase in other operating income, which was particularly influenced by a $\$ 3.0$ million recovery of a previous OTTI charge which was partially offset by a net loss of $\$ 624,000$ as a result of changes in the valuation of financial instruments carried at fair value. By comparison, for the year ended December 31, 2010, we recorded $\$ 4.2$ million of OTTI charges, which were partially offset by $\$ 1.7$ million in net fair value gains. Excluding these fair value and OTTI adjustments, our other operating income was nearly unchanged at $\$ 31.6$ million for the year ended December 31, 2011 compared to the preceding year, as increased deposit fees and other service charges were generally offset by decreased gains on the sale of loans from mortgage banking operations. Other operating expenses decreased to $\$ 158.1$ million for the year ended December 31, 2011, a decrease of $2 \%$ from the prior year, largely as a result of decreased costs related to REO and FDIC deposit insurance.

Net Interest Income. Net interest income before provision for loan losses increased by $\$ 6.8$ million, or 4\%, to $\$ 164.6$ million for the year ended December 31, 2011, compared to $\$ 157.8$ million one year earlier, primarily as a result of an increase in the net interest margin and despite a modest decrease in average interest-earning assets. The net interest margin of $4.05 \%$ for the year ended December 31, 2011 increased 38 basis points from the prior year, largely as a result of the effect of a much lower cost of deposits which more than offset a further decrease in asset yields. While less severe than in the preceding year as a result of the significant reduction in problem assets, our net interest margin continued to be adversely affected by the high level of nonaccrual loans and other non-performing assets. However, nonaccruing loans reduced the margin by 22 basis points during the year ended December 31, 2011, compared to the 34 basis point reduction for the prior year. In addition, the mix of earning assets changed to include fewer loans and more securities and interest-bearing deposits. This continued shift in the mix in the low interest rate environment had a further adverse effect on earning asset yields. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on earning assets for the year ended December 31, 2011 decreased by 21 basis points compared to the prior year. More importantly, funding costs were also significantly lower, especially deposit costs, which decreased 64 basis points to $0.75 \%$ from $1.39 \%$ a year earlier, more than offsetting the decline in asset yields. As a result, the net interest spread expanded to $3.99 \%$ for the year ended December 31, 2011 compared to $3.61 \%$ for the prior year and was only partially offset by the $5 \%$ decline in average interest-earning assets.

Interest Income. Interest income for the year ended December 31, 2011 was $\$ 197.6$ million, compared to $\$ 218.1$ million for the prior year, a decrease of $\$ 20.5$ million, or $9 \%$. The decrease in interest income occurred as a result of a $\$ 232$ million decrease in the average balance of interest-earning assets, as well as a 21 basis point decrease in the average yield on those assets. The yield on average interest-earning assets decreased to $4.86 \%$ for the year ended December 31, 2011, compared to $5.07 \%$ one year earlier, largely as a result of changes in the mix of assets and the impact of lower market rates on the securities portfolio. The Federal Reserve continued monetary policy actions during 2011 designed to maintain short-term market interest rates at the extremely low levels of the previous three years and initiated further actions to move intermediate- and longer-term rates even lower in 2011. Despite the pressure from lower market interest rates, our loan yields were only modestly lower at $5.59 \%$ for the year ended December 31, 2011 compared to $5.70 \%$ in the preceding year largely because of a decrease in the amount of non-performing loans. Average loans receivable for the year ended December 31, 2011 decreased $\$ 310$ million, or $9 \%$, to $\$ 3.298$ billion, compared to $\$ 3.607$ billion for the prior year. Interest income on loans decreased by $\$ 21.4$ million, or $10 \%$, to $\$ 184.4$ million for the year from $\$ 205.8$ million for the year ended December 31, 2010, reflecting the decreased average balance and the lower average yield on loans.

The combined average balance of mortgage-backed securities, investment securities, daily interest-bearing deposits and FHLB stock increased by $\$ 77$ million (excluding the effect of fair value adjustments) for the year ended

December 31, 2011, and the interest and dividend income from those investments increased by $\$ 908,000$ compared to the prior year. The effect of the increased average balance was nearly offset as the average yield on the securities portfolio and cash equivalents decreased to $1.72 \%$ for the year ended December 31, 2011, from $1.78 \%$ one year earlier. The modest decrease in the combined yield on those investments, despite declining market interest rates, reflects a change in the mix to include lower balances of daily interest-bearing deposits and more investment securities, primarily U.S. Government Agency securities, which helped to offset the adverse impact of lower market rates.

Interest Expense. Interest expense for the year ended December 31, 2011 was $\$ 33.0$ million, compared to $\$ 60.3$ million for the prior year, a decrease of $\$ 27.3$ million, or $45 \%$. The sharp decline in interest expense occurred as a result of a 59 basis point decrease in the average cost of all interest-bearing liabilities to $0.87 \%$ for the year ended December 31, 2011, from $1.46 \%$ one year earlier, and a $\$ 317$ million, or $8 \%$, decrease in average interest-bearing liabilities. The decrease in average interest-bearing balances reflects a substantial decrease in the average balance of certificates of deposit, as well as a decrease in FHLB advances and other borrowings, which were only partially offset by increases in transaction and savings accounts.

Deposit interest expense decreased $\$ 26.1$ million, or $50 \%$, to $\$ 26.2$ million for the year ended December 31, 2011 compared to $\$ 52.3$ million for the prior year as a result of a 64 basis point decrease in the cost of deposits despite a $\$ 258$ million decrease in the average balance of deposits. Average deposit balances decreased to $\$ 3.510$ billion for the year ended December 31, 2011, from $\$ 3.769$ billion for the year ended December 31, 2010, while the average rate paid on deposit balances decreased to $0.75 \%$ in 2011 from $1.39 \%$ for the prior year. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits frequently tend to be less severe and to lag changes in market interest rates. In addition, non-interest-bearing deposits dampen the effect of changes in market rates on our aggregate cost of deposits. This lower degree of volatility and lag effect for deposit pricing have been evident in the continuing decrease in deposit costs as the Federal Reserve pursued policies beginning in 2007 first to aggressively lower short-term interest rates and subsequently to maintain the very low level of interest rates. Furthermore, competitive pricing pressure for interest-bearing deposits was quite intense for certain periods two to three years earlier, as many financial institutions experienced increased liquidity concerns in the deteriorating economic conditions. However, as market rates remained low for an extended period, competitors' liquidity strains were generally mitigated and certificates of deposit issued at those times reached maturity, we experienced significantly declining deposit costs during 2009, 2010 and
2011. Further, changes in our deposit mix, reflecting growth in lower cost transaction and savings accounts as a result of our branch network continuing to mature and the successful execution of targeted marketing strategies, also meaningfully contributed to the decrease in funding costs.

Average FHLB advances (excluding the effect of fair value adjustments) decreased to $\$ 15$ million for the year ended December 31, 2011, compared to $\$ 51$ million for the prior year. The decline in outstanding FHLB advances was primarily responsible for a $\$ 948,000$ decrease in the related interest expense as the average rate paid on FHLB advances remained nearly unchanged for the years ended December 31, 2011 and 2010 at $2.52 \%$ and $2.56 \%$, respectively.

The average balance for other borrowings, consisting of customer retail repurchase agreements and senior bank notes, was $\$ 154$ million for the year ended December 31, 2011, a decrease of $\$ 22$ million compared to the prior year, while the related interest expense for other borrowings decreased by $\$ 183,000$ to $\$ 2.3$ million for the year ended December 31, 2011, from $\$ 2.4$ million one year earlier. All of the decrease in average balance and interest expense was related to the retail repurchase agreements, as there was no change in the senior bank notes during the year ended December 31, 2011. As a result, the average rate paid on other borrowings increased eight basis points to $1.47 \%$ for the year ended December 31, 2011, compared to $1.39 \%$ one year earlier.

Junior subordinated debentures had an average balance (excluding the effect of fair value adjustments) of $\$ 124$ million for both the years ended December 31, 2011 and 2010. The average rate decreased slightly to $3.39 \%$ for 2011 compared to $3.42 \%$ for 2010 . With one exception, these junior subordinated debentures were adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index. The slightly lower average cost of the junior subordinated debentures in 2011 reflects the relatively minor difference in the average three-month Libor rate for the two-year period.

Provision and Allowance for Loan Losses. During the year ended December 31, 2011, the provision for loan losses was $\$ 35.0$ million, compared to $\$ 70.0$ million for the year ended December 31, 2010. While our provision for loan losses was substantially less in the year ended December 31, 2011 than in 2010, it remained elevated in relation to historical loss rates prior to the economic downturn in response to still high levels of delinquencies, non-performing assets and net charge-offs as well as declining property values during the year. However, all of our asset quality indicators improved significantly throughout 2011, allowing us to decrease the level of provisioning as the year progressed and compared to the prior year. Although the provision for loan losses for the year ended December 31, 2011 continued to largely reflect material levels of delinquencies and net charge-offs for construction, land and land development loans, our exposure to these types of loans was further reduced during 2011 as problem asset resolutions occurred. The provision and allowance for loan losses also continued to reflect our concerns that the significant number of distressed sellers in the market and additional expected lender foreclosures might further disrupt certain housing markets and adversely affect home prices and the demand for building lots. Aside from housing-related construction and development loans, non-performing loans often reflect unique operating difficulties for the individual borrower, however, the weak pace of general economic activity and declining commercial real estate values significantly contributed to defaults in other non-housing-related segments of the portfolio.

We recorded net charge-offs of $\$ 49$ million for the year ended December 31, 2011, compared to $\$ 68$ million for the prior year, and non-performing loans decreased by $\$ 76$ million during the year to $\$ 75$ million at December 31, 2011, compared to $\$ 151$ million at December, 31, 2010. A comparison of the allowance for loan losses at December 31, 2011 and 2010 reflected a decrease of $\$ 14$ million, or $15 \%$, to $\$ 83$ million at December 31, 2011, from $\$ 97$ million at December 31, 2010. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) decreased to $2.52 \%$ at December 31, 2011, compared to $2.86 \%$ at December 31, 2010. However, as a result of the reduction in problem loans, the allowance as a percentage of non-performing loans increased to $110 \%$ at December 31, 2011, compared to $64 \%$ a year earlier.

Other Operating Income. Other operating income, which includes changes in the valuation of financial instruments carried at fair value as well as non-interest revenues from core operations, increased $\$ 4.9$ million to $\$ 34.0$ million for the year ended December 31, 2011, compared to $\$ 29.1$ million for the year ended December 31, 2010. This increase was primarily due to a $\$ 3.0$ million recovery of a security that had been written off as an OTTI charge in the prior year, which was partially offset by a $\$ 2.4$ million unfavorable variance in net fair value adjustments compared to the prior year. Excluding fair value and OTTI adjustments, other operating income from core operations remained essentially unchanged at $\$ 31.6$ million for the years ended December 31, 2011 and 2010, as increased deposit fees and other service charges were offset by decreased revenues from mortgage banking activity. Primarily as a result of growth in our customer base, income from deposit fees and other service charges increased by $\$ 953,000$, or approximately $4 \%$, to $\$ 23.0$ million for the year ended December 31,2011 , compared to $\$ 22.0$ million for the prior year. While our mortgage banking activity increased in the second half of 2011, gain on sale of loans decreased by $\$ 1.2$ million to $\$ 5.2$ million for the full year ended December 31,2011 , compared to $\$ 6.4$ million in the prior year. Loan sales for the year ended December 31, 2011 totaled $\$ 282$ million, compared to $\$ 351$ million for the year ended December 31, 2010. Loan servicing fee income increased $\$ 127,000$ compared to the prior year, reflecting an increase in the balance of loans serviced for others. Miscellaneous revenues also increased modestly, largely as a result of increased fees associated with interest rate swaps which were partially offset by lower returns on bank-owned life insurance.

For the year ended December 31, 2011, we recorded a net charge of $\$ 624,000$ for changes in the valuation of financial instruments carried at fair value, compared to a net gain of $\$ 1.7$ million for the year ended December 31, 2010. The adjustments in 2011 primarily reflect changes in the valuation of the junior subordinated debentures we have issued, which resulted in $\$ 1.6$ million in charges that were partially offset by net gains in the values of certain investment securities. The net fair value gain in 2010 was largely a result of the impact of lower market interest rates on the valuation of certain fixed-rate securities. Additionally, in 2011, we had a $\$ 3.0$ million recovery as a result of the full cash repayment of a trust preferred security issued by a commercial bank that had been written off in 2010. For the year ended December 31, 2010, we had total OTTI charges of $\$ 4.2$ million, while in 2011 we did not experience any OTTI charges.

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Other Operating Expenses. Other operating expenses for the year ended December 31, 2011 totaled $\$ 158.1$ million compared to $\$ 160.8$ million in 2010 , a decrease of $\$ 2.7$ million, or $2 \%$, compared to the prior year, largely as a result of decreased costs related to REO and FDIC deposit insurance which were partially offset by increased compensation expenses. While lower in 2011 than in 2010, both years' expenses reflect significant charges related to REO operations, including holding costs, losses on sales and valuation adjustments on foreclosed properties. Total REO expenses were $\$ 22.3$ million, including $\$ 16.4$ million of losses and valuation adjustments, for the year ended December 31, 2011, compared to $\$ 26.0$ million, including $\$ 17.0$ million of losses and valuation adjustments, for the year ended December 31, 2010. Importantly, however, our total REO was reduced by nearly $\$ 58$ million during 2011 to $\$ 43$ million at December 31, 2011, compared to $\$ 101$ million a year earlier. The cost of FDIC insurance decreased by $\$ 2.6$ million in 2011, compared to the prior year, largely because of changes in the assessment formula mandated in the Dodd-Frank Act. Compensation increased $\$ 5.0$ million to $\$ 72.5$ million for the year ended December 31, 2011 from $\$ 67.5$ million for the year ended December 31,2010 , primarily reflecting changes in salary levels and benefit costs. The increase in compensation costs was partially offset by an $\$ 800,000$ increase in the amount of the credit for capitalized loan origination costs as a result of increased new loan originations and a $\$ 671,000$ reduction in occupancy and equipment expenses as a result of lower equipment and software depreciation and charges. Payment and card processing expenses increased by $\$ 807,000$, primarily reflecting the increased number of transaction accounts and increased customer usage of debit and credit cards. All other expenses were only modestly changed from the prior year.

Income Taxes. Our normal, expected statutory income tax rate is $36.4 \%$, representing a blend of the statutory federal income tax rate of $35.0 \%$ and apportioned effects of the Oregon and Idaho income tax rates of $6.6 \%$ and $7.6 \%$, respectively. However, because of the full valuation allowance for our net deferred tax asset, there was no net provision for income taxes for the year ended December 31, 2011, although our pre-tax net income was $\$ 5.5$ million. For the year ended December 31, 2010, as a result of establishing the deferred tax valuation allowance, we recorded a net provision for income taxes of $\$ 18.0$ million despite having a pre-tax loss of $\$ 43.9$ million, which resulted in an effective tax rate of negative $41.0 \%$.

During 2010, we determined that it was prudent to provide a full valuation allowance against our net deferred tax asset. Reasons for the determination included the negative evidence of three years of cumulative losses, the modest pace of economic recovery, and the continued difficulty in segments of the loan portfolio that put a near-term return to profitability in question. A valuation allowance was established during 2010 against the entire net deferred tax asset, reducing the balance, net of the allowance, to zero. The valuation allowance was subsequently adjusted going forward for any changes in the net deferred tax asset, and the balance of our deferred tax asset, net of the allowance, continued to remain at zero on our balance sheet throughout 2011. For more information on deferred taxes, see Note 13 of the Notes to the Consolidated Financial Statements.

## Market Risk and Asset/Liability Management

Our financial condition and operations are influenced significantly by general economic conditions, including the absolute level of interest rates as well as changes in interest rates and the slope of the yield curve. Our profitability is dependent to a large extent on our net interest income, which is the difference between the interest received from our interest-earning assets and the interest expense incurred on our interest-bearing liabilities.

Our activities, like all financial institutions, inherently involve the assumption of interest rate risk. Interest rate risk is the risk that changes in market interest rates will have an adverse impact on the institution's earnings and underlying economic value. Interest rate risk is determined by the maturity and repricing characteristics of an institution's assets, liabilities and off-balance-sheet contracts. Interest rate risk is measured by the variability of financial performance and economic value resulting from changes in interest rates. Interest rate risk is the primary market risk affecting our financial performance.

The greatest source of interest rate risk to us results from the mismatch of maturities or repricing intervals for rate sensitive assets, liabilities and off-balance-sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets, although our floating-rate assets tend to be more immediately responsive to changes in market rates than most funding deposit liabilities. Additional interest rate risk results from mismatched repricing indices and formula (basis risk and yield curve risk), and product caps and floors and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to us. An exception to this generalization is the beneficial effect of interest rate floors on a substantial portion of our performing floating-rate loans, which help us maintain higher loan yields in periods when market interest rates decline significantly. However, in a declining interest rate environment, as loans with floors are repaid they generally are replaced with new loans which have lower interest rate floors. As of December 31, 2012, our loans with interest rate floors totaled approximately $\$ 1.5$ billion and had a weighted average floor rate of $5.08 \%$. An additional source of interest rate risk, which is currently of concern, is a prolonged period of exceptionally low market interest rates. Because interest-bearing deposit costs have been reduced to nominal levels, there is very little possibility that they will be significantly further reduced. By contrast, if market rates remain very low, loan and securities yields will likely continue to decline as longer-term instruments mature or are repaid. Further, non-interest-bearing deposits provide a meaningful portion of our funding. As a result, a prolonged period of very low interest rates will likely result in compression of our net interest margin. While this pressure on the margin may be mitigated by further changes in the mix of assets and deposits, particularly increases in non-interest-bearing deposits, a prolonged period of low interest rates will present a very difficult operating environment for most banks, including us.

The principal objectives of asset/liability management are: to evaluate the interest rate risk exposure; to determine the level of risk appropriate given our operating environment, business plan strategies, performance objectives, capital and liquidity constraints, and asset and liability allocation alternatives; and to manage our interest rate risk consistent with regulatory guidelines and policies approved by the Board of Directors. Through such management, we seek to reduce the vulnerability of our earnings and capital position to changes in the level of interest rates. Our actions in this regard are taken under the guidance of the Asset/Liability Management Committee, which is comprised of members
of our senior management. The Committee closely monitors our interest sensitivity exposure, asset and liability allocation decisions, liquidity and capital positions, and local and national economic conditions and attempts to structure the loan and investment portfolios and funding sources to maximize earnings within acceptable risk tolerances.

## Sensitivity Analysis

Our primary monitoring tool for assessing interest rate risk is asset/liability simulation modeling, which is designed to capture the dynamics of balance sheet, interest rate and spread movements and to quantify variations in net interest income resulting from those movements under different rate environments. The sensitivity of net interest income to changes in the modeled interest rate environments provides a measurement of interest rate risk. We also utilize economic value analysis, which addresses changes in estimated net economic value of equity arising from changes in the level of interest rates. The net economic value of equity is estimated by separately valuing our assets and liabilities under varying interest rate environments. The extent to which assets gain or lose value in relation to the gains or losses of liability values under the various interest rate assumptions determines the sensitivity of net economic value to changes in interest rates and provides an additional measure of interest rate risk.

The interest rate sensitivity analysis performed by us incorporates beginning-of-the-period rate, balance and maturity data, using various levels of aggregation of that data, as well as certain assumptions concerning the maturity, repricing, amortization and prepayment characteristics of loans and other interest-earning assets and the repricing and withdrawal of deposits and other interest-bearing liabilities into an asset/liability computer simulation model. We update and prepare simulation modeling at least quarterly for review by senior management and the directors. We believe the data and assumptions are realistic representations of our portfolio and possible outcomes under the various interest rate scenarios. Nonetheless, the interest rate sensitivity of our net interest income and net economic value of equity could vary substantially if different assumptions were used or if actual experience differs from the assumptions used.

The following table sets forth as of December 31, 2012 and 2011, the estimated changes in our net interest income over a one-year time horizon and the estimated changes in economic value of equity based on the indicated interest rate environments (dollars in thousands):

Table 23: Interest Rate Risk Indicators

| Change (in Basis Points) in Interest Rates ${ }^{(1)}$ | December 31, 2012 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Estimated Increase (Decrease) in |  |  |  |  |  |  |
|  | Net Interest Income |  |  | Economic Value of Equity |  |  |  |
| +400 | \$(608 | ) $(0.4$ | )\% | \$(163,443 |  | (26.9 | )\% |
| +300 | (485 | ) $(0.3$ | ) | (118,067 | ) | (19.4 | ) |
| +200 | (348 | ) $(0.2$ | ) | $(76,879$ |  | (12.7 | ) |
| +100 | (888 | ) $(0.5$ | ) | (36,029 |  | (5.9 | ) |
| 0 | - | - |  | - |  | - |  |
| -25 | (27 | ) - |  | 3,193 |  | 0.5 |  |
|  | Decem | 2011 |  |  |  |  |  |
|  | Estima | rease (D |  |  |  |  |  |
| Change (in Basis Points) in Interest Rates ${ }^{(1)}$ | Net In <br> Next 1 | come hs |  | Economic | ue | of Equ |  |
| +400 | \$(227 | ) $(0.1$ | )\% | \$(153,297 |  | (25.0 | )\% |
| +300 | 537 | 0.3 |  | (106,609 |  | (17.4 | ) |
| +200 | 1,150 | 0.7 |  | (64,836 |  | (10.6 | ) |

$\left.\begin{array}{lllll}+100 & 1,218 & 0.7 & (23,991 & )(3.9 \\ 0 & - & - & - & - \\ -25 & (207 & ) & (0.1 & ) \\ 1,400 & 0.2\end{array}\right)$
(1) Assumes an instantaneous and sustained uniform change in market interest rates at all maturities; however, no rates are allowed to go below zero. The current federal funds rate is $0.25 \%$.

Another (although less reliable) monitoring tool for assessing interest rate risk is gap analysis. The matching of the repricing characteristics of assets and liabilities may be analyzed by examining the extent to which assets and liabilities are interest sensitive and by monitoring an institution's interest sensitivity gap. An asset or liability is said to be interest sensitive within a specific time period if it will mature or reprice within that time period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets anticipated, based upon certain assumptions, to mature or reprice within a specific time period and the amount of interest-bearing liabilities anticipated to mature or reprice, based upon certain assumptions, within that same time period. A gap is considered positive when the amount of interest-sensitive assets
exceeds the amount of interest-sensitive liabilities. A gap is considered negative when the amount of interest-sensitive liabilities exceeds the amount of interest-sensitive assets. Generally, during a period of rising rates, a negative gap would tend to adversely affect net interest income while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income while a positive gap would tend to adversely affect net interest income.

Certain shortcomings are inherent in gap analysis. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as ARM loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of some borrowers to service their debt may decrease in the event of a severe change in market rates.

Table 24, Interest Sensitivity Gap, presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at December 31, 2012 and 2011. The tables set forth the amounts of interest-earning assets and interest-bearing liabilities which are anticipated by us, based upon certain assumptions, to reprice or mature in each of the future periods shown. At December 31, 2012, total interest-earning assets maturing or repricing within one year exceeded total interest-bearing liabilities maturing or repricing in the same time period by $\$ 470.5$ million, representing a one-year cumulative gap to total assets ratio of $11.03 \%$.

Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible. The interest rate risk indicators and interest sensitivity gaps as of December 31, 2012 and 2011 are within our internal policy guidelines and management considers that our current level of interest rate risk is reasonable.

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The following tables provide a GAP analysis as of December 31, 2012 and 2011 (dollars in thousands):
Table 24: Interest Sensitivity Gap
December 31, 2012

|  | After 6 | After 1 | After 3 | After 5 Years |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Within | Months | Year | Years | Within 10 | Over | Total |
| 6 Months | Within 1 | Within 3 | Within 5 | Years | 10 Years |  |
|  | Year | Years | Years |  |  |  |

Interest-earning assets:
(1)

| Construction loans | $\$ 165,905$ | $\$ 10,984$ | $\$ 21,430$ | $\$ 4,933$ | $\$ 2,102$ | $\$ 39$ | $\$ 205,393$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Fixed-rate mortgage <br> loans | 151,588 | 94,294 | 241,811 | 135,813 | 155,118 | 60,460 | 839,084 |
| Adjustable-rate <br> mortgage loans | 424,937 | 136,720 | 321,554 | 259,410 | 12,622 | - | $1,155,243$ |
| Fixed-rate <br> mortgage-backed <br> securities | 33,360 | 29,831 | 98,904 | 68,115 | 28,972 | 25,776 | 284,958 |
| Adjustable-rate <br> mortgage-backed | 1,574 | 3,376 | - | - | - | - | 4,950 |
| securities |  |  |  |  |  |  |  |
| Fixed-rate <br> commercial/agricultural 48,658 | 34,237 | 79,089 | 35,713 | 7,732 | 126 | 205,555 |  |

loans
Adjustable-rate

| commercial/agricultural <br> loans | 508,340 | 12,270 | 37,324 | 15,905 | 24 | - | 573,863 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Consumer and other <br> loans | 170,879 | 14,357 | 35,701 | 21,450 | 19,110 | 1,181 | 262,678 |
| Investment securities <br> and interest-earning <br> deposits | 240,794 | 33,840 | 63,488 | 31,626 | 62,954 | 63,681 | 496,383 |
| Total rate sensitive <br> assets | $1,746,035$ | 369,909 | 899,301 | 572,965 | 288,634 | 151,263 | $4,028,107$ |

Interest-bearing
liabilities: (2)
Regular savings and

| interest-bearing checking accounts | 187,258 | 167,884 | 391,730 | 391,730 | - | - | 1,138,602 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Money market deposit accounts | 204,499 | 122,699 | 81,800 | - | - | - | 408,998 |
| Certificates of deposit | 453,519 | 299,246 | 216,651 | 56,352 | 3,490 | 34 | 1,029,292 |
| FHLB advances | 10,000 | - | - | - | - | - | 10,000 |
| Trust preferred securities | 123,716 | - | - | - | - | - | 123,716 |
| Retail repurchase agreements | 76,634 | - | - | - | - | - | 76,634 |
| Total rate sensitive liabilities | 1,055,626 | 589,829 | 690,181 | 448,082 | 3,490 | 34 | 2,787,242 |

Excess (deficiency) of $\begin{array}{lllllll}\begin{array}{l}\text { interest-sensitive assets } \\ \text { over interest-sensitive }\end{array} & \$ 690,409 & \$(219,920) & \$ 209,120 & \$ 124,883 & \$ 285,144 & \$ 151,229\end{array} \$ 1,240,865$ liabilities
Cumulative excess (deficiency) of $\quad \$ 690,409 \quad \$ 470,489 \quad \$ 679,609 \quad \$ 804,492 \quad \$ 1,089,636 \quad \$ 1,240,865 \quad \$ 1,240,865$ interest-sensitive assets
Cumulative ratio of $\begin{array}{llllllllllll}\text { interest-earning assets to } \\ 165.40 & \% & 128.59 & \% & 129.10 & \% & 128.90 & \% & 139.09 & \% & 144.52 & \% \\ 144.52 & \%\end{array}$ interest-bearing liabilities
$\left.\begin{array}{llllllllll}\text { Interest sensitivity gap } & 16.19 & \text { \% (5.16 } & ) \% 4.90 & \% 2.93 & \% 6.68 & \% & 3.55 & \% & 29.09\end{array}\right) \%$
(footnotes follow)
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Table 24: Interest Sensitivity Gap (continued)
December 31, 2011

|  | After 6 | After 1 | After 3 | After 5 |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Within | Months | Year | Years | Years | Over | Total |
| 6 Months | Within 1 | Within 3 | Within 5 | Within 10 | 10 Years |  |
|  | Year | Years | Years | Years |  |  |

Interest-earning assets:
(1)

| Construction loans | $\$ 167,009$ | $\$ 9,624$ | $\$ 21,206$ | $\$ 2,728$ | $\$ 1,161$ | $\$ 41$ | $\$ 201,769$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Fixed-rate mortgage <br> loans | 158,622 | 95,103 | 309,196 | 158,238 | 172,391 | 67,471 | 961,021 |
| Adjustable-rate | 398,999 | 140,517 | 394,604 | 183,712 | $(1,232$ | $)$ | - |
| mortgage loans |  |  |  |  |  | $1,116,600$ |  |
| Fixed-rate <br> mortgage-backed <br> securities | 19,084 | 15,570 | 41,066 | 22,042 | 14,736 | 1,803 | 114,301 |
| Adjustable-rate <br> mortgage-backed | 1,409 | 573 | 4,808 | - | - | - | 6,790 |

securities
Fixed-rate

| commercial/agricultural | 82,787 | 33,377 | 78,773 | 19,826 | 231 | - |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |

loans
Adjustable-rate

| commercial/agricultural <br> loans <br> Consumer and other <br> loans | 163,640 | 18,628 | 36,131 | 14,960 | 739 | - | 554,098 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Investment securities <br> and interest-earning <br> deposits <br> Total rate sensitive <br> assets | 306,433 | 14,388 | 39,505 | 18,441 | 19,292 | 1,538 | 254,140 |
| Interest-bearing | $1,779,959$ | 476,736 | 980,514 | 439,720 | 245,199 | 134,919 | $4,057,047$ |
| liabilities: (2) |  |  |  |  |  |  |  |
| Regular savings and <br> interest-bearing <br> checking accounts | 172,355 | 151,726 | 354,028 | 354,028 | - | - | 633,334 |
| Money market deposit <br> accounts | 207,728 | 124,637 | 83,091 | - | - | - | $1,032,137$ |
| Certificates of deposit <br> FHLB advances | 534,399 | 430,674 | 221,332 | 60,865 | 3,208 | 18 | 415,456 |
| Other borrowings | 50,000 | - | - | - | - | - | $1,250,496$ |
| Trust preferred | 123,716 | - | - | - | - | - | 10,000 |
| securities <br> Retail repurchase <br> agreements | 102,131 | - | - | - | - | - | 123,997 |
| Total rate sensitive | $1,190,329$ | 707,037 | 668,451 | 414,893 | 3,208 | 15 | 102,131 |
| liabilities |  |  |  |  |  |  |  |

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Excess (deficiency) of interest-sensitive assets over interest-sensitive liabilities
Cumulative excess $\begin{array}{llllllll}\text { (deficiency) of } & \$ 589,630 & \$ 359,329 & \$ 671,392 & \$ 696,219 & \$ 938,210 & \$ 1,073,114 & \$ 1,073,114\end{array}$ interest-sensitive assets
Cumulative ratio of
interest-earning assets to $149.54 \quad \% \quad 118.94 \quad \% \quad 126.17 \quad \% \quad 123.36 \quad \% \quad 131.44 \quad \% \quad 135.96 \quad \% \quad 135.96 \quad \%$ interest-bearing liabilities

| Interest sensitivity gap | 13.85 | $\%$ | (5.41 | ) 7.33 | $\%$ | 0.58 | $\%$ | 5.68 | $\%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 3.17 | $\%$ | 25.21 | $\%$ |  |  |  |  |  |  |
| to total assets |  |  |  |  |  |  |  |  |  |
| Ratio of cumulative gap <br> to total assets | 13.85 | $\% 8.44$ | $\%$ | 15.77 | $\%$ | 16.35 | $\%$ | 22.04 | $\%$ |
| 25.21 | $\%$ | 25.21 | $\%$ |  |  |  |  |  |  |

(footnotes follow)

Adjustable-rate assets are included in the period in which interest rates are next scheduled to adjust rather than in the period in which they are due to mature, and fixed-rate assets are included in the period in which they are scheduled to be repaid based upon scheduled amortization, in each case adjusted to take into account estimated prepayments. Mortgage loans and other loans are not reduced for allowances for loan losses and non-performing loans. Mortgage loans, mortgage-backed securities, other loans and investment securities are not adjusted for deferred fees and unamortized acquisition premiums and discounts.
Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, interest-bearing checking, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities. For the
(2) purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of these accounts had been assumed to be short-term, the one-year cumulative gap of interest-sensitive assets would have been $\$(394.8)$ million, or ( $9.3 \%$ ) of total assets at December 31, 2012, and $\$(431.8)$ million, or $(10.1 \%)$, at December 31, 2011. Interest-bearing liabilities for this table exclude certain non-interest-bearing deposits that are included in the average balance calculations reflected in Table 19, Analysis of Net Interest Spread.

## Liquidity and Capital Resources

Our primary sources of funds are deposits, borrowings, proceeds from loan principal and interest payments and sales of loans, and the maturity of and interest income on mortgage-backed and investment securities. While maturities and scheduled amortization of loans and mortgage-backed securities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, economic conditions, competition and our pricing strategies.

Our primary investing activity is the origination and purchase of loans and, to a lesser extent, the purchase of securities. During the years ended December 31, 2012, 2011 and 2010, we purchased loans of $\$ 5$ million, $\$ 5$ million and $\$ 341,000$, respectively, while loan originations, net of repayments, totaled $\$ 460$ million, $\$ 270$ million and $\$ 114$ million, respectively. This activity was funded primarily by sales of loans. During the years ended December 31, 2012, 2011 and 2010, we sold $\$ 505$ million, $\$ 282$ million, and $\$ 351$ million, respectively, of loans. During the year ended December 31, 2012, deposits increased by $\$ 82$ million, despite a $\$ 221$ million decline in certificates of deposit, while during the years ended December 31, 2011 and 2010, deposits decreased by $\$ 116$ million and $\$ 274$ million, respectively. The increase in deposits in 2012 was the result of our increased marketing focus on retail deposits and our success in growing the number and dollar volume of core deposit accounts. The decrease in deposits in the two previous years and in certificates of deposit in 2012 was driven by our pricing decisions designed to shift our deposit portfolio into lower cost checking, savings and money market accounts, and allow higher rate certificates of deposit to run-off. Additionally, during 2012 we further reduced brokered deposits by $\$ 33$ million to just $\$ 16$ million at December 31, 2012. Brokered deposits and public funds are generally more price sensitive than retail deposits and our use of those deposits varies significantly based upon our liquidity management strategies at any point in time. FHLB advances (excluding fair value adjustments) decreased $\$ 229,000, \$ 33$ million, and $\$ 146$ million, respectively, for the years ended December 31, 2012, 2011 and 2010. Other borrowings at December 31, 2012 decreased $\$ 75$ million to $\$ 77$ million following a decrease of $\$ 24$ million in 2011 and a decrease of $\$ 1$ million in 2010. The decrease in other borrowings in the year ended December 31, 2012 was due to the $\$ 50$ million repayment of the senior bank notes issued under the TLGP and a decrease of $\$ 25$ million of retail repurchase agreements.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to accommodate deposit withdrawals, to support loan growth, to satisfy financial commitments and to take advantage of investment opportunities. During the years ended December 31, 2012, 2011 and 2010, we used our sources of funds primarily to fund loan commitments, purchase securities, add to our short-term liquidity position and pay maturing savings
certificates and deposit withdrawals. At December 31, 2012, we had outstanding loan commitments totaling \$1.014 billion, including undisbursed loans in process and unused credit lines totaling $\$ 925$ million. While representing potential growth in the loan portfolio and lending activities, this level of commitments is proportionally consistent with our historical experience and does not represent a departure from normal operations.

We generally maintain sufficient cash and readily marketable securities to meet short-term liquidity needs; however, our primary liquidity management practice is to increase or decrease short-term borrowings, including FHLB advances and Federal Reserve Board borrowings. We maintain credit facilities with the FHLB-Seattle, which at December 31, 2012 provide for advances that in the aggregate may equal the lesser of $35 \%$ of Banner Bank's assets or adjusted qualifying collateral (subject to a sufficient level of ownership of FHLB stock), up to a total possible credit line of $\$ 889$ million, and $25 \%$ of Islanders Bank's assets or adjusted qualifying collateral, up to a total possible credit line of $\$ 26$ million. Advances under these credit facilities (excluding fair value adjustments) totaled $\$ 10$ million, or less than $1 \%$ of our assets at December 31, 2012. In addition, Banner Bank has been approved for participation in the Federal Reserve Bank's Borrower-In-Custody (BIC) program. Under this program Banner Bank can borrow from 57\% up to $91 \%$ of eligible loans, depending on collateral type and risk rating. We currently estimate the Federal Reserve's BIC program would provide additional borrowing capacity of $\$ 595$ million. We had no funds borrowed from the Federal Reserve Bank at December 31, 2012 or 2011.

At December 31, 2012, certificates of deposit amounted to $\$ 1.029$ billion, or $29 \%$ of our total deposits, including $\$ 760$ million which were scheduled to mature within one year. Certificates of deposit declined from $36 \%$ of our total deposits at December 31, 2011, and 43\% of total deposits at December 31, 2010, reflecting our efforts to shift the portfolio mix into lower cost core deposits. While no assurance can be given as to future periods, historically, we have been able to retain a significant amount of our deposits as they mature, although in 2012 and 2011 we intentionally encouraged certificates of deposit to decline. Management believes it has adequate resources and funding potential to meet our foreseeable liquidity requirements.

In addition to the trust preferred securities we issued, our capital base is primarily comprised of common stock and paid in capital, which were reduced by an accumulated deficit largely as a result of goodwill impairment charges recorded in 2008 and net losses in 2009 and 2010. During 2008, we received $\$ 124$ million when we issued our Series A Preferred Stock and a related warrant to the Treasury through its Capital Purchase Program. The Series A Preferred Stock was repaid during 2012 and the warrant to purchase up to $\$ 18.6$ million in Banner Corporation common stock remains outstanding at December 31, 2012. During 2010, the Company completed a secondary offering of its common stock, resulting in net proceeds of $\$ 162$ million. (For additional information see Notes 2 and 17 of the Notes to the Consolidated Financial Statements.) In addition, during the years ended December 31, 2012, 2011 and 2010, we issued shares of common stock through our DRIP, which resulted in net proceeds of $\$ 36$ million, $\$ 22$ million and $\$ 16$ million, respectively. Banner Corporation has allocated a significant portion of these net proceeds to strengthen Banner Bank's regulatory capital ratios; however, at December 31, 2012, Banner Corporation had retained $\$ 37$ million in cash to be used for general corporate purposes.

## Capital Requirements

Banner Corporation is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended (BHCA), and the regulations of the Federal Reserve. Banner Bank and Islanders Bank, as state-chartered, federally insured commercial banks, are subject to the capital requirements established by the FDIC. The capital adequacy requirements are quantitative measures established by regulation that require Banner Corporation and the Banks to maintain minimum amounts and ratios of capital. The Federal Reserve requires Banner Corporation to maintain capital adequacy that generally parallels the FDIC requirements. The FDIC requires the Banks to maintain minimum ratios of Tier 1 total capital to risk-weighted assets as well as Tier 1 leverage capital to average assets. At December 31, 2012, Banner Corporation and the Banks each exceeded all current regulatory capital requirements. (See Item 1, "Business-Regulation," and Note 18 of the Notes to the Consolidated Financial Statements for additional information regarding Banner Corporation's and Banner Bank's regulatory capital requirements.)

The following table shows the regulatory capital ratios of Banner Corporation and its subsidiaries, Banner Bank and Islanders Bank, as of December 31, 2012, and minimum regulatory requirements for the Banks to be categorized as "well-capitalized."

Table 25: Regulatory Capital Ratios

| Capital Ratios | Banner Corporation |  | Banner Bank |  | Islanders Bank |  | "We |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total capital to risk-weighted assets | 16.96 | \% | 16.38 | \% | 17.53 | \% | 10.00 | \% |
| Tier 1 capital to risk-weighted assets | 15.70 |  | 15.12 |  | 16.28 |  | 6.00 |  |
| Tier 1 leverage capital to average assets | 12.74 |  | 12.29 |  | 13.02 |  | 5.00 |  |

(1) A bank holding company such as Banner Corporation does not have a "Well-capitalized" measurement. "Well-capitalized" only applies to the Banks.

Effect of Inflation and Changing Prices
The Consolidated Financial Statements and related financial data presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative
purchasing power of money over time due to inflation. The primary effect of inflation on our operations is reflected in increased operating costs. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates generally have a more significant effect on a financial institution's performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

The following table shows the obligations of Banner Corporation and its subsidiaries, Banner Bank and Islanders Bank, as of December 31, 2012 by maturity (in thousands):

Table 26: Contractual Obligations
$\left.\begin{array}{llllll} & \begin{array}{l}\text { Due In One } \\ \text { Year Or Less }\end{array} & \begin{array}{l}\text { Due In One } \\ \text { to Three } \\ \text { Years }\end{array} & \begin{array}{l}\text { Due In Three } \\ \text { To Five Years }\end{array} & \begin{array}{l}\text { Due In More } \\ \text { Than Five }\end{array} & \text { Total } \\ \text { Years }\end{array}\right]$

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At December 31, 2012, we had commitments to extend credit of $\$ 1.014$ billion. In addition, we have contracts with various vendors to provide services, including information processing, for periods generally ranging from one to five years, for which our financial obligations are dependent upon acceptable performance by the vendor. For additional information regarding future financial commitments, this discussion should be read in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this filing, including Note 27: "Financial Instruments with Off-Balance-Sheet Risk."

ITEM 7A - Quantitative and Qualitative Disclosures about Market Risk
See pages 71-76 of Management's Discussion and Analysis of Financial Condition and Results of Operations.
ITEM 8 - Financial Statements and Supplementary Data
For financial statements, see index on page 82.
ITEM 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
Not applicable.

## ITEM 9A - Controls and Procedures

The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (Exchange Act). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.
(a) Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer and several other members of our senior management as of the end of the period covered by this report. Based on their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2012, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.
(b) Changes in Internal Controls Over Financial Reporting: In the quarter ended December 31, 2012, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting: Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we included a report of management's assessment of the design and effectiveness of its internal controls as part of this Annual Report on Form 10-K for the year ended December 31, 2012.

ITEM 9B - Other Information
None.

## PART III

## ITEM 10 - Directors, Executive Officers and Corporate Governance

The information required by this item contained under the section captioned "Proposal - Election of Directors," "Meetings and Committees of the Board of Directors" and "Shareholder Proposals" in the Proxy Statement for the Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year, is incorporated herein by reference.

Information regarding the executive officers of the Registrant is provided herein in Part I, Item 1 hereof.
The information regarding our Audit Committee and Financial Expert included under the sections captioned "Meetings and Committees of the Board of Directors" and "Audit Committee Matters" in the Proxy Statement for the Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year, is incorporated herein by reference.

Reference is made to the cover page of this Annual Report and the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" of the Proxy Statement for the Annual Meeting of the Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year, regarding compliance with Section 16(a) of the Securities Exchange Act of 1934.

## Code of Ethics

The Board of Directors adopted a Code of Business Conduct and Ethics for our officers (including its senior financial officers), directors, and employees. The Code of Business Conduct and Ethics requires our officers, directors, and employees to maintain the highest standards of professional conduct. A copy of the Code of Business Conduct and Ethics was filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2004 and is available without charge, upon request to Investor Relations, Banner Corporation, P.O. Box 907, Walla Walla, WA 99362.

## Whistleblower Program and Protections

We subscribe to the Ethicspoint reporting system and encourage employees, customers, and vendors to call the Ethicspoint hotline at 1-866-ETHICSP (384-4277) or visit its website at www.Ethicspoint.com to report any concerns regarding financial statement disclosures, accounting, internal controls, or auditing matters. We will not retaliate against any of our officers or employees who raise legitimate concerns or questions about an ethics matter or a suspected accounting, internal control, financial reporting, or auditing discrepancy or otherwise assists in investigations regarding conduct that the employee reasonably believes to be a violation of Federal Securities Laws or any rule or regulation of the Securities Exchange Commission, Federal Securities Laws relating to fraud against shareholders or violations of applicable banking laws. Non-retaliation against employees is fundamental to our Code of Ethics and there are strong legal protections for those who, in good faith, raise an ethical concern or a complaint about their employer.

ITEM 11 - Executive Compensation
Information required by this item regarding management compensation and employment contracts, director compensation, and Compensation Committee interlocks and insider participation in compensation decisions is incorporated by reference to the sections captioned "Executive Compensation," "Directors' Compensation," and "Compensation Committee Matters," respectively, in the Proxy Statement for the Annual Meeting of Stockholders,
which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year.

ITEM 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters
Information required by this item is incorporated herein by reference to the section captioned "Proposal 5 - Approval of an amendment to the Banner Corporation 2012 Restricted Stock Plan" in the Proxy Statement for the Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year.

ITEM 13 - Certain Relationships and Related Transactions, and Director Independence
The information required by this item contained under the sections captioned "Related Party Transactions" and "Director Independence" in the Proxy Statement for the Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year, is incorporated herein by reference.

ITEM 14 - Principal Accounting Fees and Services
The information required by this item contained under the section captioned "Independent Auditors" in the Proxy Statement for the Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year, is incorporated herein by reference.

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## PART IV

ITEM 15 - Exhibits and Financial Statement Schedules

(a) (1) \begin{tabular}{ll}
Financial Statements <br>
(2) $\quad$ \& See Index to Consolidated Financial Statements on page $\underline{82 .}$ <br>
\& Financial Statement Schedules <br>
\& All financial statement schedules are omitted because they are not applicable or not required, or <br>
because the required information is included in the Consolidated Financial Statements or the Notes <br>
thereto or in Part 1, Item 1. <br>

(b) | Exhibits |
| :--- | <br>

\& See Index of Exhibits on page 152. <br>
\& Exhibits <br>
\& See Index of Exhibits on page 152.
\end{tabular}

## 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.

Date: March 14, 2013

## Banner Corporation

/s/ Mark J. Grescovich
Mark J. Grescovich
President and Chief Executive Officer
(Principal Executive Officer)
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 and on the dates indicated.
/s/ Mark J. Grescovich
Mark J. Grescovich
President and Chief Executive Officer; Director
(Principal Executive Officer)
Date: March 14, 2013
/s/ Robert J. Lane
Robert J. Lane
Director
Date: March 14, 2013
/s/ Edward L. Epstein
Edward L. Epstein
Director
Date: March 14, 2013
/s/ Gary Sirmon
Gary Sirmon
Chairman of the Board
Date: March 14, 2013
/s/ Brent A. Orrico
Brent A. Orrico
Director
Date: March 14, 2013
/s/ Michael M. Smith
Michael M. Smith
Director
Date: March 14, 2013
/s/ Constance H. Kravas
/s/ Lloyd W. Baker
Lloyd W. Baker
Executive Vice President and Chief Financial
Officer
(Principal Financial and Accounting Officer)
Date: March 14, 2013
/s/ Robert D. Adams
Robert D. Adams
Director
Date: March 14, 2013
/s/ Jesse G. Foster
Jesse G. Foster
Director
Date: March 14, 2013
/s/ D. Michael Jones
D. Michael Jones

Former President and Chief Executive Officer;
Director
Date: March 14, 2013
/s/ Gordon E. Budke
Gordon E. Budke
Director
Date: March 14, 2013
/s/ David A. Klaue
David A. Klaue
Director
Date: March 14, 2013
/s/ John R. Layman

Constance H. Kravas
Director
Date: March 14, 2013

John R. Layman
Director
Date: March 14, 2013
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Consolidated Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2012, 2011 and 2010 ..... $\underline{88}$
Consolidated Statements of Cash Flows for the Years Ended December 31, 2012, 2011 and 2010 ..... 92
Notes to the Consolidated Financial Statements ..... 94

March 14, 2013
Report of Management
To the Shareholders:
The management of Banner Corporation (the Company) is responsible for the preparation, integrity, and fair presentation of its published financial statements and all other information presented in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include amounts based on informed judgments and estimates made by management. In the opinion of management, the financial statements and other information herein present fairly the financial condition and operations of the Company at the dates indicated in conformity with accounting principles generally accepted in the United States of America.

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting. The internal control system is augmented by written policies and procedures and by audits performed by an internal audit staff (assisted in certain instances by contracted external audit resources other than the independent registered public accounting firm), which reports to the Audit Committee of the Board of Directors. Internal auditors monitor the operation of the internal and external control system and report findings to management and the Audit Committee. When appropriate, corrective actions are taken to address identified control deficiencies and other opportunities for improving the system. The Audit Committee provides oversight to the financial reporting process. There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control system may vary over time.

The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of the Company's management. The Audit Committee is responsible for the selection of the independent auditors. It meets periodically with management, the independent auditors and the internal auditors to ensure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting, and auditing procedures of the Company in addition to reviewing the Company's financial reports. The independent auditors and the internal auditors have full and free access to the Audit Committee, with or without the presence of management, to discuss the adequacy of the internal control structure for financial reporting and any other matters which they believe should be brought to the attention of the Committee.

Mark J. Grescovich, Chief Executive Officer<br>Lloyd W. Baker, Chief Financial Officer

## Management Report on Internal Control over Financial Reporting

March 14, 2013
The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention of overriding controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Also, projection of any evaluation of effectiveness to future periods is subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management with the participation of the Chief Executive Officer and Chief Financial Officer assessed the effectiveness of Banner Corporation's internal control over financial reporting as of December 31, 2012. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework.

Based on its assessment, Management concluded that Banner Corporation maintained effective internal control over financial reporting as of December 31, 2012.

The Company's registered public accounting firm has audited the Company's consolidated financial statements and the effectiveness of our internal control over financial reporting as of and for the year ended December 31, 2012 that are included in this annual report and issued their Report of Independent Registered Public Accounting Firm, appearing under Item 8. The attestation report expresses an unqualified opinion on the effectiveness of the Company's internal controls over financial reporting as of December 31, 2012.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM 

To the Board of Directors and Stockholders<br>Banner Corporation and Subsidiaries<br>Walla Walla, Washington

We have audited the accompanying consolidated statements of financial condition of Banner Corporation and subsidiaries, (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. We also have audited the Company's internal control over financial reporting as of December 31, 2012, based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. The Company's management is responsible for these consolidated financial statements, 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 Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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.

## Edgar Filing: BANNER CORP - Form 10-K

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Banner Corporation and subsidiaries, as of December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31,2012 , in conformity with generally accepted accounting principles. Also in our opinion, Banner Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework.
/s/Moss Adams LLP
Moss Adams LLP
Portland, Oregon
March 14, 2013

| BANNER CORPORATION AND SUBSIDIARIES |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION |  |  |  |  |
| December 31, 2012 and 2011 |  |  |  |  |
| ASSETS | 2012 |  | 2011 |  |
| Cash and due from banks | \$181,298 |  | \$ 132,436 |  |
| Securities-trading, amortized cost \$90,339 and \$112,663, respectively | 71,232 |  | 80,727 |  |
| Securities-available-for-sale, amortized cost \$469,650 and \$462,579, respectively | 472,920 |  | 465,795 |  |
| Securities-held-to-maturity, fair value \$92,458 and \$80,107, respectively | 86,452 |  | 75,438 |  |
| Federal Home Loan Bank stock | 36,705 |  | 37,371 |  |
| Loans receivable: |  |  |  |  |
| Held for sale | 11,920 |  | 3,007 |  |
| Held for portfolio | 3,223,794 |  | 3,293,331 |  |
| Allowance for loan losses | (77,491 | ) | (82,912 | ) |
|  | 3,158,223 |  | 3,213,426 |  |
| Accrued interest receivable | 13,930 |  | 15,570 |  |
| Real estate owned, held for sale, net | 15,778 |  | 42,965 |  |
| Property and equipment, net | 89,117 |  | 91,435 |  |
| Intangible assets, net | 4,230 |  | 6,331 |  |
| Bank-owned life insurance (BOLI) | 59,891 |  | 58,563 |  |
| Deferred tax assets, net | 35,007 |  | - |  |
| Other assets | 40,781 |  | 37,255 |  |
|  | \$4,265,564 |  | \$4,257,312 |  |
| LIABILITIES |  |  |  |  |
| Deposits: |  |  |  |  |
| Non-interest-bearing | \$981,240 |  | \$777,563 |  |
| Interest-bearing transactions and savings accounts | 1,547,271 |  | 1,447,594 |  |
| Interest-bearing certificates | 1,029,293 |  | 1,250,497 |  |
|  | 3,557,804 |  | 3,475,654 |  |
| Advances from FHLB at fair value | 10,304 |  | 10,533 |  |
| Other borrowings 152,128 |  |  |  |  |
| Preferred Securities) 73,063 49,988 |  |  |  |  |
| Accrued expenses and other liabilities | 26,389 |  | 23,253 |  |
| Deferred compensation | 14,452 |  | 13,306 |  |
|  | 3,758,645 |  | 3,724,862 |  |
| COMMITMENTS AND CONTINGENCIES (Notes 19 and 27) |  |  |  |  |
| STOCKHOLDERS' EQUITY |  |  |  |  |
| Preferred stock - \$0.01 par value, 500,000 shares authorized; |  |  |  |  |
| Series A - liquidation preference $\$ 1,000$ per share, no shares outstanding at December- 120,702 31, 2012 and 124,000 outstanding at December 31, 2011 |  |  |  |  |
| Common stock and paid in capital - $\$ 0.01$ par value per share, $50,000,000$ shares authorized, 19,454,965 shares issued: 19,420,625 shares and 17,519,132 shares outstanding at December 31, 2012 and 2011, respectively | 567,907 |  | 531,149 |  |
| Accumulated deficit | (61,102 | ) | (119,465 | ) |
| Accumulated other comprehensive income | 2,101 |  | 2,051 |  |
| Unearned shares of common stock issued to Employee Stock Ownership Plan (ESO trust at cost: |  |  |  |  |
| 34,340 restricted shares outstanding at December 31, 2012 and 2011 | (1,987 | ) | (1,987 | ) |

Carrying value of shares held in trust for stock related compensation plans

| $(7,242$ | $)(7,715$ |
| :--- | :--- |
| 7,242 | 7,715 |
| 506,919 | 532,450 |
| $\$ 4,265,564$ | $\$ 4,257,312$ |

See notes to consolidated financial statements
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$\left.\begin{array}{lllll}\text { Preferred stock discount accretion } & 3,298 & 1,701 & 1,593 \\ \text { Gain on repurchase of preferred stock } & (2,471 & ) & - & - \\ \text { NET INCOME (LOSS) AVAILABLE TO COMMON } & \$ 59,117 & \$(2,444 & ) & \$(69,689\end{array}\right)$

See notes to the consolidated financial statements
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## BANNER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
For the Years Ended December 31, 2012, 2011 and 2010

|  | 2012 |  | 2011 |  | 2010 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| NET INCOME (LOSS) | \$64,882 |  | \$5,457 |  | \$(61,896 | ) |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES: |  |  |  |  |  |  |
| Unrealized holding gain on AFS securities arising during the period | 28 |  | 2,638 |  | 56 |  |
| Income tax expense related to AFS unrealized holding gains | (10 | ) | (950 | ) | (20 | ) |
| Reclassification for net (gains) losses on AFS securities realized in earnings | 38 |  | (5 |  | 36 |  |
| Income tax benefit (expense) related to AFS realized gains (losses) | (14 | ) | 2 |  | (13 | ) |
| Amortization of unrealized gain on tax exempt securities transferred from available-for-sale to held-to-maturity | 8 |  | 16 |  | 42 |  |
| Other comprehensive income | 50 |  | 1,701 |  | 101 |  |
| COMPREHENSIVE INCOME (LOSS) | \$64,932 |  | \$7,158 |  | \$(61,795 | ) |

See notes to the consolidated financial statements

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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

 (in thousands)For the Years Ended December 31, 2012, 2011 and 2010


Carrying Value, Net of
Liability, Of Shares Held in Stockholders' Equity Trust for Stock-Related Compensation Plans
Balance, January 1, 2012 \$120,702 \$531,149 \$(119,465) \$ 2,051 \$(1,987 ) \$\$ 532,450
Net income (loss)
Change in valuation of securities-available-for-sale, net 42 42 of income tax
Amortization of unrealized loss on tax exempt securities transferred from available-for-sale to held-to-maturity, net of income tax
Accretion of preferred stock discount
Repurchase of preferred stock (124,000)
(3,298 )

| Gain on repurchase of preferred |  |  |
| :--- | :--- | :--- |
| stock | 2,471 | 2,471 |

Accrual of dividends on preferred stock $(4,938) \quad(4,938$
Accrual of dividends on common stock (754 ) (754 )
(\$.04/share-cumulative)
Proceeds from issuance of common stock for stockholder reinvestment program, net of 36,31736,317
registration expenses

Amortization of compensation
related to restricted stock grant
434434
Amortization of compensation
related to stock options
7 7
BALANCE, December 31, 2012

## Continued

## BANNER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (in thousands)
For the Years Ended December 31, 2012, 2011 and 2010


Continued

## BANNER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (in thousands)
For the Years Ended December 31, 2012, 2011 and 2010

|  |  |  |  |  | Carrying <br> Value, Net <br> of |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |

BALANCE, December 31,
2010
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## BANNER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(continued) (in thousands)
For the Years Ended December 31, 2012, 2011 and 2010

|  | 2012 | 2011 | 2010 |
| :--- | :--- | :--- | :--- |
| COMMON STOCK—SHARES ISSUED <br> Common stock, shares issued, beginning of period | 17,553 | 16,165 | 3,077 |
| Issuance of unvested restricted common stock or exercise of stock <br> options | 87 | 16 | 17 |
| Issuance of common stock for stockholder reinvestment program | 1,815 | 1,372 | 837 |
| Issuance of common stock through public offering | - | - | 12,234 |
| Net number of shares issued during the period | 1,902 | 1,388 | 13,088 |
| COMMON SHARES ISSUED, END OF PERIOD | 19,455 | 17,553 | 16,165 |
| UNEARNED, RESTRICTED ESOP SHARES | $(34$ | $)(34$ | ) (34 |
| NET COMMON STOCK—SHARES OUTSTANDING | 19,421 | 17,519 | 16,131 |

See notes to consolidated financial statements

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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)
For the Years Ended December 31, 2012, 2011 and 2010

OPERATING ACTIVITIES:
Net income (loss)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:
Depreciation
Deferred income and expense, net of amortization
Amortization of core deposit intangibles
Other-than-temporary impairment losses (recovery)
Net change in valuation of financial instruments carried at fair value
Purchases of securities-trading
Proceeds from sales of securities-trading
Principal repayments and maturities of securities-trading
Deferred taxes
Increase in current taxes payable
Equity-based compensation
Increase in cash surrender value of bank-owned life insurance
Gain on sale of loans, net of capitalized servicing rights
(Gain) Loss on disposal of real estate held for sale and property and equipment
Provision for losses on loans and real estate held for sale
Origination of loans held for sale

| 2012 | 2011 | 2010 |
| :--- | :--- | :--- |
| $\$ 64,882$ | $\$ 5,457$ | $\$(61,896$ |

Proceeds from sales of loans held for sale
Net change in:
Other assets
Other liabilities
Net cash provided from operating activities
INVESTING ACTIVITIES:
Purchases of available-for-sale securities
Principal repayments and maturities of available-for-sale securities
Proceeds from sales of securities available-for-sale
Purchases of securities held-to-maturity
Principal repayments and maturities of securities held-to-maturity
Principal repayments of loans, net of originations
Purchases of loans and participating interest in loans
Purchases of property and equipment, net of sales
Proceeds from sale of real estate held for sale, net
Other
Net cash provided from (used by) investing activities
FINANCING ACTIVITIES
Increase (decrease) in deposits, net
Repayment of FHLB advances
Decrease in other borrowings, net
Cash dividends paid
Cash proceeds from issuance of stock for stockholder reinvestment plan 36,317

| $(413,482$ | $)$ | $(622,192$ | $)$ | $(238,499$ |
| :--- | :--- | :--- | :--- | :--- |
| 389,414 | 328,037 | 131,900 |  |  |
| 13,282 | 28,179 | 1,965 |  |  |
| $(23,007$ | $)$ | $(12,480$ | $)$ | $(8,727$ |
| 11,806 | 12,074 | 8,416 | $)$ |  |
| 55,763 | 9,125 | 235,847 |  |  |
| $(18,410$ | $)$ | $(5,092$ | $)$ | $(341$ |
| $(5,613$ | $)$ | $(3,587$ | $)$ | $(2,167$ |
| 40,834 | 94,957 |  | 47,809 |  |
| 1,892 | $(234$ | $)$ | $(149$ | $)$ |
| 52,479 | $(171,213$ | $)$ | 176,054 |  |
|  |  |  |  |  |
| 82,150 | $(115,544$ | $)$ | $(274,352$ | $)$ |
| $(6$ | $)(32,806$ | $)$ | $(145,506$ | $)$ |
| $(75,495$ | $(23,695$ | $)$ | $(1,039$ | $)$ |
| $(6,470$ | $)(8,827$ | $)$ | $(8,867$ | $)$ |
| 36,317 | 21,556 | 16,201 |  |  |


| Cash proceeds from issuance of stock in secondary offering, net of costs | $(121,528$ | $)$ | - | 161,637 |
| :--- | :--- | :--- | :--- | :--- |
| Redemption of preferred stock | $(85,032$ | $)$ | $(159,316$ | $)$ |
| Net cash used by financing activities | $(251,926$ |  |  |  |
| NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS | 48,862 | $(229,216$ | $)$ | 38,647 |
| CASH AND DUE FROM BANKS, BEGINNING OF YEAR | 132,436 | 361,652 | 323,005 |  |
| CASH AND DUE FROM BANKS, END OF YEAR | $\$ 181,298$ | $\$ 132,436$ | $\$ 361,652$ |  |

(Continued on next page)
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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2012, 2011 and 2010
(in thousands)
(continued from prior page)

|  | 2012 | 2011 | 2010 |
| :--- | :--- | :--- | :--- |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW |  |  |  |
| INFORMATION: | $\$ 20,712$ | $\$ 35,114$ | $\$ 64,112$ |
| Interest paid in cash | 9,631 | $(13,048$ | ) (592 |
| Taxes paid (received) in cash |  |  |  |
| NON-CASH INVESTING AND FINANCING TRANSACTIONS: |  |  |  |
| Loans, net of discounts, specific loss allowances and unearned income | 14,070 | 53,518 | 87,967 |
| transferred to real estate owned and other repossessed assets |  |  |  |

See notes to consolidated financial statements

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## BANNER CORPORATION AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1: BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business: Banner Corporation (Banner or the Company) is a bank holding company incorporated in the State of Washington. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of two wholly-owned subsidiaries, Banner Bank and, subsequent to May 1, 2007, Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2012, its 85 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System. Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks (DFI) and the Federal Deposit Insurance Corporation (the FDIC).

The Company's operating results depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits, Federal Home Loan Bank (FHLB) advances, other borrowings and junior subordinated debentures. Net income also is affected by the level of the Company's other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as non-interest operating expenses, provisions for loan losses and income tax provisions. In addition, net income is affected by the net change in the value of certain financial instruments carried at fair value. During the three-year period ended December 31, 2012, the Company's net income was significantly impacted by high levels of provisions for loan losses, expenses related to real estate owned, net changes in the value of financial instruments carried at fair value, and the provision for, and benefit from, income taxes as a result of establishing and eliminated a valuation allowance for its net deferred tax assets.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All material intercompany transactions, profits and balances have been eliminated.

Subsequent events: The Company has evaluated events and transactions subsequent to December 31, 2012 for potential recognition or disclosure.

Use of Estimates: In the opinion of management, the accompanying consolidated statements of financial condition and related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity and cash flows reflect all adjustments (which include reclassification and normal recurring adjustments) that are necessary for a fair presentation in conformity with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Various elements of the Company's accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of Banner's financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including other-than-temporary impairment (OTTI) losses, (iv) the valuation of intangibles, such as core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale and (vi) the valuation of or recognition of deferred tax assets and liabilities. These policies and judgments, estimates and assumptions are described in greater detail in subsequent notes to the consolidated financial statements and Management's Discussion and Analysis of Financial Condition and

Results of Operations (Critical Accounting Policies) in this Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission (SEC). Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in the Company's results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and the Company's financial condition and operating results in future periods.

Securities: Securities are classified as held-to-maturity when the Company has the ability and positive intent to hold them to maturity. Securities classified as available-for-sale are available for future liquidity requirements and may be sold prior to maturity. Securities classified as trading are also available for future liquidity requirements and may be sold prior to maturity. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities classified as held-to-maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts to maturity and, if appropriate, any other-than-temporary impairment losses. Securities classified as available-for-sale are recorded at fair value. Unrealized gains and losses on securities classified as available-for-sale are excluded from earnings and are reported net of tax as accumulated other comprehensive income, a component of stockholders' equity, until realized. Securities classified as trading are also recorded at fair value. Unrealized holding gains and losses on securities classified as trading are included in earnings. (See Note 22 for a more complete discussion of accounting for the fair value of financial instruments.) Declines in the fair value of securities below their cost that are deemed to be other-than-temporary are recognized in earnings as realized losses. Realized gains and losses on sale are computed on the specific identification method and are included in earnings on the trade date sold.

We review investment securities on an ongoing basis for the presence of OTTI or permanent impairment, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend
to sell a security or if it is likely that we will be required to sell the security before recovery of our amortized cost basis of the investment, which may be maturity, and other factors.

For debt securities, if the Company intends to sell the security or it is likely that the Company will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the security and it is not likely that the Company will be required to sell the security but the Company does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI.

The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (OCI). Impairment losses related to all other factors are presented as separate categories within OCI. For investment securities transferred from held-to-maturity to available-for-sale, this amount is accreted from the time of transfer over the remaining life of the debt security based on the amount and timing of future estimated cash flows. The accretion of the amount recorded in OCI increases the carrying value of the investment and does not affect earnings. If there is an indication of additional credit losses, the security is re-evaluated according to the procedures described above.

Investment in FHLB Stock: At December 31, 2012, the Company had recorded $\$ 36.7$ million in FHLB stock, compared to $\$ 37.4$ million at December 31, 2011. The Banks' investments in FHLB stock are generally viewed as a long-term investment and are carried at par value ( $\$ 100$ per share), which reasonably approximates its fair value. It does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions and can only be purchased and redeemed at par. As members of the FHLB system, the Banks are required to maintain a minimum level of investment in FHLB stock based on specific percentages of their outstanding FHLB advances. For the years ended December 31, 2012, 2011 and 2010, the Banks did not receive any dividend income on FHLB stock.

Management periodically evaluates FHLB stock for impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

The Seattle FHLB announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the FHFA), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. The FHLB of Seattle announced September 7, 2012 that the FHFA now considers the FHLB of Seattle to be adequately capitalized. Dividends on, or repurchases of, the FHLB of Seattle stock continue to require consent of the FHFA. The FHFA subsequently approved the repurchase of portions of FHLB of Seattle stock, and as of December 31, 2012, the FHLB had repurchased $\$ 665,900$ of the Banks' stock. The Company will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of Banner's investment. Based on the above, the Company has determined there is not any impairment on the FHLB stock investment as of December 31, 2012.

Loans Receivable: The Banks originate residential mortgage loans for both portfolio investment and sale in the secondary market. At the time of origination, mortgage loans are designated as held for sale or held for investment. Loans held for sale are stated at lower of cost or estimated market value determined on an aggregate basis. Net unrealized losses on loans held for sale are recognized through a valuation allowance by charges to income. The Banks also originate construction and land development, commercial and multifamily real estate, commercial business, agricultural and consumer loans for portfolio investment. Loans receivable not designated as held for sale are recorded at the principal amount outstanding, net of allowance for loan losses, deferred fees, discounts and premiums. Premiums, discounts and deferred loan fees are amortized to maturity using the level-yield methodology.

Some of the Company's loans are reported as troubled debt restructures (TDRs). Loans are reported as restructured when the Bank grants a concession(s) to a borrower experiencing financial difficulties that it would not otherwise consider. Examples of such concessions include forgiveness of principal or accrued interest, extending the maturity date(s) or providing a lower interest rate than would be normally available for a transaction of similar risk. As a result of these concessions, loans identified as TDRs are impaired as the Bank will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. TDRs are accounted for in accordance with the Banks' impaired loan accounting policies.

Income Recognition on Nonaccrual and Impaired Loans: Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the interest may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.

Provision and Allowance for Loan Losses: The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. The Company maintains an allowance for loan losses consistent in all material respects with generally accepted accounting principles. The Company has established systematic methodologies for the determination of the adequacy of the Company's allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for a general valuation allowance as well as specific allowances that are tied to individual problem loans. The Company increases its allowance for loan losses by charging provisions for probable loan losses against its income and values impaired loans consistent with accounting guidelines.

The allowance for losses on loans is maintained at a level sufficient to provide for estimated losses based on evaluating known and inherent risks in the loan portfolio and upon the Company's continuing analysis of the factors underlying the quality of the loan portfolio. These factors include, among others, changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loans. Realized losses related to specific assets are applied as a reduction of the carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by Banner at the time financial statements are prepared. Although the Company uses the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond the Company's control. The adequacy of general and specific reserves is based on a continuing evaluation of the pertinent factors underlying the quality of the loan portfolio as well as individual review of certain large balance loans. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment. Loans are considered impaired when, based on current information and events, the Company determines that it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, an allocated formula allowance and an unallocated allowance. Losses on specific loans are provided for when the losses are probable and estimable. General loan loss reserves are established to provide for inherent loan portfolio risks not specifically provided for. The level of general reserves is based on analysis of potential exposures existing in Banner's loan portfolio including evaluation of historical trends, current market conditions and other relevant factors identified by us at the time the financial statements are prepared. The formula allowance is calculated by applying loss factors to outstanding loans, excluding those loans that are subject to individual analysis for specific allowances. Loss factors are based on the Company's historical loss experience adjusted for significant environmental considerations, including the experience of other banking organizations, which in the judgment of management affects the collectability of the portfolio as of the evaluation date. The unallocated allowance is based upon the Company's evaluation of various factors that are not directly measured in the determination of the formula and specific allowances.

While the Company believes the estimates and assumptions used in Banner's determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proved incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the financial condition and results of operations of the Company. In addition, the determination of the amount of the Banks' allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Loan Origination and Commitment Fees: Loan origination fees, net of certain specifically defined direct loan origination costs, are deferred and recognized as an adjustment of the loans' interest yield using the level-yield method over the contractual term of each loan adjusted for actual loan prepayment experience. Net deferred fees or costs related to loans held for sale are recognized in income at the time the loans are sold. Loan commitment fees are deferred until the expiration of the commitment period unless management believes there is a remote likelihood that the underlying commitment will be exercised, in which case the fees are amortized to fee income using the straight-line method over the commitment period. If a loan commitment is exercised, the deferred commitment fee is accounted for in the same manner as a loan origination fee. Deferred commitment fees associated with expired commitments are recognized as fee income.

Real Estate Held for Sale: Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Development and improvement costs relating to the property are capitalized while direct holding costs are expensed. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts the Banks will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of market factors beyond the Banks' control or because of changes in the Banks' strategies for recovering the investment.

Property and Equipment: The provision for depreciation is based upon the straight-line method applied to individual assets and groups of assets acquired in the same year at rates adequate to charge off the related costs over their estimated useful lives:
Buildings and leased improvements 10-30 years
Furniture and equipment
3-10 years
Routine maintenance, repairs and replacement costs are expensed as incurred. Expenditures which significantly increase values or extend useful lives are capitalized. The Company reviews buildings, leasehold improvements and equipment for impairment whenever events or changes in circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

Other Intangible Assets: Other intangible assets consist primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

Mortgage Servicing Rights: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of the servicing right is estimated and capitalized. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized servicing rights are reported in other assets and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, balance outstanding, loan type, age and remaining term, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

Bank-Owned Life Insurance (BOLI): The Banks have purchased, or acquired through mergers, life insurance policies in connection with the implementation of certain executive supplemental income, salary continuation and deferred compensation retirement plans. These policies provide protection against the adverse financial effects that could result from the death of a key employee and provide tax-exempt income to offset expenses associated with the plans. It is the Banks' intent to hold these policies as a long-term investment; however, there may be an income tax impact if the Bank chooses to surrender certain policies. Although the lives of individual current or former management-level employees are insured, the Banks are the respective owners and sole or partial beneficiaries. At December 31, 2012 and 2011, the cash surrender value of these policies was $\$ 59.9$ million and $\$ 58.6$ million, respectively.

Derivative Instruments: Derivatives include "off-balance-sheet" financial products, the value of which is dependent on the value of underlying financial assets, such as stock, bonds, foreign currency, or a reference rate or index. Such derivatives include "forwards," "futures," "options" or "swaps." As a result of the 2007 acquisition of F\&M Bank, we became a party to approximately $\$ 23$ million ( $\$ 16$ million as of December 31, 2012) in notional amounts of interest rate swaps. These swaps serve as hedges to an equal amount of fixed rate loans which include market value prepayment penalties that mirror the provision of the specifically matched interest rate swaps. In addition, in 2011 we began actively marketing interest rate swaps to certain loan customers in connection with longer-term floating rate loans, allowing them to effectively fix their loan interest rates. These customer swaps are matched with third party swaps with qualified broker/dealer or banks to offset the risk. As of December 31, 2012, we had $\$ 95$ million in notional amounts of these customer interest rate swaps outstanding, with an equal amount of offsetting third party swaps also in place. The fair value adjustments for these swaps and the related loans are reflected in other assets or other liabilities as appropriate, and in the carrying value of the hedged loans.

Further, as a part of mortgage banking activities, we issue "rate lock" commitments to borrowers and obtain offsetting "best efforts" delivery commitments from purchasers of loans. We also use forward contracts for the sale of mortgage-backed securities and mandatory delivery commitments for the sale of loans to hedge "rate lock" commitments. We enter into forward delivery contracts to sell residential mortgage loans to secondary market investors (i.e., Freddie Mac or Fannie Mae or others) at specific prices and dates in order to hedge the interest rate risk in their portfolios of mortgage loans held for sale and their residential mortgage loan commitments. The commitments to originate mortgage loans held for sale and the related delivery contracts are considered derivatives. The Company recognizes all derivatives as either assets or liabilities in the balance sheet and requires measurement of those instruments at fair value through adjustments to accumulated other comprehensive income and/or current earnings, as appropriate. None of these residential mortgage loan related derivatives are designated as hedging instruments for accounting purposes. Rather, they are accounted for as free-standing derivatives, or economic hedges, and the Company reports changes in fair values of its derivatives in current period net income. The fair value of the derivative loan commitments is estimated using the present value of expected future cash flows. Assumptions used include rate assumptions based on historical information, current mortgage interest rates, the
stage of completion of the underlying application and underwriting process, the time remaining until the expiration of the derivative loan commitment, and the expected net future cash flows related to the associated servicing of the loan.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Banks, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Banks do not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Advertising Expenses: Advertising costs are expensed as incurred. Costs related to production of advertising are considered incurred when the advertising is first used.

Income Taxes: The Company files a consolidated income tax return including all of its wholly-owned subsidiaries on a calendar year basis. Income taxes are accounted for using the asset and liability method. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates which will be in effect when the differences between the financial statement carrying amounts and tax bases of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period of change. A valuation allowance is recognized as a reduction to deferred tax assets when management determines it is more likely than not that deferred tax assets will not be available to offset future income tax liabilities.

Accounting standards for income taxes prescribe a recognition threshold and measurement process for financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a tax return, and also provides guidance on the de-recognition of previously recorded benefits and their classification, as well as the proper recording of interest and penalties, accounting in interim periods, disclosures and transition. The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

As of December 31, 2012, the Company had an insignificant amount of unrecognized tax benefits for uncertain tax positions, none of which would materially affect the effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will significantly increase or decrease in the next twelve months. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in the income tax expense. The amount of interest and penalties accrued for the years ended December 31, 2012 and 2011 is immaterial. The Company files consolidated income tax returns in Oregon and Idaho and for federal purposes. The tax years which remain subject to examination by the taxing authorities are the years ended December 31, 2011, 2010, 2009 and 2008.

Employee Stock Ownership Plan: The Company loaned the Employee Stock Ownership Plan (ESOP) the funds necessary to fund the purchase of $8 \%$ of the common stock sold in the Company's initial public offering of common stock. The loan to the ESOP is repaid principally from the Company's contribution to the ESOP, and the collateral for the loan is the Company's common stock purchased by the ESOP. However, the Company has not made a contribution since 2007. Annually, in consultation with the Company's directors, the ESOP's trustees determine if a contribution will be made and whether it will be used to make a payment on the loan or purchase shares in the open market. When the contribution is used to repay debt, shares are released from collateral based on the proportion of debt service paid in the year and allocated to participants' accounts. When shares are released from collateral, compensation expense is recorded equal to the average current market price of the shares, and the shares become outstanding for earnings-per-share calculations. When the contribution is used to purchase shares in the open market, compensation
expense is recorded in the amount of the contribution. Stock and cash dividends on allocated shares are recorded as a reduction of retained earnings and paid or distributed directly to participants' accounts. Dividends on unallocated shares are used to fund a portion of the Company's contribution to the ESOP (see additional discussion in Note 15).

Share-Based Compensation: At December 31, 2012, the Company had the following stock-based employee/director compensation plans: three stock option plans (the 1996 Stock Option Plan, the 1998 Stock Option Plan and the 2001 Stock Option Plan), the 2012 Restricted Stock Plan and the Banner Corporation Long-Term Incentive Plan. In addition, in 2011 and 2010, the Company made restricted stock grants to Mark Grescovich, President and CEO of Banner Bank and Banner Corporation, in accordance with his employment agreement. The restricted grants value shares awarded at their fair value, which is their intrinsic value on the date of the award grant. The expense of the award grants are accrued ratably over the vesting period from the date of each award. These plans are described more fully in Note 16.

The Company has adopted the fair value recognition for recognizing stock compensation exposure, using the modified-prospective-transition method. Under that method, compensation costs are recognized based upon grant date fair value. This method requires the cash flows resulting from the tax benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows (see Note 16).

The Banner Corporation Long-Term Incentive Plan (the Plan) was initiated in June 2006. The Plan is an account-based type of benefit, the value of which is directly related to changes in the value of the Company's common stock (the excess of the fair market value of a share of the Company's common stock on the date of vesting over the fair market value of such share on the date granted) plus, for certain awards, dividends declared on the Company's common stock and changes in Banner Bank's average earnings rate. Awards granted through the Plan are considered stock appreciation rights (SARs) and are included in deferred compensation. The Company remeasures the fair value of a SAR each reporting period until the award is settled and compensation expense is recognized each reporting period for changes in the SAR's fair value and vesting.

Comprehensive Income: Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. In addition, certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as
a separate component of the equity section of the Consolidated Statements of Financial Condition, and such items, along with net income, are components of comprehensive income which is reported in the Consolidated Statements of Comprehensive Income (Loss).

Business Segments: The Company is managed by legal entity and not by lines of business. Each of the Banks is a community oriented commercial bank chartered in the State of Washington. The Banks' primary business is that of a traditional banking institution, gathering deposits and originating loans for portfolio in its respective primary market areas. The Banks offer a wide variety of deposit products to their consumer and commercial customers. Lending activities include the origination of real estate, commercial/agriculture business and consumer loans. Banner Bank is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, the Banks receive other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Banks is reviewed by the Company's executive management and Board of Directors on a monthly basis. All of the executive officers of the Company are members of Banner Bank's management team.

Generally Accepted Accounting Principles establish standards to report information about operating segments in annual financial statements and require reporting of selected information about operating segments in interim reports to stockholders. The Company has determined that its current business and operations consist of a single business segment.

Reclassification: Certain reclassifications have been made to the prior years' consolidated financial statements and/or schedules to conform to the current year's presentation. These reclassifications may have affected certain reported amounts and ratios for the prior periods. These reclassifications had no effect on retained earnings (accumulated deficit) or net income (loss) as previously presented and the effect of these reclassifications is considered immaterial.

## Note 2: RECENT DEVELOPMENTS AND SIGNIFICANT EVENTS

Regulatory Actions: On March 23, 2010, Banner Bank entered into a Memorandum of Understanding (Bank MOU) with the FDIC and Washington DFI. The Company also entered into a similar MOU with the Federal Reserve Bank of San Francisco on March 29, 2010 (FRB MOU). On March 19, 2012, the Bank MOU was terminated. On April 10, 2012, the FRB MOU was also terminated.

Income Tax Reporting and Accounting:
Amended Federal Income Tax Returns: On October 25, 2011, the Company filed amended federal income tax returns for tax years 2005, 2006, 2008 and 2009. The amended tax returns, which are under review by the Internal Revenue Service (IRS), would significantly affect the timing for recognition of credit losses within previously filed income tax returns and, if approved, would result in the refund of up to $\$ 13.6$ million of previously paid taxes from the utilization of net operating loss carryback claims into prior tax years. The outcome of the anticipated IRS review is inherently uncertain and since there can be no assurance of approval of some or all of the tax carryback claims, no asset has been recognized to reflect the possible results of these amendments as of December 31, 2012, because of this uncertainty. Accordingly, the Company does not anticipate recognizing any tax benefit until the results of the IRS review have been determined.

Deferred Tax Asset Valuation Allowance: The Company and the Banks file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred
taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP, a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of our deferred tax assets will not be realized. While realization of the deferred tax asset is ultimately dependent on sustained profitability, the guidance reflected in the accounting standard is significantly influenced by consideration of recent historical operating results. During 2010, the Company evaluated its net deferred tax asset and determined it was prudent to establish a valuation allowance against the entire asset. As a result, we recorded an $\$ 18.0$ million income tax expense for the year ended December 31, 2010. No tax benefit or expense was recognized during 2011. During the year ended December 31, 2012, management analyzed the Company's performance and trends, focusing on trends in asset quality, loan loss provisioning, capital position, net interest margin, core operating income and net income and the likelihood of continued profitability. Based on this analysis, management determined that a full valuation allowance was no longer appropriate and reversed all of the valuation allowance during the year ended December 31, 2012. See Note 13 of the Notes to the Consolidated Financial Statements for more information.

Stockholder Equity Transactions:
Reverse stock split: On May 26, 2011, Banner Corporation filed with the Secretary of State of the State of Washington Articles of Amendment to the Amended and Restated Articles of Incorporation of the Company, which effected a 1 -for-7 reverse stock split. The amendment to the Company's Amended and Restated Articles of Incorporation was effective June 1, 2011. As a result of the reverse stock split, every seven shares of the Company's common stock issued and outstanding immediately prior to the effective date automatically consolidated into one share of common stock. No fractional shares of common stock were issued by the Company in connection with the reverse stock split. Approximately $\$ 50,000$ in cash was paid for fractional shares based on the closing price of the common stock on May 31, 2011. All prior shares outstanding and per share information have been retroactively adjusted for the reverse stock split.

Participation in the U.S. Treasury's Capital Purchase Program: On November 21, 2008, Banner received $\$ 124$ million from the Treasury Department ("Treasury") as part of the Treasury's Capital Purchase Program. Banner issued \$124 million of Series A Preferred Stock of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, (the Series A Preferred Stock) having a liquidation value of $\$ 1,000$ per share, with

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a related warrant to purchase up to $\$ 18.6$ million in common stock, to the U.S. Treasury. The warrant provides the Treasury the option to purchase up to 243,998 shares (post reverse-split) of the Company's common stock at a price of $\$ 76.23$ per share (post reverse-split) at any time during the next 10 years. On March 29, 2012, the Company's $\$ 124$ million of Series A Preferred Stock was sold by the Treasury as part of its efforts to manage and recover its investments under the Troubled Asset Relief Program (TARP). While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrants to purchase up to $\$ 18.6$ million in Banner common stock.

Redemption of senior preferred shares: Subsequent to March 29, 2012, the Company repurchased or redeemed all of its Series A Preferred Stock, realizing gains aggregating $\$ 2.5$ million, which was partially offset by accelerated amortization of a portion of the initial discount recorded at the issuance of the Series A Preferred Stock. In addition, the accrual for the quarterly dividend was reduced by the retirement of the repurchased shares.

Restricted Stock Grants: On April 24, 2012, shareholders approved the Banner Corporation 2012 Restricted Stock Plan (the Plan). Under the Plan, the Company was authorized to issue up to 300,000 shares of its common stock to provide a means for attracting and retaining highly skilled officers of Banner and its affiliates. Shares granted under the Plan have a minimum vesting period of three years. The Plan has a ten-year term after which no further awards may be granted. Concurrent with the approval of the Plan was the approval of a grant of $\$ 300,000$ of restricted stock ( 14,535 restricted shares) that vests in one-third increments over a three-year period to Mark J. Grescovich, President and Chief Executive Officer of Banner Corporation and Banner Bank. Subsequent to that initial issuance from this new plan was the issuance of 78,500 additional shares to certain other officers of the Company.

Note 3: ACCOUNTING STANDARDS RECENTLY ADOPTED OR ISSUED

## Accounting Standards Recently Adopted

In April 2011, FASB issued Accounting Standards Update (ASU) No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. This guidance is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance has been applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The amendments remove the transferor's ability criterion from the consideration of effective control for repurchase and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. The adoption of this guidance did not have a material effect on the Company's Consolidated Financial Statements.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurement - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the first interim or annual period beginning on or after December 15, 2011 and did not have a significant impact on the Company's Consolidated Financial Statements.

In June 2011, FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The amendments in this Update are required to be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The FASB decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, the
amendments require the consecutive presentation of the statement of net income and other comprehensive income and require the presentation of reclassification adjustments on the face of the financial statements from other comprehensive income to net income. See also ASU No. 2011-12. The adoption of this guidance did not have a material effect on the Company's Consolidated Financial Statements.

In December 2011, FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. This ASU was made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. The amendments in this Update are effective at the same time as the amendments in Update 2011-05 so that entities were not required to comply with the presentation requirements in Update 2011-05 until this ASU becomes effective. The adoption of this guidance has not had a material effect on the Company's Consolidated Financial Statements.

## Note 4: CASH AND SECURITIES

Cash, due from bank and cash equivalents consisted of the following at the dates indicated (in thousands):
December 31
20122011
Cash on hand and due from banks $\quad \$ 181,100 \quad \$ 132,189$
Cash equivalents:
Short-term cash investments 247
\$181,298 \$132,436
Federal regulations require depository institutions to maintain certain minimum reserve balances. Included in cash and demand deposits were required reserves of $\$ 25.4$ million and $\$ 20.4$ million at December 31, 2012 and 2011, respectively.

The following table sets forth a summary of Banner's interest-bearing deposits and securities at the dates indicated (includes securities-trading, available-for-sale and held-to-maturity, all at carrying value) (in thousands):

|  | December 31 |  |
| :--- | :--- | :--- |
|  | 2012 | 2011 |
| Interest-bearing deposits included in cash and due from banks | $\$ 114,928$ | $\$ 69,758$ |
| U.S. Government and agency obligations | 98,617 | 341,606 |
| Municipal bonds: | 31,480 | 18,497 |
| Taxable | 103,545 | 88,963 |
| Tax exempt | 135,025 | 107,460 |
| Total municipal bonds | 48,519 | 42,565 |
| Corporate bonds |  |  |
| Mortgage-backed or related securities: | 115,966 | 107,173 |
| 1-4 residential agency guaranteed | 1,299 | 1,835 |
| 1-4 residential other | 10,659 | 20,919 |
| Multifamily agency guaranteed | 305,864 | - |
| Multifamily other | 42,516 | - |
| Total mortgage-backed securities | 63 | 402 |
| Asset-backed securities: | 630,604 | 621,960 |
| Equity securities (excludes FHLB stock) | 36,705 | 37,371 |
| Total securities | $\$ 782,237$ | $\$ 729,089$ |
| FHLB stock |  |  |

Securities-Trading: The amortized cost and estimated fair value of securities-trading at December 31, 2012 and 2011 are summarized as follows (dollars in thousands):


There were eight sales of securities-trading for the year ended December 31, 2012 with proceeds of $\$ 5.1$ million and related gains of $\$ 13,000$. There were no sales of securities-trading for the years ended December 31, 2011, and 2010. The Company recognized $\$ 409,000$ in OTTI charges on securities-trading for the year ended December 31, 2012 compared to no OTTI charges in 2011 and OTTI charges of $\$ 1.2$ million for the year ended December 31, 2010. Additionally, at December 31, 2012 and 2011, there were no securities-trading in a nonaccrual status. Net unrealized holding gains of $\$ 6.3$ million were recognized in 2012 compared to $\$ 754,000$ and $\$ 497,000$ of net unrealized holding gains on securities-trading for the years ended December 31, 2011 and 2010, respectively.

The amortized cost and estimated fair value of securities-trading at December 31, 2012 and 2011, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

December 31, 2012
Amortized
Cost
Due in one year or less
Due after one year through five years
Due after five years through ten years
Due after ten years through twenty years
Due after twenty years
Mortgage-backed securities
Equity securities

December 31, 2011
Amortized

| Amortized | Fair Value |
| :--- | :--- |
| Cost |  |
| $\$ 1,000$ | $\$ 1,009$ |
| 1,545 | 1,626 |
| 4,087 | 4,123 |
| 6,544 | 6,184 |
| 58,549 | 30,710 |
| 71,725 | 43,652 |
| 34,024 | 36,673 |
| 6,914 | 402 |
| $\$ 112,663$ | $\$ 80,727$ |

Securities-Available-for-Sale: The amortized cost, gross unrealized losses and gains and estimated fair value of securities- available-for-sale at December 31, 2012 and 2011 are summarized as follows (dollars in thousands):

December 31, 2012


At December 31, 2012 and 2011, an aging of unrealized losses and fair value of related securities-available-for-sale was as follows (in thousands):

|  | December 31, 2012 |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Less Than 12 Months |  |  | 12 Months or More |  | Total |  |  |
|  | Fair Value | Unreal Losses |  | Fair Value | Unrealized Losses |  | Fair Value | Unrealized Losses |
| U.S. Government and agency obligations | \$22,955 | \$ (53 | ) | \$- | \$- |  | \$22,955 | \$(53 |
| Municipal bonds: |  |  |  |  |  |  |  |  |
| Taxable | 11,009 | (67 | ) | - | - |  | 11,009 | (67 |
| Tax exempt | 4,619 | (11 | ) | - | - |  | 4,619 | (11 |
| Total municipal bonds | 15,628 | (78 | ) | - | - |  | 15,628 | (78 |
| Corporate bonds | 6,670 | (9 | ) | - | - |  | 6,670 | (9 |
| Mortgage-backed or related securities: |  |  |  |  |  |  |  |  |
| 1-4 residential agency guaranteed | 132,459 | (503 | ) | 5,746 | (81 | ) | 38,205 | (584 |
| Multifamily agency guaranteed | 32,170 | (226 | ) | - | - |  | 32,170 | (226 |
| Multifamily other | 7,279 | (45 | ) | - | - |  | 7,279 | (45 |
| Total mortgage-backed or related securities | 71,908 | (774 | ) | 5,746 | (81 | ) | 77,654 | (855 |
| Asset-backed securities: |  |  |  |  |  |  |  |  |
| SLMA | 19,716 | (74 | ) | - | - |  | 19,716 | (74 |
|  | \$136,877 | \$(988 |  | \$5,746 | \$ (81 | ) | \$142,623 | \$ 1,069 |

U.S. Government and agency obligations
Municipal bonds:
$\left.\begin{array}{llllllll}\text { Taxable } & 3,599 & (2 & ) & - & 3,599 & (2 & ) \\ \text { Tax exempt } & 4,075 & (16 & ) & - & 4,075 & (16 & ) \\ \text { Total municipal bonds } & 7,674 & (18 & )- & - & 7,674 & (18 & ) \\ \begin{array}{l}\text { Mortgage-backed or related } \\ \text { securities: }\end{array} & & & & & & \\ \begin{array}{llllll}1-4 \text { residential agency guaranteed } 26,730\end{array} & (133 & ) & - & - & 26,730 & (133 & ) \\ \begin{array}{l}\text { Multifamily agency guaranteed } \\ \text { Total mortgage-backed or related } \\ \text { securities }\end{array} & (153,888 & (148 & ) & - & - & 7,158 & (15\end{array}\right)$

Proceeds from the sale of three available-for-sale securities were $\$ 13$ million for the year ended December 31, 2012 and the Company recognized a gain of $\$ 38,000$ on those sales. There were four sales of securities-available-for-sale during the year ended December 31, 2011 with proceeds of $\$ 28$ million and resulting losses of $\$ 5,000$. There was one sale of securities-available-for-sale of $\$ 2$ million with a resulting gain of $\$ 36,000$ during the year ended December 31, 2010. There were no OTTI impairment charges on securities-available-for-sale for the years ended December 31, 2012, 2011 and 2010. At December 31, 2012, there were 52 securities- available-for-sale with unrealized losses, compared to 26 at December 31, 2011 and 24 at December 31, 2010. Management does not believe that any
individual unrealized loss as of December 31, 2012, 2011 or 2010 represented OTTI. The decline in fair market value of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase.

The amortized cost and estimated fair value of securities-available-for-sale at December 31, 2012 and 2011, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

|  | December 31, 2012 |  | December 31, 2011 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$16,369 | \$16,393 | \$19,520 | \$ 19,602 |
| Due after one year through five years | 104,917 | 105,579 | 312,862 | 313,930 |
| Due after five years through ten years | 51,654 | 51,637 | 38,916 | 39,009 |
| Due after ten years through twenty years | 21,369 | 21,554 | - | - |
|  | 194,309 | 195,163 | 371,298 | 372,541 |
| Mortgage-backed securities | 275,341 | 277,757 | 91,281 | 93,254 |
|  | \$469,650 | \$472,920 | \$462,579 | \$465,795 |

Securities-Held-to-Maturity: The amortized cost, gross gains and losses and estimated fair value of securities-held-to-maturity at December 31, 2012 and 2011 are summarized as follows (dollars in thousands):

|  | December 31, 2012 |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
|  | Amortized <br> Cost | Gross <br> Unrealized <br> Gains | Gross <br> Unrealized <br> Losses | Fair Value | Percent of Total |  |
|  |  |  |  |  |  |  |
| Municipal bonds: | $\$ 10,326$ | $\$ 436$ | $\$(157$ | $)$ | $\$ 10,605$ | 11.5 |$\quad \%$

At December 31, 2012 and 2011, an age analysis of unrealized losses and fair value of related securities-held-to-maturity was as follows (in thousands):

|  | December 31, 2012 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Less Than 12 Months |  |  | 12 Months or More |  | Total |  |
|  | Fair Value | Unrealized <br> Losses |  | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Municipal bonds: |  |  |  |  |  |  |  |
| Taxable | \$4,137 | \$(157 | ) | \$- | \$- | \$4,137 | \$(157 |
| Tax exempt | 910 | (30 | ) | - | - | 910 | (30 |
| Total municipal bonds | 5,047 | (187 | ) | - | - | 5,047 | (187 |
|  | \$5,047 | \$(187 | ) | \$- | \$- | \$5,047 | \$(187 |


|  | December 31, 2011 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Less Than 12 Months |  | 12 Months or More |  | Total |  |  |
|  | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |  | Fair Value | Unrealized Losses |
| Corporate bonds | \$- | \$- | \$498 | \$ (2 | ) | \$498 | \$ (2 |
|  | \$- | \$- | \$498 | \$(2 | ) | \$498 | \$(2 |

There were no sales of securities-held-to-maturity during the years ended December 31, 2012, 2011 or 2010. The Company recognized no OTTI charges on securities—held-to-maturity for the year ended December 31, 2012 compared to a $\$ 3$ million OTTI recovery for the year ended December 31, 2011 and a $\$ 3$ million charge for the year ended December 31, 2010. As of December 31, 2012, there were no securities-held-to-maturity in a nonaccrual status. There were two held-to-maturity non-rated corporate bonds issued by a housing authority in nonaccrual status as of December 31, 2011. There were five securities-held-to-maturity with unrealized losses at December 31, 2012 compared to two at December 31, 2011 and 13 at December 31, 2010. Management does not believe that any individual unrealized losses as of December 31, 2012 or 2011 represented OTTI. The decline in fair market value of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase.

The amortized cost and estimated fair value of securities-held-to-maturity at December 31, 2012 and 2011, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

|  | December 31, 2012 <br> Amortized | December 31, 2011 |
| :--- | :--- | :--- | :--- | :--- |
| Cost |  |  |

Pledged Securities: The following table presents, as of December 31, 2012, investment securities which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law (in thousands):

Amortized Cost Fair Value
Purpose or beneficiary:
State and local governments public deposits $\quad \$ 119,426 \quad \$ 125,433$
Interest rate swap counterparties
Retail repurchase transaction accounts
12,149 12,480

Other
107,225
109,479

Total pledged securities
2,176
2,205
\$240,976
\$249,597

The carrying value of investment securities pledged to secure borrowings as of December 31, 2012 was $\$ 244.1$ million.

Note 5: ADDITIONAL INFORMATION REGARDING INTEREST INCOME FROM SECURITIES AND CASH EQUIVALENTS

The following table sets forth the composition of income from securities for the periods indicated (in thousands):

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|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Mortgage-backed securities interest | $\$ 4,176$ | $\$ 3,455$ | $\$ 4,045$ |
| Taxable interest income | 5,087 | 6,247 | 5,091 |
| Tax-exempt interest income | 3,577 | 3,504 | 3,162 |
| Total income from securities | $\$ 12,840$ | $\$ 13,206$ | $\$ 12,298$ |

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## Note 6: LOANS RECEIVABLE AND THE ALLOWANCE FOR LOAN LOSSES

Loans receivable, including loans held for sale, at December 31, 2012 and 2011 are summarized as follows (dollars in thousands):

|  | December 31, 2012 |  | December 31, 2011 |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | Amount | Percent | Amount | Percent |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | $\$ 489,581$ | 15.1 | $\%$ | $\$ 469,806$ | 14.2 |
| Investment properties | 583,641 | 18.0 | 621,622 | 18.9 |  |
| Multifamily real estate | 137,504 | 4.3 | 139,710 | 4.2 |  |
| Commercial construction | 30,229 | 0.9 | 42,391 | 1.3 |  |
| Multifamily construction | 22,581 | 0.7 | 19,436 | 0.6 |  |
| One- to four-family construction | 160,815 | 5.0 | 144,177 | 4.4 |  |
| Land and land development: |  |  |  |  |  |
| Residential | 77,010 | 2.4 | 97,491 | 3.0 |  |
| Commercial | 13,982 | 0.4 | 15,197 | 0.5 |  |
| Commercial business | 618,049 | 19.1 | 601,440 | 18.2 |  |
| Agricultural business, including secured by | 230,031 | 7.1 | 218,171 | 6.6 |  |
| farmland | 581,670 | 18.0 | 642,501 | 19.5 |  |
| One- to four-family real estate |  |  |  |  |  |
| Consumer: | 170,123 | 5.3 | 181,049 | 5.5 |  |
| Consumer secured by one- to four-family | 120,498 | 3.7 | 103,347 | 3.1 |  |
| Consumer-other | $3,235,714$ | 100.0 | $\%$ | $3,296,338$ | 100.0 |
| Total loans outstanding | $(77,491$ | $)$ | $(82,912$ | $)$ |  |
| Less allowance for loan losses | $\$ 3,158,223$ |  | $\$ 3,213,426$ |  |  |
| Net loans |  |  |  |  |  |

Loan amounts are net of unearned, unamortized loan fees (and costs) of approximately $\$ 9.0$ million at December 31, 2012 and $\$ 10.0$ million at December 31, 2011.

The Company's loans by geographic concentration at December 31, 2012 were as follows (dollars in thousands):

|  | Washington | Oregon | Idaho | Othe | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$366,422 | \$57,903 | \$61,379 | \$3,877 | \$489,581 |
| Investment properties | 450,142 | 85,416 | 42,774 | 5,309 | 583,641 |
| Multifamily real estate | 117,654 | 11,309 | 8,249 | 292 | 137,504 |
| Commercial construction | 20,839 | 6,107 | 934 | 2,349 | 30,229 |
| Multifamily construction | 12,383 | 10,198 | - | - | 22,581 |
| One- to four-family construction | 88,090 | 71,663 | 1,062 | - | 160,815 |
| Land and land development: |  |  |  |  |  |
| Residential | 41,680 | 33,478 | 1,852 | - | 77,010 |
| Commercial | 8,979 | 3,092 | 1,911 | - | 13,982 |
| Commercial business | 396,935 | 72,594 | 58,416 | 90,104 | 618,049 |
| Agricultural business, including secured by farmland | 108,671 | 51,286 | 70,074 | - | 230,031 |
| One- to four-family real estate | 360,625 | 195,364 | 23,596 | 2,085 | 581,670 |
| Consumer: |  |  |  |  |  |
|  | 114,405 | 42,395 | 12,644 | 679 | 170,123 |

Consumer secured by one- to four-family
Consumer-other
Total loans
Percent of total loans

| 80,209 |  | 34,668 | 5,621 |  |  | 120,498 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
|  |  |  |  |  |  |  |
| $\$ 2,167,034$ | $\$ 675,473$ |  | $\$ 288,512$ |  | $\$ 104,695$ |  |
| 67.0 | $\%$ | 20.9 | $\%$ | 8.9 | $\%$ | 3.2 |

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The geographic concentrations of Banner's land and land development loans by state at December 31, 2012 were as follows (dollars in thousands):

## Residential:

| Acquisition and development | $\$ 10,182$ | $\$ 13,454$ | $\$ 1,612$ | $\$ 25,248$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Improved land and lots | 23,418 | 18,823 | 240 | 42,481 |  |
| Unimproved land | 8,080 | 1,201 | - | 9,281 |  |
| Commercial and industrial: |  |  |  |  |  |
| Acquisition and development | 1,273 | - | 482 | 4,755 |  |
| Improved land and lots | 4,204 | 136 | 552 | 4,892 |  |
| Unimproved land | 3,502 | 2,956 | 877 | 7,335 |  |
| Total land and land development loans | $\$ 50,659$ | $\$ 36,570$ | $\$ 3,763$ | $\$ 90,992$ |  |
| Percent of land and land development loans | 55.7 | $\% 40.2$ | $\%$ | 4.1 | $\%$ |
|  |  |  |  | 100.0 | $\%$ |

The Company originates both adjustable- and fixed-rate loans. At December 31, 2012 and 2011, the maturity and repricing composition of all those loans, less undisbursed amounts and deferred fees, were as follows (in thousands):

December 31 $2012 \quad 2011$
Fixed-rate (term to maturity):
Due in one year or less
\$183,004 \$216,782
Due after one year through three years
Due after three years through five years
Due after five years through ten years
Due after ten years
171,724
250,715

Total fixed-rate loans
Adjustable-rate (term to rate adjustment):
Due in one year or less
173,251 182,647
167,858 157,559

Due after one year through three years
Due after three years through five years
Due after five years through ten years
Due after ten years
473,927 502,196

Total adjustable-rate loans
1,169,764
1,309,899

Total loans
1,260,472 1,200,182
275,223 425,309
467,895 336,382
60,316 23,618
2,044 948
2,065,950 1,986,439
\$3,235,714 \$3,296,338
The adjustable-rate loans have interest rate adjustment limitations and are generally indexed to various prime (The Wall Street Journal) or LIBOR rates, FHLB advance rates or One-to-Five-Year Constant Maturity Treasury Indices. Future market factors may affect the correlation of the interest rate adjustment with the rates the Banks pay on the short-term deposits that primarily have been utilized to fund these loans.

The Company's loans to directors, executive officers and related entities are on substantially the same terms and underwriting as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collectability. Such loans had the following balances and activity during the years ended December 31, 2012 and 2011 (in thousands):

|  | Years Ended December 31 |  |
| :--- | :--- | :--- |
| Balance at beginning of year | 2012 | 2011 |
| New loans or advances | $\$ 10,239$ | $\$ 5,428$ |
| Repayments and adjustments | 31,394 | 19,742 |
| Balance at end of period | $(29,170$ | $(14,931$ |

Impaired Loans and the Allowance for Loan Losses. A loan is considered impaired when, based on current information and circumstances, the Company determines it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Impaired loans are comprised of loans on nonaccrual, TDRs that are performing under their restructured terms, and loans that are 90 days or more past due, but are still on accrual.

The amount of impaired loans and the related allocated reserve for loan losses at the dates indicated were as follows (in thousands):

|  | $\begin{array}{l}\text { December 31, 2012 } \\ \text { Allocated } \\ \text { Reserves }\end{array}$ |  | $\begin{array}{l}\text { December 31, 2011 } \\ \text { Allocated }\end{array}$ |  |
| :--- | :--- | :--- | :--- | :--- |
|  | Loan Amount Amount |  |  |  |
| Reserves |  |  |  |  |$]$

As of December 31, 2012, the Company had additional commitments to advance funds up to an amount of $\$ 1.8$ million related to TDRs.

The following tables provide additional information on impaired loans with and without specific allowance reserves as of December 31, 2012 and December 31, 2011. Recorded investment includes the unpaid principal balance or the carrying amount of loans less charge-offs and net deferred loan fees (in thousands):

December 31, 2012

| Recorded | Unpaid | Related | Average | Interest |
| :--- | :--- | :--- | :--- | :--- |
| Investment | Principal | Recorded | Income |  |
| Balance | Allowance | Investment | Recognized |  |

Without a specific allowance reserve ${ }^{(1)}$
Commercial real estate:
Owner-occupied
Investment properties
Multifamily real estate
One- to four-family construction
Land and land development:
Residential
Commercial
Commercial business
One- to four-family residential
Consumer:
Consumer secured by one- to four-family
Consumer-other
With a specific allowance reserve ${ }^{(2)}$
Commercial real estate:
Owner-occupied
Investment properties
Multifamily real estate
One- to four-family construction
Land and land development:
Residential
Commercial
Commercial business
One- to four-family residential
Consumer:
Consumer secured by one- to four-family
Consumer-other
Total
Commercial real estate:
Owner occupied
Investment properties
Multifamily real estate
One- to four-family construction
Land and land development:
Residential
Commercial
Commercial business
One- to four-family residential
Consumer:

| $\$ 1,300$ | $\$ 1,551$ | $\$ 103$ | $\$ 1,470$ | $\$-$ |
| :--- | :--- | :--- | :--- | :--- |
| 624 | 861 | 90 | 735 | 17 |
| 2,131 | 2,131 | 392 | 2,136 | 113 |
| 4,460 | 4,460 | 571 | 3,335 | 145 |
|  |  |  |  |  |
| 2,122 | 2,587 | 404 | 2,948 | 73 |
| 46 | 46 | 12 | 46 | - |
| 4,352 | 4,970 | 821 | 2,121 | 154 |
| 10,886 | 12,004 | 150 | 11,458 | 44 |
|  |  |  |  |  |
| 1,641 | 2,335 | 54 | 1,966 | 14 |
| 1,167 | 1,275 | 16 | 1,297 | 5 |
| 28,729 | 32,220 | 2,613 | 27,512 | 565 |


| 2,993 | 2,993 | 518 | 3,113 | - |
| :--- | :--- | :--- | :--- | :--- |
| 8,884 | 10,120 | 630 | 9,449 | 229 |
| 5,000 | 5,000 | 1,273 | 5,000 | 295 |
| 3,831 | 3,831 | 870 | 3,611 | 194 |
|  |  |  |  |  |
| 4,782 | 4,782 | 586 | 5,039 | 185 |
| - | - | - | - | - |
| 3,373 | 3,734 | 134 | 3,931 | 6 |
| 32,494 | 33,672 | 1,656 | 33,100 | 1,259 |
|  |  |  |  |  |
| 1,042 | 1,140 | 26 | 1,074 | 15 |
| 724 | 740 | 32 | 754 | - |
| 63,123 | 66,012 | 5,725 | 65,071 | 2,183 |


| 4,293 | 4,544 | 621 | 4,583 | - |
| :--- | :--- | :--- | :--- | :--- |
| 9,508 | 10,981 | 720 | 10,184 | 246 |
| 7,131 | 7,131 | 1,665 | 7,136 | 408 |
| 8,291 | 8,291 | 1,441 | 6,946 | 339 |
|  |  |  |  |  |
| 6,904 | 7,369 | 990 | 7,987 | 258 |
| 46 | 46 | 12 | 46 | - |
| 7,725 | 8,704 | 955 | 6,052 | 160 |
| 43,380 | 45,676 | 1,806 | 44,558 | 1,303 |

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| Consumer secured by one- to four-family | 2,683 | 3,475 | 80 | 3,040 | 29 |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Consumer-other | 1,891 | 2,015 | 48 | 2,051 | 5 |
|  | $\$ 91,852$ | $\$ 98,232$ | $\$ 8,338$ | $\$ 92,583$ | $\$ 2,748$ |

Without a specific allowance reserve ${ }^{(1)}$
Commercial real estate:
Owner-occupied
Investment properties
Multifamily real estate
One- to four-family construction
Land and land development:
Residential
Commercial
Commercial business
Agricultural business, including secured by
farmland
One- to four-family residential
Consumer:
Consumer secured by one- to four-family
Consumer-other
With a specific allowance reserve ${ }^{(2)}$
Commercial real estate:
Owner-occupied
Investment properties
Multifamily real estate
Commercial construction
One- to four-family construction
Land and land development:
Residential
Commercial
Commercial business
Agricultural business, including secured by
farmland
One- to four-family residential
Consumer:
Consumer secured by one- to four-family
Consumer-other

Total
Commercial real estate:

| Owner-occupied | 4,495 | 4,866 | 285 | 4,775 | 13 |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Investment properties | 13,326 | 15,818 | 1,746 | 15,199 | 433 |
| Multifamily real estate | 2,449 | 2,449 | 17 | 2,423 | 114 |
| Commercial construction | 949 | 1,493 | - | 1,465 | - |
| One- to four-family construction | 14,985 | 15,309 | 2,435 | 14,765 | 519 |
| Land and land development: |  |  |  |  |  |
| Residential | 24,395 | 38,747 | 1,792 | 41,271 | 319 |
| Commercial | 1,099 | 1,099 | 45 | 1,070 | - |


| Commercial business | 18,062 | 18,868 | 2,336 | 19,308 | 225 |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Agricultural business, including secured by | 1,895 | 2,303 | 629 | 2,384 | - |
| farmland <br> One- to four-family residential <br> Consumer: | 44,406 | 46,422 | 935 | 45,488 | 1,388 |
| Consumer secured by one- to four-family <br> Consumer-other | 2,310 | 2,792 | 29 | 2,627 | 22 |
|  | 1,474 | 1,581 | 67 | 1,505 | 25 |
|  | $\$ 129,845$ | $\$ 151,747$ | $\$ 10,316$ | $\$ 152,280$ | $\$ 3,058$ |

(1) Loans without a specific allowance reserve have not been individually evaluated for impairment, but have been included in pools of homogeneous loans for evaluation of related allowance reserves.

Loans with a specific allowance reserve have been individually evaluated for impairment using either a discounted (2) cash flow analysis or, for collateral dependent loans, current appraisals to establish realizable value. These analyses may identify a specific impairment amount needed or may conclude that no reserve is needed. Any specific impairment that is identified is included in the category's Related Allowance column.

The following tables present TDRs at December 31, 2012 and 2011 (in thousands):

|  | December 31, 2012 |  |  |
| :---: | :---: | :---: | :---: |
|  | Accrual | Nonaccrual | Total |
|  | Status | Status | Modifications |
| Commercial real estate: |  |  |  |
| Owner-occupied | \$188 | \$1,551 | \$1,739 |
| Investment properties | 7,034 | 1,514 | 8,548 |
| Multifamily real estate | 7,131 | - | 7,131 |
| One- to four-family construction | 6,726 | 1,044 | 7,770 |
| Land and land development: |  |  |  |
| Residential | 4,842 | 15 | 4,857 |
| Commercial business | 2,975 | 247 | 3,222 |
| One- to four-family residential | 27,540 | 2,703 | 30,243 |
| Consumer: |  |  |  |
| Consumer secured by one- to four-family | 538 | 496 | 1,034 |
| Consumer-other | 488 | 396 | 884 |
|  | \$57,462 | \$7,966 | \$65,428 |
|  | December 31, 2011 |  |  |
|  | Accrual | Nonaccrual | Total |
|  | Status | Status | Modifications |
| Commercial real estate: |  |  |  |
| Owner-occupied | \$- | \$142 | \$142 |
| Investment properties | 7,751 | 1,822 | 9,573 |
| Multifamily real estate | 2,088 | - | 2,088 |
| One- to four-family construction | 8,362 | 271 | 8,633 |
| Land and land development: |  |  |  |
| Residential | 5,334 | 557 | 5,891 |
| Commercial | - | 949 | 949 |
| Commercial business | 4,401 | - | 4,401 |
| One- to four-family residential | 23,291 | 3,086 | 26,377 |
| Consumer: |  |  |  |
| Consumer secured by one- to four-family | 371 | 549 | 920 |
| Consumer-other | 2,935 | 3,974 | 6,909 |
|  | \$54,533 | \$11,350 | \$65,883 |

The following tables present new TDRs that occurred during the twelve months ended December 31, 2012 and 2011 (dollars in thousands):

|  | Twelve Months Ended December 31, 2012 |  |
| :--- | :--- | :--- | :--- |
| Pre-modification |  |  | \(\left.\begin{array}{l}Post-modification <br>

Outstanding\end{array}\right)\)
(1) Since most loans were already considered classified and/or on non-accrual status prior to restructuring, the modifications did not have a material effect on the Company's determination of the allowance for loan losses. The majority of these modifications do not fit into one separate type, such as: rate, term, amount, interest-only or
${ }^{(2)}$ payment; but instead are a combination of multiple types of modifications, therefore they are disclosed in aggregate.

The following table presents TDRs which incurred a payment default within the twelve-month periods ended December 31, 2012 and 2011, for which the payment default occurred within twelve months of the restructure date. A default on a restructured loan results in a transfer to nonaccrual status, a charge-off or a combination of both (in thousands):

|  | Twelve Months Ended December 31 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2012 |  | 2011 |  |
|  | Number of Loans | Amount | Number of Loans | Amount |
| Commercial real estate | 2 | \$2,346 | 2 | \$1,964 |
| Construction and land | 6 | 1,044 | 2 | 578 |
| One- to four-family residential | 4 | 492 | 1 | 598 |
| Consumer | - | - | 11 | 1,732 |
| Balance, end of period | 12 | \$3,882 | 16 | \$4,872 |

Credit Quality Indicators: To appropriately and effectively manage the ongoing credit quality of the Company's loan portfolio, management has implemented a risk-rating or loan grading system for its loans. The system is a tool to evaluate portfolio asset quality throughout each applicable loan's life as an asset of the Company. Generally, loans and leases are risk rated on an aggregate borrower/relationship basis with individual loans sharing similar ratings. There are some instances when specific situations relating to individual loans will provide the basis for different risk ratings within the aggregate relationship. Loans are graded on a scale of 1 to 9 . A description of the general characteristics of these categories is shown below:

Overall Risk Rating Definitions: Risk-ratings contain both qualitative and quantitative measurements and take into account the financial strength of a borrower and the structure of the loan or lease. Consequently, the definitions are to be applied in the context of each lending transaction and judgment must also be used to determine the appropriate risk rating, as it is not unusual for a loan or lease to exhibit characteristics of more than one risk-rating category. Consideration for the final rating is centered in the borrower's ability to repay, in a timely fashion, both principal and interest. There were no material changes in the risk-rating or loan grading system in 2012.

## Risk Rating 1: Exceptional

A credit supported by exceptional financial strength, stability, and liquidity. The risk rating of 1 is reserved for the Company's top quality loans, generally reserved for investment grade credits underwritten to the standards of institutional credit providers.

## Risk Rating 2: Excellent

A credit supported by excellent financial strength, stability and liquidity. The risk rating of 2 is reserved for very strong and highly stable customers with ready access to alternative financing sources.

## Risk Rating 3: Strong

A credit supported by good overall financial strength and stability. Collateral margins are strong, cash flow is stable although susceptible to cyclical market changes.

## Risk Rating 4: Acceptable

A credit supported by the borrower's adequate financial strength and stability. Assets and cash flow are reasonably sound and provide for orderly debt reduction. Access to alternative financing sources will be more difficult to obtain.

## Risk Rating 5: Watch

A credit with the characteristics of an acceptable credit but one which requires more than the normal level of supervision and warrants formal quarterly management reporting. Credits in this category are not yet criticized or
classified, but due to adverse events or aspects of underwriting require closer than normal supervision. Generally, credits should be watch credits in most cases for six months or less as the impact of stress factors are analyzed.

## Risk Rating 6: Special Mention

A credit with potential weaknesses that deserves management's close attention is risk rated a 6 . If left uncorrected, these potential weaknesses will result in deterioration in the capacity to repay debt. A key distinction between Special Mention and Substandard is that in a Special Mention credit, there are identified weaknesses that pose potential risk(s) to the repayment sources, versus well defined weaknesses that pose risk(s) to the repayment sources. Assets in this category are expected to be in this category no more than 9-12 months as the potential weaknesses in the credit are resolved.

## Risk Rating 7: Substandard

A credit with well defined weaknesses that jeopardize the ability to repay in full is risk rated a 7. These credits are inadequately protected by either the sound net worth and payment capacity of the borrower or the value of pledged collateral. These are credits with a distinct possibility of loss. Loans headed for foreclosure and/or legal action due to deterioration are rated 7 or worse.

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## Risk Rating 8: Doubtful

A credit with an extremely high probability of loss is risk rated 8. These credits have all the same critical weaknesses that are found in a substandard loan; however, the weaknesses are elevated to the point that based upon current information, collection or liquidation in full is improbable. While some loss on doubtful credits is expected, pending events may strengthen a credit making the amount and timing of any loss indeterminate. In these situations taking the loss is inappropriate until it is clear that the pending event has failed to strengthen the credit and improve the capacity to repay debt.

## Risk Rating 9: Loss

A credit that is considered to be currently uncollectible or of such little value that it is no longer a viable Bank asset is risk rated 9. Losses are taken in the accounting period in which the credit is determined to be uncollectible. Taking a loss does not mean that a credit has absolutely no recovery or salvage value but, rather, it is not practical or desirable to defer writing off the credit, even though partial recovery may occur in the future.

The following table shows Banner's portfolio of risk-rated loans and non-risk-rated loans by grade or other characteristic as of December 31, 2012 (in thousands):

December 31, 2012
Commercial

Real Estate Multifamily \begin{tabular}{l}
ConstructionCommercial Agricultural <br>
and Land

 

One- to <br>
Four-Family

 

Consumer <br>
(1)
\end{tabular} Total Loans

Risk-rated
loans:

| Pass (Risk <br> Ratings 1-5) | \$1,016,964 | \$130,815 | \$ 274,407 | \$581,846 | \$228,304 | \$ 560,781 | \$284,816 | \$3,077,933 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Special mention | 14,332 | - | 3,146 | 7,905 | 713 | 438 | 148 | 26,682 |
| Substandard | 41,382 | 6,689 | 27,064 | 28,287 | 1,014 | 20,451 | 5,657 | 130,544 |
| Doubtful | 544 | - | - | 11 | - | - | - | 555 |
| Total loans | \$ 1,073,222 | \$137,504 | \$ 304,617 | \$618,049 | \$230,031 | \$ 581,670 | \$290,621 | \$3,235,714 |
| Performing loans | \$1,066,643 | \$137,504 | \$ 300,945 | \$613,299 | \$230,031 | \$ 565,829 | \$287,073 | \$3,201,324 |
| Non-performin loans ${ }^{(2)}$ | $g_{6,579}$ | - | 3,672 | 4,750 | - | 15,841 | 3,548 | 34,390 |
| Total loans | \$1,073,222 | \$137,504 | \$ 304,617 | \$618,049 | \$230,031 | \$ 581,670 | \$290,621 | \$3,235,714 |

Most consumer loans are not individually risk-rated. For consumer loans that are not risk-rated, those that are
${ }^{(1)}$ performing consumer loans are reflected above as "Pass," while non-performing consumer loans are reflected above as "Substandard."
(2) Non-performing loans include loans on non-accrual status and loans more than 90 days delinquent, but still accruing interest.

The following table shows Banner's portfolio of risk-rated loans and non-risk-rated loans by grade or other characteristic as of December 31, 2011 (in thousands):

December 31, 2011
Commercial
Real Estate Multifamily $\begin{aligned} & \text { ConstructionCommercial Agricultural One- to } \\ & \text { and Land }\end{aligned} \begin{aligned} & \text { Business }\end{aligned} \quad \begin{aligned} & \text { Business }\end{aligned} \begin{aligned} & \text { Four-Family } \\ & \text { Residential }\end{aligned}$ (1) $\begin{aligned} & \text { Total Loans }\end{aligned}$
Risk-rated
loans:

| Pass (Risk <br> Ratings 1-5) | \$1,003,990 | \$132,108 | \$ 257,685 | \$542,625 | \$213,512 | \$ 607,793 | \$276,642 | \$3,034,355 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Special mentio | 29,751 | 5,000 | 3,359 | 13,447 | 923 | 772 | 402 | 53,654 |
| Substandard | 57,687 | 2,602 | 57,648 | 45,032 | 3,736 | 33,936 | 7,352 | 207,993 |
| Doubtful | - | - | - | 336 | - | - | - | 336 |
| Total loans | \$1,091,428 | \$139,710 | \$ 318,692 | \$601,440 | \$218,171 | \$ 642,501 | \$284,396 | \$3,296,338 |
| Performing loans | \$1,082,202 | \$139,348 | \$ 290,961 | \$587,976 | \$216,275 | \$ 622,946 | \$281,318 | \$3,221,026 |
| Non-performin loans ${ }^{(2)}$ | ,226, | 362 | 27,731 | 13,464 | 1,896 | 19,555 | 3,078 | 75,312 |
| Total loans | \$1,091,428 | \$139,710 | \$ 318,692 | \$601,440 | \$218,171 | \$ 642,501 | \$284,396 | \$3,296,338 |

Most consumer loans are not individually risk-rated. For consumer loans that are not risk-rated, those that are
${ }^{(1)}$ performing consumer loans are reflected above as "Pass," while non-performing consumer loans are reflected above as "Substandard."
(2) Non-performing loans include loans on non-accrual status and loans more than 90 days delinquent, but still accruing interest.

The following tables provide additional detail on the age analysis of Banner's past due loans as of December 31, 2012 and 2011 (in thousands):

December 31, 2012

|  | $\begin{aligned} & 30-59 \\ & \text { Days Past } \\ & \text { Due } \end{aligned}$ | 60-89 <br> Days Past <br> Due | Greater <br> Than 90 <br> Days Past <br> Due | Total Past Due | Current | Total Loans | Loans 90 <br> Days or More Past Due and Accruing |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial real estate: |  |  |  |  |  |  |  |
| Owner-occupied | \$1,693 | \$- | \$1,371 | \$3,064 | \$486,517 | \$489,581 | \$- |
| Investment properties | 743 | - | 1,431 | 2,174 | 581,467 | 583,641 | - |
| Multifamily real estate | - | - | - | - | 137,504 | 137,504 | - |
| Commercial construction | - | - | - | - | 30,229 | 30,229 | - |
| Multifamily construction | - | - | - | - | 22,581 | 22,581 | - |
| One- to four-family construction | 611 | - | - | 611 | 160,204 | 160,815 | - |
| Land and land development: |  |  |  |  |  |  |  |
| Residential | - | - | 2,047 | 2,047 | 74,963 | 77,010 | - |
| Commercial | 2,083 | - | 45 | 2,128 | 11,854 | 13,982 | - |
| Commercial business | 1,849 | 49 | 842 | 2,740 | 615,309 | 618,049 | - |
| Agricultural business, including secured by | - | - | - | - | 230,031 | 230,031 | - |


| One- to four-family <br> residential | 1,376 | 3,468 | 11,488 | 16,332 | 565,338 | 581,670 | 2,877 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Consumer: <br> Consumer secured by one- to | 699 | 74 | 1,204 | 1,977 | 168,146 | 170,123 | - |
| four-family | 816 | 673 | 839 | 2,328 | 118,170 | 120,498 | 152 |
| Consumer-other | $\$ 9,870$ | $\$ 4,264$ | $\$ 19,267$ | $\$ 33,401$ | $\$ 3,202,313$ | $\$ 3,235,714$ | $\$ 3,029$ |
| Total |  |  |  |  |  |  |  |

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December 31, 2011

|  |  |  |  |  |  | Loans 90 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 30-59 | $60-89$ <br> Days P | Greater <br> Than 90 | Total Past | Current |  | Days or <br> More Pa |
| Due | Due | Days Past | Due | Current | Total Loans | Due and |
|  |  | Due |  |  |  | Accruing |


| Commercial real estate: |  |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Owner-occupied | $\$ 1,251$ | $\$ 2,703$ | $\$ 3,462$ | $\$ 7,416$ | $\$ 462,390$ | $\$ 469,806$ | $\$-$ |
| Investment properties | - | - | 3,087 | 3,087 | 618,535 | 621,622 | - |
| Multifamily real estate <br> Commercial construction | - | - | - | - | 139,710 | 139,710 | - |
| Multifamily construction <br> One- to four-family <br> construction | - | - | 949 | 949 | 41,442 | 42,391 | - |
| Land and land development: | 643 | - | - | - | 19,436 | 19,436 | - |
| Residential <br> Commercial | 638 | - | 15,819 | 4,462 | 139,715 | 144,177 | - |
| Commercial business | 308 | - | 7919 | 16,557 | 80,934 | 97,491 | - |
| Agricultural business, <br> including secured by <br> farmland | 99 | - | 1,099 | 14,098 | 15,197 | - |  |
| One- to four-family <br> residential | 794 | 585 | 5,612 | 12,193 | 589,247 | 601,440 | 4 |
| Consumer: |  | 15,849 | 1,948 | 216,223 | 218,171 | - |  |
| Consumer secured by one- to <br> four-family | 1,072 | 109 | 1,374 | 2,555 | 178,494 | 181,049 | 148 |
| Consumer-other | 670 | 363 | 769 | 1,802 | 101,545 | 103,347 | 25 |
| Total |  |  |  |  |  |  |  |

The following tables provide additional information on the allowance for loan losses and loan balances individually and collectively evaluated for impairment as of December 31, 2012 (in thousands):

December 31, 2012

| Commercial | ConstructiorCommercialAgriculturaOne- to |  |  | Commitments |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| Real | Multifamily |  |  |  |  |  |
| Estate | and Land |  | Business | Business | Four-Family | Unallocated |

Allowance for loan losses:

| Beginning <br> balance | $\$ 16,457$ | $\$ 3,952$ | $\$ 18,184$ | $\$ 15,159$ | $\$ 1,548$ | $\$ 12,299$ | $\$ 1,253$ | $\$ 14,060$ | $\$ 82,912$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

$\left.\begin{array}{llllllllll}\text { Provision for } & 2,009 & 554 & 399 & (1,142 & \text { ) } & 1,154 & 8,918 & 2,571 & (1,463\end{array}\right) 13,000$

| Recoveries | 921 | - | 2,954 | 2,425 | 49 | 586 | 531 | - | 7,466 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Charge-offs (4,065 ) - (6,546 ) (6,485 ) (456 ) (5,328 ) (3,007 ) - ( 25,887 )
Ending balance $\begin{array}{lllllllll} & \$ 15,322 & \$ 4,506 & \$ 14,991 & \$ 9,957 & \$ 2,295 & \$ 16,475 & \$ 1,348 & \$ 12,597\end{array} \quad \$ 77,491$
Allowance individually
evaluated for impairment
Allowance
collectively
evaluated for
$\begin{array}{lllllllll}14,173 & 3,233 & 13,535 & 9,824 & 2,295 & 14,819 & 1,290 & 12,597 & 71,766\end{array}$
impairment

$\begin{array}{llllllll}\$ 1,149 & \$ 1,273 & \$ 1,456 & \$ 133 & \$- & \$ 1,656 & \$ 58 & \$-\end{array}$
(

| Commercial | ConstructioCommerciaAgriculturaOne- to |  |  | Commitments |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Real Estate | Multifamily | and Land | Business | Business | Four-Family |

Loan balances:
Loans
$\begin{array}{lllllllll}\text { individually } \\ \text { evaluated for }\end{array} \$ 11,877 \quad \$ 5,000 \quad \$ 8,613 \quad \$ 3,373 \quad \$-\quad \$ 32,494 \quad \$ 1,766 \quad \$-\quad \$ 63,123$
impairment
Loans
$\begin{array}{llllllllll}\text { collectively } \\ \text { evaluated for } & 1,061,345 & 132,504 & 296,004 & 614,676 & 230,031 & 549,176 & 288,855 & - & 3,172,591\end{array}$
impairment
Total loans $\quad \$ 1,073,222 \$ 137,504 \$ 304,617 \$ 618,049 \quad \$ 230,031 \quad \$ 581,670 \quad \$ 290,621 \quad \$-\quad \$ 3,235,714$

The following tables provide additional information on the allowance for loan losses and loan balances individually and collectively evaluated for impairment as of December 31, 2011 (in thousands):

December 31, 2011

| Commercial | ConstructiorCommerciaAgriculturaDne- to |  |  | Commitments |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| Real | Multifamily |  |  |  |  |  |
| Estate |  | and Land | Business | Business | Four-Family | Unallocated |

Allowance for
loan losses:
$\begin{array}{llllllllll}\text { Beginning } & \$ 11,779 & \$ 3,963 & \$ 33,121 & \$ 24,545 & \$ 1,846 & \$ 5,829 & \$ 1,794 & \$ 14,524 & \$ 97,401\end{array}$ balance
Provision for
$\left.\begin{array}{llllllllll}\text { loan losses } & 10,704 & 671 & 9,789 & (2,072 & ) & 159 & 16,024 & 189 & (464\end{array}\right) 35,000$
$\begin{array}{llllllllllllll}\text { Recoveries } & 53 & - & 1,602 & 1,082 & 20 & 356 & 304 & - & 3,417\end{array}$
Charge-offs (6,079 ) (682 ) (26,328 ) (8,396 ) (477 ) (9,910 ) (1,034 ) - (52,906 )
Ending balance $\begin{array}{llllllll} & 16,457 & \$ 3,952 & \$ 18,184 & \$ 15,159 & \$ 1,548 & \$ 12,299 & \$ 1,253\end{array} \quad \$ 14,060 \quad \$ 82,912$
Allowance individually
evaluated for
$\begin{array}{llllllll}\$ 1,693 & \$ 11 & \$ 2,614 & \$ 1,404 & \$ 592 & \$ 658 & \$ 62 & \$-\end{array}$ impairment
Allowance
collectively
evaluated for
$\begin{array}{lllllllll}14,764 & 3,941 & 15,570 & 13,755 & 956 & 11,641 & 1,191 & 14,060 & 75,878\end{array}$
impairment $\begin{aligned} & \text { Total allowance } \\ & \text { for loan losses }\end{aligned}$ $\begin{array}{llllllll} & \$ 16,457 & \$ 3,952 & \$ 18,184 & \$ 15,159 & \$ 1,548 & \$ 12,299 & \$ 1,253\end{array}$

|  | ComstructioCommerciaAgriculturaDne- to |  |  | Commitments |  |
| :--- | :--- | :--- | :--- | :--- | :---: |
| Commercial | Multifamily | and Land | Business | Business |  |
| Real Estate | Four-Family | Total |  |  |  |
| Unallocated |  |  |  |  |  |

Loan balances:
Loans
individually
evaluated for $\begin{array}{llllll}\$ 15,393 & \$ 1,997 & \$ 31,290 & \$ 12,889 & \$ 1,483 & \$ 16,877\end{array}$ \$1,518 $\quad \$-\$ 81,447$
impairment
Loans
$\begin{array}{llllllllll}\text { collectively } & 1,076,035 & 137,713 & 287,402 & 588,551 & 216,688 & 625,624 & 282,878 & - & 3,214,891\end{array}$
for impairment
Total loans $\quad \$ 1,091,428 \$ 139,710 \$ 318,692 \quad \$ 601,440 \quad \$ 218,171 \quad \$ 642,501 \quad \$ 284,396 \$-\quad \$ 3,296,338$

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## Note 7: REAL ESTATE OWNED, NET

The following table presents the changes in real estate owned (REO), net of valuation allowance, for the years ended December 31, 2012, 2011 and 2010 (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Balance, beginning of period | $\$ 42,965$ | $\$ 100,872$ | $\$ 77,743$ |
| Additions from loan foreclosures | 13,930 | 53,197 | 87,761 |
| Additions from capitalized costs | 300 | 4,404 | 4,006 |
| Dispositions of REO | $(40,965$ | $)$ | $(99,070$ |
| Gain (loss) on sale of REO | 4,725 | $(1,374$ | $)$ |
| Valuation adjustments in the period | $(5,177$ | $)(15,061$ | $)$ |
| Balance, end of period | $\$ 15,778$ | $\$ 42,965$ | $\$ 100,09$ |$)$

The following table shows REO by type and geographic location by state as of December 31, 2012 (dollars in thousands):

|  | Washington | Oregon | Idaho | Total |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Commercial real estate | $\$ 390$ | $\$-$ | $\$ 199$ | $\$ 589$ |  |
| Land development—commercial | - | - | 177 | 177 | 9,682 |
| Land development—residential | 3,174 | 6,438 | 70 | 365 |  |
| Agricultural land | 365 | - | - | 4,965 |  |
| One- to four-family real estate | 1,866 | 3,099 | - | $\$ 15,778$ |  |
| Total REO | $\$ 5,795$ | $\$ 9,537$ | $\$ 446$ | $\%$ |  |
| Percent of total REO | 36.7 | $\%$ | 60.5 | $\%$ | 2.8 |

REO properties are recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan, establishing a new cost basis. Subsequently, REO properties are carried at the lower of the new cost basis or updated fair market values, based on updated appraisals of the underlying properties, as received. Valuation allowances on the carrying value of REO may be recognized based on updated appraisals or on management's authorization to reduce the selling price of a property.

## Note 8: PROPERTY AND EQUIPMENT

Land, buildings and equipment owned by the Company and its subsidiaries at December 31, 2012 and 2011 are summarized as follows (in thousands):

|  | December 31 |  |
| :--- | :--- | :--- |
|  | 2012 | 2011 |
| Buildings and leasehold improvements | $\$ 95,270$ | $\$ 95,374$ |
| Furniture and equipment | 61,519 | 56,387 |
| Less accumulated depreciation | $(87,646$ | $)(80,949$ |
| Subtotal | 69,143 | 70,812 |
| Land | 19,974 | 20,623 |
| Property and equipment, net | $\$ 89,117$ | $\$ 91,435$ |

The Company's depreciation expense related to property and equipment was $\$ 7.8$ million, $\$ 8.6$ million, and $\$ 9.2$ million for the years ended December 31, 2012, 2011 and 2010, respectively. The Company's rental expense was $\$ 7.1$ million, $\$ 6.7$ million, and $\$ 6.8$ million for the years ended December 31, 2012, 2011 and 2010, respectively.

The Company's obligations under long-term property leases over the next five years is as follows:

Year
2013
2014
2015
2016
2017
Thereafter

Amount
$\$ 6.8$ million
6.0 million
3.9 million
3.0 million
2.2 million
9.4 million

## Note 9: DEPOSITS

Deposits consist of the following at December 31, 2012 and 2011 (dollars in thousands):

$$
\text { December } 31
$$

|  | 2012 |  | 2011 |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | Amount | Percent of | Amount | Percent of |  |
| Total |  |  |  |  |  |
| Non-interest-bearing checking | $\$ 981,240$ | 27.6 | $\%$ | $\$ 777,563$ | 22.4 |
| Interest-bearing checking | 410,316 | 11.5 | 362,542 | 10.4 |  |
| Regular savings accounts | 727,957 | 20.5 | 669,596 | 19.3 |  |
| Money market accounts | 408,998 | 11.5 | 415,456 | 11.9 |  |
| Total transaction and savings accounts | $2,528,511$ | 71.1 | $2,225,157$ | 64.0 |  |
| Certificates of deposit: |  |  |  |  |  |
| Up to 1.00\% | 792,674 | 22.3 | 701,593 | 20.2 |  |
| $1.01 \%$ to $2.00 \%$ | 155,144 | 4.3 | 394,285 | 11.3 |  |
| $2.01 \%$ to 3.00\% | 59,094 | 1.6 | 96,334 | 2.8 |  |
| $3.01 \%$ to $4.00 \%$ | 12,881 | 0.4 | 19,495 | 0.6 |  |
| 4.01\% and greater | 9,500 | 0.3 | 38,790 | 1.1 |  |
| Total certificates of deposit | $1,029,293$ | 28.9 | $1,250,497$ | 36.0 |  |
| Total deposits | $\$ 3,557,804$ | 100.0 | $\%$ | $\$ 3,475,654$ | 100.0 |
| Included in total deposits: |  |  |  | $\%$ |  |
| Public transaction accounts | $\$ 79,955$ | 2.2 | $\%$ | $\$ 72,064$ | 2.1 |

Deposits at December 31, 2012 and 2011 included deposits from the Company's directors, executive officers and related entities totaling $\$ 8.9$ million and $\$ 11.1$ million, respectively.

Scheduled maturities and weighted average interest rates of certificate accounts at December 31, 2012 and 2011 are as follows (dollars in thousands):

|  | December 31 <br> 2012 |  |  | 2011 |
| :--- | :--- | :--- | :--- | :--- |

Included in total deposits are certificate of deposit accounts in excess of \$100,000 totaling \$571 million and \$734 million at December 31, 2012 and 2011, respectively. Interest expense on certificate of deposit accounts in excess of $\$ 100,000$ totaled $\$ 6.7$ million for the year ended December 31, 2012 and $\$ 11.1$ million for the year ended December 31, 2011.

The following table sets forth the deposit activities for the years ended December 31, 2012, 2011 and 2010 (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
| Balance at beginning of year | 2012 | 2011 | 2010 |
| Net increase (decrease) before interest credited | $\$ 3,475,654$ | $\$ 3,591,198$ | $\$ 3,865,550$ |
| Interest credited | 67,043 | $(141,708$ | $(326,672$ |
| Net increase (decrease) in deposits | 15,107 | 26,164 | 52,320 |
| Balance at end of year | 82,150 | $(115,544$ | $(274,352$ |$)$

Deposit interest expense by type for the years ended December 31, 2012, 2011 and 2010 was as follows (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Certificates of deposit | $\$ 11,458$ | $\$ 19,752$ | $\$ 40,569$ |
| Demand, interest-bearing-checking and money market accounts | 1,824 | 3,293 | 6,598 |
| Regular savings | 1,825 | 3,119 | 5,153 |
|  | $\$ 15,107$ | $\$ 26,164$ | $\$ 52,320$ |

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## Note 10: ADVANCES FROM FEDERAL HOME LOAN BANK OF SEATTLE

Utilizing a blanket pledge, qualifying loans receivable at December 31, 2012 were pledged as security for FHLB borrowings and there were no securities pledged as collateral as of December 31, 2012 or 2011. At December 31, 2012 and 2011, FHLB advances were scheduled to mature as follows (dollars in thousands):

December 31

|  | 2012 |  | 2011 |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | Amount | Weighted | Average Rate | Amount | Weighted <br> Average Rate |
| Due in one year or less | $\$ 10,000$ | 2.38 | $\%-$ | - | $\%$ |
| Due after one year through three years | - | - | 10,000 | 2.38 |  |
| Due after three years through five years | - | - | - | - |  |
| Due after five years | 210 | 5.94 | 217 | 5.94 |  |
| Total FHLB advances, at par | 10,210 | 2.45 | 10,217 | 2.45 |  |
| Fair value adjustment | 94 |  | 316 |  |  |
| Total FHLB advances, carried at fair value | $\$ 10,304$ |  | $\$ 10,533$ |  |  |

The maximum, average outstanding and year-end balances (excluding fair value adjustments) and average interest rates on advances from the FHLB were as follows for the years ended December 31, 2012, 2011 and 2010 (dollars in thousands):

|  | Years Ended December 31 |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |  |
|  | $\$ 10,216$ | $\$ 36,522$ | $\$ 66,028$ |  |
| Maximum outstanding at any month end, at par | 10,215 | 14,699 | 51,411 |  |
| Average outstanding, at par | 10,210 | 10,217 | 43,023 |  |
| Year-end outstanding, at par |  |  |  |  |
| Weighted average interest rates: | 2.49 | $\%$ | 2.52 | $\%$ |
| Annual | 2.45 | $\%$ | 2.45 | $\%$ |
| End of period | $\$ 254$ | $\$ 370$ | $\$ 1,67$ | $\%$ |
| Interest expense during the period |  |  | $\$ 18$ |  |

As of December 31, 2012, Banner Bank has established a borrowing line with the FHLB to borrow up to 35\% of its total assets, contingent on having sufficient qualifying collateral and ownership of FHLB stock. Islanders Bank has a similar line of credit, although it may borrow up to $25 \%$ of its total assets, also contingent on collateral and FHLB stock. At December 31, 2012, the maximum total FHLB credit line was $\$ 889$ million and $\$ 26$ million for Banner Bank and Islanders Bank, respectively.

## Note 11: OTHER BORROWINGS

Other borrowings consist of retail repurchase agreements, other term borrowings and Federal Reserve Bank borrowings.

Retail Repurchase Agreements: At December 31, 2012, retail repurchase agreements carry interest rates ranging from $0.20 \%$ to $0.70 \%$, payable at maturity, and are secured by the pledge of certain mortgage-backed and agency securities with a carrying value of $\$ 109$ million. Banner Bank has the right to pledge or sell these securities, but they must replace them with substantially the same security. There were no wholesale repurchase agreements and other term borrowings, such as Fed Funds, outstanding as of December 31, 2012 and 2011.

Federal Reserve Bank of San Francisco and Other Borrowings: Banner Bank periodically borrows funds on an overnight basis from the Federal Reserve Bank through the Borrower-In-Custody (BIC) program. Such borrowings

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are secured by a pledge of eligible loans. At December 31, 2012, based upon available unencumbered collateral, Banner Bank was eligible to borrow $\$ 595$ million from the Federal Reserve Bank, although, at that date, as well as at December 31, 2011, the Bank had no funds borrowed under this arrangement. There were no other borrowings at December 31, 2012.

A summary of all other borrowings at December 31, 2012 and 2011 by the period remaining to maturity is as follows (dollars in thousands):

|  | At or for the Years Ended December 31 |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2012 |  | 2011 |  |
|  | Amount | Weighted Average Rate | Amount | Weighted Average Rate |
| Retail repurchase agreements: |  |  |  |  |
| Due in one year or less | \$76,633 | 0.30 \% | \$ 102,131 | 0.29 \% |
| Total year-end outstanding | \$76,633 | 0.30 | \$ 102,131 | 0.29 |
| Average outstanding | \$90,017 | 0.31 | \$ 103,704 | 0.34 |
| Maximum outstanding at any month-end | 100,949 | n/a | 125,136 | $\mathrm{n} / \mathrm{a}$ |
| Temporary liquidity guarantee program notes: ${ }^{(1)}$ |  |  |  |  |
| Due in one year or less | \$- | \% | \$49,997 | 3.82 \% |
| Total year-end outstanding | \$- | - | \$49,997 | 3.82 |
| Average outstanding | \$ 12,158 | 3.92 | \$49,993 | 3.82 |
| Maximum outstanding at any month-end | 49,999 | n/a | 49,997 | $\mathrm{n} / \mathrm{a}$ |

(1) These notes matured and were repaid on March 31, 2012. Weighted average rate includes FDIC guarantee fee and amortization of origination costs.

The table below summarizes interest expense for other borrowings for the years ended December 31, 2012, 2011 and 2010 (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
| Retail repurchase agreements | 2012 | 2011 | 2010 |
| FDIC guaranteed debt | $\$ 281$ | $\$ 356$ | $\$ 539$ |
| Total expense | 477 | 1,909 | 1,909 |

## NOTE 12: JUNIOR SUBORDINATED DEBENTURES AND MANDATORILY REDEEMABLE TRUST PREFERRED SECURITIES

At December 31, 2012, six wholly-owned subsidiary grantor trusts, Banner Capital Trust II, III, IV, V, VI and VII (BCT II, BCT III, BCT IV, BCT V, BCT VI and BCT VII (collectively, the Trusts)), established by the Company had issued $\$ 120$ million of trust preferred securities to third parties, as well as $\$ 3.7$ million of common capital securities, carried among other assets, which were issued to the Company. Trust preferred securities and common capital securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The Trusts used the proceeds from the offerings to purchase a like amount of junior subordinated debentures (the Debentures) of the Company. The Debentures are the sole assets of the Trusts. The Company's obligations under the debentures and related documents, taken together, constitute a full and unconditional guarantee by the Company of the obligations of the Trusts. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole on or after specific dates, at a redemption price specified in the indentures plus any accrued but unpaid interest to the redemption date. All of the trust preferred securities issued by the Trusts qualified as Tier 1 capital as of December 31, 2012, under guidance issued by the Board of Governors of the Federal Reserve System. At December 31, 2012, the Trusts comprised $\$ 69.3$ million, or $11.9 \%$ of the Company's total risk-based capital.

The following table is a summary of trust preferred securities at December 31, 2012 (dollars in thousands):

| Name of Trust | Aggregate <br> Liquidation <br> Amount <br> of Trust <br> Preferred <br> Securities | Aggregat <br> Liquidati <br> Amount <br> of <br> Common <br> Capital <br> Securities | Aggregate Principal <br> Amount of Junior <br> Subordinat <br> Debentures | Stated Maturity d | Current <br> Interest <br> Rate | Reset <br> Period | Interest Rate Spread | Interest <br> Deferral <br> Period | Redemption Option |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | \$ 15,000 | \$ 464 | \$ 15,464 | 2033 | 3.69 \% | Quarterly | LIBOR + | Consecutive | January 7, |
| Trust II |  |  |  |  |  |  | 3.35\% | Quarters | 2008 |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | 15,000 | 465 | 15,465 | 2033 | 3.24 | Quarterly | LIBOR + | Consecutive | October 8, |
| Trust III |  |  |  |  |  |  | 2.90\% | Quarters | 2008 |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | 15,000 | 465 | 15,465 | 2034 | 3.19 | Quarterly | LIBOR + | Consecutive | April 7, |
| Trust IV |  |  |  |  |  |  | 2.85\% | Quarters | 2009 |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | 25,000 | 774 | 25,774 | 2035 | 1.88 | Quarterly | LIBOR + | Consecutive | November |
| Trust V |  |  |  |  |  |  | 1.57\% | Quarters | 23, 2010 |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | 25,000 | 774 | 25,774 | 2037 | 1.93 | Quarterly | LIBOR + | Consecutive | March 1, |
| Trust VI |  |  |  |  |  |  | 1.62\% | Quarters | 2012 |
| Banner |  |  |  |  |  |  | Three-month | 20 | On or after |
| Capital | 25,000 | 774 | 25,774 | 2037 | 1.74 | Quarterly | LIBOR + | Consecutive | July 31, |
| Trust VII |  |  |  |  |  |  | 1.38\% | Quarters | 2012 |
| Total TPS |  |  |  |  |  |  |  |  |  |
| liability at par | \$ 120,000 | \$ 3,716 | 123,716 |  | 2.42 |  |  |  |  |
| Fair value adjustment |  |  | (50,653 ) |  |  |  |  |  |  |

Total TPS
liability at
\$ 73,063
fair value
125

## Note 13: INCOME TAXES

The following table presents the components of the provision for income tax (benefit) expense included in the Consolidated Statement of Operations for the years ended December 31, 2012, 2011 and 2010 (in thousands):

Years Ended December 31
$\left.\begin{array}{lll}2012 & 2011 & 2010 \\ \$ 10,759 & \$- & \$ 3,025 \\ 841 & (3,322 & ) \\ (36,385 & ) & 3,322 \\ \$(24,785 & ) & 36,171 \\ \hline\end{array}\right)$

The following tables present the reconciliation of the provision for income taxes computed at the federal statutory rate to the actual effective rate for the years ended December 31, 2012, 2011 and 2010 (dollars in thousands):
$\begin{array}{lcl}\text { Years Ended December } 31 \\ 2012 & 2011 & 2010\end{array}$
Provision for (benefit from) income taxes computed at federal statutory rate
Increase (decrease) in taxes due to:

| Tax-exempt interest | $(1,710$ | $)(1,616$ | $)(1,471$ |
| :--- | :--- | :--- | :--- |
| Investment in life insurance | $(894$ | $)(663$ | $)(683)$ |
| State income taxes (benefit), net of federal tax offset | 539 | $(2,260$ | $)(495$ |
| Tax credits | $(788$ | $)(840$ | $)(816$ |
| Valuation allowance | $(36,385$ | $)$ | 3,322 |
| Other | 419 | 147 | 36,171 |
| Provision for (benefit from) income taxes | $\$(24,785$ | $)$ | $\$-$ |


|  | Years Ended December 31 |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |  |  |  |
| Federal income tax statutory rate | 35.0 | $\%$ | 35.0 | $\%$ | 35.0 | $\%$ |
| Increase (decrease) in tax rate due to: | $(4.3$ | $)$ | $(29.6$ | $)$ | 3.4 |  |
| Tax-exempt interest | $(2.2$ | $)$ | $(12.1$ | $)$ | 1.6 |  |
| Investment in life insurance | 1.3 |  | $(41.5$ | $)$ | 1.1 |  |
| State income taxes (benefit), net of federal tax offset | $(2.0$ | $)$ | $(15.4$ | $)$ | 1.9 |  |
| Tax credits | $(90.7$ | $)$ | 60.9 | $(82.4$ | $)$ |  |
| Valuation allowance | 1.1 | 2.7 | $(1.6$ | $)$ |  |  |
| Other | $(61.8$ | $) \%$ | $\%$ | $(41.0$ | $) \%$ |  |

The following table reflects the effect of temporary differences that gave rise to the components of the net deferred tax asset as of December 31, 2012 and 2011 (in thousands):

|  | December 31 <br> 2012 | 2011 |
| :--- | :--- | :--- |
| Deferred tax assets: |  |  |
| REO and loan loss reserves | $\$ 24,615$ | $\$ 31,156$ |
| Deferred compensation | 6,122 | 6,032 |
| Net operating loss carryforward | 26,959 | 27,992 |
| Low income housing tax credits | 4,767 | 7,202 |
| State net operating losses | 1,081 | - |
| Other | 689 | 309 |
| Total deferred tax assets | 64,233 | 72,691 |
| Deferred tax liabilities: | $(6,187$ | $)(6,137$ |
| FHLB stock dividends | $(4,061$ | $)(3,570$ |
| Depreciation | $(5,608$ | $)(4,863$ |
| Deferred loan fees, servicing rights and loan origination costs | $(1,544$ | $)(2,243$ |
| Intangibles | $(10,632$ | $)$ |
| Financial instruments accounted for under fair value accounting | $(28,032$ | $)(33,399$ |
| Total deferred tax liabilities | 36,201 | 39,379 |
| Deferred income tax asset | $(1,194$ | $)$ |
| Unrealized gain on securities available-for-sale | - | $(1,151$ |
| Valuation allowance | $\$ 35,007$ | $\$-$ |
| Deferred tax asset, net |  |  |

During the quarter ended September 30, 2010, the Company evaluated its net deferred tax asset and determined it was prudent to establish a full valuation allowance against the net asset. At each subsequent quarter-end, the Company has re-analyzed that position. During the quarter ended June 30, 2012, management analyzed the Company's performance and trends over the prior five quarters, focusing strongly on trends in asset quality, loan loss provisioning, capital position, net interest margin, core operating income and net income. Based on this analysis, management determined that a full valuation allowance was no longer appropriate and the full amount has been reversed to a zero balance as of December 31, 2012. The ultimate realization of deferred tax assets is dependent upon the existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered the scheduled reversal of deferred tax assets and liabilities, taxes paid in carryback years, projected future taxable income, available tax planning strategies, and other factors in making its assessment to reverse the deferred tax valuation allowance.

At December 31, 2012, the Company has federal and state net operating loss carryforwards of approximately $\$ 77.0$ million and $\$ 22.8$ million, respectively, which will expire, if unused, by the end of 2031. The Company has federal general business credits and state tax credit carryforwards of $\$ 3.3$ million and $\$ 600,000$, respectively, which will expire, if unused, by the end of 2031 and 2025, respectively. The Company also has alternative minimum tax credit carryforwards of approximately $\$ 1.5$ million, which are available to reduce future federal regular income taxes, if any, over an indefinite period.

As a consequence of our capital raise in June 2010, the Company experienced a change in control within the meaning of Section 382 of the Internal Revenue code of 1986, as amended. Section 382 limits the ability of a corporate taxpayer to use net operating loss carryforwards, general business credit, and recognized built-in-losses incurred prior to the change in control against income earned after the change in control. As a result of the Section 382 limitation, the Company expects it will be able to utilize approximately $\$ 6.9$ million of net operating loss carryforwards on an annual basis. Based on its analysis, the Company does not believe the change in control will impact its ability to

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utilize all of the available net operating loss carryforwards, general business credit, and recognized built-in-losses.
As of December 31, 2012, the Company has an insignificant amount of unrecognized tax benefits for uncertain tax positions, none of which would materially affect the effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will significantly increase or decrease in the next twelve months. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in the income tax expense. The amount of interest and penalties accrued for the years ended December 31, 2012 and 2011 is immaterial. The Company files consolidated income tax returns in Oregon and Idaho and for federal purposes. The tax years which remain subject to examination by the taxing authorities are the years ending December 31, 2006 through 2011.

Retained earnings (accumulated deficits) at December 31, 2012 and 2011 include approximately $\$ 5.4$ million in tax basis bad debt reserves for which no income tax liability has been booked. In the future, if this tax bad debt reserve is used for purposes other than to absorb bad debts or the Company no longer qualifies as a bank or is completely liquidated, the Company will incur a federal tax liability at the then-prevailing corporate tax rate, established as $\$ 1.9$ million at December 31, 2012.

On October 25, 2011, the Company filed amended federal income tax returns for tax years 2005, 2006, 2008 and 2009. The amended tax returns, which are under review by the Internal Revenue Service (IRS), significantly affect the timing for recognition of credit losses within previously filed income tax returns and, if approved, would result in the refund of up to $\$ 13.6$ million of previously paid taxes from the utilization of net operating loss carryback claims into prior tax years. The outcome of the anticipated IRS review is inherently uncertain and since there can be no assurance of approval of some or all of the tax carryback claims, no asset has been recognized to reflect the possible results of these amendments as of December 31, 2012. Accordingly, the Company does not anticipate recognizing any tax benefit until the results of the IRS review have been determined. We expect this review to be completed and the issue resolved during 2013.

## Note 14: EMPLOYEE BENEFIT PLANS

Employee Retirement Plans. Substantially all of the Company's employees are eligible to participate in its 401(k)/Profit Sharing Plan, a defined contribution and profit sharing plan sponsored by the Company. Employees may elect to have a portion of their salary contributed to the plan in conformity with Section 401(k) of the Internal Revenue Code. At the discretion of the Company's Board of Directors, the Company may elect to make matching and/or profit sharing contributions for the employees' benefit. For the year ended December 31, 2012, $\$ 43,000$ was expensed for $401(\mathrm{k})$ contributions. There were no contributions under the plan for the years ended December 31, 2011 and 2010. The Board of Directors has elected to make a $2 \%$ of eligible compensation matching contribution for 2013.

Supplemental Retirement and Salary Continuation Plans. Through the Banks, the Company is obligated under various non-qualified deferred compensation plans to help supplement the retirement income of certain executives, including certain retired executives, selected by resolution of the Banks' Boards of Directors or in certain cases by the former directors of acquired banks. These plans are unfunded, include both defined benefit and defined contribution plans, and provide for payments after the executive's retirement. In the event of a participant employee's death prior to or during retirement, the Bank is obligated to pay to the designated beneficiary the benefits set forth under the plan. For the years ended December 31, 2012, 2011 and 2010, expense recorded for supplemental retirement and salary continuation plan benefits totaled $\$ 879,000, \$ 848,000$, and $\$ 1.4$ million, respectively. At December 31, 2012 and 2011, liabilities recorded for the various supplemental retirement and salary continuation plan benefits totaled $\$ 12.6$ million and $\$ 12.3$ million, respectively, and are recorded in a deferred compensation liability account.

Deferred Compensation Plans and Rabbi Trusts. The Company and the Banks also offer non-qualified deferred compensation plans to members of their Boards of Directors and certain employees. The plans permit each participant to defer a portion of director fees, non-qualified retirement contributions, salary or bonuses for future receipt. Compensation is charged to expense in the period earned. In connection with its acquisitions, the Company also assumed liability for certain deferred compensation plans for key employees, retired employees and directors.

In order to fund the plans' future obligations, the Company has purchased life insurance policies or other investments, including Banner Corporation common stock, which in certain instances are held in irrevocable trusts commonly referred to as "Rabbi Trusts." As the Company is the owner of the investments and the beneficiary of the insurance policies, and in order to reflect the Company's policy to pay benefits equal to the accumulations, the assets and liabilities are reflected in the Consolidated Statements of Financial Condition. Banner Corporation common stock held for such plans is reported as a contra-equity account and was recorded at an original cost of $\$ 7.2$ million at

December 31, 2012 and $\$ 7.7$ million at December 31, 2011. At December 31, 2012 and 2011, liabilities recorded in connection with deferred compensation plan benefits totaled $\$ 8.5$ million ( $\$ 7.2$ million in contra-equity) and $\$ 8.3$ million ( $\$ 7.7$ million in contra-equity), respectively, and are recorded in deferred compensation or equity as appropriate.

The Banks have purchased, or acquired through mergers, life insurance policies in connection with the implementation of certain executive supplemental retirement, salary continuation and deferred compensation retirement plans, as well as additional policies not related to any specific plan. These policies provide protection against the adverse financial effects that could result from the death of a key employee and provide tax-exempt income to offset expenses associated with the plans. It is the Banks' intent to hold these policies as a long-term investment. However, there will be an income tax impact if the Banks choose to surrender certain policies. Although the lives of individual current or former management-level employees are insured, the Banks are the owners and sole or partial beneficiaries. At December 31, 2012 and 2011, the cash surrender value of these policies was $\$ 59.9$ million and $\$ 58.6$ million, respectively. The Banks are exposed to credit risk to the extent an insurance company is unable to fulfill its financial obligations under a policy. In order to mitigate this risk, the Banks use a variety of insurance companies and regularly monitor their financial condition.

Note 15: EMPLOYEE STOCK OWNERSHIP PLAN AND TRUST
The Company established for eligible employees an ESOP and related trust that became effective upon the former mutual holding company's conversion to a stock-based holding company. Eligible employees of Banner Bank as of January 1, 1995 and eligible employees of the Banks or Company employed after such date who have been credited with at least 1,000 hours during a twelve-month period are participants.

In 1995, the ESOP borrowed $\$ 8.7$ million from the Company in order to purchase the common stock. The loan is repaid principally from the Company's contributions to the ESOP over a period not to exceed 25 years, and the collateral for the loan is the unreleased, restricted common stock purchased by the ESOP. Contributions to the ESOP are discretionary. The interest rate for the loan is $8.75 \%$. Shares are released to participants for allocation based on the cumulative debt service paid to the Company by the ESOP divided by cumulative debt service paid to
date plus the scheduled debt service remaining. Dividends on allocated shares are distributed to the participants as additional earnings. Dividends on unallocated shares are used to reduce the Company's contribution to the ESOP or offset administrative expenses of the ESOP.

Participants generally become $100 \%$ vested in their ESOP account after seven years of credited service or if their service was terminated due to death, early retirement, permanent disability or a change in control of the Company. Prior to the completion of one year of credited service, a participant who terminates employment for reasons other than death, retirement, disability or change in control of the Company will not receive any benefit. Forfeitures will be reallocated among remaining participating employees in the same proportion as contributions. Benefits are payable upon death, retirement, early retirement, disability or separation from service. The contributions to the ESOP are not fixed, so benefits payable under the ESOP cannot be estimated.

No ESOP contributions were made for the years ended December 31, 2012, 2011 or 2010 and no payments were made on the loan in those years. Dividends on unallocated ESOP shares for the year ended December 31, 2012, 2011 and 2010 were $\$ 1,374, \$ 3,434$ and $\$ 9,615$, respectively. As of December 31, 2012, the Company had 34,340 unearned, restricted shares remaining to be released to the ESOP. The fair value of unearned, restricted shares held by the ESOP trust was $\$ 1.1$ million at December 31, 2012. The ESOP held 129,271 allocated, earned shares at December 31, 2012. No payments were made on the loan for the years ended December 31, 2012, 2011 and 2010. The balance of the ESOP loan was $\$ 2.5$ million at December 31, 2012, with accrued interest of $\$ 1.3$ million.

## Note 16: STOCK-BASED COMPENSATION PLANS

The Company operates the following stock-based compensation plans as approved by the shareholders: the 1996 Stock Option Plan, the 1998 Stock Option Plan and the 2001 Stock Option Plan (collectively, SOPs) and the Banner Corporation 2012 Restricted Stock Plan. In addition, during 2006 the Board of Directors approved the Banner Corporation Long-Term Incentive Plan, an account-based benefit plan which for reporting purposes is considered a stock appreciation rights plan.

Restricted Stock Grants. The Company granted shares of restricted common stock to Mark J. Grescovich, President and Chief Executive Officer of Banner Bank and Banner Corporation on August 22, 2010 and on August 23, 2011. The restricted shares were granted to Mr. Grescovich in accordance with his employment agreement, which, as an inducement material to his joining the Company and the Bank, provided for the granting of restricted shares on the six-month and the 18-month anniversaries of the effective date of the agreement. The shares vest in one-third annual increments over the subsequent three-year periods following the grants. Under the 2012 Restricted Stock Plan, which was approved by shareholders on April 24, 2012, the Company is authorized to issue up to 300,000 shares of its common stock to provide a means for attracting and retaining highly skilled officers of Banner Corporation and its affiliates. Shares granted under the Plan have a minimum vesting period of three years. The Plan will continue in effect for a term of ten years, after which no further awards may be granted. Concurrent with the approval of the Plan was the approval of a grant of $\$ 300,000$ of restricted stock ( 14,535 restricted shares) to Mr. Grescovich. Subsequent to that initial issuance from this new plan was the issuance of 78,500 additional shares to certain other officers of the Company. All of these shares also vest in one-third annual increments over the subsequent three-year period following the grant.

The expense associated with restricted stock was $\$ 434,000$ and $\$ 111,000$ and 28,000 respectively, for the years ended December 31, 2012, 2011 2010. Unrecognized compensation expense for these awards as of December 31, 2012 was $\$ 1.8$ million and will be amortized over the next 33 months.

A summary of the Company's unvested Restricted Stock activity during the years ended December 31, 2010, 2011 and 2012 follows:

|  | Shares | Weighted <br> Average <br> Grant-Date |
| :--- | :--- | :--- |
| Unvested at December 31, 2009 |  | Fair Value |
| Granted | - | $\$-$ |
| Vested | 16,565 | 15.09 |
| Forfeited | - | - |
| Unvested at December 31, 2010 | - | - |
| Granted | 16,565 | 15.09 |
| Vested | 17,692 | 14.13 |
| Forfeited | $(5,522$ | 15.09 |
| Unvested at December 31, 2011 | - | - |
| Granted | 28,735 | 14.50 |
| Vested | 92,035 | 21.77 |
| Forfeited | $(11,419$ | 14.60 |
| Unvested at December 31, 2012 | $(1,500$ | 21.94 |

Stock Options. Under the SOPs, Banner reserved 2,284,186 shares for issuance pursuant to the exercise of stock options to be granted to directors and employees. Authority to grant additional options under the 1996 Stock Option Plan terminated on July 26, 2006. Authority to grant additional options under the 1998 Stock Option Plan terminated on July 24, 2008 with all options having been granted. Authority to grant additional options under the 2001 Stock Option Plan terminated on April 20, 2011. The exercise price of the stock options is set at $100 \%$ of the fair market value of the stock price on the date of grant. Options granted vest at a rate of $20 \%$ per year from the date of grant and any unexercised incentive stock options will expire ten years after date of grant or 90 days after employment or service ends.

During the years ended December 31, 2012, 2011 and 2010, the Company did not grant any stock options. Additionally, there were no significant modifications made to any stock option grants during the period. The fair values of stock options granted are amortized as compensation expense on a straight-line basis over the vesting period of the grant.

For the years ended December 31, 2012, 2011 and 2010, stock-based compensation costs related to the SOPs were $\$ 7,000, \$ 25,000$ and $\$ 53,000$, respectively. The SOPs' stock option grant compensation costs are generally based on the fair value calculated from the Black-Scholes option pricing on the date of the grant award. The Black-Scholes model assumes an expected stock price volatility based on the historical volatility at the date of the grant and an expected term based on the remaining contractual life of the vesting period. The Company bases the estimate of risk-free interest rate on the Treasury's Constant Maturities Indices in effect at the time of the grant. The dividend yield is based on the current quarterly dividend in effect at the time of the grant.

The Company is required to estimate potential forfeitures of stock option grants and adjust compensation cost recorded accordingly. The estimate of forfeitures is 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 are recognized through a cumulative catch-up adjustment in the period of change and also impact the amount of stock compensation expense to be recognized in future periods.

A summary of the Company's stock option award activity (post reverse split) for the years ended December 31, 2010, 2011 and 2012 follows:

|  | Shares | Weighted <br> Average <br> Exercise Price | Weighted <br> Average <br> Remaining <br> Contractual <br> Term, In Years | Aggregate <br> Intrinsic Value |
| :--- | :--- | :--- | :--- | :--- |
|  |  | n0,769 | $\$ 156.38$ | 3.8 |

Outstanding at December 31, 2012, net of expected forfeitures
Exercisable at December 31, 2012
42,521 -
n/a n/a
1.75

The intrinsic value of stock options is calculated as the amount by which the market price of Banner's common stock exceeds the exercise price at the time of exercise or the end of the period as applicable.

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A summary of the Company's unvested stock option activity for the years ended December 31, 2010, 2011 and 2012 follows:

|  | Shares | Weighted Average <br> Grant-Date <br> Fair Value |
| :--- | :--- | :--- |
| Unvested at December 31, 2009 | 5,247 | $\$ 54.74$ |
| Granted | - | - |
| Vested | $(2,247$ | 57.47 |
| Forfeited | - | - |
| Unvested at December 31, 2010 | 3,000 | 52.78 |
| Granted | - | - |
| Vested | $(1,500$ | 57.12 |
| Forfeited | - | - |
| Unvested at December 31, 2011 | 1,500 | 48.37 |
| Granted | - | - |
| Vested | $(1,500$ | 48.37 |
| Forfeited | - | - |

At December 31, 2012, financial data pertaining to outstanding stock options was as follows:

| Exercise Price | Weighted Average |  | Weighted Average | Weighted Average |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Exercise Price of | Number of Option | Option Shares | Exercise Price of | Remaining |
|  | Option Shares | Shares Granted | Vested and | Option Shares | Contractual Life |
|  | Granted |  | Exercisable | Exercisable |  |
| \$0.00 to \$110.00 | \$109.69 | 11,193 | 11,193 | \$109.69 | 0.6 years |
| $\begin{aligned} & \$ 110.01 \text { to } \\ & \$ 184.00 \end{aligned}$ | 156.52 | 11,657 | 11,657 | 156.52 | 0.3 years |
| $\begin{aligned} & \$ 184.01 \text { to } \\ & \$ 220.00 \end{aligned}$ | 203.76 | 9,643 | 9,643 | 203.76 | 0.9 years |
| greater than $\$ 220.00$ | 221.97 | 10,028 | 10,028 | 221.97 | 0.5 years |
|  | 173.98 | 42,521 | 42,521 | 173.98 |  |

During the year ended December 31, 2012, there were no exercises of stock options. Cash was not used to settle any equity instruments previously granted. The Company issues shares from authorized but unissued shares upon the exercise of stock options. The Company does not currently expect to repurchase shares from any source to satisfy such obligations under the SOPs.

The following are the stock-based compensation costs recognized in the Company's consolidated statements of operations for the years ended December 31, 2012, 2011 and 2010 (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Salary and employee benefits | $\$ 11$ | $\$ 39$ | $\$ 83$ |
| Decrease in provision for income taxes | $(4$ | $)$ | $(14$ |
| Decrease in equity, net | $\$ 7$ | $\$ 25$ | $(30$ |

Banner Corporation Long-Term Incentive Plan: In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is directly related to changes in the value of Company common stock, dividends declared on Company common stock
and changes in Banner Bank's average earnings rate, and is considered a stock appreciation right (SAR). Each SAR entitles the holder to receive cash, upon vesting, equal to the excess of the fair market value of a share of the Company's common stock on the date of exercise over the fair market value of such share on the date granted plus, for some grants, the dividends declared on the stock from the date of grant to the date of vesting. On April 27, 2008, the Board of Directors amended the Plan and also authorized the repricing of certain awards to non-executive officers based upon the price of Banner common stock three business days

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following the public announcement of the Company's earnings for the quarter ended March 31, 2008. The primary objective of the Plan is to create a retention incentive by allowing officers who remain with the Company or the Banks for a sufficient period of time to share in the increases in the value of Company stock. Detailed information with respect to the Plan and the amendments to the Plan were disclosed on Forms 8-K filed with SEC on July 19, 2006 and May 6, 2008. The Company re-measures the fair value of SARs each reporting period until the award is settled and compensation expense is recognized each reporting period for changes in fair value and vesting. The Company recognized compensation expense of $\$ 314,000, \$ 148,000$, and $\$ 228,000$, respectively, for the years ended December 31, 2012, 2011 and 2010 related to the increase in the fair value of SARs and additional vesting during the period. At December 31, 2012, the aggregate liability related to SARs was $\$ 591,000$ and is included in deferred compensation.

## Note 17: PREFERRED STOCK AND RELATED WARRANT

On November 21, 2008, as part of the Capital Purchase Program established by the Treasury under the Emergency Economic Stabilization Act of 2008 (the EESA), the Company entered into a Purchase Agreement with Treasury pursuant to which the Company issued and sold to Treasury 124,000 shares of Series A Preferred Stock, having a liquidation preference of $\$ 1,000$ per share ( $\$ 124$ million liquidation preference in the aggregate), and as more fully explained below, a ten-year warrant to purchase up to 243,998 shares (post reverse-split) of the Company's common stock, par value $\$ 0.01$ per share, at an initial exercise price of $\$ 76.23$ per share (post reverse-split), for an aggregate purchase price of $\$ 18.6$ million in cash. The warrant issued is immediately exercisable, in whole or in part, has a ten-year term and the number of shares is subject to certain customary anti-dilution and other adjustments. The warrant is not subject to any contractual restrictions on transfer. The Company has granted the warrant holder piggyback registration rights for the warrant and the common stock underlying the warrant and has agreed to take such other steps as may be reasonably requested to facilitate the transfer of the warrant and the common stock underlying the warrant. The holder of the warrant is not entitled to any common stockholder rights. The Treasury agreed not to exercise voting power with respect to any shares of common stock of the Company issued to it upon exercise of the warrant.

On March 29, 2012, the Company's $\$ 124$ million of Series A Preferred Stock was sold by the Treasury as part of its efforts to manage and recover its investments under the TARP. While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrant to purchase up to $\$ 18.6$ million in Banner common stock.

Subsequent to March 29, 2012, the Company repurchased or redeemed all of its Series A Preferred Stock, realizing gains aggregating $\$ 2.5$ million, which was partially offset by accelerated amortization of a portion of the initial discount recorded at the issuance of the Series A Preferred Stock. As a result, the accrual for the quarterly dividend was reduced by the retirement of these shares. As of December 31, 2012, all of the Series A Preferred Stock had been retired.

## Note 18: REGULATORY CAPITAL REQUIREMENTS

Banner Corporation is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended (BHCA), and the regulations of the Federal Reserve. Banner Bank and Islanders Bank, as state-chartered federally insured commercial banks, are subject to the capital requirements established by the FDIC. The Federal Reserve requires Banner to maintain capital adequacy that generally parallels the FDIC requirements.

Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is $10 \%$ or more, its ratio of core capital to risk-weighted assets is $6 \%$ or more, its ratio of core capital to adjusted total assets (leverage ratio) is $5 \%$ or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than $8 \%$, a core capital to risk-weighted assets ratio of not less than $4 \%$, and a leverage ratio of not less than $4 \%$. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

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

FDIC regulations recognize two types, or tiers, of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common stockholders' equity and qualifying noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is recognized up to $100 \%$ of Tier 1 capital for risk-based capital purposes (after any deductions for disallowed intangibles and disallowed deferred tax assets), includes such items as qualifying general loan loss reserves (up to $1.25 \%$ of risk-weighted assets), cumulative perpetual preferred stock, long-term preferred stock, certain perpetual preferred stock, hybrid capital instruments including mandatory convertible debt, term subordinated debt, intermediate-term preferred stock (original average maturity of at least five years), and net unrealized holding gains on equity

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securities (subject to certain limitations); provided, however, the amount of term subordinated debt and intermediate term preferred stock that may be included in Tier 2 capital for risk-based capital purposes is limited to $50 \%$ of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least $3 \%$ to $4 \%$ of total assets. The FDIC retains the right to require a particular institution to maintain a higher capital level based on an institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight- $0 \%, 20 \%, 50 \%$ or $100 \%$-based on the relative risk of the category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least $8 \%$, and the ratio of Tier 1 capital to risk-weighted assets must be at least $4 \%$. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks.

FDIC capital requirements are designated as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The FDIC capital regulations state that, where the FDIC determines that the financial history or condition, including off-balance-sheet risk, managerial resources and/or the future earnings prospects of a bank are not adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of capital for the bank is greater than the minimum standards established in the regulation.

The following table shows the regulatory capital ratios of the Company and the Banks and the minimum regulatory requirements (dollars in thousands):


At December 31, 2012, Banner Corporation and the Banks each exceeded all regulatory capital adequacy requirements. There have been no conditions or events since December 31, 2012 that have materially adversely changed the Tier 1 or Tier 2 capital of the Company or the Banks. However, events beyond the control of the Banks, such as weak or depressed economic conditions in areas where the Banks have most of their loans, could adversely affect future earnings and, consequently, the ability of the Banks to meet their respective capital requirements. The Company may not declare or pay cash dividends on, or repurchase, any of its shares of common stock if the effect thereof would cause equity to be reduced below applicable regulatory capital maintenance requirements or if such declaration and payment would otherwise violate regulatory requirements.

## Note 19: CONTINGENCIES

In the normal course of business, the Company and/or its subsidiaries have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. These claims and counter-claims typically arise during the course of collection efforts on problem loans or with respect to action to enforce liens on properties in which the Banks hold a security interest. Based upon the information known to management at this time, the Company and the Banks are not a party to any legal proceedings that management believes would have a material adverse effect on the results of operations or consolidated financial position at December 31, 2012.

In connection with certain asset sales, the Banks typically make representations and warranties about the underlying assets conforming to specified guidelines. If the underlying assets do not conform to the specifications, the Bank may have an obligation to repurchase the assets or indemnify

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the purchaser against any loss. The Banks believe that the potential for material loss under these arrangements is remote. Accordingly, the fair value of such obligations is not material.

In February 2009, for the first time in its history, the State of Washington's Public Deposit Protection Commission assessed all Qualified Public Depositories participating in the State's public deposit program an amount that, in aggregate, covered the uninsured portion of the public funds on deposit at a failed Washington bank. Generally, the maximum liability should any member(s) of the State's public deposit program default on its uninsured public funds is limited to $10 \%$ of the public funds held by the Banks. A similar program is also in place in Oregon, where Banner Bank also holds public deposits. Should other bank failures occur in either state, the Banks could be subject to additional assessments; however, the rules for participation have been revised to require $100 \%$ collateralization of these deposits, which serves to significantly limit the contingent liability that currently exists for Qualified Public Depositories. As a result of these collateralization requirements, the Banks have generally sought to reduce their reliance on public funds since February 2009; however, public funds increased by $\$ 1$ million in 2012 after decreasing $\$ 7$ million and $\$ 20$ million in the years ended December 31, 2011 and 2010, respectively. Public funds totaled $\$ 140$ million at December 31, 2012.

## Note 20: INTEREST RATE RISK

The financial condition and operation of the Company are influenced significantly by general economic conditions, including the absolute level of interest rates as well as changes in interest rates and the slope of the yield curve. The Company's profitability is dependent to a large extent on its net interest income, which is the difference between the interest received from its interest-earning assets and the interest expense incurred on its interest-bearing liabilities.

The activities of the Company, like all financial institutions, inherently involve the assumption of interest rate risk. Interest rate risk is the risk that changes in market interest rates will have an adverse effect on the institution's earnings and underlying economic value. Interest rate risk is determined by the maturity and repricing characteristics of an institution's assets, liabilities and off-balance-sheet contracts. Interest rate risk is measured by the variability of financial performance and economic value resulting from changes in interest rates. Interest rate risk is the primary market risk impacting the Company's financial performance.

The greatest source of interest rate risk to the Company results from the mismatch of maturities or repricing intervals for rate-sensitive assets, liabilities and off-balance-sheet contracts. Additional interest rate risk results from mismatched repricing indices and formula (basis risk and yield curve risk), product caps and floors, and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to the Company.

The Company's primary monitoring tool for assessing interest rate risk is asset/liability simulation modeling, which is designed to capture the dynamics of balance sheet, interest rate and spread movements, and to quantify variations in net interest income and economic value of equity resulting from those movements under different rate environments. Another monitoring tool used by the Company to assess interest rate risk is gap analysis. The matching of repricing characteristics of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are interest sensitive and by monitoring the Company's interest sensitivity gap. Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible, and considers that the Company's current level of interest rate risk is reasonable.

## Note 21: OTHER INTANGIBLE ASSETS AND MORTGAGE SERVICING RIGHTS

At December 31, 2012, intangible assets consisted primarily of CDI, which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the
customer relationships associated with the deposits.
The Company amortizes CDI over their estimated useful life and reviews them at least annually for events or circumstances that could impact their recoverability. The CDI assets shown in the table below represent the value ascribed to the long-term deposit relationships acquired in three separate bank acquisitions during 2007. These intangible assets are being amortized using an accelerated method over estimated useful lives of eight years. The CDI assets are not estimated to have a significant residual value. Other intangible assets are amortized over their useful lives and are also reviewed for impairment.

The following table summarizes the changes in the Company's other intangibles for the years ended December 31, 2010, 2011 and 2012 (in thousands):

Balance, December 31, 2009
Core Deposit

Amortization
Balance, December 31, 2010
Amortization
Balance, December 31, 2011
Amortization
Balance, December 31, 2012
Estimated amortization expense in future years with respect to existing intangibles as of December 31, 2012 (in thousands):

Year Ended
December 31, 2013
December 31, 2014
December 31, 2015
Net carrying amount
Core Deposit
Intangibles
$\$ 1,908$
1,724
598
$\$ 4,230$

| Other | Total |
| :--- | :--- |
| $\$-$ | $\$ 1,908$ |
| - | 1,724 |
| - | 598 |
| $\$-$ | $\$ 4,230$ |

Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially reported at fair value and are amortized in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Mortgage servicing rights are subsequently evaluated for impairment based upon the fair value of the rights compared to the amortized cost (remaining unamortized initial fair value). If the fair value is less than the amortized cost, a valuation allowance is created through an impairment charge to servicing fee income. However, if the fair value is greater than the amortized cost, the amount above the amortized cost is not recognized in the carrying value. In 2012, the Company recorded $\$ 400,000$ in impairment charges against mortgage servicing rights. In 2011 and in 2010, the Company did not record an impairment charge. Loans serviced for others totaled $\$ 1.031$ billion and $\$ 773$ million at December 31, 2012 and 2011, respectively. Custodial accounts maintained in connection with this servicing totaled $\$ 5.0$ million and $\$ 3.4$ million at December 31, 2012 and 2011, respectively.

An analysis of the mortgage servicing rights for the years ended December 31, 2012, 2011 and 2010 is presented below (in thousands):

|  | Years Ended December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 | 2010 |
| Balance, beginning of the year | $\$ 5,584$ | $\$ 5,441$ | $\$ 5,703$ |
| Amounts capitalized | 3,662 | 1,928 | 1,736 |
| Amortization $(1)$ | $(2,602$ | $)(1,785$ | $(1,998$ |
| Valuation adjustments in the period | $(400$ | $)$ | - |
| Balance, end of the year | $\$ 6,244$ | $\$ 5,584$ | $\$ 5,441$ |

(1) Amortization of mortgage servicing rights is recorded as a reduction of loan servicing income and any unamortized balance is fully written off if the loan repays in full.

## Note 22: FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company has elected to record certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at
the measurement date (that is, not a forced liquidation or distressed sale). The GAAP standard (ASC 820, Fair Value Measurements) establishes a consistent framework for measuring fair value and disclosure requirements about fair value measurements. Among other things, the standard requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's estimates for market assumptions. These two types of inputs create the following fair value hierarchy:

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Level 1 - Quoted prices in active markets for identical instruments. An active market is a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2 - Observable inputs other than Level 1 including quoted prices in active markets for similar instruments, quoted prices in less active markets for identical or similar instruments, or other observable inputs that can be corroborated by observable market data. Our use of Level 2 measurements is generally based upon a matrix pricing model from an investment reporting and valuation service. Matrix pricing is a mathematical technique used principally to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities.

Level 3 - Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs from non-binding single dealer quotes not corroborated by observable market data. In developing Level 3 measurements, management incorporates whatever market data might be available and uses discounted cash flow models where appropriate. These calculations include projections of future cash flows, including appropriate default and loss assumptions, and market based discount rates.

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values. Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Items Measured at Fair Value on a Recurring Basis:
Banner records trading account securities, securities available-for-sale, FHLB debt, junior subordinated debentures and certain derivative transactions at fair value on a recurring basis.

The securities assets primarily consist of U.S. Government and agency obligations, municipal bonds, corporate bonds, single issue trust preferred securities (TPS), pooled trust preferred collateralized debt

- obligation securities (TRUP CDO), mortgage-backed securities, asset-backed securities, equity securities and certain other financial instruments.

From mid-2008 through the current year, the lack of active markets and market participants for certain securities resulted in an increase in Level 3 measurements. This has been particularly true for our TRUP CDO securities. As of December 31, 2012, Banner owned $\$ 32$ million in current par value of these securities. The market for TRUP CDO securities is inactive, which was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which TRUP CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as almost no new TRUP CDOs have been issued since 2007. There are still very few market participants who are willing and/or able to transact for these securities. Thus, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator
of credit problems with a particular issuer or of the fair value of the security.
Given these conditions in the debt markets and the absence of observable transactions in the secondary and new issue markets, management determined that for the TRUP CDOs at December 31, 2012 and 2011:

The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value,

An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs was equally or more representative of fair value than the market approach valuation technique, and

The Company's TRUP CDOs should be classified exclusively within Level 3 of the fair value hierarchy because of the significant assumptions required to determine fair value at the measurement date.

The TRUP CDO valuations were derived using input from independent third parties who used proprietary cash flow models for analyzing collateralized debt obligations. Their approaches to determining fair value involve considering the credit quality of the collateral, assuming a level of defaults based on the probability of default of each underlying trust preferred security, creating expected cash flows for each TRUP CDO security and discounting that cash flow at an appropriate risk-adjusted rate plus a liquidity premium.

Where appropriate, management reviewed the valuation methodologies, and assumptions used by the independent third party providers and for certain securities determined that the fair value estimates were reasonable and utilized those estimates in the Company's reported financial statements, while for other securities management adjusted the third party providers modeling to be more reflective of the
characteristics of the Company's remaining TRUP CDOs. The result of this fair value analysis of these Level 3 measurements was a fair value gain of $\$ 3.3$ million for the year-ended December 31, 2012. This gain was primarily the result of a reduction in the spread between the benchmark credit equivalent indices used to establish an appropriate discount rate and a similar maturity point on the interest rate swap curve. In management's opinion the reduction in this spread was consistent with a general market tightening in credit spreads supported by other market observations.

At December 31, 2012, Banner also directly owned approximately $\$ 19$ million in amortized cost of single issuer TPS securities for which no market data or independent valuation source is available. Similar to the TRUP CDOs above, there were too few, if any, issuances of new TPS securities or sales of existing TPS securities to provide Level 1 or even Level 2 fair value measurements for these securities. Management, therefore, utilized a discounted cash-flow model to calculate the present value of each security's expected future cash flows to determine their respective fair values. Management took into consideration the limited market data that was available regarding similar securities, assessed the performance of the three individual issuers of TPS securities owned by the Company and, in June 2012, concluded that each had demonstrated sufficient improvement in asset quality, capital position and general performance measures to warrant a reduction in the discount rate used in fair value modeling from the level used in prior periods. At year end, the Company again sought input from independent third parties to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. In addition, management concluded that the general market tightening of credit spreads reflected in the TRUP CDO valuations was also appropriate to apply to the valuation of the TPS securities. These factors were then incorporated into the model at December 31, 2012, and discount rates equal to three-month LIBOR plus 525 basis points were used to calculate the respective fair values of these securities, compared to three-month LIBOR plus 600-800 basis points at December 31, 2011. The result of this change in the discount rates of this Level 3 fair value measurement was a fair value gain of $\$ 2.3$ million in the year ended December 31, 2012. The Company has and will continue to assess the appropriate fair value hierarchy for determination of these fair values on a quarterly basis.

For all other trading securities and securities available-for-sale we used matrix pricing models from investment reporting and valuation services. Management considers this to be a Level 2 input method.

Fair valuations for FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. Management considers this to be a Level 2 input method.

- The fair valuations of junior subordinated debentures (TPS-related debt that the Company has issued) were also valued using discounted cash flows. These debentures carry interest rates that reset quarterly, using the three-month LIBOR index plus spreads of $1.38 \%$ to $3.35 \%$. While the quarterly reset of the index on this debt would seemingly keep its fair value reasonably close to book values, the disparity in the fixed spreads above the index and the inability to determine realistic current market spreads, due to lack of new issuances and trades, resulted in having to rely more heavily on assumptions about what spread would be appropriate if market transactions were to take place. In periods prior to the third quarter of 2008, the discount rate used was based on recent issuances or quotes from brokers on the date of valuation for comparable bank holding companies and was considered to be a Level 2 input method. However, as noted above in the discussion of TPS and TRUP CDOs, due to the unprecedented disruption of certain financial markets, management concluded that there were insufficient transactions or other indicators to continue to reflect these measurements as Level 2 inputs. Due to this reliance on assumptions and not on directly observable transactions, management believes fair value for these instruments should follow a Level 3 input methodology. From March 2009 to March 2012, the Company used a discount rate of LIBOR plus 800 basis points to value its junior subordinated debentures. However, similar to the discussion above about the TPS securities, in June 2012, management assessed the performance of Banner and concluded that it had
demonstrated sufficient improvement in asset quality, capital position and other performance measures to project sustainable profitability for the foreseeable future sufficient to warrant a reduction in the discount rate used in its fair value modeling. Since the discount rate used in the fair value modeling is the most sensitive unobservable estimate in the calculation, the Company again utilized input from the same independent third party noted above to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. In valuing the debentures at June 30, 2012, these changes in credit quality were the primary factor contributing to a reduction in the discount rate from 800 basis points to 550 basis points. In further valuing the debentures at September 30, 2012, management evaluated the general market tightening of credit spreads as noted above and for the discount rate used the period-ending three-month LIBOR plus 525 basis points. This same spread of 525 basis points was used again at December 31,2012 , resulting in a fair value loss on these instruments of $\$ 23.1$ million for the year ended December 31, 2012.

Derivative instruments include interest rate commitments related to one- to four family loans and residential mortgage backed securities and interest rate swaps. The fair value of interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical trends, where appropriate. The fair value of interest rate swaps is determined by using current market quotes on similar instruments provided by active broker/dealers in the swap market. Management considers these to be Level 2 input methods. The changes in the fair value of all of these derivative instruments are primarily attributable to changes in the level of market interest rates. The Company has elected to record the fair value of these derivative instruments on a net basis.

The following tables present financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012 and 2011 (in thousands):

December 31, 2012
Level 1 Level 2 Level 3 Total
Assets:

| Securities-available-for-sale |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| U.S. Government and agency | \$- | \$96,980 | \$- | \$96,980 |
| Corporate bonds | - | 44,938 | - | 44,938 |
| Municipal bonds | - | 10,729 | - | 10,729 |
| Mortgage-backed securities | - | 277,757 | - | 277,757 |
| Asset-backed securities | - | 42,516 | - | 42,516 |
|  | - | 472,920 | - | 472,920 |
| Securities-trading |  |  |  |  |
| U.S. Government and agency | - | 1,637 | - | 1,637 |
| Municipal bonds | - | 5,684 | - | 5,684 |
| TPS and TRUP CDOs | - | - | 35,741 | 35,741 |
| Mortgage-backed securities | - | 28,107 | - | 28,107 |
| Equity securities and other | - | 63 | - | 63 |
|  | - | 35,491 | 35,741 | 71,232 |
| Derivatives |  |  |  |  |
| Interest rate lock commitments | - | 510 | - | 510 |
| Interest rate swaps | - | 8,353 | - | 8,353 |
|  | \$- | \$517,274 | \$35,741 | \$553,015 |
| Liabilities |  |  |  |  |
| Advances from FHLB at fair value | \$- | \$ 10,304 |  | \$ 10,304 |
| Junior subordinated debentures net of unamortized deferred issuance costs at fair value | - | - | 73,063 | 73,063 |
| Derivatives |  |  |  |  |
| Interest rate forward sales commitments | - | 195 | - | 195 |
| Interest rate swaps | - | 8,353 | - | 8,353 |
|  | \$- | \$ 18,852 | \$73,063 | \$91,915 |

December 31, 2011
$\begin{array}{llll}\text { Level } 1 & \text { Level } 2 & \text { Level } 3 & \text { Total }\end{array}$
Assets:

| Securities-available-for-sale |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| U.S. Government and agency | $\$-$ | $\$ 338,971$ | $\$-$ | $\$ 338,971$ |
| Corporate bonds | - | 6,260 | - | 6,260 |
| Municipal bonds | - | 27,309 | - | 27,309 |
| Mortgage-backed securities | - | 93,255 | - | 93,255 |
|  | - | 465,795 | - | 465,795 |
| Securities-trading | - |  |  |  |
| U.S. Government and agency | - | 2,635 | - | 2,635 |
| Municipal bonds | - | 5,962 | - | 5,962 |
| TPS and TRUP CDOs | - | 3,600 | 30,455 | 35,055 |
| Mortgage-backed securities | - | 40,673 | - | 36,673 |
| Equity securities and other | - | 50,272 | 30,455 | 402 |
|  | - | 617 | - | 80,727 |
| Derivatives | $\$-$ | 5,667 | - | 617 |
| Interest rate lock commitments | $\$ 522,351$ | $\$ 30,455$ | 5,667 |  |
| Interest rate swaps |  |  |  | $\$ 552,806$ |
|  | $\$-$ | $\$ 10,533$ | $\$-$ | $\$ 10,533$ |
| Liabilities | - | - | 49,988 | 49,988 |
| Advances from FHLB at fair value |  |  |  |  |
| Junior subordinated debentures net of unamortized |  |  |  |  |
| deferred issuance costs at fair value | - | 617 | - | 617 |
| Derivatives | - | 5,666 | - | 5,666 |
| Interest rate forward sales commitments | $\$-$ | $\$ 16,816$ | $\$ 49,988$ | $\$ 66,804$ |

The following table provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the year ended December 31, 2012 and 2011 (in thousands):

Year Ended December 31, 2012
Level 3 Fair Value Inputs Borrowings-
TPS and TRUP Junior
CDOs Subordinated Debentures
Beginning balance at December 31, 2011
\$30,455 \$49,988
Total gains or losses recognized
Assets gains (losses)
Liabilities (gains) losses
Purchases, issuances and settlements
Paydowns and maturities
Transfers in and/or out of Level 3
Ending balance at December 31, 2012

Beginning balance at December 31, 2010

| 5,286 | - |
| :--- | :--- |
| - | 23,075 |
| - | - |
| - | - |
| $\$ 35,741$ | $\$ 73,063$ |

Year Ended December 31, 2011
Level 3 Fair Value Inputs Borrowings-
TPS and TRUP Junior
CDOs Subordinated
Debentures
\$29,661 \$48,425
Total gains or losses recognized
Assets gains (losses)
Liabilities (gains) losses
Purchases, issuances and settlements
Paydowns and maturities
Transfers in and/or out of Level 3
Ending balance at December 31, 2011

794
-
-
\$30,45
-
1,563
-
\$49,988

The Company has elected to continue to recognize the interest income and dividends from the securities reclassified to fair value as a component of interest income as was done in prior years when they were classified as available-for-sale. Interest expense related to the FHLB advances and junior subordinated debentures continues to be measured based on contractual interest rates and reported in interest expense. The change in fair value of these financial instruments has been recorded as a component of other operating income.

Items Measured at Fair Value on a Non-recurring Basis:
Carrying values of certain impaired loans are periodically evaluated to determine if valuation adjustments, or partial write-downs, should be recorded. These non-recurring fair value adjustments are recorded when observable market prices or current appraised values of collateral indicate a shortfall in collateral value or discounted cash flows indicate a shortfall compared to current carrying values of the related loan. If the Company determines that the value of the impaired loan is less than the carrying value of the loan, the Company either establishes an impairment reserve as a specific component of the allowance for loan and lease losses (ALLL) or charges off the impaired amount. The remaining impaired loans are evaluated for reserve needs in homogenous pools within the Company's ALLL methodology. As of December 31, 2012, the Company reviewed all of its classified loans totaling $\$ 131$ million and identified $\$ 92$ million which were considered impaired. Of those $\$ 92$ million in impaired loans, $\$ 63$ million were individually evaluated to determine if valuation adjustments, or partial write-downs, should be recorded, or if specific
impairment reserves should be established. The $\$ 63$ million had original carrying values of $\$ 66$ million which have been reduced by partial write-downs totaling $\$ 3$ million. In addition to these write-downs, in order to bring the impaired loan balances to fair value, Banner also established $\$ 6$ million in specific reserves on these impaired loans. Impaired loans that were collectively evaluated for reserve purposes within homogenous pools totaled $\$ 29$ million and were found to require allowances totaling $\$ 3$ million. The $\$ 29$ million evaluated for reserve purposes within homogeneous pools included $\$ 11$ million of restructured loans which are currently performing according to their restructured terms. The valuation inputs for impaired loans are considered to be Level 3 inputs.

The Company records REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at the lower of the estimated fair value of the properties, less expected selling costs, or the carrying amount of the defaulted loans. From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current
appraised value of property. Banner considers any valuation inputs related to REO to be Level 3 inputs. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the years ended December 31, 2012 and 2011, the Company recognized $\$ 5.2$ million and $\$ 15.1$ million, respectively of impairment charges related to these types of assets.

Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially reported at fair value and are amortized in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Mortgage servicing rights are subsequently evaluated for impairment based upon the fair value of the rights compared to the amortized cost (remaining unamortized initial fair value). If the fair value is less than the amortized cost, a valuation allowance is created through an impairment charge to servicing fee income. However, if the fair value is greater than the amortized cost, the amount above the amortized cost is not recognized in the carrying value. In 2012, the Company recorded $\$ 400,000$ in impairment charges against mortgage servicing rights. In 2011 the Company did not record an impairment charge. Loans serviced for others totaled $\$ 1.031$ billion and $\$ 773$ million at December 31, 2012 and 2011, respectively.

The following tables present financial assets and liabilities measured at fair value on a non-recurring basis and the level within the fair value hierarchy at December 31, 2012 and 2011 (in thousands):

December 31, 2012

|  | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant <br> Other <br> Observable <br> Inputs <br> (Level 2) | Significant <br> Unobservable <br> Inputs <br> (Level 3) | Losses <br> Recognized <br> During the Year |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Impaired loans | \$52,475 | \$- | \$- | \$52,475 | \$ 6,381 |
| REO | 15,778 | - | - | 15,778 | (1,915 |
| MSRs | 6,244 | - | - | 6,244 | (400 |
|  | December 3 |  |  |  |  |
|  | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant <br> Unobservable <br> Inputs <br> (Level 3) | Losses <br> Recognized <br> During the Year |
| Impaired loans | \$47,959 | \$- | \$- | \$47,959 | \$(21,902 |
| REO | 42,965 | - | - | 42,965 | (7,325 |

The following table provides a description of the valuation technique, unobservable inputs, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring and nonrecurring basis at December 31, 2012:
Financial Instruments

Valuation Technique | Unobservable | Weighted |
| :--- | :--- |
| Inputs | Average |

TPS securities

| Discounted cash <br> flows | Discount rate | $5.56 \%$ |
| :--- | :--- | :--- |
| Discounted cash <br> flows | Discount rate | $3.83 \%$ |
| Discounted cash <br> flows | Discount rate | $5.56 \%$ |
| Discounted cash <br> flows | Discount rate | various |
| Market values | n/a |  |

REO
MSRs

Collateral valuations

| Appraisals | Market values $\mathrm{n} / \mathrm{a}$ |
| :--- | :--- |
| Discounted cash | Prepayment rate $19.80 \%$ |
| flows | Discount rate $\quad 11.11 \%$ |

TPS and TRUP CDOs: Management believes that the credit risk-adjusted spread used to develop the discount rate utilized in the fair value measurement of our trust preferred securities and trust preferred collateralized debt obligations is indicative of the risk premium a willing market participant would require under current market conditions for instruments with similar contractual rates and terms and conditions and issuers with similar credit risk profiles and with similar expected probability of default. Management attributes the change in fair value of these instruments during 2012 primarily to perceived general market adjustments to the risk premiums for these types of assets and to improved performance of the underlying issuers. A widening of the risk-adjusted spreads subsequent to issuance of these instruments has resulted in a
cumulative fair value loss on these instruments; however, more recently contraction in those spreads has resulted in positive fair value adjustments in 2012 and 2011.

Junior subordinated debentures: Similar to the trust preferred and TRUP CDOs securities discussed above, management believes that the credit risk-adjusted spread utilized in the fair value measurement of the junior subordinated debentures is indicative of the risk premium a willing market participant would require under current market conditions for an issuer with Banner's credit risk profile. Management attributes the change in fair value of the junior subordinated debentures during 2012 primarily to perceived general market adjustments to the risk premiums for these types of liabilities and to changes to our entity-specific credit risk profile as a result of improved operating performance. Future contractions in the risk adjusted spread relative to the spread currently utilized to measure the Company's junior subordinated debentures at fair value as of December 31, 2012, or the passage of time, will result in negative fair value adjustments. At December 31, 2012 the discount rate utilized was based on a credit spread of 525 basis points and three month Libor of 31 basis points.

Impaired loans: Loans are considered impaired when, based on current information and events; we determine that it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

REO: Fair value adjustments on REO are based on updated real estate appraisals which are based on current market conditions. In many of our markets real estate sales are still slow and prices are negatively affected by an over-supply of properties for sale. These market conditions decrease the amount of comparable sales data and increase the reliance on estimates and assumptions about current and future market conditions and could negatively affect our operating results.

MSRs: Management believes that the discount rate utilized in the fair valuation of our MSRs is indicative of a reasonable yield expectation in an orderly transaction between willing market participants at the measurement date. Generally, any significant increases in the prepayment rate and discount rate utilized in the fair value measurement of the mortgage servicing rights will result in negative fair value adjustments and a decrease in the fair value measurement. Alternatively, a decrease in the prepayment rate and discount rate will result in a positive fair value adjustment and increase in the fair value measurement. An increase in the weighted average life assumptions will result in a decrease in the prepayment rate and a decrease in the weighted average life will result in an increase of the prepayment rate.

## Fair Values of Financial Instruments:

The following table presents estimated fair values of the Company's financial instruments as of December 31, 2012 and 2011, whether or not recognized or recorded in the consolidated balance sheets. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret market data in the development of the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The carrying value and estimated fair value of financial instruments at December 31, 2012 and 2011 are as follows (in thousands):

|  | December 31, 2012 |  | December 31, 2011 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Carrying <br> Value | Estimated Fair Value | Carrying <br> Value | Estimated Fair Value |
| Assets: |  |  |  |  |
| Cash and due from banks | \$ 181,298 | \$ 181,298 | \$132,436 | \$132,436 |
| Securities-trading | 71,232 | 71,232 | 80,727 | 80,727 |
| Securities-available-for-sale | 472,920 | 472,920 | 465,795 | 465,795 |
| Securities-held-to-maturity | 86,452 | 92,458 | 75,438 | 80,107 |
| Loans receivable held for sale | 11,920 | 12,059 | 3,007 | 3,069 |
| Loans receivable | 3,223,794 | 3,143,853 | 3,293,331 | 3,224,112 |
| FHLB stock | 36,705 | 36,705 | 37,371 | 37,371 |
| BOLI | 59,891 | 59,891 | 58,563 | 58,563 |
| Mortgage servicing rights | 6,244 | 6,244 | 5,584 | 5,584 |
| Derivatives | 8,863 | 8,863 | 6,284 | 6,284 |
| Liabilities: |  |  |  |  |
| Demand, interest-bearing-checking and money market | 1,800,555 | 1,729,351 | 1,555,561 | 1,487,080 |
| Regular savings | 727,956 | 694,609 | 669,596 | 630,450 |
| Certificates of deposit | 1,029,293 | 1,033,931 | 1,250,497 | 1,258,431 |
| FHLB advances at fair value | 10,304 | 10,304 | 10,533 | 10,533 |
| Junior subordinated debentures at fair value | 73,063 | 73,063 | 49,988 | 49,988 |
| Other borrowings | 76,633 | 76,633 | 152,128 | 152,128 |
| Derivatives | 8,548 | 8,548 | 6,283 | 6,283 |
| Off-balance-sheet financial instruments: |  |  |  |  |
| Commitments to originate loans | 510 | 510 | 617 | 617 |
| Commitments to sell loans | (195 | ) (195 | (617 | ) (617 |

Fair value estimates, methods and assumptions are set forth below for the Company's financial and off-balance-sheet instruments:

Cash and Due from Banks: The carrying amount of these items is a reasonable estimate of their fair value. These fair values are considered Level 1 measures.

Securities: The estimated fair values of investment securities and mortgaged-backed securities are priced using current active market quotes, if available, which are considered Level 1 measurements. For most of the portfolio, matrix pricing based on the securities' relationship to other benchmark quoted prices is used to establish the fair value. These measurements are considered Level 2. Due to the increasing credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads for some of the Company's TPS and TRUP CDO securities (see earlier discussion above in determining the securities' fair market
value), management has classified these securities as a Level 3 fair value measure.
Loans Receivable Held for Sale: Carrying values are based on the lower of estimated fair values or book values. Fair values are estimated based on secondary market pricing for similar loans. This is considered a Level 2 fair value measure.

Loans Receivable: Fair values are estimated first by stratifying the portfolios of loans with similar financial characteristics. Loans are segregated by type such as multifamily real estate, residential mortgage, nonresidential mortgage, commercial/agricultural, consumer and other. Each loan category is further segmented into fixed- and adjustable-rate interest terms and by performing and non-performing categories.

A preliminary estimate of fair value is then calculated based on discounted cash flows using as a discount rate the current rate offered on similar products, plus an adjustment for liquidity to reflect the non-homogeneous nature of the loans. The preliminary estimate is then further reduced by the amount of the allowance for loan losses to arrive at a final estimate of fair value.

The fair value of performing residential mortgages held for sale is estimated based upon secondary market sources by type of loan and terms such as fixed or variable interest rates. Fair value for significant non-performing loans is based on recent appraisals or estimated cash flows discounted using rates commensurate with risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information. Fair value estimates for loans are considered Level 3 measures.

FHLB Stock: The fair value is based upon the redemption value of the stock which equates to its carrying value. This fair value is considered a Level 1 measure.

Bank Owned Life Insurance: The fair value of BOLI policies owned are based on the various insurance contracts' cash surrender value. This fair value is considered a Level 1 measure.

Mortgage Servicing Rights: The fair value of mortgage servicing rights is estimated using a discounted cash flow model. Assumptions used include market discount rates, anticipated prepayment speed, delinquency rates, and fee income. The fair value estimates are also compared to observable trades of similar portfolios, when available. Due to the limited observability of the significant inputs used in the valuation model, particularly the discount rate and prepayment speeds; and the lack of readily available quotes or observable trades of similar assets, we consider this fair value estimate as a Level 3 measure.

Derivative Instruments: The fair value of derivative instruments is estimated using quoted or published prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. Fair value estimates for derivatives are considered Level 2 measures.

Deposit Liabilities: The fair value of deposits with no stated maturity, such as savings and checking accounts, is estimated by applying decay rate assumptions to segregated portfolios of similar deposit types to generate cash flows which are then discounted using short-term market interest rates. The market value of certificates of deposit is based upon the discounted value of contractual cash flows. The discount rate is determined using the rates currently offered on comparable instruments. Fair value estimates for deposits are considered Level 3 measures.

FHLB Advances and Other Borrowings: Fair valuations for Banner's FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. This is considered to be a Level 2 input method. Other borrowings are priced using discounted cash flows to the date of maturity based on using current rates at which such borrowings can currently be obtained. This fair value is considered a Level 3 measure.

Junior Subordinated Debentures: Due to the increasing credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads (see earlier discussion above in determining the junior subordinated debentures' fair market value), junior subordinated debentures have been classified as a Level 3 fair value measure. Management believes that the credit risk adjusted spread and resulting discount rate utilized is indicative of those that would be used by market participants. Fair value estimates for these debentures are considered Level 3 measures.

Commitments: Commitments to sell loans with notional balances of $\$ 85$ million and $\$ 54$ million at December 31, 2012 and 2011, respectively, have a carrying value of $\$ 510,000$ and $\$ 617,000$, representing the fair value of such commitments. Interest rate lock commitments to originate loans held for sale with notional balances of $\$ 89$ million and $\$ 54$ million at December 31, 2012 and 2011, respectively, have a carrying value of $(\$ 195,000)$ and $(\$ 617,000)$. The fair value of commitments to sell loans and of interest rate locks reflect changes in the level of
market interest rates from the date of the commitment or rate lock to the date of the Company's financial statements. Other commitments to fund loans totaled $\$ 925$ million and $\$ 780$ million at December 31, 2012 and 2011, respectively, and have no carrying value at both dates, representing the cost of such commitments. There was one commitment to purchase securities at December 31, 2012, for $\$ 11.5$ million, and no commitments to purchase or sell securities at December 31, 2011. Fair value estimates for commitments are considered Level 2 measures

Limitations: The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2012 and 2011. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not financial instruments include the deferred tax assets/liabilities; land, buildings and equipment; costs in excess of net assets acquired; and real estate held for sale.

## Note 23: BANNER CORPORATION (PARENT COMPANY ONLY)

| Summary financial information is as follows (in thousands): |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Statements of Financial Condition |  | December 31 |  |  |  |  |
|  |  |  | 2012 |  | 2011 |  |
| ASSETS |  |  |  |  |  |  |
| Cash |  |  | \$36,884 |  | \$73,033 |  |
| Investment in trust equities |  |  | 3,716 |  | 3,716 |  |
| Investment in subsidiaries |  |  | 556,125 |  | 532,561 |  |
| Other assets |  |  | 2,601 |  | 1,207 |  |
|  |  |  | \$599,326 |  | \$610,517 |  |
| LIABILITIES AND STOCKHOLDERS' EQUITY |  |  |  |  |  |  |
| Miscellaneous liabilities |  |  | \$6,401 |  | \$2,106 |  |
| Deferred tax liability |  |  | 12,943 |  | 25,973 |  |
| Junior subordinated debentures at fair value |  |  | 73,063 |  | 49,988 |  |
| Stockholders' equity |  |  | 506,919 |  | 532,450 |  |
|  |  |  | \$599,326 |  | \$610,517 |  |
| Statements of Operations | Years Ended December 31 |  |  |  |  |  |
|  | 2012 |  | 2011 |  | 2010 |  |
| INTEREST INCOME: |  |  |  |  |  |  |
| Certificates, time deposits and dividends | \$218 |  | \$277 |  | \$362 |  |
| OTHER INCOME (EXPENSE): |  |  |  |  |  |  |
| Dividend income from subsidiaries | 61,329 |  | 990 |  | 1,760 |  |
| Equity in undistributed income of subsidiaries | 23,507 |  | 9,478 |  | (58,766 | ) |
| Other income | 55 |  | 46 |  | 46 |  |
| Net change in valuation of financial instruments carried at fair value | (23,075 | ) | (1,563 | ) | (730 | ) |
| Interest on other borrowings | (3,395 | ) | (4,193 | ) | (4,226 | ) |
| Other expenses | (2,375 | ) | (2,313 | ) | (2,818 | ) |
| Net income (loss) before taxes | 56,264 |  | 2,722 |  | (64,372 | ) |
| BENEFIT FROM INCOME TAXES | (8,618 | ) | (2,735 | ) | (2,476 | ) |
| NET INCOME (LOSS) | \$64,882 |  | \$5,457 |  | \$(61,896 | ) |

Statements of Cash Flows

## OPERATING ACTIVITIES:

Net income (loss)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:
Equity in undistributed earnings of subsidiaries
Increase (decrease) in deferred taxes
Net change in valuation of financial instruments carried at fair value
Increase in other assets
Increase (decrease) in other liabilities
Net cash provided by (used by) operating activities
INVESTING ACTIVITIES:
Funds transferred to deferred compensation trust
Additional funds invested in subsidiaries
Net cash used by investing activities
FINANCING ACTIVITIES:
Issuance of stock for stockholder reinvestment program
Redemption of senior preferred stock
Issuance of stock in secondary offering, net of costs
Cash dividends paid
Net cash provided by (used by) financing activities
NET INCREASE (DECREASE) IN CASH
CASH, BEGINNING OF PERIOD
CASH, END OF PERIOD

Years Ended December 31
$2012 \quad 2011$
$\$ 64,882 \quad \$ 5,457 \quad \$(61,896)$
$\left.\begin{array}{llll}(23,507 & )(9,478 & ) \\ (13,030 & ) & (562,766 \\ 23,075 & 1,563 & ) \\ (496 & ) & 7,933 & (847 \\ 4,941 & (957 & ) & 3 \\ 55,865 & (2,044 & )(2,541 & ) \\ (332 & )(162 & )(110 & (110,000\end{array}\right)$

| 36,316 | 21,556 | 16,201 |
| :--- | :--- | :--- |
| $(121,528$ | - | - |
| - | - | 161,637 |
| $(6,470$ | $)$ | $(8,827$ |
| $(91,682$ | $)$ | 12,729 |
| $(36,149$ | 62,523 | 168,971 |
| 73,033 | $\$ 73,033$ | 56,320 |
| $\$ 36,884$ |  | $\$ 62,5100$ |

## Note 24: STOCK REPURCHASES

During 2012, the Company repurchased or redeemed all of its Series A Preferred Stock, realizing gains aggregating $\$ 2.5$ million, which was partially offset by accelerated amortization of a portion of the initial discount recorded at the issuance of the Series A Preferred Stock. As a result, the accrual for the quarterly dividend was reduced by the retirement of the repurchased shares. As of December 31, 2012, all of the Series A Preferred Stock had been retired. The Company did not repurchase any of its common stock during the years ended December 31, 2012, 2011 or 2010.

## Note 25: CALCULATION OF EARNINGS PER COMMON SHARE

The following tables show the calculation of earnings (loss) per common share (in thousands, except per share data):

| Years Ended December 31 |  |  |  |
| :--- | :--- | :--- | :--- |
| 2012 | 2011 | 2010 |  |
| $\$ 64,882$ | $\$ 5,457$ | $\$(61,896$ | $)$ |
| $(4,938$ | $)$ | $(6,200$ | $)$ |
| $(3,298$ | $)$ | $(1,701$ | $)$ |
| 2,471 | - | $(1,593$ | $)$ |
| $\$ 59,117$ | $\$(2,444$ | $)$ | $\$(69,689$ |$)$

At December 31, 2012 there were 72,523 issued but unvested restricted stock shares that were included in the computation of diluted earnings per share.

Options to purchase an additional 42,521 shares of common stock were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. Also, as of December 31, 2012, the warrant issued to the Treasury in the fourth quarter of 2008 to purchase up to 243,998 shares (post reverse-split) of common stock was not included in the computation of diluted EPS because the exercise price of the warrant was greater than the average market price of common shares.

## Note 26: SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Results of operations on a quarterly basis for the years ended December 31, 2012 and 2011 were as follows (dollars in thousands except for per share data):

|  | Year Ended December 31, 2012 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | First | Second |  | Third |  | Fourth |
|  | Quarter | Quarter |  | Quarter |  | Quarter |
| Interest income | \$47,198 | \$47,265 |  | \$47,174 |  | \$45,525 |
| Interest expense | 6,072 | 4,975 |  | 4,476 |  | 3,991 |
| Net interest income before provision for loan losses | 41,126 | 42,290 |  | 42,698 |  | 41,534 |
| Provision for loan losses | 5,000 | 4,000 |  | 3,000 |  | 1,000 |
| Net interest income | 36,126 | 38,290 |  | 39,698 |  | 40,534 |
| Other operating income | 10,971 | (9,064 | ) | 11,684 |  | 13,311 |
| Other operating expenses | 37,913 | 35,666 |  | 33,355 |  | 34,519 |
| Income (loss) before provision for income taxes | 9,184 | (6,440 | ) | 18,027 |  | 19,326 |
| Provision (benefit) for income taxes | - | (31,830 | ) | 2,407 |  | 4,638 |
| Net income | 9,184 | 25,390 |  | 15,620 |  | 14,688 |
| Preferred stock dividend | 1,550 | 1,550 |  | 1,227 |  | 611 |
| Preferred stock discount accretion | 454 | 454 |  | 1,216 |  | 1,174 |
| Gain on repurchase and retirement of preferred stock | - | - |  | (2,070 | ) | (401 |
| Net income available to common shareholders | \$7,180 | \$23,386 |  | \$ 15,247 |  | \$13,304 |
| Basic earnings per share | \$0.40 | \$1.27 |  | \$0.80 |  | \$0.69 |

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| Diluted earnings per share | 0.40 | 1.27 | 0.79 | 0.69 |
| :--- | :--- | :--- | :--- | :--- |
| Cumulative dividends declared | 0.01 | 0.01 | 0.01 | 0.01 |

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|  | Year End | Dec | ember 31, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | First |  | Second |  | Third |  | Fourth |  |
|  | Quarter |  | Quarter |  | Quarter |  | Quarter |  |
| Interest income | \$49,663 |  | \$49,888 |  | \$49,561 |  | \$48,451 |  |
| Interest expense | 9,607 |  | 8,687 |  | 7,833 |  | 6,865 |  |
| Net interest income before provision for loan losses | 40,056 |  | 41,201 |  | 41,728 |  | 41,586 |  |
| Provision for loan losses | 17,000 |  | 8,000 |  | 5,000 |  | 5,000 |  |
| Net interest income | 23,056 |  | 33,201 |  | 36,728 |  | 36,586 |  |
| Other operating income | 7,246 |  | 9,253 |  | 10,340 |  | 7,151 |  |
| Other operating expenses | 38,144 |  | 40,255 |  | 41,038 |  | 38,667 |  |
| Income before provision for income taxes | (7,842 | ) | 2,199 |  | 6,030 |  | 5,070 |  |
| Provision (benefit) for income taxes | - |  | - |  | - |  | - |  |
| Net loss | (7,842 |  | 2,199 |  | 6,030 |  | 5,070 |  |
| Preferred stock dividend | 1,550 |  | 1,550 |  | 1,550 |  | 1,550 |  |
| Preferred stock discount accretion | 426 |  | 425 |  | 425 |  | 425 |  |
| Net loss available to common shareholders | \$(9,818 | ) | \$224 |  | \$4,055 |  | \$3,095 |  |
| Basic earnings (loss) per share | \$(0.61 |  | \$0.01 |  | \$0.24 |  | \$0.18 |  |
| Diluted earnings (loss) per share | (0.61 |  | 0.01 |  | 0.24 |  | 0.18 |  |
| Cumulative dividends declared | 0.07 |  | 0.01 |  | 0.01 |  | 0.01 |  |
|  | Year End | ec | ember 31, |  |  |  |  |  |
|  | First |  | Second |  | Third |  | Fourth |  |
|  | Quarter |  | Quarter |  | Quarter |  | Quarter |  |
| Interest income | \$55,970 |  | \$55,634 |  | \$54,250 |  | \$52,228 |  |
| Interest expense | 17,820 |  | 16,693 |  | 14,328 |  | 11,471 |  |
| Net interest income before provision for loan losses | 38,150 |  | 38,941 |  | 39,922 |  | 40,757 |  |
| Provision for loan losses | 14,000 |  | 16,000 |  | 20,000 |  | 20,000 |  |
| Net interest income | 24,150 |  | 22,941 |  | 19,922 |  | 20,757 |  |
| Other operating income | 7,724 |  | 6,186 |  | 7,652 |  | 7,586 |  |
| Other operating expenses | 35,415 |  | 38,024 |  | 46,328 |  | 41,034 |  |
| Income before provision for income taxes | (3,541 | ) | (8,897 | ) | (18,754 | ) | (12,691 | ) |
| Provision (benefit) for income taxes | (2,024 |  | (3,951 | ) | 23,988 |  | - |  |
| Net loss | (1,517 | ) | (4,946 | ) | (42,742 | ) | (12,691 | ) |
| Preferred stock dividend | 1,550 |  | 1,550 |  | 1,550 |  | 1,550 |  |
| Preferred stock discount accretion | 398 |  | 399 |  | 398 |  | 398 |  |
| Net loss available to common shareholders | \$(3,465 | ) | \$(6,895 | ) | \$(44,690 | ) | \$(14,639 | ) |
| Basic earnings (loss) per share | \$(1.12 |  | \$(1.96 | ) | \$(2.80 | ) | \$(0.91 | ) |
| Diluted earnings (loss) per share | (1.12 |  | (1.96 | ) | (2.80 | ) | (0.91 | ) |
| Cumulative dividends declared | 0.07 |  | 0.07 |  | 0.07 |  | 0.07 |  |

## Note 27: FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Banks have financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of their customers. These financial instruments include commitments to extend credit, commitments related to standby letters of credit, commitments to originate loans held for sale, commitments to sell loans secured by one- to four-family residential properties and commitments to sell mortgage-backed securities. These instruments involve, to varying degrees, elements of credit and interest rate risk similar to the risk involved in on-balance sheet items recognized in our Consolidated Statements of Financial Condition.

The Banks exposure to credit loss in the event of nonperformance by the other party to the financial instrument from commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Banks use the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments.

Outstanding commitments for which no liability has been recorded consisted of the following at the dates indicated (dollars in thousands):

Undisbursed loans and lines of credit
Standby letters of credit and financial guarantees
To originate loans
To originate loans held for sale
To sell loans secured by one- to four-family residential properties
To sell mortgage backed securities

| Contract or Notional Amount |  |
| :--- | :--- |
| December 31, 2012 | December 11, 2011 |
| $\$ 907,892$ | $\$ 761,637$ |
| 6,660 | 7,872 |
| 10,733 | 10,516 |
| 89,049 | 54,082 |
| 70,263 | 54,082 |
| 41,500 | - |

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. Many of the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income producing commercial properties.

Standby letters of credit are conditional commitments issued to guarantee a customer's performance or payment 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.

Interest rates on residential one- to four-family mortgage loan applications are typically rate locked (committed) to customers during the application stage for periods ranging from 30 to 60 days, the most typical period being 45 days. Historically, these loan applications with rate lock commitments had the pricing for the sale of these loans locked with various qualified investors under a "best-efforts" delivery program at or near the time the interest rate is locked with the customer. The Banks then attempted to deliver these loans before their rate locks expired. This arrangement generally required delivery of the loans prior to the expiration of the rate lock. Delays in funding the loans required a lock extension. The cost of a lock extension at times was borne by the customer and at times by the Banks. These lock extension costs have not had a material impact to our operations. In 2012, the Company also began entering into forward commitments at specific prices and settlement dates to deliver either: (1) residential mortgage loans for purchase by secondary market investors (i.e., Freddie Mac or Fannie Mae), or (2) mortgage-backed securities to broker/dealers. The purpose of these forward commitments is to offset the movement in interest rates between the execution of its residential mortgage rate lock commitments with borrowers and the sale of those loans to the secondary market investor. There were no counterparty default losses on forward contracts during 2012 or 2011. Market risk with respect to forward contracts arises principally from changes in the value of contractual positions due to changes in interest rates. We limit our exposure to market risk by monitoring differences between commitments to customers and forward contracts with market investors and securities broker/dealers. In the event we have forward delivery contract commitments in excess of available mortgage loans, the transaction is completed by either paying or receiving a fee to or from the investor or broker/dealer equal to the increase or decrease in the market value of the forward contract. Changes in the value of rate lock commitments are recorded as assets and liabilities as explained in Note 1: "Derivative Instruments."

The Company has stand-alone derivative instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates (see Note 1). These transactions involve both credit and market risk. The notional amount is the amount on which calculations, payments, and the value of the derivative are based. The notional amount does not represent direct credit exposure. Direct credit exposure is limited to the net difference between the calculated amount to be received and paid. This difference represents the fair value of the derivative instrument.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparty to these agreements. Credit risk of the financial contract is controlled through the credit approval, limits, and monitoring procedures and management does not expect the counterparty to fail its obligations.

Information pertaining to outstanding interest rate swaps at December 31, 2012 and 2011 follows (dollars in thousands):

|  | December 31 |  |  |
| :--- | :--- | :--- | :--- |
|  | 2012 | 2011 |  |
| Notional amount | $\$ 205,505$ | $\$ 117,110$ | $\%$ |
| Weighted average pay rate | 4.52 | $\%$ | 4.66 |
| Weighted average receive rate | 4.11 | $\%$ | 3.85 |
| Weighted average maturity in years | 7.9 | 7.7 | $\%$ |
| Unrealized gain included in total loans | $\$ 3,300$ | $\$ 3,559$ |  |
| Unrealized gain included in other assets | $\$ 5,053$ | $\$ 2,108$ |  |
| Unrealized loss included in other liabilities | $\$ 8,353$ | $\$ 5,666$ |  |

At December 31, 2012, the Company's interest rate swap agreements are with the Pacific Coast Bankers Bank, Wells Fargo, N.A., Credit Suisse, and various loan customers.

## BANNER CORPORATION

## Exhibit Index of Exhibits

Amended and Restated Articles of Incorporation of Registrant [incorporated by reference to the Registrant's
$3\{\mathrm{a}\} \quad$ Current Report on Form 8-K filed on April 29, 2010 (File No. 000-26584)], as amended on May 26, 2011 [incorporated by reference to the Current Report on Form 8-K filed on June 1, 2011 (File No. 000-26584)].

Certificate of designation relating to the Company's Fixed Rate Cumulative Perpetual Preferred Stock Series
3\{b\} A [incorporated by reference to the Registrant's Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].

Bylaws of Registrant [incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 1, 2011 (File No. 0-26584)].

4\{a\} Warrant to purchase shares of Company's common stock dated November 21, 2008 [incorporated by reference to the Registrant's Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)]

Letter Agreement (including Securities Purchase Agreement Standard Terms attached as Exhibit A) dated November 21, 2008 between the Company and the United States Department of the Treasury [incorporated by reference to the Registrant's Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].

Executive Salary Continuation Agreement with Gary L. Sirmon [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].

Employment Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].

Employment Agreement, as amended, with Mark J. Grescovich [incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on March 28, 2012 (File No. 000-265840].

Executive Salary Continuation Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].

1996 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].

1996 Management Recognition and Development Plan [incorporated by reference to Exhibit 99.2 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].

Consultant Agreement with Jesse G. Foster, dated as of December 19, 2003 [incorporated by reference to
$10\{\mathrm{~g}\}$ exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. $0-23584)]$.

Employment Agreement with Gary Sirmon dated as of January 23, 2003 [incorporated by reference to $10\{\mathrm{~h}\}$ exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. $0-23584)]$.

Supplemental Executive Retirement Program Agreement with D. Michael Jones [incorporated by reference $10\{1\}$ to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. $0-26584)]$.

Form of Supplemental Executive Retirement Program Agreement with Gary Sirmon, Michael K. Larsen, Lloyd W. Baker, Cynthia D. Purcell and Paul E. Folz [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 and the exhibits filed with the Form 8 -K on May 6, 2008].

1998 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (File No. 333-71625)].

2001 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 8, 2001 (File No. 333-67168)].

Form of Employment Contract entered into with Cynthia D. Purcell, Richard B. Barton, Paul E. Folz and $10\{\mathrm{p}\}$ Douglas M. Bennett [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].

2004 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference
$10\{\mathrm{q}\}$ to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. $0-26584)$ ].

2004 Executive Officer and Director Investment Account Deferred Compensation Plan [incorporated by
$10\{\mathrm{r}\} \quad$ reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)]. with the Annual Report on Form 10-K for the year ended March 31, 1997 (File No. 0-26584)].

Employment Agreement with Lloyd W. Baker [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].

Employment Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].

Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed

## $10\{\mathrm{~s}\}$

21 Subsidiaries of the Registrant.
23.1 Consent of Registered Independent Public Accounting Firm - Moss Adams LLP.
31.1 Certification of Chief Executive Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and

15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Long-Term Incentive Plan and Form of Repricing Agreement [incorporated by reference to the exhibits filed with the Current Report on Form 8-K on May 6, 2008].

Form of Compensation Modification Agreement [incorporated by reference to the Registrant's Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].

2005 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2008 (File No. $0-26584)]$.

Entry into an Indemnification Agreement with each of the Registrant's Directors [incorporated by reference to exhibits filed with the Form 8-K on January 29, 2010].

2012 Restricted Stock Plan [incorporated by reference to Appendix B included in the Registrant's definitive proxy statement filed on March 22, 2012 (File No. 000-26584)].

Form of Restricted Stock Award Agreement [incorporated by reference to Exhibit 10.1 included in the Registrant's Current Report on Form 8-K filed on April 25, 2012 (File No. 000-26584)].

Code of Ethics [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 0-26584)].

Certification of Chief Financial Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Certification of Principal Executive Officer of Banner Corporation to Chief Compliance Officer of the Troubled Asset Relief Program Pursuant to 31 CFR § 30.15.

Certification of Principal Financial Officer of Banner Corporation to Chief Compliance Officer of the Troubled Asset Relief Program Pursuant to 31 CFR § 30.15.

The following materials from Banner Corporation's Annual Report on Form 10-K for the year ended December 31, 2012, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Balance Sheets; (b) Consolidated Statements of Operations; (c) Consolidated Statements of Comprehensive Income (Loss); (d) Consolidated Statements of Shareholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Notes to Consolidated Financial Statements. *

## Edgar Filing: BANNER CORP - Form 10-K

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.


[^0]:    (1) Includes loans accounted for on a nonaccrual basis and loans 90 days or more past due. Amortization of net deferred loan fees/costs is included with interest on loans.
    ${ }^{(2)}$ Includes non-interest-bearing deposits.

