## UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2013.
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM $\qquad$ 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)

91-1691604
(I.R.S. Employer Identification Number)

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
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 [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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).

$$
\left.\begin{array}{lll}
\text { Yes } & {[\mathrm{x}]} & \text { No }
\end{array}\right]
$$

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

Large accelerated filer [
]

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

## APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Title of class:
Common Stock, $\$ .01$ par value per share

As of April 30, 2013
$19,461,758$ shares *

* Includes 34,340 shares held by the Employee Stock Ownership Plan that have not been released, committed to be released, or allocated to participant accounts.


## BANNER CORPORATION AND SUBSIDIARIES

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Special Note Regarding Forward-Looking Statements
Certain matters in this report on Form 10-Q contain certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning our future operations. 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," "targ "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "sh "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, 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 our bank subsidiaries 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 changes related to 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. 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.

## BANNER CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited) (In thousands, except shares)
March 31, 2013 and December 31, 2012

| ASSETS | $\begin{aligned} & \text { March } 31 \\ & 2013 \end{aligned}$ |  | $\begin{aligned} & \text { December } 31 \\ & 2012 \end{aligned}$ |
| :---: | :---: | :---: | :---: |
| Cash and due from banks | \$ 155,714 |  | \$ 181,298 |
| Securities-trading, amortized cost \$80,193 and \$90,339, respectively | 67,761 |  | 71,232 |
| Securities—available-for-sale, amortized cost \$473,908 and \$469,650, respectively | 476,683 |  | 472,920 |
| Securities-held-to-maturity, fair value \$93,785 and \$92,458, respectively | 88,408 |  | 86,452 |
| Federal Home Loan Bank (FHLB) stock | 36,373 |  | 36,705 |
| Loans receivable: |  |  |  |
| Held for sale | 5,384 |  | 11,920 |
| Held for portfolio | 3,234,937 |  | 3,223,794 |
| Allowance for loan losses | (77,128 | ) | (77,491 ) |
|  | 3,163,193 |  | 3,158,223 |
| Accrued interest receivable | 15,235 |  | 13,930 |
| Real estate owned (REO), held for sale, net | 11,160 |  | 15,778 |
| Property and equipment, net | 88,414 |  | 89,117 |
| Intangible assets, net | 3,724 |  | 4,230 |
| Bank-owned life insurance (BOLI) | 60,425 |  | 59,891 |
| Income taxes | 34,242 |  | 35,007 |
| Other assets | 36,294 |  | 40,781 |
|  | \$4,237,626 |  | \$4,265,564 |
| LIABILITIES |  |  |  |
| Deposits: |  |  |  |
| Non-interest-bearing | \$962,156 |  | \$981,240 |
| Interest-bearing transaction and savings accounts | 1,575,525 |  | 1,547,271 |
| Interest-bearing certificates | 982,903 |  | 1,029,293 |
|  | 3,520,584 |  | 3,557,804 |
| Advances from FHLB at fair value | 278 |  | 10,304 |
| Other borrowings | 88,446 |  | 76,633 |
| Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities) | 73,220 |  | 73,063 |
| Accrued expenses and other liabilities | 24,157 |  | 26,389 |
| Deferred compensation | 14,879 |  | 14,452 |
|  | 3,721,564 |  | 3,758,645 |
| COMMITMENTS AND CONTINGENCIES (Note 15) STOCKHOLDERS' EQUITY |  |  |  |
|  |  |  |  |
| Common stock and paid in capital - $\$ 0.01$ par value per share, $50,000,000$ shares authorized, 19,462,483 shares issued and 19,428,143 shares outstanding at March 31, 2013; 19,454,965 shares issued and 19,420,625 shares outstanding at December 31, 2012 |  |  |  |
| Accumulated deficit | (51,851 | ) | (61,102 ) |
| Accumulated other comprehensive income | 1,784 |  | 2,101 |
| Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost: 34,340 restricted shares outstanding at March 31, 2013 and December 31, 2012 | (1,987 | ) | $(1,987)$ |
|  | 516,062 |  | 506,919 |

See Selected Notes to the Consolidated Financial Statements

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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited) (In thousands except for per share amounts)
For the Three Months Ended March 31, 2013 and 2012


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| Preferred stock discount accretion | - | 454 |
| :--- | :--- | :--- |
| NET INCOME AVAILABLE TO COMMON SHAREHOLDERS | $\$ 11,582$ | $\$ 7,180$ |
| Earnings per common share: | $\$ 0.60$ | $\$ 0.40$ |
| Basic | $\$ 0.60$ | $\$ 0.40$ |
| Diluted | $\$ 0.12$ | $\$ 0.01$ |
| Cumulative dividends declared per common share |  |  |

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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)
For the Three Months Ended March 31, 2013 and 2012

|  | Three Months Ended March 31 |  |  |
| :---: | :---: | :---: | :---: |
|  | 2013 |  | 2012 |
| NET INCOME | \$11,582 |  | \$9,184 |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES: |  |  |  |
| Unrealized holding gain (loss) on AFS securities arising during the period | (378 |  | (55 |
| Income tax benefit (expense) related to AFS unrealized holding gains (losses) | 136 |  | 20 |
| Reclassification for net (gains) losses on AFS securities realized in earnings | (117 |  | - |
| Income tax benefit (expense) related to AFS unrealized holding gains (losses) | 42 |  | - |
| Amortization of unrealized gain on tax exempt securities transferred from available-for-sale to held-to-maturity | - |  | 2 |
| Other comprehensive income (loss) | (317 |  | (33 |
| COMPREHENSIVE INCOME | \$11,265 |  | \$9,151 |

See Selected Notes to the Consolidated Financial Statements
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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited) (In thousands, except for shares)
For the Three Months Ended March 31, 2013


See Selected Notes to the Consolidated Financial Statements

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## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited) (In thousands, except for shares)
For the Year Ended December 31, 2012

|  | Preferred Stock |  | Common Stock and Paid in Capital |  | Accumulhtadarned |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Shares | Amount | Shares | Amount | Deficit) | Compre Income | hesopre Shares | Equity |
| Balance, January 1, 2012 | 124,000 | \$120,702 | 17,519,132 | \$531,149 | \$(119,465) | \$2,051 | \$ 1,987 ) | \$532,450 |
| Net income |  |  |  |  | 64,882 |  |  | 64,882 |
| Change in valuation of securities-available-for-sale, net of income tax |  |  |  |  |  | 42 |  | 42 |
| Amortization of unrealized loss on tax exempt securities transferred from available-for-sale to held-to-maturity, net of income tax |  |  |  |  |  | 8 |  | 8 |
| Accretion of preferred stock discount |  | 3,298 |  |  | (3,298 ) |  |  | - |
| Accrual of dividends on preferred stock |  |  |  |  | (4,938 ) |  |  | (4,938 |
| Repurchase of preferred stock | $(124,000)$ | (124,000 ) |  |  |  |  |  | (124,000 ) |
| Gain on repurchase of preferred stock |  |  |  |  | 2,471 |  |  | 2,471 |
| Accrual of dividends on common stock ( $\$ .04 /$ share cumulative) |  |  |  |  | (754 ) |  |  | (754 |
| Proceeds from issuance of common stock for stockholder reinvestment program |  |  | 1,814,320 | 36,317 |  |  |  | 36,317 |
| Amortization of compensation related to restricted stock grant |  |  | 87,173 | 434 |  |  |  | 434 |
| Amortization of compensation related to stock options |  |  |  | 7 |  |  |  | 7 |
| BALANCE, December 31, 2012 | - | \$- | 19,420,625 | \$567,907 | \$(61,102 ) | \$2,101 | \$(1,987) | \$506,919 |

See Selected Notes to the Consolidated Financial Statements

## BANNER CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)
For the Three Months Ended March 31, 2013 and 2012


| Cash proceeds from issuance of stock for stockholder reinvestment plan | 2 | 8,874 |
| :--- | :--- | :--- |
| Net cash used by financing activities | $(35,602$ | $)(103,214$ |
| NET (DECREASE) INCREASE IN CASH AND DUE FROM BANKS | $(25,584$ | $)$ |
| CASH AND DUE FROM BANKS, BEGINNING OF PERIOD | 181,298 | 132,436 |
| CASH AND DUE FROM BANKS, END OF PERIOD | $\$ 155,714$ | $\$ 199,609$ |

(Continued on next page)
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BANNER CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited) (In thousands)
For the Three Months Ended March 31, 2013 and 2012
$\left.\begin{array}{llc}\text { Three Months Ended } \\ \text { March } 31 \\ \text { SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: } & 2013\end{array}\right] 2012$

See Selected Notes to the Consolidated Financial Statements

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## BANNER CORPORATION AND SUBSIDIARIES

## SELECTED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## Note 1: BASIS OF PRESENTATION AND CRITICAL ACCOUNTING POLICIES

The accompanying unaudited consolidated financial statements include the accounts of Banner Corporation (the Company or Banner), a bank holding company incorporated in the State of Washington and its wholly-owned subsidiaries, Banner Bank and Islanders Bank (the Banks).

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (SEC). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. Certain reclassifications have been made to the 2012 Consolidated Financial Statements and/or schedules to conform to the 2013 presentation. These reclassifications may have affected certain ratios for the prior periods. The effect of these reclassifications is considered immaterial. All significant intercompany transactions and balances have been eliminated.

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 our 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.

The information included in this Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC (2012 Form 10-K). Interim results are not necessarily indicative of results for a full year.

## Note 2: 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 State Department of Financial Institutions, Division of Banks (originally effective

March 29, 2010) was terminated. On April 10, 2012, a similar MOU by and between the Company and the Federal Reserve Bank of San Francisco (originally effective March 23, 2010) was also terminated.

Income Tax Reporting and Accounting:
Amended Federal Income Tax Returns: The Company has years 2008-2012 open under the Statute of Limitations provisions of the Internal Revenue Code of 1986. Refund claims have been filed for 2008 and 2009 for which carry back of NOLs and tax credits has been applied for in 2005-2007. Aside from the refund claims applied for in 2005-2007, those years are otherwise closed under the Statute of Limitations. The amended tax returns, which are under review by the Internal Revenue Service (IRS), could 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 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 March 31, 2013 and 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 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, a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of Banner's deferred tax assets will not be realized. 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 and the Company continued to maintain a full valuation allowance through March 31, 2012. During the quarter ended June 30, 2012, management analyzed the Company's performance and trends over the previous five quarters, 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 nearly all of the valuation allowance at that time. The Company utilized the remaining valuation allowance to offset tax expense in the third and fourth quarters of 2012. The ultimate utilization of a deferred tax valuation allowance and 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. See Note 12 of the Selected Notes to the Consolidated Financial Statements for more information.

Stockholder Equity Transactions:
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 shall continue in effect for a term of ten years, after which no further awards may be granted. As of March 31, 2013, the Company had granted 97,995 shares of restricted stock from the 2012 Restricted Stock Plan and 34,257 shares in accordance with the CEO's employment agreement.

Preferred Stock: On March 29, 2012, the Company's $\$ 124$ million of senior preferred stock with a liquidation value of $\$ 1,000$ per share, originally issued to the U.S. 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 ( 243,998 shares). Subsequent to March 29, 2012 and by the end of the year ended December 31, 2012, the Company repurchased or redeemed all of its Series A Preferred Stock.

## Note 3: ACCOUNTING STANDARDS RECENTLY ADOPTED

## Offsetting Assets and Liabilities

In December 2011, the Financial Accounting Standards Board (the "FASB") issued Accounting Standard Update ("ASU") No. 2011-11, "Disclosures About Offsetting Assets and Liabilities." The new disclosure requirements mandate that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial condition as well as instruments and transactions subject to an agreement similar to a master netting arrangement. ASU No. 2011-11 also requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements.

In January 2013, the FASB issued ASU No. 2013-01, "Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The provisions of ASU No. 2013-01 limits the scope of the new balance sheet offsetting disclosures to the following financial instruments, to the extent they are offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in the statement of financial position: (1) derivative financial instruments; (2) repurchase agreements and reverse repurchase agreements; and (3) securities borrowing and securities lending transactions.

The Company adopted the provisions of ASU No. 2011-11 and ASU No. 2013-01 effective January 1, 2013. As the provisions of ASU No. 2011-11 and ASU No. 2013-01 only impact disclosure requirements related to the offsetting of assets and liabilities and information instruments and transactions eligible for offset in the statement of financial condition, the adoption had no impact on the Company's consolidated statements of operations and financial condition.

Reclassifications Out of Accumulated Other Comprehensive Income

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU No. 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income (e.g., unrealized gains or losses on available-for-sale investment securities) and separately present reclassification adjustments and current period other comprehensive income. The provisions of ASU No. 2013-02 also require that entities present, either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., unrealized gains or losses on available-for-sale investment securities). The Company adopted the provisions of ASU No. 2013-02 effective January 1, 2013. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

## Note 4: 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.

## Note 5: INTEREST-BEARING DEPOSITS AND SECURITIES

The following table sets forth additional detail regarding our 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):

|  | March 31 | December 31 | March 31 |
| :--- | :--- | :--- | :--- |
|  | 2013 | 2012 | 2012 |
| Interest-bearing deposits included in cash and due from banks | $\$ 96,300$ | $\$ 114,928$ | $\$ 143,885$ |
| U.S. Government and agency obligations | 79,959 | 98,617 | 238,866 |
| Municipal bonds: |  |  |  |
| Taxable | 43,921 | 31,480 | 18,071 |
| Tax exempt | 110,062 | 103,545 | 90,965 |
| Total municipal bonds | 153,983 | 135,025 | 109,036 |
| Corporate bonds | 47,233 | 48,519 | 43,674 |
| Mortgage-backed or related securities: | 89,036 | 105,770 | 112,328 |
| One- to four-family residential agency guaranteed | 1,282 | 1,299 | 1,808 |
| One- to four-family residential other | 200,012 | 188,136 | 35,156 |
| Multifamily agency guaranteed | 10,787 | 10,659 | - |
| Multifamily other | 301,117 | 305,864 | 149,292 |
| Total mortgage-backed or related securities |  |  |  |
| Asset-backed securities: | 32,239 | 32,474 | - |
| Student Loan Marketing Association (SLMA) | 18,261 | 10,042 | - |
| Other asset-backed securities | 50,500 | 42,516 | - |
| Total asset-backed securities | 60 | 63 | 407 |
| Equity securities (excludes FHLB stock) | 632,852 | 630,604 | 541,275 |
| Total securities | 36,373 | 36,705 | 37,371 |
| FHLB stock | $\$ 765,525$ | $\$ 782,237$ | $\$ 722,531$ |

Securities-Trading: The amortized cost and estimated fair value of securities-trading at March 31, 2013 and December 31, 2012 are summarized as follows (dollars in thousands):

|  | March 31, 2013 |  |  |  | December 31, 2012 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amortized Cost | Fair Value | Percent <br> Total |  | Amortized Cost | Fair Value | Percent of Total |
| U.S. Government and agency obligations | \$1,370 | \$1,617 | 2.4 | \% | \$1,380 | \$1,637 | 2.3 \% |
| Municipal bonds: |  |  |  |  |  |  |  |
| Tax exempt | 5,245 | 5,347 | 7.9 |  | 5,590 | 5,684 | 8.0 |
| Corporate bonds | 49,678 | 34,520 | 50.9 |  | 57,807 | 35,741 | 50.2 |
| Mortgage-backed or related securities: |  |  |  |  |  |  |  |
| One- to four-family residential agency guaranteed | 14,952 | 16,166 | 23.9 |  | 16,574 | 17,911 | 25.1 |
| Multifamily agency guaranteed | 8,934 | 10,051 | 14.8 |  | 8,974 | 10,196 | 14.3 |
| Total mortgage-backed or related securities | 23,886 | 26,217 | 38.7 |  | 25,548 | 28,107 | 39.4 |
| Equity securities | 14 | 60 | 0.1 |  | 14 | 63 | 0.1 |
|  | \$80,193 | \$67,761 | 100.0 | \% | \$90,339 | \$71,232 | 100.0 |

There were 21 sales of securities-trading totaling $\$ 6.1$ million with a resulting net gain of $\$ 1.1$ million during the three months ended March 31, 2013, including $\$ 1.0$ million which represented recoveries on certain collateralized debt obligations that had previously been written off. There were no sales of securities-trading during the three months ended March 31, 2012. The Company recognized a $\$ 409,000$ OTTI recovery on securities-trading related to the sale of certain equity securities issued by government sponsored entities during the three months ended March 31, 2013 and no OTTI charges or recoveries during the three months ended March 31, 2012. As of March 31, 2013 and 2012, there were no securities-trading in a nonaccrual status.

The amortized cost and estimated fair value of securities-trading at March 31, 2013 and December 31, 2012, 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.

|  | March 31, 2013 |  |  | December 31, 2012 |  |
| :--- | :--- | :--- | :--- | :--- | :---: |
|  | Amortized | Fair Value | Amortized | Foair Value |  |
|  | Cost |  |  | $\$-$ |  |
| Due in one year or less | $\$-$ | $\$-$ | $\$-$ | $\$-$ |  |
| Due after one year through five years | 4,390 | 4,732 | 4,496 | 4,867 |  |
| Due after five years through ten years | 13,830 | 15,021 | 14,251 | 15,536 |  |
| Due after ten years through twenty years | 11,882 | 10,945 | 12,055 | 11,346 |  |
| Due after twenty years | 50,077 | 37,003 | 59,523 | 39,420 |  |
|  | 80,179 | 67,701 | 90,325 | 71,169 |  |
| Equity securities | 14 | 60 | 14 | 63 |  |
|  | $\$ 80,193$ | $\$ 67,761$ | $\$ 90,339$ | $\$ 71,232$ |  |

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Securities-Available-for-Sale: The amortized cost and estimated fair value of securities-available-for-sale at March 31, 2013 and December 31, 2012 are summarized as follows (dollars in thousands):

|  | March 31, 2013 |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amortized <br> Cost | Gross <br> Unrealized <br> Gains | Gross <br> Unrealized Losses |  | Fair Value | Percent of Total |  |
| U.S. Government and agency obligations | \$78,085 | \$295 | \$(38 | ) | \$78,342 | 16.4 | \% |
| Municipal bonds: |  |  |  |  |  |  |  |
| Taxable | 32,613 | 232 | (39 | ) | 32,806 | 6.9 |  |
| Tax exempt | 29,272 | 254 | (54 | ) | 29,472 | 6.2 |  |
| Total municipal bonds | 61,885 | 486 | (93 | ) | 62,278 | 13.1 |  |
| Corporate bonds | 10,629 | 35 | (1 | ) | 10,663 | 2.2 |  |
| Mortgage-backed or related securities: |  |  |  |  |  |  |  |
| One- to four-family residential agency guaranteed | 72,468 | 954 | (552 | ) | 72,870 | 15.3 |  |
| One- to four-family residential other | 1,195 | 87 | - |  | 1,282 | 0.3 |  |
| Multifamily agency guaranteed | 188,553 | 1,691 | (283 | ) | 189,961 | 39.8 |  |
| Multifamily other | 10,677 | 110 | - |  | 10,787 | 2.3 |  |
| Total mortgage-backed or related securities | 272,893 | 2,842 | (835 | ) | 274,900 | 57.7 |  |
| Asset-backed securities: |  |  |  |  |  |  |  |
| SLMA | 32,083 | 173 | (17 | ) | 32,239 | 6.8 |  |
| Other asset-backed securities | 18,333 | - | (72 | ) | 18,261 | 3.8 |  |
| Total asset-backed securities | 50,416 | 173 | (89 | ) | 50,500 | 10.6 |  |
|  | \$473,908 | \$3,831 | \$(1,056 | ) | \$476,683 | 100.0 | \% |
|  | December 31, 2012 |  |  |  |  |  |  |
|  |  | Gross | Gross |  |  |  |  |
|  | Cost | Unrealized Gains | Unrealized <br> Losses |  | Value | Total |  |
| U.S. Government and agency obligations | \$96,666 | \$367 | \$(53 | ) | \$96,980 | 20.5 | \% |
| Municipal bonds: |  |  |  |  |  |  |  |
| Taxable | 20,987 | 233 | (67 | ) | 21,153 | 4.5 |  |
| Tax exempt | 23,575 | 221 | (11 | ) | 23,785 | 5.0 |  |
| Total municipal bonds | 44,562 | 454 | (78 | ) | 44,938 | 9.5 |  |
| Corporate bonds | 10,701 | 37 | (9 | ) | 10,729 | 2.3 |  |
| Mortgage-backed or related securities: |  |  |  |  |  |  |  |
| One- to four-family residential agency guaranteed | 87,392 | 1,051 | (584 | ) | 87,859 | 18.6 |  |
| One- to four-family residential other | 1,223 | 76 | - |  | 1,299 | 0.3 |  |
| Multifamily agency guaranteed | 176,026 | 2,140 | (226 | ) | 177,940 | 37.6 |  |
| Multifamily other | 10,700 | 4 | (45 | ) | 10,659 | 2.2 |  |
| Total mortgage-backed or related securities | 275,341 | 3,271 | (855 | ) | 277,757 | 58.7 |  |
| Asset-backed securities: |  |  |  |  |  |  |  |
| SLMA | 32,309 | 210 | (45 | ) | 32,474 | 6.9 |  |
| Other asset-backed securities | 10,071 | - | (29 | ) | 10,042 | 2.1 |  |
| Total asset-backed securities | 42,380 | 210 | (74 | ) | 42,516 | 9.0 |  |
|  | \$469,650 | \$4,339 | \$(1,069 | ) | \$472,920 | 100.0 | \% |

At March 31, 2013 and December 31, 2012, an aging of unrealized losses and fair value of related securities-available-for-sale was as follows (in thousands):

March 31, 2013

| Less Than 12 Months |  |  | 12 Months or More |  |  | Total |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Fair Value | Unrealized |  | Fair Value | Unrealized |  | Fair Value | Unrealized |  |
| Fair Value | Losses |  |  | Losses |  |  | Losses |  |
| \$15,964 | \$ (38 | ) | \$- | \$- |  | \$15,964 | \$ (38 | ) |
| 11,776 | (39 | ) | - | - |  | 11,776 | (39 | ) |
| 10,574 | (53 | ) | 382 | (1 | ) | 10,956 | (54 | ) |
| 22,350 | (92 | ) | 382 | (1 | ) | 22,732 | (93 | ) |
| 3,179 | (1 | ) | - | - |  | 3,179 | (1 | ) |
| 23,923 | (309 | ) | 10,798 | (243 | ) | 34,721 | (552 | ) |
| 49,007 | (283 | ) | - | - |  | 49,007 | (283 | ) |
| 72,930 | (592 | ) | 10,798 | (243 | ) | 83,728 | (835 | ) |
| 16,451 | (17 | ) | - | - |  | 16,451 | (17 | ) |
| 18,261 | (72 | ) | - | - |  | 18,261 | (72 | ) |
| 34,712 | (89 | ) | - | - |  | 34,712 | (89 | ) |
| \$149,135 | \$(812 | ) | \$11,180 | \$(244 | ) | \$160,315 | \$(1,05 | ) |

$\left.\begin{array}{lllllllll}\text { U.S. Government and agency obligations } & \$ 22,955 & \$(53 & ) & \$- & \$- & \$ 22,955 & \$(53 & ) \\ \text { Municipal bonds: } & & & & & & & & \\ \text { Taxable } & 11,009 & (67 & ) & - & - & 11,009 & (67 & ) \\ \text { Tax exempt } & 4,619 & (11 & ) & - & - & 4,619 & (11 & ) \\ \text { Total municipal bonds } & 15,628 & (78 & ) & - & - & 15,628 & (78 & ) \\ \text { Corporate bonds } & 6,670 & (9 & ) & - & - & 6,670 & (9 & ) \\ \text { Mortgage-backed or related securities: } & & & & & & & \\ \begin{array}{l}\text { One- to four-family residential agency } \\ \text { guaranteed }\end{array} & 32,459 & (503 & ) & 5,746 & (81 & ) & 38,205 & (584\end{array}\right)$

Proceeds from the sale of four securities-available-for-sale during the three months ended March 31, 2013 were $\$ 13.9$ million with a resulting loss of $\$ 117,000$. There were no sales of securities-available-for-sale during the three months ended March 31, 2012. At March 31, 2013, there were 59 securities-available for sale with unrealized losses, compared to 52 securities at December 31, 2012. Management does not believe that any individual unrealized loss as
of March 31, 2013 represents OTTI. The decline in fair market values 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 March 31, 2013 and December 31, 2012, 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.

|  | March 31, 2013 |  |  | December 31, 2012 |  |
| :--- | :--- | :--- | :--- | :--- | :---: |
| Amortized | Fair Value | Amortized | Fair Value |  |  |
|  | Cost |  |  |  |  |
| Due in one year or less | $\$ 9,539$ | $\$ 9,576$ | $\$ 16,369$ | $\$ 16,393$ |  |
| Due after one year through five years | 250,405 | 251,532 | 205,913 | 207,147 |  |
| Due after five years through ten years | 115,019 | 115,980 | 132,372 | 133,407 |  |
| Due after ten years through twenty years | 39,877 | 39,892 | 43,386 | 43,414 |  |
| Due after twenty years | 59,068 | 59,703 | 71,610 | 72,559 |  |
|  | $\$ 473,908$ | $\$ 476,683$ | $\$ 469,650$ | $\$ 472,920$ |  |

Securities-Held-to-Maturity: The amortized cost and estimated fair value of securities-held-to-maturity at March 31, 2013 and December 31, 2012 are summarized as follows (dollars in thousands):

March 31, 2013
$\left.\begin{array}{llllllll} & \begin{array}{llllll}\text { Amortized } \\ \text { Cost }\end{array} & \begin{array}{l}\text { Gross } \\ \text { Unrealized } \\ \text { Gains }\end{array} & \begin{array}{l}\text { Gross } \\ \text { Unrealized } \\ \text { Losses }\end{array} & \text { Fair Value }\end{array} \begin{array}{l}\text { Percent of } \\ \text { Total }\end{array}\right]$

At March 31, 2013 and December 31, 2012, an age analysis of unrealized losses and fair value of related securities-held-to-maturity was as follows (in thousands):

|  | March 31, 2013 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Less Than 12 Months |  | 12 Months or More |  | Total |  |
|  | Fair Value | Unrealized <br> Losses | Fair Value | Unrealized <br> Losses | Fair Value | Unrealized <br> Losses |
| Municipal bonds: |  |  |  |  |  |  |
| Taxable | \$3,313 | \$(18 ) | \$- | \$- | \$3,313 | \$(18 |
| Tax exempt | 5,354 | (74 | - | - | 5,354 | (74 |
|  | \$8,667 | \$(92 ) | \$- | \$- | \$8,667 | \$(92 |
|  | December 31, 2012 |  |  |  |  |  |
|  | Less Than | 2 Months | 12 Months | or More | Total |  |
|  | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Municipal bonds: |  |  |  |  |  |  |
| Taxable | \$4,137 | \$(157 | \$- | \$- | \$4,137 | \$(157 |
| Tax exempt | 910 | (30 | - | - | 910 | (30 |
|  | \$5,047 | \$(187 | \$- | \$- | \$5,047 | \$(187 |

There were no sales of securities-held-to-maturity and the Company recognized no OTTI charges on securities-held-to-maturity during the three months ended March 31, 2013 and 2012. As of March 31, 2013, there were no securities-held-to-maturity in a nonaccrual status. There were seven securities-held-to-maturity with unrealized losses at March 31, 2013, compared to five securities at December 31, 2012. Management does not believe that any individual unrealized loss as of March 31, 2013 represents 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 March 31, 2013 and December 31, 2012, 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.

|  | March 31, 2013 |  | December 31, 2012 |  |
| :--- | :--- | :--- | :--- | :--- |
|  | Amortized | Fair Value | Amortized | Fair Value |
| Cost | Cost | $\$ 3,410$ |  |  |
| Due in one year or less | $\$ 3,322$ | $\$ 3,383$ | $\$ 3,323$ | $\$ 14,335$ |
| Due after one year through five years | 13,634 | 14,261 | 13,641 | 13,452 |
| Due after five years through ten years | 13,230 | 13,475 | 13,295 | 57,868 |
| Due after ten years through twenty years | 55,097 | 59,403 | 53,031 | 573,162 |
| Due after twenty years | 3,125 | 3,263 | 3,162 | 3,393 |
|  | $\$ 88,408$ | $\$ 93,785$ | $\$ 86,452$ | $\$ 92,458$ |

Pledged Securities: The following table presents, as of March 31, 2013, investment securities which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law (in thousands):

|  | Amortized <br> Cost | Fair Value |
| :--- | :--- | :--- |
| Purpose or beneficiary: |  |  |
| State and local governments public deposits | $\$ 116,343$ | $\$ 121,720$ |
| Interest rate swap counterparties | 10,967 | 11,152 |
| Retail repurchase agreements | 104,594 | 106,562 |
| Total pledged securities | $\$ 231,904$ | $\$ 239,434$ |

The carrying value of investment securities pledged to secure borrowings as of March 31, 2013 was $\$ 235$ million.

## Note 6: FHLB STOCK

The Banks' investments in Federal Home Loan Bank of Seattle stock are carried at par value ( $\$ 100$ per share), which reasonably approximates its fair value. 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 three months ended March 31, 2013 and 2012, the Banks did not receive any dividend income on FHLB stock. At March 31, 2013 and December 31, 2012, respectively, the Company had recorded $\$ 36.4$ million and $\$ 36.7$ million in FHLB stock. This stock is generally viewed as a long-term investment and is carried at par. 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.

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 FHLB of Seattle 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 on 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 March 31, 2013, the FHLB had repurchased $\$ 998,500$ of the Banks' stock, including $\$ 332,600$ during the quarter ending March 31, 2013. 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 March 31, 2013.

## Note 7: LOANS RECEIVABLE AND THE ALLOWANCE FOR LOAN LOSSES

We 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 the 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, land and land development, commercial and multifamily real estate, commercial business, agricultural business 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.

Interest is accrued as earned unless management doubts the collectability of the loan or the unpaid interest. Interest accruals are generally discontinued when loans become 90 days past due for scheduled interest payments. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is included in interest income based upon an assessment of the likelihood that the loans 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 loan may be uncollectable. Such interest is then recognized as income only if it is ultimately collected.

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Loans receivable, including loans held for sale, at March 31, 2013, December 31, 2012 and March 31, 2012 are summarized as follows (dollars in thousands):


Loan amounts are net of unearned loan fees and unamortized costs of $\$ 9$ million as of March 31, 2013 and December 31, 2012 and $\$ 10$ million as of March 31, 2012.

|  | Washington | Oregon | Idaho | Other | Total |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$376,330 | \$58,671 | \$57,363 | \$5,078 | \$497,442 |
| Investment properties | 467,720 | 87,184 | 43,750 | 4,107 | 602,761 |
| Multifamily real estate | 112,625 | 13,208 | 8,196 | 261 | 134,290 |
| Commercial construction | 23,636 | 6,566 | 1,207 | 3,353 | 34,762 |
| Multifamily construction | 15,566 | 18,581 | - | - | 34,147 |
| One- to four-family construction | 97,016 | 72,729 | 2,131 | - | 171,876 |
| Land and land development: |  |  |  |  |  |
| Residential | 47,106 | 29,614 | 1,726 | - | 78,446 |
| Commercial | 7,482 | 3,043 | 1,952 | - | 12,477 |
| Commercial business | 393,638 | 83,574 | 55,047 | 87,219 | 619,478 |
| Agricultural business, including secured by farmland | 105,886 | 38,934 | 65,405 | - | 210,225 |
| One- to four-family real estate | 352,209 | 188,804 | 23,660 | 2,057 | 566,730 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 111,010 | 41,897 | 11,721 | 677 | 165,305 |

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| Consumer-other | 76,807 | 30,233 | 5,337 | 5 |  | 112,382 |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Total loans | $\$ 2,187,031$ | $\$ 673,038$ | $\$ 277,495$ | $\$ 102,757$ |  | $\$ 3,240,321$ |  |  |
| Percent of total loans | 67.5 | $\%$ | 20.8 | $\%$ | 8.5 | $\%$ | 3.2 | $\%$ |
|  |  |  | 100.0 | $\%$ |  |  |  |  |

The geographic concentrations of the Company's land and land development loans by state at March 31, 2013 were as follows (dollars in thousands):

Residential:

| Acquisition and development | $\$ 8,982$ | $\$ 12,071$ | $\$ 1,523$ | $\$ 22,576$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Improved land and lots | 29,463 | 17,093 | 203 | 46,759 |  |
| Unimproved land | 8,661 | 450 | - | 9,111 |  |
| Commercial: | - |  |  |  |  |
| Acquisition and development | 4,143 | - | 482 | 482 |  |
| Improved land and lots | 3,339 | 2,907 | 541 | 4,820 |  |
| Unimproved land | $\$ 54,588$ | $\$ 32,657$ | 929 | 7,175 |  |
| Total land and land development loans | 60.0 | $\%$ | 35.9 | $\%$ | 4.1 |
| Percent of land and land development loans |  |  | $\%$ | 100.0 | $\%$ |

The Company originates both adjustable- and fixed-rate loans. The maturity and repricing composition of those loans, less undisbursed amounts and deferred fees, at March 31, 2013, December 31, 2012 and March 31, 2012 were as follows (in thousands):

Fixed-rate (term to maturity):
Due in one year or less
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
Total fixed-rate loans
Adjustable-rate (term to rate adjustment):
Due in one year or less
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
Total adjustable-rate loans
Total loans

| March 31, 2013 | December 31, <br> 2012 | March 31, 2012 |
| :--- | :--- | :--- |
| $\$ 152,586$ $\$ 183,004$ <br> 176,372 171,724 | $\$ 213,503$ |  |
| 187,021 | 173,251 | 231,148 |
| 172,654 | 167,858 | 175,846 |
| 445,872 | 473,927 | 159,453 |
| $1,134,505$ | $1,169,764$ | 477,495 |
| $1,274,415$ | $1,260,472$ | $1,257,445$ |
| 253,048 | 275,223 | 387,588 |
| 515,861 | 467,895 | 363,719 |
| 62,443 | 60,316 | 25,863 |
| 49 | 2,044 | 6,383 |
| $2,105,816$ | $2,065,950$ | $1,972,217$ |
| $\$ 3,240,321$ | $\$ 3,235,714$ | $\$ 3,229,662$ |

The adjustable-rate loans have interest rate adjustment limitations and are generally indexed to various prime (The Wall Street Journal) or LIBOR rates, One to Five Year Constant Maturity Treasury Indices or FHLB advance rates. Future market factors may affect the correlation of the interest rate adjustment with the rates the Banks pay on the short-term deposits that were primarily utilized to fund these loans.

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, troubled debt restructurings (TDRs) that are performing under their restructured terms, and loans that are 90 days or more past due, but are still on accrual.

Troubled Debt Restructures. Some of the Company's loans are reported as TDRs. Loans are reported as TDRs 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. Our TDRs have generally not involved forgiveness of amounts due, but almost always include a modification of multiple factors; the most common combination includes interest rate, payment amount and maturity date. As a result of these concessions, restructured loans 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. Loans identified as TDRs are accounted for in accordance with the Banks' impaired loan accounting policies.

The amount of impaired loans and the related allocated reserve for loan losses as of March 31, 2013 and December 31, 2012 were as follows (in thousands):

March 31, 2013
Loan Amount $\begin{aligned} & \text { Allocated } \\ & \text { Reserves }\end{aligned}$

December 31, 2012

Loan Amount | Allocated |
| :--- |
| Reserves |

Impaired loans:
Nonaccrual loans
Commercial real estate:

| Owner-occupied | $\$ 3,558$ | $\$ 52$ | $\$ 4,105$ | $\$ 618$ |
| :--- | :--- | :--- | :--- | :--- |
| Investment properties | 3,169 | 53 | 2,474 | 56 |
| Multifamily real estate | 339 | 71 | - | - |
| One- to four-family construction | 1,951 | 308 | 1,565 | 326 |
| Land and land development: <br> Residential | 1,777 | 233 | 2,061 | 323 |
| Commercial | - | - | 46 | 12 |
| Commercial business | 4,370 | 341 | 4,750 | 344 |
| One- to four-family residential | 12,875 | 387 | 12,964 | 520 |
| Consumer: |  |  |  |  |
| Consumer secured by one- to four-family | 1,838 | 24 | 2,073 | 41 |
| Consumer-other | 1,240 | 121 | 1,323 | 16 |
| Total nonaccrual loans | $\$ 31,117$ | $\$ 1,590$ | $\$ 31,361$ | $\$ 2,256$ |
| Past due and still accruing | $\$ 2,289$ | $\$ 4$ | $\$ 3,029$ | $\$ 62$ |
| Troubled debt restructuring on accrual status: |  |  |  |  |
| Commercial real estate: | $\$ 187$ | $\$ 4$ | $\$ 188$ | $\$ 4$ |
| Owner-occupied | 7,020 | 1,026 | 7,034 | 664 |
| Investment properties | 7,075 | 1,775 | 7,131 | 1,665 |
| Multifamily real estate | 6,551 | 1,007 | 6,726 | 1,115 |
| One- to four-family construction | 4,542 | 788 | 4,842 | 667 |
| Land and land development: | 1,194 | 215 | 2,975 | 610 |
| Residential | 27,013 | 1,916 | 27,540 | 1,228 |

Consumer:

| Consumer secured by one- to four-family | 544 | 32 | 538 | 29 |
| :--- | :--- | :--- | :--- | :--- |
| Consumer-other | 485 | 62 | 488 | 38 |
| Total troubled debt restructurings on accrual status | 54,611 | 6,825 | 57,462 | 6,020 |
| Total impaired loans | $\$ 88,017$ | $\$ 8,419$ | $\$ 91,852$ | $\$ 8,338$ |

As of March 31, 2013 and 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 March 31, 2013 and December 31, 2012 (in thousands):

At or For the Three Months Ended March 31, 2013

|  | Recorded <br> Investment | Unpaid <br> Principal <br> Balance | Related <br> Allowance | Average <br> Recorded <br> Investment | Interest <br> Income <br> Recognized |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Without a specific allowance reserve ${ }^{(1)}$ |  |  |  |  |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$ 1,018 | \$1,168 | \$52 | \$1,027 | \$- |
| Investment properties | 284 | 467 | 53 | 289 | - |
| Multifamily real estate | 339 | 339 | 71 | 339 | - |
| One- to four-family construction | 992 | 1,108 | 96 | 1,036 | - |
| Land and land development: |  |  |  |  |  |
| Residential | 691 | 905 | 233 | 731 | - |
| Commercial business | 1,427 | 2,145 | 271 | 1,537 | - |
| One- to four-family residential | 8,187 | 9,013 | 80 | 8,260 | 2 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 1,496 | 2,001 | 23 | 1,502 | - |
| Consumer-other | 952 | 1,070 | 9 | 942 | - |
|  | 15,386 | 18,216 | 888 | 15,663 | 2 |
| With a specific allowance reserve ${ }^{(2)}$ |  |  |  |  |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$2,727 | \$2,727 | \$4 | \$2,750 | \$3 |
| Investment properties | 9,905 | 11,532 | 1,026 | 10,138 | 85 |
| Multifamily real estate | 7,075 | 7,075 | 1,775 | 7,076 | 90 |
| One- to-four family construction | 7,511 | 7,511 | 1,219 | 6,947 | 65 |
| Land and land development: |  |  |  |  |  |
| Residential | 5,628 | 5,628 | 789 | 5,719 | 52 |
| Commercial business | 4,137 | 4,498 | 285 | 4,247 | 14 |
| One- to four-family residential | 33,944 | 34,843 | 2,225 | 33,730 | 311 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 885 | 898 | 33 | 891 | 7 |
| Consumer-other | 819 | 834 | 175 | 820 | 8 |
|  | 72,631 | 75,546 | 7,531 | 72,318 | 635 |
| Total |  |  |  |  |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$3,745 | \$3,895 | \$56 | \$3,777 | \$3 |
| Investment properties | 10,189 | 11,999 | 1,079 | 10,427 | 85 |
| Multifamily real estate | 7,414 | 7,414 | 1,846 | 7,415 | 90 |
| One- to four-family construction | 8,503 | 8,619 | 1,315 | 7,983 | 65 |
| Land and land development: |  |  |  |  |  |
| Residential | 6,319 | 6,533 | 1,022 | 6,450 | 52 |
| Commercial business | 5,564 | 6,643 | 556 | 5,784 | 14 |
| One- to four-family residential | 42,131 | 43,856 | 2,305 | 41,990 | 313 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 2,381 | 2,899 | 56 | 2,393 | 7 |
| Consumer-other | 1,771 | 1,904 | 184 | 1,762 | 8 |
|  | \$88,017 | \$93,762 | \$8,419 | \$87,981 | \$637 |


| At or For the Year Ended December 31, 2012 |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Recorded Investment | Unpaid Principal Balance | Related <br> Allowance | Average <br> Recorded <br> Investment | Interest <br> Income <br> Recognized |
| Without a specific allowance reserve ${ }^{(1)}$ ( ${ }^{\text {a }}$ |  |  |  |  |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$1,300 | \$1,551 | \$103 | \$ 1,470 | \$- |
| Investment properties | 624 | 861 | 90 | 735 | 17 |
| Multifamily real estate | 2,131 | 2,131 | 392 | 2,136 | 113 |
| One- to four-family construction | 4,460 | 4,460 | 571 | 3,335 | 145 |
| Land and land development: |  |  |  |  |  |
| Residential | 2,122 | 2,587 | 404 | 2,948 | 73 |
| Commercial | 46 | 46 | 12 | 46 | - |
| Commercial business | 4,352 | 4,970 | 821 | 2,121 | 154 |
| One- to four-family residential | 10,886 | 12,004 | 150 | 11,458 | 44 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 1,641 | 2,335 | 54 | 1,966 | 14 |
| Consumer-other | 1,167 | 1,275 | 16 | 1,297 | 5 |
|  | 28,729 | 32,220 | 2,613 | 27,512 | 565 |
| With a specific allowance reserve ${ }^{(2)}$ |  |  |  |  |  |
| Commercial real estate: |  |  |  |  |  |
| Owner-occupied | \$2,993 | \$2,993 | \$518 | \$3,113 | \$- |
| Investment properties | 8,884 | 10,120 | 630 | 9,449 | 229 |
| Multifamily real estate | 5,000 | 5,000 | 1,273 | 5,000 | 295 |
| One- to-four family construction | 3,831 | 3,831 | 870 | 3,611 | 194 |
| Land and land development: |  |  |  |  |  |
| Residential | 4,782 | 4,782 | 586 | 5,039 | 185 |
| Commercial | - | - | - | - | - |
| Commercial business | 3,373 | 3,734 | 134 | 3,931 | 6 |
| One- to four-family residential | 32,494 | 33,672 | 1,656 | 33,100 | 1,259 |
| Consumer: |  |  |  |  |  |
| Consumer secured by one- to four-family | 1,042 | 1,140 | 26 | 1,074 | 15 |
| Consumer-other | 724 | 740 | 32 | 754 | - |
|  | 63,123 | 66,012 | 5,725 | 65,071 | 2,183 |
| Total |  |  |  |  |  |
| Commercial real estate |  |  |  |  |  |
| Owner-occupied | \$4,293 | \$4,544 | \$621 | \$4,583 | \$- |
| Investment properties | 9,508 | 10,981 | 720 | 10,184 | 246 |
| Multifamily real estate | 7,131 | 7,131 | 1,665 | 7,136 | 408 |
| One- to four-family construction | 8,291 | 8,291 | 1,441 | 6,946 | 339 |
| Land and land development |  |  |  |  |  |
| Residential | 6,904 | 7,369 | 990 | 7,987 | 258 |
| Commercial | 46 | 46 | 12 | 46 | - |
| Commercial business | 7,725 | 8,704 | 955 | 6,052 | 160 |
| One- to four-family residential | 43,380 | 45,676 | 1,806 | 44,558 | 1,303 |
| Consumer |  |  |  |  |  |
| 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 |

(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) 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.

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The following tables present TDRs at March 31, 2013 and December 31, 2012 (in thousands):

|  | March 31, 2013 |  |  |
| :---: | :---: | :---: | :---: |
|  | Accrual Status | Nonaccrual Status | Total <br> Modifications |
| Commercial real estate: |  |  |  |
| Owner-occupied | \$187 | \$1,287 | \$ 1,474 |
| Investment properties | 7,020 | 1,486 | 8,506 |
| Multifamily real estate | 7,075 | - | 7,075 |
| One- to four-family construction | 6,551 | 1,143 | 7,694 |
| Land and land development: |  |  |  |
| Residential | 4,542 | - | 4,542 |
| Commercial business | 1,194 | 577 | 1,771 |
| One- to four-family residential | 27,013 | 3,525 | 30,538 |
| Consumer: |  |  |  |
| Consumer secured by one- to four-family | 544 | 467 | 1,011 |
| Consumer-other | 485 | 334 | 819 |
|  | \$54,611 | \$8,819 | \$63,430 |
|  | 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 |

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The following tables present new TDRs that occurred during the three months ended March 31, 2013 and 2012 (dollars in thousands):

|  | Three Months Ended March 31, 2013 |  |  |
| :---: | :---: | :---: | :---: |
|  | Number of Contracts | Pre- <br> modification <br> Outstanding <br> Recorded <br> Investment | Postmodification Outstanding Recorded Investment |
| Recorded Investment ${ }^{(1)(2)}$ |  |  |  |
| One- to four-family construction | 4 | \$427 | \$427 |
| One- to four-family residential | 10 | 3,709 | 3,695 |
|  | 14 | \$4,136 | \$4,122 |
|  | Three Months Ended March 31, 2012 |  |  |
|  | Number of Contracts | Pre- | Post- |
|  |  | Outstanding | Outstanding |
|  |  | Recorded | Recorded |
|  |  | Investment | Investment |
| Recorded Investment ${ }^{(1)(2)}$ |  |  |  |
| Commercial real estate |  |  |  |
| Investment properties | 2 | \$877 | \$877 |
| One- to four-family construction | 2 | 750 | 750 |
| Land and land development-residential | 2 | 560 | 560 |
| Commercial business | 3 | 355 | 355 |
| One- to four-family residential | 15 | 8,489 | 8,489 |
| Consumer | 2 | 291 | 291 |
|  | 26 | \$11,322 | \$11,322 |

[^0]The following table presents TDRs which incurred a payment default within twelve months of the restructure date during the three-month periods ended March 31, 2013 and 2012 (in thousands). A default on a TDR results in either a transfer to nonaccrual status or a partial charge-off:

| Three Months Ended |  |
| :--- | ---: |
| March 31 |  |
| 2013 | 2012 |

Commercial real estate:
Owner occupied
\$-\$29

Investment properties - 2, - 253
Commercial business
351
One- to four-family residential 231
Consumer secured by one- to four-family - 85 Total \$351 \$2,698

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 the three months ended March 31, 2013.

## 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 which requires, however, 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.

## 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 indeterminable. 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 should be 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 the Company's portfolio of risk-rated loans and non-risk-rated loans by grade or other characteristics as of March 31, 2013 and December 31, 2012 (in thousands):

March 31, 2013

|  | One- to |  |  |  |  |
| :---: | :--- | :--- | :--- | :--- | :--- | :--- |
| Commercial | Multifamily | ConstructiorCommercialAgriculturalFour- |  |  |  |
| Real | and Land | Business | Business | Family | Consumer Total Loans |
| Real Estate | Residential |  |  |  |  |

Risk-rated loans:
Pass (Risk Ratings
1-5) ${ }^{(1)}$

| Special mention | 13,338 | - | 2,015 | 4,798 | 685 | 437 | 145 | 21,418 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Substandard | 36,410 | 6,975 | 24,707 | 23,764 | 249 | 19,419 | 5,775 | 117,299 |
| Doubtful | 544 | - | - | 11 | - | - | - | 555 |
| Loss | - | - | - | - | - | - | - | - |
| Total loans | $\$ 1,100,203$ | $\$ 134,290$ | $\$ 331,708$ | $\$ 619,478$ | $\$ 210,225$ | $\$ 566,730$ | $\$ 277,687$ | $\$ 3,240,321$ |
| Performing loans | $\$ 1,093,477$ | $\$ 133,951$ | $\$ 327,979$ | $\$ 615,108$ | $\$ 210,225$ | $\$ 551,611$ | $\$ 274,564$ | $\$ 3,206,915$ |
| Non-performing | 6,726 | 339 | 3,729 | 4,370 | - | 15,119 | 3,123 | 33,406 |
| loans |  |  |  |  |  |  |  |  |
| Total loans | $\$ 1,100,203$ | $\$ 134,290$ | $\$ 331,708$ | $\$ 619,478$ | $\$ 210,225$ | $\$ 566,730$ | $\$ 277,687$ | $\$ 3,240,321$ |

December 31, 2012

Risk-rated loans:
Pass (Risk Ratings
1-5) ${ }^{(1)}$

| 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 |
| Loss | - | - | - | - | - | - | - | - |
| 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-performing | 6,579 | - | 3,672 | 4,750 | - | 15,841 | 3,548 | 34,390 |
| loans ${ }^{(2)}$ | - |  |  |  |  |  |  |  |
| Total loans | $\$ 1,073,222$ | $\$ 137,504$ | $\$ 304,617$ | $\$ 618,049$ | $\$ 230,031$ | $\$ 581,670$ | $\$ 290,621$ | $\$ 3,235,714$ |

The Pass category includes some performing loans that are part of homogenous pools which are not individually risk-rated. This includes all consumer loans, all one- to four-family residential loans and, as of March 31, 2013
${ }^{(1)}$ and December 31, 2012, in the commercial business category, $\$ 78$ million and $\$ 77$ million, respectively, of credit-scored small business loans. As loans in these pools become non-performing, they are individually risk-rated.
${ }^{(2)}$ Non-performing loans include non-accrual loans and loans past due greater than 90 days and on accrual status.

The following tables provide additional detail on the age analysis of the Company's past due loans as of March 31, 2013 and December 31, 2012 (in thousands):

March 31, 2013

|  | 30-59 <br> Days <br> Past Due | $\begin{aligned} & 60-89 \\ & \text { Days } \\ & \text { Past Due } \end{aligned}$ | 90 Days or More Past Due | Total Past Due | Current | Total Loans | Loans 90 <br> Days or <br> More Past <br> Due and <br> Accruing |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial real estate: |  |  |  |  |  |  |  |
| Owner-occupied | \$1,794 | \$4 | \$824 | \$2,622 | \$494,820 | \$497,442 | \$- |
| Investment properties | 715 | 49 | 1,410 | 2,174 | 600,587 | 602,761 | - |
| Multifamily real estate | - | - | - | - | 134,290 | 134,290 | - |
| Commercial construction | - | - | - | - | 34,762 | 34,762 | - |
| Multifamily construction | - | - | - | - | 34,147 | 34,147 | - |
| One-to-four-family construction | 430 | - | 196 | 626 | 171,250 | 171,876 | - |
| Land and land development: |  |  |  |  |  |  |  |
| Residential | 286 | - | 1,777 | 2,063 | 76,383 | 78,446 | - |
| Commercial | - | - | - | - | 12,477 | 12,477 | - |
| Commercial business | 1,326 | 248 | 1,430 | 3,004 | 616,474 | 619,478 | - |
| Agricultural business | 181 | 30 | - | 211 | 210,014 | 210,225 | - |
| One- to four-family residential Consumer: | 241 | 1,802 | 9,422 | 11,465 | 555,265 | 566,730 | 2,243 |
| Consumer secured by one- to four-family | 129 | - | 1,592 | 1,721 | 163,584 | 165,305 | - |
| Consumer-other | 1,261 | 190 | 1,062 | 2,513 | 109,869 | 112,382 | 46 |
| Total | \$6,363 | \$2,323 | \$17,713 | \$26,399 | \$3,213,922 | \$3,240,321 | \$2,289 |

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December 31, 2012

|  |  |  |  |  |  | Loans 90 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 30-59 | 60-89 | 90 Days |  |  |  | Days or |
| Days | Days | or More |  | Current | Total Loans | More Past |
| Past Due | Past Due | Past Due |  |  |  | Due and |

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 | - | - | - | - | 230,031 | 230,031 | - |
| One-to four-family residential | 1,376 | 3,468 | 11,488 | 16,332 | 565,338 | 581,670 | 2,877 |
| Consumer: |  |  |  |  |  |  |  |
| Consumer secured by one- to four-family | 699 | 74 | 1,204 | 1,977 | 168,146 | 170,123 | - |
| Consumer-other | 816 | 673 | 839 | 2,328 | 118,170 | 120,498 | 152 |
| Total | \$9,870 | \$4,264 | \$19,267 | \$33,401 | \$3,202,313 | \$3,235,714 | \$3,029 |

The following tables provide additional information on the allowance for loan losses and loan balances individually and collectively evaluated for impairment at or for the three months ended March 31, 2013 and 2012 (in thousands):

For the Three Months Ended March 31, 2013


Allowance for loan losses:

| Beginning balance | \$15,322 | \$ 4,506 | \$ 14,991 | \$ 9,957 | \$ 2,295 | \$ 16,475 | \$ 1,348 | \$ 12,597 | \$77,491 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Provision for loan losses | (1,784 ) | 569 | 557 | 597 | (50 | (10 | ) 116 | 5 | - |
| Recoveries | 1,586 | - | 101 | 386 | 37 | 116 | 102 | - | 2,328 |
| Charge-offs | (348) | - | (435 ) | (929 | - | (651 ) | ) (328 | - | (2,691 ) |
| Ending balance | \$14,776 | \$ 5,075 | \$ 15,214 | \$ 10,011 | \$ 2,282 | \$15,930 | \$ 1,238 | \$ 12,602 | \$77,128 |

At March 31, 2013

| Commercial | ConstructiorCommercialAgriculturalo- to |  | Commitments |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Real | Multifamily | and Land | Business | business | Four- |
| Consumerand | Family | Unallocated |  |  |  |

Allowance individually evaluated for impairment Allowance collectively evaluated for impairment Total allowance for loan losses

| $\$ 14,776$ | $\$ 5,075$ | $\$ 15,214$ | $\$ 10,011$ | $\$ 2,282$ | $\$ 15,930$ | $\$ 1,238$ | $\$ 12,602$ | $\$ 77,128$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

At March 31, 2013

|  | ConstructioCommerciaAgricultural One- to |  |  | Commitments |  |
| :--- | :--- | :--- | :--- | :--- | :---: |
| Commercial |  |  |  |  |  |
| Real Estate | Multifamily | and Land | Business | business |  |
|  | Four- | Consumer and Total |  |  |  |
|  | Family | Unallocated |  |  |  |

Loan balances:
Loans
individually
evaluated for
\$12,632 $\quad \$ 7,075 \quad \$ 13,139 \quad \$ 4,137 \quad \$-$
\$33,945 \$1,704 $\quad \$-\quad \$ 72,632$
impairment
Loans
collectively
evaluated for
impairment
Total loans $\quad \$ 1,100,203 \quad \$ 134,290 \quad \$ 331,708 \quad \$ 619,478 \quad \$ 210,225 \quad \$ 566,730 \quad \$ 277,687 \quad \$-\quad \$ 3,240,321$

For the Three Months Ended March 31, 2012


Allowance for loan losses:

| Beginning balance | \$16,457 | \$ 3,952 | \$ 18,184 | \$ 15,159 | \$ 1,548 | \$12,299 | \$ 1,253 | \$ 14,060 | \$82,912 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Provision for | 1,335 | (691 | 241 | (865 | 614 | 1,531 | 719 | 2,116 | 5,000 |
| Recoveries | 614 | - | 370 | 236 | - | 5 | 136 | - | 1,361 |
| Charge-offs | (1,323 | - | (2,924 | (1,407 | (275 | (966 | ) 834 | - | (7,729 ) |
| Ending balance | \$17,083 | \$ 3,261 | \$ 15,871 | \$ 13,123 | \$ 1,887 | \$ 12,869 | \$ 1,274 | \$ 16,176 | \$81,544 |

At March 31, 2012

| Commercial | ConstructiorommercialAgriculturate- to |  | Commitments |  |  |
| :--- | :---: | :--- | :--- | :---: | :--- |
| Real | Multifamily | and Land | Business | business | Four- |
| Consumerand | Family | Unallocated |  |  |  |

Allowance individually evaluated for

| $\$ 239$ | $\$ 37$ | $\$ 2,100$ | $\$ 799$ | $\$ 480$ | $\$ 824$ | $\$ 71$ | $\$-$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | impairment Allowance collectively evaluated for $\begin{array}{lllllllll}16,844 & 3,224 & 13,771 & 12,324 & 1,407 & 12,045 & 1,203 & 16,176 & 76,994\end{array}$ impairment Total allowance for loan losses


| $\$ 17,083$ | $\$ 3,261$ | $\$ 15,871$ | $\$ 13,123$ | $\$ 1,887$ | $\$ 12,869$ | $\$ 1,274$ | $\$ 16,176$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

At March 31, 2012


Loan balances:
Loans individually evaluated for impairment Loans collectively evaluated $\begin{array}{lllllllll} & 1,067,812 & 130,671 & 288,871 & 599,681 & 187,994 & 596,250 & 285,993 & - \\ 3,157,272\end{array}$ for impairment Total loans \$1,080,935 \$ 132,306 \$311,020 \$609,497 \$188,955 \$619,511 \$287,438 \$ - \$3,229,662 32

## Note 8: REAL ESTATE OWNED, NET

The following table presents the changes in REO, net of valuation adjustments, for the three months ended March 31, 2013 and 2012 (in thousands):

|  | Three Months Ended |  |
| :--- | :--- | :--- |
|  | March 31 |  |
|  | 2013 | 2012 |
| Balance, beginning of the period | $\$ 15,778$ | $\$ 42,965$ |
| Additions from loan foreclosures | 1,086 | 1,601 |
| Additions from capitalized costs | 46 | 127 |
| Dispositions of REO | $(6,481$ | $(15,441$ |
| Gain on sale of REO | 804 | 100 |
| Valuation adjustments in the period | $(73$ | $)$ |
| Balance, end of the period | $\$ 11,160$ | $\$ 27,723$ |

The following table shows REO by type and geographic location by state as of March 31, 2013 (in thousands):

|  | Washington | Oregon | Idaho | Total |
| :--- | :--- | :--- | :--- | :--- |
| Commercial real estate | $\$-$ | $\$-$ | $\$ 198$ | $\$ 198$ |
| One- to four-family construction | 401 | - | - | 401 |
| Land development-residential | 1,610 | 6,321 | 70 | 8,001 |
| One- to four-family real estate | 1,077 | 1,483 | - | 2,560 |
| Balance, end of period | $\$ 3,088$ | $\$ 7,804$ | $\$ 268$ | $\$ 11,160$ |

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 9: INTANGIBLE ASSETS AND MORTGAGE SERVICING RIGHTS

Intangible Assets: At March 31, 2013, intangible assets consisted 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.

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. Intangible assets are amortized over their useful lives and are also reviewed for impairment.

The following table summarizes the changes in the Company's core deposit intangibles and other intangibles for the three months ended March 31, 2013 and the year ended December 31, 2012 (in thousands):

|  | Core Deposit | Other | Total |
| :--- | :--- | :--- | :--- |
| Balance, December 31, 2012 | Intangibles |  | $\$-$ |
| Amortization | $\$ 4,230$ | - | $\$ 4,230$ |
| Balance, March 31, 2013 | $(506$ | $\$-$ | $(506$ |
|  | $\$ 3,724$ |  | $\$ 3,724$ |
|  |  |  |  |
| Core Deposit | Other | Total |  |
| Balance, December 31, 2011 | Intangibles | $\$ 9$ | $\$ 6,331$ |
| Amortization | $\$ 6,322$ | $(2)$ | $(554$ |
| Balance, March 31, 2012 | $(552$ | $\$ 7$ | $\$ 5,777$ |

The following table presents the estimated annual amortization expense with respect to existing intangibles as of March 31, 2013 (in thousands):

| Year Ended | Core Deposit |
| :--- | :---: |
| December 31, 2013 | Intangibles |
| December 31, 2014 | $\$ 1,908$ |
| December 31, 2015 | 1,724 |
|  | 598 |
|  | $\$ 4,230$ |

Mortgage Servicing Rights: Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially recorded 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. During the three months ended March 31, 2013 and 2012, the Company did not record an impairment charge. Loans serviced for others totaled $\$ 984$ million, $\$ 918$ million and $\$ 717$ million at March 31, 2013, December 31, 2012 and March 31, 2012, respectively. Custodial accounts maintained in connection with this servicing totaled $\$ 2.8$ million, $\$ 4.7$ million and $\$ 1.8$ million at March 31, 2013, December 31, 2012, and March 31, 2012, respectively.

An analysis of our mortgage servicing rights for the three months ended March 31, 2013 and 2012 is presented below (in thousands):

|  | Three Months Ended |  |
| :--- | :--- | :--- |
| March 31 |  |  |
|  | 2013 | 2012 |
| Balance, beginning of the period | $\$ 6,244$ | $\$ 5,584$ |
| Amounts capitalized | 776 | 913 |
| Amortization ${ }^{(1)}$ | $(685$ | $(627$ |
| Balance, end of the period | $\$ 6,335$ | $\$ 5,870$ |

(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 10: DEPOSITS AND RETAIL REPURCHASE AGREEMENTS

Deposits consisted of the following at March 31, 2013, December 31, 2012 and March 31, 2012 (dollars in thousands):

|  | March 31, 2013 |  |  | December 31, 2012 |  | March 31, 2012 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Amount | Percent of Total |  | Amount | Percent of Total |  | Amount | Percent of Total |  |
| Non-interest-bearing accounts | \$962,156 | 27.3 | \% | \$981,240 | 27.6 | \% | \$771,812 | 22.5 | \% |
| Interest-bearing checking | 400,598 | 11.4 |  | 410,316 | 11.5 |  | 368,810 | 10.8 |  |
| Regular savings accounts | 759,866 | 21.6 |  | 727,957 | 20.5 |  | 673,704 | 19.7 |  |
| Money market accounts | 415,061 | 11.8 |  | 408,998 | 11.5 |  | 414,516 | 12.1 |  |
| Total transaction and saving accounts | 2,537,681 | 72.1 |  | 2,528,511 | 71.1 |  | 2,228,842 | 65.1 |  |
| Certificates which mature or reprice: |  |  |  |  |  |  |  |  |  |
| Within 1 year | 705,933 | 20.0 |  | 759,626 | 21.3 |  | 918,696 | 26.8 |  |
| After 1 year, but within 3 years | 220,615 | 6.3 |  | 209,790 | 5.9 |  | 210,161 | 6.1 |  |
| After 3 years | 56,355 | 1.6 |  | 59,877 | 1.7 |  | 68,471 | 2.0 |  |
| Total certificate accounts | 982,903 | 27.9 |  | 1,029,293 | 28.9 |  | 1,197,328 | 34.9 |  |
| Total deposits | \$3,520,584 | 100.0 | \% | \$3,557,804 | 100.0 | \% | \$3,426,170 | 100.0 | \% |
| Included in total deposits: |  |  |  |  |  |  |  |  |  |
| Public fund transaction accounts | \$73,273 | 2.1 | \% | \$79,955 | 2.2 | \% | \$68,590 | 2.0 | \% |
| Public fund interest-bearing certificates | 53,552 | 1.5 | \% | 60,518 | 1.7 | \% | 69,856 | 2.0 | \% |
| Total public deposits | \$ 126,825 | 3.6 | \% | \$140,473 | 3.9 | \% | \$138,446 | 4.0 | \% |
| Total brokered deposits | \$15,709 | 0.4 | \% | \$15,702 | 0.4 | \% | \$30,978 | 0.9 | \% |

The following table presents the geographic concentration of deposits at March 31, 2013 (in thousands):

|  | Washington | Oregon | Idaho | Total |
| :--- | :--- | :--- | :--- | :--- |
| Total deposits | $\$ 2,665,776$ | $\$ 618,161$ | $\$ 236,647$ | $\$ 3,520,584$ |

In addition to deposits, we also offer retail repurchase agreements which are customer funds that are primarily associated with sweep account arrangements tied to transaction deposit accounts. While we include these collateralized borrowings in other borrowings reported in our Consolidated Statements of Financial Condition, these accounts primarily represent customer utilization of our cash management services and related deposit accounts.

The following table presents retail repurchase agreement balances as of March 31, 2013, December 31, 2012 and March 31, 2012 (in thousands):

|  | March 31, 2013 | December 31, | March 31, 2012 |
| :--- | :--- | :--- | :--- |
| Retail repurchase agreements | $\$ 88,446$ | $\$ 76,633$ | $\$ 91,253$ |

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## Note 11: FAIR VALUE ACCOUNTING AND MEASUREMENT

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:

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.

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.

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 and junior subordinated debentures 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. Level 1 measurements are based upon quoted prices in active markets. Level 2 measurements are 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 measurements are based primarily on unobservable inputs. 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.

From mid-2008 through the current quarter, 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 March 31, 2013, we owned $\$ 31$ million in current par value of these securities, exclusive of those securities the Company elected to write-off completely. 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 March 31, 2013 and December 31, 2012:

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 loss of $\$ 990,000$ in the quarter ended March 31, 2013. This loss was primarily the result of an increase to the liquidity premium for these securities which was partially offset by 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, while the increase in the liquidity premium was reflective of the yield levels observed for securities with similar priorities in issuers' capital structures.

At March 31, 2013, Banner also owned approximately $\$ 19$ million in amortized cost of TPS securities issued by three individual financial institutions for which no direct 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. In the current quarter, 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. Management concluded that the general market tightening of credit spreads reflected in the TRUP CDO valuations should likewise be offset by an increase in the liquidity premium when determining an appropriate discount rate to apply to the valuation of these TPS securities. These factors were then incorporated into the model at March 31, 2013, and discount rates equal to three-month LIBOR plus 525 basis points were used to calculate the respective fair values of these securities, the same spread to LIBOR as that used in the preceding quarter. With the discount rate changed only by a three basis point decrease in LIBOR, the resulting fair value change was a gain of $\$ 9,000$ in the quarter ended March 31, 2013. The Company has and will continue to assess the appropriate fair value hierarchy for determination of these fair values on a quarterly basis.

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. As of March 31, 2013, all of 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 value, 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. As noted above in the discussions of TPS securities and TRUP CDOs, because of the unprecedented disruption of certain financial markets, management concluded that there were insufficient transactions or other indicators to reflect these measurements as Level 1 or Level 2 inputs. Due to the reliance on assumptions and not on directly observable transactions, management believes fair value for this instrument should follow a Level 3 input methodology. 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 March 31, 2013, management evaluated the general market conditions as noted above and for the discount rate used the period-ending three-month LIBOR plus 525 basis points, the same spread to LIBOR, resulting in a fair value loss on these instruments of $\$ 157,000$ in the current quarter ended March 31, 2013.

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 March 31, 2013 and December 31, 2012 (in thousands):

March 31, 2013
Level 1 Level 2 Level $3 \quad$ Total
Assets:
Securities-available-for-sale

| U.S. Government and agency | $\$-$ | $\$ 78,342$ | $\$-$ | $\$ 78,342$ |
| :--- | :--- | :--- | :--- | :--- |
| Municipal bonds | - | 62,278 | - | 62,278 |
| Corporate bonds | - | 10,663 | - | 10,663 |
| Mortgage-backed or related securities | - | 274,900 | - | 274,900 |
| Asset-backed securities | - | 50,500 | - | 50,500 |
|  | - | 476,683 | - | 476,683 |

## Securities-trading

| U.S. Government and agency | - | 1,617 | - | 1,617 |
| :--- | :--- | :--- | :--- | :--- |
| Municipal bonds | - | 5,347 | - | 5,347 |
| TPS and TRUP CDOs | - | - | 34,520 | 34,520 |
| Mortgage-backed or related securities | - | 26,217 | - | 26,217 |
| Equity securities and other | - | 60 | - | 60 |
|  | - | 33,241 | 34,520 | 67,761 |
| Derivatives | - | 710 | - | 710 |


| Interest rate lock commitments | - | 710 | - | 710 |
| :---: | :---: | :---: | :---: | :---: |
| Interest rate swaps | - | 7,447 | - | 7,447 |
|  | \$- | \$518,081 | \$34,520 | \$552,601 |
| Liabilities: |  |  |  |  |
| Advances from FHLB at fair value | \$- | \$278 | \$- | \$278 |
| Junior subordinated debentures net of unamortized deferred issuance costs at fair value | - | - | 73,220 | 73,220 |
| Derivatives |  |  |  |  |
| Interest rate sales forward commitments, net | - | 388 | - | 388 |
| Interest rate swaps | - | 7,447 | - | 7,447 |
|  | \$- | \$8,113 | \$73,220 | \$81,333 |

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December 31, 2012

| Level 1 | Level 2 | Level 3 | Total |
| :--- | :--- | :--- | :--- |

Assets:
Securities-available-for-sale

| U.S. Government and agency | $\$-$ | $\$ 96,980$ | $\$-$ | $\$ 96,980$ |
| :--- | :--- | :--- | :--- | :--- |
| Municipal bonds | - | 44,938 | - | 44,938 |
| Corporate bonds | - | 10,729 | - | 10,729 |
| Mortgage-backed or related 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 | - | -684 | - | 5,684 |
| TPS and TRUP CDOs | - | 28,107 | - | 35,741 |
| Mortgage-backed or related securities | - | 63 | - | 35,741 |
| Equity securities and other | - | 35,491 | 35,741 | 63 |
|  |  |  |  | 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 sales forward commitments, net | - | 195 | - | 195 |
| Interest rate swaps | - | 8,353 | - | 8,353 |
|  | \$- | \$18,852 | \$73,063 | \$91,915 |

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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 three months ended March 31, 2013 and 2012 (in thousands):

|  | $\begin{array}{l}\text { Three Months Ended } \\ \text { March 31, 2013 }\end{array}$ |  |
| :--- | :--- | :--- |
|  | Level 3 Fair Value Inputs |  |
| Borrowings- |  |  |$]$

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 market 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 March 31, 2013, the Company reviewed all of its adversely classified loans totaling $\$ 118$ million and identified $\$ 88$ million which were considered impaired. Of those $\$ 88$ million in impaired loans, $\$ 73$ 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 $\$ 73$ million had original carrying values of $\$ 76$ million which were 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, the Company also established $\$ 8$ million in specific reserves on these impaired loans. Impaired loans that were collectively evaluated for reserve purposes within homogenous pools totaled $\$ 15$ million and were found to require allowances totaling $\$ 888,000$. All TDRs which are currently performing according to their restructured payments terms were included in the specific reserve analysis. 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 value 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 three months ended March 31, 2013, the Company recognized $\$ 73,000$ of additional impairment charges related to REO assets, compared to $\$ 1.6$ million for the same quarter one year earlier.

Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially recorded 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. During the three months ended March 31, 2013 and 2012, the Company did not record an impairment charge. Loans serviced for others totaled $\$ 984$ million, $\$ 918$ million and $\$ 717$ million at March 31, 2013, December 31, 2012 and March 31, 2012, respectively. Custodial accounts maintained in connection with this servicing totaled $\$ 2.8$ million, $\$ 4.7$ million and $\$ 1.8$ million at March 31, 2013, December 31, 2012, and March 31, 2012, 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 of the fair value measurements for those assets at March 31, 2013 and December 31, 2012 (in thousands):


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 March 31, 2013:

| Financial Instruments | Valuation Techniques | Unobservable Inputs | Weighted Average |
| :---: | :---: | :---: | :---: |
| TPS securities | Discounted cash flows | Discount rate | 5.54\% |
| TRUP CDOs | Discounted cash Flows | Discount rate | 4.09\% |
| Junior Subordinated Debentures | Discounted cash flows | Discount rate | 5.54\% |
| Impaired loans | Discounted cash flows | Discount rate | Various |
|  | Collateral Valuations | Market values | $\mathrm{n} / \mathrm{a}$ |
| REO | Appraisals | Market values | $\mathrm{n} / \mathrm{a}$ |

MSRs
Discounted cash
flows
Prepayment rate $19.80 \%$
Discount rate $11.11 \%$

## Fair Values of Financial Instruments:

The following table presents estimated fair values of the Company's financial instruments as of March 31, 2013 and December 31, 2012, whether or not recognized or recorded in the consolidated Statements of Financial Condition. 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 estimated fair value of financial instruments is as follows (in thousands):

March 31, 2013

| Carrying <br> Value | Estimated Fair <br> Value | Carrying <br> Value | Estimated Fair <br> Value |
| :--- | :--- | :--- | :--- |
| $\$ 155,714$ $\$ 155,714$ | $\$ 181,298$ | $\$ 181,298$ |  |
| 67,761 | 67,761 | 71,232 | 71,232 |
| 476,683 | 476,683 | 472,920 | 472,920 |
| 88,408 | 93,785 | 86,452 | 92,458 |
| 5,384 | 5,438 | 11,920 | 12,059 |
| $3,234,937$ | $3,163,536$ | $3,223,794$ | $3,143,853$ |
| 36,373 | 36,373 | 36,705 | 36,705 |
| 60,425 | 60,425 | 59,891 | 59,891 |
| 6,335 | 6,335 | 6,244 | 6,244 |
| 8,157 | 8,157 | 8,863 | 8,863 |
|  |  |  |  |
| $1,777,815$ | $1,660,687$ | $1,800,555$ | $1,729,351$ |
| 759,866 | 703,054 | 727,956 | 694,609 |
| 982,903 | 977,609 | $1,029,293$ | $1,033,931$ |
| 278 | 278 | 10,304 | 10,304 |
| 73,220 | 73,220 | 73,063 | 73,063 |
| 88,446 | 88,446 | 76,633 | 76,633 |
| 7,835 | 7,835 | 8,548 | 8,548 |
| 710 |  |  |  |
| 388 | 710 | 510 | 510 |
|  | 388 | $(195$ | $)$ |

Assets:
Cash and due from banks
Securities-trading
Securities-available-for-sale
Securities-held-to-maturity
Loans receivable held for sale
Loans receivable
FHLB stock
Bank-owned life insurance
Mortgage servicing rights
Derivatives
Liabilities:
Demand, interest checking and money market accounts
Regular savings
Certificates of deposit
FHLB advances at fair value
Junior subordinated debentures at fair value
Other borrowings
Derivatives
Off-balance-sheet financial instruments:
Commitments to originate loans
Commitments to sell loans

Fair value estimates, methods, assumptions and the level within the fair value hierarchy of the fair value measurements 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 and management considers this to be a Level 1 measurement.

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 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: 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. Fair value for significant non-performing loans is also 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. Management considers this to be a Level 3 measurement.

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. Management considers this to be a Level 2 measurement.

FHLB Stock: The fair value is based upon the redemption value of the stock which equates to its carrying value. Management considers this to be a Level 3 measurement.

Mortgage Servicing Rights: Fair values are estimated based on current pricing for sales of servicing for new loans adjusted up or down based on the serviced loan's interest rate versus current new loan rates. Management considers this to be a Level 3 measurement.

Deposit Liabilities: The fair value of deposits with no stated maturity, such as savings, checking and interest 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. Management considers this to be a Level 3 measurement.

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.

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.

Commitments: Commitments to sell loans with notional balances of $\$ 31$ million and $\$ 70$ million at March 31, 2013 and December 31, 2012, respectively, had a carrying value of $\$ 234,000$ and $\$ 328,000$, representing the fair value of such commitments. Interest rate lock commitments to originate loans held for sale with notional balances of $\$ 71$ million and $\$ 89$ million at March 31, 2013 and December 31, 2012, respectively, have a carrying value of $\$ 286,000$ and $\$ 362,000$. 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. Management considers this to be a Level 2 measurement. Other commitments to fund loans totaled $\$ 1$ billion and $\$ 925$ million at March 31, 2013 and December 31, 2012, respectively, and have no carrying value at both dates. There were 16 commitments to purchase securities at March 31, 2013 for $\$ 39$ million and one commitment to purchase securities at December 31, 2012 for $\$ 12$ million. There were three commitments to sell securities at March 31, 2013 for $\$ 5$ million and none at December 31, 2012. Additionally, at March 31, 2013, there were commitments to sell mortgage backed securities of $\$ 34$ million related to mortgage banking hedging activities, with carrying values of ( $\$ 177,000$ ), and at December 31, 2012, there were similar hedging commitments to sell mortgage backed securities of $\$ 42$ million, with carrying values of $(\$ 121,000)$.

Limitations: The fair value estimates presented herein are based on pertinent information available to management as of March 31, 2013 and December 31, 2012. 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; and REO.

## Note 12: INCOME TAXES AND DEFERRED 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 March 31, 2013, 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 Company files consolidated income tax returns in U.S. federal jurisdiction and in the Oregon and Idaho state jurisdictions. The tax years which remain subject to examination by the taxing authorities are the years ended December 31, 2012, 2011, 2010, 2009 and 2008.

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## Note 13: CALCULATION OF WEIGHTED AVERAGE SHARES OUTSTANDING FOR EARNINGS (LOSS) PER SHARE (EPS)

The following table reconciles basic to diluted weighted shares outstanding used to calculate earnings per share data dollars and shares (in thousands, except per share data):

|  | Three Months Ended |  |
| :--- | :--- | :--- |
|  | March 31 |  |
|  | 2013 | 2012 |
| Net income (loss) | $\$ 11,582$ | $\$ 9,184$ |
| Preferred stock dividend accrual | - | 1,550 |
| Preferred stock discount accretion | - | 454 |
| Net income (loss) available to common shareholders | $\$ 11,582$ | $\$ 7,180$ |
|  |  |  |
| Basic weighted average shares outstanding | 19,313 | 17,762 |
| Plus unvested restricted stock | 110 | 29 |
| Diluted weighted shares outstanding | 19,423 | 17,791 |
| Earnings (loss) per common share | $\$ 0.60$ | $\$ 0.40$ |
| Basic | $\$ 0.60$ | $\$ 0.40$ |

Options to purchase an additional 29,671 and 51,279 shares of common stock as of March 31, 2013 and 2012, respectively, were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. Also, as of March 31, 2013, the warrant issued to the U.S. 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 14: STOCK-BASED COMPENSATION PLANS AND STOCK OPTIONS

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 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. As of March 31, 2013, the Company had granted 97,995 shares of restricted stock from the 2012 Restricted Stock Plan and 34,257 shares in accordance with Mr. Grescovich's employment agreement. The expense associated with restricted stock was $\$ 207,000$ for the three-month period ended March 31, 2013 and was $\$ 42,000$ for the three-month periods ended March 31, 2012. Unrecognized compensation expense for these awards as of March 31, 2013 was $\$ 1.9$ million and will be
amortized over the next 35 months.
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 three months ended March 31, 2013 and 2012, 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. There was no stock-based compensation costs related to the SOPs for the quarter ended March 31, 2013 and $\$ 3,000$ in expense for the quarter ended March 31, 2012. 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 U.S. Treasury 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.

During the three months ended March 31, 2013 and 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.

Banner Corporation Long-Term Incentive Plan: The Plan is an account-based type of benefit, the value of which is directly related to changes in the value of Company stock, dividends declared on the Company 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. 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. 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. To adjust for a change in its estimated liability pursuant to the Plan, the Company recognized a compensation expense of $\$ 89,000$ for the three months ended March 31, 2013, compared to compensation expense of $\$ 136,000$ for the three months ended March 31, 2012. At March 31, 2013, the aggregate liability related to SARs was $\$ 677,000$ and was included in deferred compensation.

## Note 15: COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance-Sheet Risk
We have financial instruments with off-balance-sheet risk generated in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit, commitments related to standby letters of credit, commitments to originate loans, commitments to sell loans, commitments to buy and sell mortgage-backed and other 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.

Our 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. We 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 (in thousands):

Commitments to extend credit
Standby letters of credit and financial guarantees
Commitments to originate loans
Commitments to originate loans held for sale
Commitments to sell loans secured by one- to four residential properties

Contract or Notional Amount
March 31, 2013
December 31, 2012
\$976,830 \$907,892
6,514 6,660
21,363 10,733
71,234 89,049
30,844 70,263

| Commitments to sell securities related to mortgage banking activities | 34,047 | 41,500 |
| :--- | :--- | :--- |
| Commitments to purchase investment securities | 38,619 | 11,500 |
| Commitments to sell investment securities | 4,860 | - |

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. The type of 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. Traditionally 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 in the three months ended March 31, 2013 or March 31, 2012. 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.

The Company has stand-alone derivative instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. 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 March 31, 2013 and December 31, 2012 follows (dollars in thousands):

|  | March 31, 2013 | December 31, 2012 |  |
| :--- | :--- | :--- | :--- |
| Notional amount | $\$ 206,220$ | $\$ 205,505$ | $\%$ |
| Weighted average pay rate | 4.52 | $\%$ | 4.52 |

At March 31, 2013, the Company's interest rate swap agreements were with Pacific Coast Bankers' Bank, Wells Fargo, N.A., Credit Suisse, and various loan customers.

ITEM 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

## 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 March 31, 2013, 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. 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 and the Federal Deposit Insurance Corporation (the FDIC). As of March 31, 2013, we had total consolidated assets of $\$ 4.2$ billion, total loans of $\$ 3.2$ billion, total deposits of $\$ 3.5$ billion and total stockholders' equity of $\$ 516$ 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. 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.

Banner Corporation's successful execution of its strategic plan and operating initiatives continued in the first quarter, as evidenced by our solid profitability for the quarter ended March 31, 2013. Highlights for the quarter included continued improvement in our asset quality, strong revenues from core operations and additional client acquisition. Additionally, the regular quarterly cash dividend was increased to $\$ 0.12$ per share from $\$ 0.01$, reflecting strong performance and our expectation of continued success in 2013.

Despite persistently weak economic conditions and exceptionally low interest rates which have created an unusually challenging banking environment for an extended period, the Company experienced marked improvement and consistent profitability in 2012 which continued in the first three months of 2013. For the quarter ended March 31, 2013, we had net income of $\$ 11.6$ million, or $\$ 0.60$ per diluted share, compared to a net income to common shareholders of $\$ 7.2$ million, or $\$ 0.40$ per diluted share, for the quarter ended March 31, 2012. 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 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 has positioned the Company well to meet this challenging environment.

Our return to consistent profitability was punctuated in the second quarter of 2012 by management's decision to reverse the valuation allowance against our deferred tax assets. This decision resulted in a substantial tax benefit in the second quarter, as well as for the full year 2012; however, for the first quarter of 2012, we did not record a provision for income taxes. By contrast, in the first quarter of 2013 our provision for income taxes was $\$ 5.3$ million. The decision to reverse the valuation allowance reflected our confidence in the sustainability of our future profitability. Further, as a result of our return to profitability, including the substantial 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 substantially in the second quarter of 2012, accounting for most of the $\$ 23.9$ million net change in the estimated fair value of the junior subordinated debentures at March 31, 2013 compared to a year earlier. 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.

As a result of substantial reserves already in place representing 2.38\% of total loans outstanding at March 31, 2013, as well as declining net charge-offs, Banner did not record a provision for loan losses in the first quarter of 2013. This compares to a $\$ 1.0$ million provision in the preceding quarter and a $\$ 5.0$ million provision in the first quarter a year ago. 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. The allowance for loan losses at March 31, 2013 was $\$ 77.1$ million, representing $231 \%$ of non-performing loans. Non-performing loans decreased by $3 \%$ to $\$ 33.4$ million at March 31, 2013, compared to $\$ 34.4$ million three months earlier, and decreased $49.1 \%$ when compared to $\$ 64.9$ million a year earlier. (See Note 7, Loans Receivable and the Allowance for Loan Losses, as well as "Asset Quality" below in this Form 10-Q.)

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. Despite a modest increase in our net interest spread and resulting net interest margin, our net interest income before provision for loan losses decreased to $\$ 41.0$ million for the quarter ended March 31, 2013, compared to $\$ 41.5$ million for the same quarter one year earlier, primarily as a result of a modest decrease in average interest-earning assets and the effect of one additional day in the first quarter of 2012 which was a leap year. The modest increase in the net interest margin compared to the first quarter
a year ago reflects continuing reductions in deposit and other funding costs, as well as further reductions in the adverse effects of non-performing assets, which were generally offset by declining yields on performing loans and securities.

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 valuation of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 11 of the Selected Notes to the Consolidated Financial Statements.) For the quarter ended March 31, 2013, we recorded a net loss of $\$ 1.3$ million in fair value adjustments, which was offset by $\$ 409,000$ of OTTI recoveries and $\$ 1.0$ million in gains on sale of securities. In comparison, we recorded a net fair value gain of $\$ 1.7$ million for the quarter ended March 31, 2012 and no net gain or loss on securities sales.

Our total other operating income, which includes the gain on sale of securities, OTTI recovery and changes in the value of financial instruments carried at fair value, was $\$ 10.0$ million for the quarter ended March 31, 2013, compared to $\$ 10.6$ million for the quarter ended March 31,2012 . However, other operating income excluding the fair value and OTTI adjustments and gain on sale of securities, which we believe is more indicative of our core operations, increased $11 \%$ to $\$ 9.9$ million for the quarter ended March 31,2013 , compared to $\$ 8.9$ million for the same quarter a year earlier, as a result of significantly increased deposit fees and service charges fueled by growth in non-interest-bearing deposit accounts and strong mortgage banking revenues

Our total revenues (net interest income before the provision for loan losses plus total other operating income) for the first quarter of 2013 decreased $\$ 1.1$ million, or $2 \%$, to $\$ 51.0$ million, compared to $\$ 52.1$ million for the first quarter of 2012, largely as a result of the changes in fair value adjustments. However, our revenues, excluding fair value and OTTI adjustments and gain on sale of securities, which we also believe are more indicative of our core operations, increased $\$ 485,000$, or $1 \%$, to $\$ 50.9$ million for the quarter ended March 31,2013 , compared to $\$ 50.4$ million for the quarter ended March 31, 2012. The modest level of growth in core revenues, despite the small increase in the net interest margin and significant increases in deposit fees and mortgage banking revenues, reflects the decrease in average interest-earning assets, particularly loans, and the adverse leap year effect compared to the first quarter a year ago.

Our other operating expenses declined in the first quarter of 2013 compared to a year earlier, largely as a result of lower costs related to loan collections and real estate owned, as well as decreases in advertising and marketing expenses and FDIC deposit insurance charges, which were partially offset by increased compensation expenses. Other operating expenses were $\$ 34.1$ million for the quarter ended March 31, 2013, compared to $\$ 37.9$ million for the quarter ended March 31, 2012.

Other operating income, revenues and other earnings information excluding fair value adjustments, OTTI losses or recoveries, and gains or losses on sale of securities are non-GAAP financial measures. 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. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP financial measures, see the tables below. 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 Three Months Ended March 31, 2013 and 2012" 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):


The ratio of tangible common stockholders' equity to tangible assets is also a non-GAAP financial measure. We calculate tangible common equity by excluding other intangible assets and preferred equity from stockholders' equity. We calculate tangible assets by excluding the balance of 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 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 this non-GAAP financial measure provides information to investors that is useful in understanding the basis of our capital position (dollars in thousands).

|  | March 31, 2013 | December 31, <br> 2012 | March 31, 2012 |
| :--- | :--- | :--- | :--- |
| Stockholders' equity | $\$ 516,062$ | $\$ 506,919$ | $\$ 548,790$ |
| Other intangible assets, net | 3,724 | 4,230 | 5,777 |
| Tangible equity | 512,338 | 502,689 | 543,013 |
| Preferred equity | - | - | 121,156 |
| Tangible common stockholders' equity | $\$ 512,338$ | $\$ 502,689$ | $\$ 421,857$ |
| Total assets | $\$ 4,237,626$ | $\$ 4,265,564$ | $\$ 4,160,764$ |
| Other intangible assets, net | 3,724 | 4,230 | 5,777 |


| Tangible assets | $\$ 4,233,902$ | $\$ 4,261,334$ |  | $\$ 4,154,987$ |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Tangible common stockholders' equity to tangible assets12.10 | $\%$ | 11.80 | $\%$ | 10.15 | $\%$ | 49

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. Prior to 2008, 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 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 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 and in the three months ended March 31, 2013, leading to meaningful increases in residential mortgage originations compared to the same periods 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 March 31, 2013, our net loan portfolio totaled $\$ 3.163$ billion compared to $\$ 3.158$ billion at December 31, 2012 and $\$ 3.148$ billion at March 31, 2012.

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 in 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. As a result, our cost of deposits has declined significantly and fees and service charges have increased compared to earlier periods. Total deposits at March 31, 2013 were $\$ 3.521$ billion, compared to $\$ 3.558$ billion at December 31, 2012 and $\$ 3.426$ billion at March 31, 2012. While certificates of deposit decreased $\$ 214$ million compared to a year earlier, transaction and savings account deposits increased by $\$ 309$ million over the same one-year period and represented $72 \%$ of total deposits at March 31, 2013 compared to 65\% at March 31, 2012.

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 Selected Notes to the Consolidated Financial Statements contained in Item 1 of this Form 10-Q.

Summary of Critical Accounting Policies

Our significant accounting policies are described in Note 1 of the Notes to the Consolidated Financial Statements for the year ended December 31, 2012 included in the 2012 Form 10-K. 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 during the first three months of 2013.

Interest Income: (Note 1) 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: (Note 7) 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 on an individual loan basis. The level of general loan loss 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: (Note 11) 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 11 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

Other Intangible Assets: (Note 9) 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: (Note 8) 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 12) 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.

Comparison of Financial Condition at March 31, 2013 and December 31, 2012
General. Total assets decreased $\$ 28$ million, or $0.7 \%$, to $\$ 4.238$ billion at March 31, 2013, from $\$ 4.266$ billion at December 31, 2012. However, net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) increased $\$ 5$ million, or $0.2 \%$, to $\$ 3.163$ billion at March 31, 2013, from $\$ 3.158$ billion at December 31, 2012. The increase in net loans was largely due to increases of $\$ 27$ million in commercial real estate loans, $\$ 16$ million in commercial and multifamily construction loans and $\$ 11$ million in one- to four-family construction loans, offset by decreases of $\$ 20$ million in agricultural business loans, $\$ 15$ million in one- to four-family real estate loans and $\$ 13$ million in consumer loans. Commercial business loans were nearly unchanged, as credit line utilizations remained low. Likewise, land and land development loans were also nearly unchanged.

Loans secured by investment properties comprised $\$ 19$ million, or $71 \%$, of the increase in commercial real estate loans with the balance of $\$ 8$ million, or $29 \%$, secured by owner-occupied properties. Multifamily construction loans comprised $\$ 12$ million, or $72 \%$, of the increase in commercial and multifamily construction loans while $\$ 4$ million, or $28 \%$, of the increase consisted of commercial construction loans. Much of the decrease in agricultural business loans was anticipated as it is largely due to seasonal reductions in client borrowings. The decrease in one- to four-family real estate and consumer loans was largely the result of accelerated prepayments in the current low interest rate environment.

The aggregate balance of interest-earning deposits and securities decreased $\$ 16$ million from December 31, 2012 to $\$ 729$ million at March 31, 2013. Interest-earning deposits decreased $\$ 19$ million during the quarter to $\$ 96$ million, while our total investment in securities increased $\$ 3$ million to $\$ 633$ million at March 31, 2013. The change in the mix of interest-bearing deposits and securities holdings compared to a year ago reflects both an increase in our overall securities holdings and a modest extension of the expected duration of our securities holdings designed to increase the yield relative to interest-bearing deposits. The securities purchased in recent periods were primarily short- to intermediate-term U.S. Government Agency notes and mortgage-backed securities and, to a lesser extent, intermediate-term taxable and tax-exempt municipal securities. Securities acquired during this period generally have expected maturities ranging from six months to six years. The average duration of Banner's securities portfolio was approximately 4.6 years at March 31, 2013. With the exception of certain pooled trust preferred collateralized debt obligation securities (TRUP CDO) aggregate fair value adjustments to the securities portfolio were modest during the
first three months of 2013. (See Note 11 of the Selected Notes to the Consolidated Financial Statements, in this Form 10-Q.)

REO decreased $\$ 5$ million, to $\$ 11$ million at March 31, 2013, compared to $\$ 16$ million at December 31, 2012, continuing the improving trend with respect to these non-earning assets. The March 31, 2013 total included $\$ 8$ million in residential construction, land or land development projects and $\$ 3$ million in single-family homes. During the three months ended March 31, 2013, we transferred $\$ 1$ million of loans into REO, disposed of $\$ 6$ million of REO properties recognizing $\$ 804,000$ in gains related to those sales, and charged-off $\$ 73,000$ in valuation adjustments (see "Asset Quality" discussion below).
Following a normal seasonal pattern, deposits decreased $\$ 37$ million, or $1.0 \%$, to $\$ 3.521$ billion at March 31, 2013 from $\$ 3.558$ billion at December 31, 2012. Non-interest-bearing deposits decreased by $\$ 19$ million, or $2 \%$, to $\$ 962$ million at March 31, 2013, compared to $\$ 981$ million at December 31, 2012, but have increased by $25 \%$ compared to a year earlier. Interest-bearing transaction and savings accounts increased by $\$ 28$ million, or $2 \%$, to $\$ 1.576$ billion at March 31, 2013 from $\$ 1.547$ billion at December 31, 2012 and have increased by $8 \%$ compared to a year earlier. Certificates of deposit decreased $\$ 46$ million, or 5\%, to $\$ 983$ million at March 31, 2013 from $\$ 1.029$ billion at December 31, 2012. Non-certificate core deposits increased to $72 \%$ of total deposits at the end of the first quarter, compared to $65 \%$ of total deposits a year earlier.

FHLB advances decreased $\$ 10$ million, or $97 \%$, to $\$ 278,000$ at March 31, 2013 from $\$ 10$ million at December 31, 2012, the result of the maturity and repayment of all FHLB term borrowings at Banner Bank. The remaining FHLB balance is one small term borrowing at Islanders Bank. Other borrowings, consisting of retail repurchase agreements primarily related to customer cash management accounts, increased $\$ 11$ million to $\$ 88$ million at March 31, 2013, as compared to $\$ 77$ million at December 31, 2012. No additional junior subordinated debentures were issued or matured during the quarter and the estimated fair value of these instruments remained unchanged at $\$ 73$ million. For more information, see Notes 10, 11 and 12 of the Selected Notes to the Consolidated Financial Statements.

Total stockholders' equity increased $\$ 9$ million, or $2 \%$, to $\$ 516$ million at March 31, 2013 compared to $\$ 507$ million at December 31, 2012. The increase in equity reflects the quarterly net income and payment of dividends to common stockholders. Tangible common stockholders' equity, which excludes intangible assets, also increased $\$ 9$ million to $\$ 512$ million, or $12.10 \%$ of tangible assets at March 31, 2013. During the three months ended March 31, 2013, we did not repurchase any shares of Banner Corporation common stock.

Comparison of Results of Operations for the Three Months Ended March 31, 2013 and 2012
Following three difficult years and despite a still challenging economy, Banner Corporation returned to profitability in 2011 and that progress and profitability continued throughout 2012 and into the first three months of 2013. For the quarter ended March 31, 2013, we had net income to available to common shareholders of $\$ 11.6$ million, or $\$ 0.60$ per diluted share. This compares to net income available to common shareholders of $\$ 7.2$ million, or $\$ 0.40$ per diluted share, for the quarter ended March 31, 2012. While our return to profitability and the current quarter's improved profitability largely resulted from a material decrease in credit costs, particularly our provision for loan losses, it also reflected continued strong revenue generation from our core operations. The decrease in credit costs reflects a significantly reduced level of non-performing assets while the increase in net revenues was driven largely by increased deposit fees and other service charges fueled by growth in core deposits and a significant increase in revenues from our mortgage banking operations. The current quarter's results also reflect a decrease in operating expenses which was more than offset by an increase in provision for income taxes. In addition, for the quarter ended March 31, 2012, net income available to common shareholders was net of a dividend accrual and discount accretion related to the Series A Preferred Stock, neither of which were required in the quarter ended March 31, 2013 due to the redemption of the Series A Preferred Stock.

## Net Interest Income.

Net interest income before provision for loan losses decreased by $\$ 522,000$, or ( 1.3 ) \%, to $\$ 41.0$ million for the quarter ended March 31, 2013, compared to $\$ 41.5$ million for the same quarter one year earlier, as a small increase in the net interest margin was offset by a modest decrease in the average balance of interest-earning assets and the effect of one additional day in the first quarter of 2012 which was a leap year. The net interest margin of $4.16 \%$ for the quarter ended March 31, 2013 was one basis point higher than for the same quarter in the prior year. The increase in the net interest margin compared to a year earlier reflects important reductions in deposit and other funding costs, as well as further reductions in the adverse effect of non-performing assets. Nonaccruing loans reduced the margin by just four basis points during the quarter ended March 31, 2013, a meaningful improvement compared to a 13 basis point reduction for the same quarter a year earlier. In addition, the further decrease in the average balance of real estate owned reduced the adverse effect of this non-interest-earning asset on the margin. However, the mix of earning assets changed to include fewer loans and more securities as our on-balance-sheet liquidity remained high and this shift in the mix in the low interest rate environment had an adverse effect on earning asset yields.

The net interest spread expanded to $4.13 \%$ for the quarter ended March 31, 2013 compared to $4.10 \%$ for the same quarter a year earlier. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on earning assets for the quarter ended March 31, 2013 was $4.52 \%$, a decrease of 24 basis points compared to the same quarter a year earlier. Importantly, however, funding costs were also significantly lower, especially deposit costs which decreased 21 basis points to $0.31 \%$ from $0.52 \%$ a year earlier, leading to a decrease of 27 basis points for all interest-bearing liabilities to $0.39 \%$ for the quarter ended March 31, 2013. Partially offsetting this decline in liability funding costs was a decrease in non-interest-bearing funding from average stockholders' equity as a result of the repurchase and redemption of the Series A Preferred Stock in the second half of 2012.

Interest Income. Interest income for the quarter ended March 31, 2013 was $\$ 44.5$ million, compared to $\$ 47.6$ million for the same quarter in the prior year, a decrease of $\$ 3.1$ million, or $6 \%$. The decrease in interest income occurred as a
result of the decline in both the yield and average balance of interest-earnings assets. The average balance of interest-earning assets was $\$ 3.996$ billion for the quarter ended March 31, 2013, a decrease of $\$ 26$ million, or $0.7 \%$, compared to $\$ 4.023$ billion one year earlier. The yield on average interest-earning assets decreased to $4.52 \%$ for the quarter ended March 31, 2013, compared to $4.76 \%$ for the same quarter one year earlier. The decrease in the yield on earning assets reflects changes in the mix of assets and the continuing erosion of yields as loans and investments mature or prepay and are replaced by lower yielding assets in the current low interest rate environment. Average loans receivable for the quarter ended March 31, 2013 decreased $\$ 36$ million, or $1 \%$, to $\$ 3.215$ billion, compared to $\$ 3.251$ billion for the same quarter in the prior year. Interest income on loans decreased by $\$ 2.9$ million, or $6 \%$, to $\$ 41.5$ million for the current quarter from $\$ 44.4$ million for the quarter ended March 31, 2012, reflecting the impact of a 26 basis point decrease in the average yield on loans, along with the $\$ 36$ million decrease in average loan balances. The average yield on loans was $5.23 \%$ for the quarter ended March 31, 2013, compared to $5.49 \%$ for the same quarter one year earlier.

The combined average balance of mortgage-backed securities, investment securities, and daily interest-bearing deposits increased to $\$ 781$ million for the quarter ended March 31, 2013 (excluding the effect of fair value adjustments), compared to $\$ 772$ million for the quarter ended March 31, 2012, while the interest and dividend income from those investments decreased by $\$ 191,000$ compared to the same quarter in the prior year. The average yield on the combined portfolio decreased to $1.57 \%$ for the quarter ended March 31, 2013, from $1.67 \%$ for the same quarter one year earlier. The adverse impact of lower market rates on the combined yield on these investments has been 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 quarter ended March 31, 2013 was $\$ 3.5$ million, compared to $\$ 6.1$ million for the same quarter in the prior year, a decrease of $\$ 2.6$ million, or $43 \%$. The decrease in interest expense occurred as a result of a 27 basis point decrease in the average cost of all interest-bearing liabilities to $0.39 \%$ for the quarter ended March 31, 2013, from $0.66 \%$ for the same quarter one year earlier, and an $\$ 11$ million decrease in average interest-bearing liabilities. This decrease in average interest-bearing liabilities reflects a continued managed
decline in certificates of deposit, including brokered deposits, and our borrowings, which was offset by increases in transaction and savings accounts.

Deposit interest expense decreased $\$ 1.7$ million, or $39 \%$, to $\$ 2.7$ million for the quarter ended March 31, 2013, compared to $\$ 4.4$ million for the same quarter in the prior year, as a result of a 21 basis point decrease in the cost of deposits and an $\$ 81$ million increase in the average balance of deposits. Average deposit balances increased to $\$ 3.502$ billion for the quarter ended March 31, 2013, from $\$ 3.421$ billion for the quarter ended March 31, 2012, and the average rate paid on deposit balances decreased to $0.31 \%$ in the first quarter of 2013 from $0.52 \%$ for the quarter ended March 31, 2012. While we do not anticipate further reductions in market interest rates, we do expect additional modest declines in deposit 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. However, it is clear that the pace of decline in deposit costs compared to immediately preceding periods has slowed and that the opportunity for future reductions is limited.

Average FHLB advances (excluding the effect of fair value adjustments) were $\$ 4$ million for the quarter ended March 31, 2013, compared to $\$ 10$ million for the same quarter one year earlier, and the average rate paid on FHLB advances for the quarter ended March 31, 2013 increased to $2.66 \%$ from $2.48 \%$ for the same quarter one year earlier. Average FHLB advances decreased as a result of paying off all FHLB term borrowings at Banner Bank. Interest expense on FHLB advances decreased to $\$ 24,000$ for the quarter ended March 31, 2013 from $\$ 63,000$ for the quarter ended March 31, 2012.

Other borrowings consist of retail repurchase agreements with customers secured by certain investment securities and, prior to March 31, 2012, the senior bank notes issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP). Primarily as a result of repaying the TLGP senior bank notes, the average balance for other borrowings decreased $\$ 63$ million to $\$ 83$ million during the current quarter from $\$ 147$ million during the same quarter a year earlier, while the rate on other borrowings decreased to $0.27 \%$ from $1.51 \%$ a year earlier. As a result, interest expense for other borrowings decreased to $\$ 56,000$ for the quarter ended March 31, 2013, compared to $\$ 549,000$ for the quarter ended March 31, 2012. The $\$ 50$ million of TLGP senior bank notes had a fixed rate of $2.625 \%$, plus a $1.00 \%$ guarantee fee, and matured on March 31, 2012.

Junior subordinated debentures which were issued in connection with trust preferred securities had an average balance of $\$ 124$ million (excluding the effect of fair value adjustments) and an average cost of $2.43 \%$ for the quarter ended March 31, 2013. Junior subordinated debentures outstanding in the same periods in the prior year had the same average balance of $\$ 124$ million (excluding the effect of fair value adjustments) with higher average costs of $3.29 \%$ for the quarter ended March 31, 2012. Generally, the junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index; however, one $\$ 25$ million issue of junior subordinated debentures had a fixed rate of $6.56 \%$ for an initial five-year period which expired on February 29, 2012. Subsequent to that date, the interest rate on that debenture resets every three months at a rate of three-month LIBOR plus $1.62 \%$. The change in the rate on that debenture, coupled with a modestly lower level of LIBOR, resulted in the lower cost of the junior subordinated debentures for the quarter ended March 31, 2013, compared to the same quarter a year earlier.

Analysis of Net Interest Spread presents, in the following table and 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.

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${ }_{\text {(1) }}$ Other operating expense divided by the total of net interest income (before provision for loan losses) and other operating income (non-interest income)

Provision and Allowance for Loan Losses. As a result of substantial reserves already in place representing $2.38 \%$ of total loans outstanding, as well as declining delinquencies and net charge-offs, we did not record a provision for loan losses in the quarter ended March 31, 2013. This compares to a $\$ 1$ million provision in the preceding quarter and a $\$ 5.0$ million provision in the first quarter a year ago. As discussed in the Summary of Critical Accounting Policies section above and in Note 1 of the Selected Notes to the Consolidated Financial Statements in this Form 10-Q, 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.

Reflecting lingering weakness in the economy, we continue to maintain a substantial allowance for loan losses at March 31, 2013 even though non-performing loans declined during the quarter. 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 delinquencies and defaults in other non-housing-related segments of the portfolio.

We recorded net charge-offs of $\$ 363,000$ for the quarter ended March 31, 2013, compared to $\$ 6.4$ million for the same quarter in the prior year. Non-performing loans decreased by $\$ 984,000$ during the quarter ended March 31, 2013 to $\$ 33$ million, and decreased by $\$ 32$ million compared to the quarter ended March 31, 2012. A comparison of the allowance for loan losses at March 31, 2013 and 2012 reflects a decrease of $\$ 5$ million to $\$ 77$ million at March 31, 2013, from $\$ 82$ million at March 31, 2012. Included in our allowance at March 31, 2013 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 $2.38 \%$ at March 31, 2013, from $2.52 \%$ at March 31, 2012. However, with the decrease in problem loans, the allowance as a percentage of non-performing loans increased to $231 \%$ at March 31, 2013, compared to $225 \%$ of non-performing loans at December 31, 2012 and $126 \%$ a year earlier.

As of March 31, 2013, we had identified $\$ 88$ million of impaired loans. Impaired loans are comprised of loans on nonaccrual, TDRs 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 11 of the Selected Notes to the Consolidated Financial Statements, Fair Value Accounting and Measurement, in this Form 10-Q.

We believe that the allowance for loan losses as of March 31, 2013 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 these 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.

Other Operating Income. Other operating income, which includes changes in the valuation of financial instruments carried at fair value, OTTI charges and recoveries, and gain on sale of securities, as well as non-interest revenues from core operations, was $\$ 10.0$ million for the quarter ended March 31, 2013, compared to $\$ 10.6$ million for the same quarter in the prior year. Our other operating income for the three months ended March 31, 2013 included a gain on the sale of securities of $\$ 1.0$ million and an OTTI recovery of $\$ 409,000$, both of which resulted from the sale of securities that had been fully written off in previous periods, as well as a $\$ 1.3$ million net loss for fair value adjustments as a result of changes in the valuation of our securities portfolios. During the quarter ended March 31, 2012, fair value adjustments resulted in a net loss of $\$ 1.7$ million. For a more detailed discussion of our fair value adjustments, please refer to Note 11 in the Selected Notes to the Consolidated Financial Statements in this Form 10-Q.

Excluding the fair value and OTTI adjustments and gain on sale of securities, other operating income from core operations increased by $\$ 1.0$ million, or $11 \%$, to $\$ 9.9$ million for the quarter ended March 31, 2013, compared to $\$ 8.9$ million for the quarter ended March 31, 2012, largely as a result of increased deposit fees and service charges and revenues from mortgage banking operations. Deposit fees and service charges increased by $\$ 432,000$ compared to the first quarter a year ago reflecting growth in the number of deposit accounts and increased transaction activity. Mortgage banking revenues increased by $\$ 363,000$ as increased production and sales of loans were supported by high levels of refinancing in the very low interest rate environment.

Other Operating Expenses. Other operating expenses decreased by $\$ 3.8$ million, to $\$ 34.1$ million for the quarter ended March 31, 2013, compared to $\$ 37.9$ million for the quarter ended March 31, 2012, largely as a result of decreased costs related to loan collections and REO operations as well as decreases in advertising and marketing expenses and FDIC deposit insurance charges, which were partially offset by increased compensation expenses. As a result of net gains on sales of REO properties, expenses related to REO decreased by $\$ 2.8$ million to a net gain of $\$ 251,000$ for the quarter ended March 31, 2013 from a $\$ 2.6$ million expense during the same period a year earlier. In addition to real
estate taxes and maintenance costs, expenses related to REO for the quarter ended March 31, 2013 included only $\$ 73,000$ in valuation adjustments; however, those charges were more than offset by $\$ 804,000$ in net gains on sales of REO properties. By comparison, for the quarter ended March 31, 2012, we recorded $\$ 1.6$ million in valuation adjustments and net gains on REO sales of $\$ 100,000$. Compensation expense increased $\$ 1.2$ million, or $6 \%$, to $\$ 20.7$ million for the quarter ended March 31, 2013, compared to $\$ 19.5$ million for the quarter ended March 31, 2012, primarily reflecting salary and wage adjustments, increased mortgage banking activity and higher health insurance costs. The increase in compensation expenses was partially offset by an increase of $\$ 621,000$ in capitalized loan origination costs which also reflected the increase in mortgage banking activity. The cost of FDIC insurance decreased by $\$ 718,000$ primarily as a result of a reduction in the premium assessment rate attributed to improvements in the asset quality and earnings performance of Banner Bank resulting in the termination of Banner Bank's Memorandum of Understanding with the FDIC and Washington DFI in the first quarter of 2012. All other expenses, net, increased $\$ 845,000$ largely as a result of increased payment and card processing volumes. Other operating expenses as a percentage of average assets were $3.28 \%$ for the quarter ended March 31, 2013, compared to $3.62 \%$ for the same quarter one year earlier.

Income Taxes. In the quarter ended March 31, 2013, we recognized $\$ 5.3$ million in income tax expense for an effective tax rate of approximately $31.3 \%$, which reflects our normal statutory tax rate reduced by the impact of tax-exempt income and certain tax credits. 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. For the quarter ended March 31, 2012, we had no provision for income taxes as a result of the full valuation allowance for our deferred tax assets (DTA) at that date. During the second quarter of 2012, we determined that maintaining the full valuation allowance was no longer appropriate and subsequently reversed the valuation allowance. 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 quarter ended March 31, 2012. For more discussion on our deferred tax asset and related valuation allowance, please refer to Note 12 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

## Asset Quality

Although our non-performing assets declined substantially in 2012 and have decreased further in the first quarter of 2013, achieving and maintaining a moderate risk profile by aggressively managing troubled assets has been and will continue to be a primary focus for us. All of our key credit quality metrics have improved compared to a year ago, including improvement during first quarter, and as a result our credit costs have been significantly reduced. In addition, 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. While our non-performing assets and credit costs have been materially reduced, we continue to be actively engaged with our borrowers in resolving remaining problem assets and with the effective management of real estate owned as a result of foreclosures.

Non-Performing Assets: Non-performing assets decreased to $\$ 45$ million, or $1.06 \%$ of total assets, at March 31, 2013, from $\$ 50$ million, or $1.18 \%$ of total assets, at December 31, 2012, and $\$ 93$ million, or $2.24 \%$ of total assets, at March 31, 2012. Non-performing assets are comprised of non-performing loans and REO and other repossessed assets, which total $\$ 33$ million and $\$ 12$ million, respectively. The primary components of non-performing loans are $\$ 15$ million in one- to four-family residential loans, $\$ 7$ million in commercial and multifamily real estate loans, $\$ 4$ million in commercial business loans, $\$ 4$ million in construction and land development loans and $\$ 3$ million in consumer loans. The primary components of REO are $\$ 8$ million in residential construction, land or land development projects and $\$ 3$ million in single-family homes. Non-performing construction, land and land development loans and related REO totaled $\$ 12$ million at March 31, 2013 and included approximately $\$ 3$ million, or $23 \%$, in the Puget Sound region, $\$ 8$ million, or $66 \%$, in the greater Portland market area, $\$ 500,000$, or $4 \%$, in the greater Boise market area, and $\$ 761,000$, or $7 \%$, in other areas of Washington, Oregon and Idaho. We continue to believe our level of
non-performing loans and assets, which has declined substantially, 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. However, our level of non-performing assets will continue to be meaningfully influenced by the course of recovery from the recent economic recession.

Loans are reported as TDRs when we grant concessions to a borrower experiencing financial difficulties that we would not otherwise consider. As a result of these concessions, TDRs are impaired as the Banks will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. If any TDR 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 TDR would be reclassified as nonaccrual. At March 31, 2013, we had $\$ 55$ million of TDRs currently performing under their restructured terms.

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

March 31, 2013
Nonaccrual Loans: ${ }^{(1)}$
Secured by real estate:
Commercial
Multifamily
Construction and land
One- to four-family
Commercial business
Agricultural business, including secured by farmland
Consumer

Consumer
Loans more than 90 days delinquent, still on accrual:
Secured by real estate:

| Commercial | - |  | - |  | - |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multifamily | - |  | - |  | - |  |
| Construction and land | - |  | - |  | - |  |
| One- to four-family | 2,243 |  | 2,877 |  | 2,129 |  |
| Commercial business | - |  | - |  | - |  |
| Agricultural business, including secured by farmland | - |  | - |  | - |  |
| Consumer | 46 |  | 152 |  | 84 |  |
|  | 2,289 |  | 3,029 |  | 2,213 |  |
| Total non-performing loans | 33,406 |  | 34,390 |  | 64,913 |  |
| Securities on nonaccrual at fair value | - |  | - |  | 500 |  |
| REO and other repossessed assets held for sale, net ${ }^{(2)}$ | 11,458 |  | 15,853 |  | 27,731 |  |
| Total non-performing assets | \$44,864 |  | \$50,243 |  | \$93,144 |  |
| Total non-performing loans to loans before allowance for loan losses | 1.03 | \% | 1.06 |  | 2.01 | \% |
| Total non-performing loans to total assets | 0.79 | \% | 0.81 |  | 1.56 | \% |
| Total non-performing assets to total assets | 1.06 | \% |  |  |  | \% |
| TDRs ${ }^{(3)}$ | \$54,611 |  | \$57,462 |  | \$53,391 |  |
| Loans 30-89 days past due and on accrual | \$6,984 |  | \$11,685 |  | \$14,336 |  |

Includes $\$ 8.8$ million of non-accrual TDRs. For the three months ended March 31, 2013, $\$ 459,000$ in interest
${ }^{(1)}$ income would have been recorded had nonaccrual loans been current; however, 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.

The following table sets forth the Company's non-performing assets by geographic concentration at March 31, 2013 (dollars in thousands):


In addition to the non-performing loans as of March 31, 2013, we had other classified loans with an aggregate outstanding balance of $\$ 87$ million that are not on nonaccrual status, with respect to which known 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.

We record REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at amounts which are equal to fair value of the properties based on independent appraisals (reduced by estimated selling costs) upon transfer of the loans to REO. 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. 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 quarters ended March 31, 2013 and 2012, we recognized $\$ 73,000$ and $\$ 1.6$ million, respectively, of impairment charges related to these types of assets.

Within our non-performing loans, we have a total of four nonaccrual lending relationships, each with aggregate loan exposures in excess of $\$ 1.0$ million that collectively comprise $\$ 5.4$ million, or $16.3 \%$ of our total non-performing loans as of March 31, 2013 and the single largest relationship totaled $\$ 1.7$ million at March 31, 2013. The most significant of our non-performing loan exposures are included in the following table (dollars in thousands): Percent of Total
Amount Non-Performing Collateral Securing the Indebtedness Geographic Location

| $\$ 1,729$ | 5.2 | \% | Accounts receivable and inventory |
| :--- | :--- | :---: | :--- |
| 1,410 | 4.2 | Commercial building | Greater Seattle-Puget Sound area |

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| 1,214 | 3.6 | Business assets, accounts receivable and <br> vehicles | Greater Spokane, Washington area |
| :--- | :--- | :--- | :--- |
| 1,086 | 3.3 | Four commercial lots and one <br> commercial acreage lot | Greater Portland, Oregon area |
| 27,967 | 83.7 | Various collateral; relationships under <br> \$1 million | Sum of 158 loans spread throughout the <br> franchise |
| $\$ 33,406$ | 100.0 | \% Total non-performing loans |  |

At March 31, 2013, we had $\$ 11.2$ 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 $\$ 2.0$ million. The second largest REO holding is 5.9 acres of undeveloped land in the greater Portland, Oregon area with a book value of $\$ 1.7$ million. All other REO holdings have individual book values of less than $\$ 600,000$.

The table below summarizes our REO by geographic location and property type (dollars in thousands):


## 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, in certain periods, the purchase of securities. During the three months ended March 31, 2013 our loan originations exceeded our loan repayments by $\$ 13$ million and during the three months ended March 31, 2012, our loan originations were less than loan repayments by $\$ 65$ million. During those periods we purchased loans of $\$ 91,000$ and $\$ 5$ million, respectively. During the three months ended March 31, 2013 and 2012, we sold $\$ 136$ million and $\$ 123$ million, respectively, of loans. Securities purchased during the three months ended March 31, 2013 and 2012 totaled $\$ 59$ million and $\$ 48$ million, respectively, and securities repayments and maturities were $\$ 35$ million and $\$ 129$ million, respectively.

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Our primary financing activity is gathering deposits. Deposits decreased by $\$ 37$ million during the first three months of 2013, including a $\$ 46$ million decrease in certificates of deposits. The decrease in deposits 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. Certificates of deposits are generally more price sensitive than other retail deposits and our pricing of those deposits varies significantly based upon our liquidity management strategies at any point in time. At March 31, 2013, certificates of deposit amounted to $\$ 983$ million, or $28 \%$ of our total deposits, including $\$ 706$ million which were scheduled to mature within one year. 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.

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 three months ended March 31, 2013 and 2012, we used our sources of funds primarily to fund loan commitments, purchase securities, and pay maturing savings certificates and deposit withdrawals. At March 31, 2013, we had outstanding loan commitments totaling $\$ 1.076$ billion, including undisbursed loans in process and unused credit lines totaling $\$ 1.005$ billion. 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 to supplement deposits is to increase or decrease short-term borrowings, including FHLB advances and Federal Reserve Bank of San Francisco (FRBSF) borrowings. We maintain credit facilities with the FHLB-Seattle, which at March 31, 2013 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 $\$ 948$ 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 $\$ 278,000$, or less than $1 \%$ of our assets at March 31, 2013. In addition, Banner Bank has been approved for participation in the FRBSF'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 BIC program would provide additional borrowing capacity of $\$ 579$ million as of March 31, 2013. We had no funds borrowed from the FRBSF at March 31, 2013 or December 31, 2012. Management believes it has adequate resources and funding potential to meet our foreseeable liquidity requirements.

Banner Corporation is a separate legal entity from the Banks and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. Banner's primary sources of funds consist of capital raised through dividends or capital distributions from the Banks, although there are regulatory restrictions on the ability of the Banks to pay dividends. At March 31, 2013, the Company (on an unconsolidated basis) had liquid assets of $\$ 30.5$ million.

As noted below, Banner Corporation and its subsidiary banks continued to maintain capital levels significantly in excess of the requirements to be categorized as "Well-Capitalized" under applicable regulatory standards. During the three months ended March 31, 2013, total equity increased $\$ 9$ million, or $2 \%$, to $\$ 516$ million. Total equity at March 31, 2013 is entirely attributable to common stock. At March 31, 2013, tangible common stockholders' equity, which excludes other intangible assets, was $\$ 512$ million, or $12 \%$ of tangible assets. See the discussion and reconciliation of non-GAAP financial information in the Executive Overview section of Management's Discussion and Analysis of Financial Condition and Results of Operation in this Form 10-Q for more detailed information with respect to tangible common stockholders' equity. Also, see the capital requirements discussion and table below with respect to our regulatory capital positions.

## 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 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 March 31, 2013, 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 included in the 2012 Form 10-K for additional information regarding regulatory capital requirements for Banner and the Banks.)

The actual regulatory capital ratios calculated for Banner Corporation, Banner Bank and Islanders Bank as of March 31, 2013, along with the minimum capital amounts and ratios, were as follows (dollars in thousands):

> Actual

> Minimum for Capital Adequacy Purposes

Minimum to be
Categorized as
"Well-Capitalized" Under
Prompt Corrective Action

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|  | Amount | Ratio |  | Amount | Ratio |  | Provisions <br> Amount | Ratio |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Banner Corporation-consolidated |  |  |  |  |  |  |  |  |  |
| Total capital to risk-weighted assets | \$600,052 | 17.06 | \% | \$281,339 | 8.00 |  | n/a | n/a |  |
| Tier 1 capital to risk-weighted assets | 555,684 | 15.80 | \% | 140,670 | 4.00 | \% | n/a | n/a |  |
| Tier 1 leverage capital to average assets | 555,684 | 13.28 | \% | 167,373 | 4.00 | \% | n/a | n/a |  |
| Banner Bank |  |  |  |  |  |  |  |  |  |
| Total capital to risk-weighted assets | 540,659 | 16.19 | \% | 267,239 | 8.00 | \% | \$334,048 | 10.00 | \% |
| Tier 1 capital to risk-weighted assets | 498,503 | 14.92 | \% | 133,619 | 4.00 | \% | 200,429 | 6.00 | \% |
| Tier 1 leverage capital to average assets | 498,503 | 12.57 | \% | 158,593 | 4.00 | \% | 198,241 | 5.00 | \% |
| Islanders Bank |  |  |  |  |  |  |  |  |  |
| Total capital to risk-weighted assets | 33,369 | 18.20 | \% | 14,668 | 8.00 | \% | 18,335 | 10.00 | \% |
| Tier 1 capital to risk-weighted assets | 31,068 | 16.94 | \% | 7,334 | 4.00 | \% | 11,001 | 6.00 | \% |
| Tier 1 leverage capital to average assets | 31,068 | 13.53 | \% | 9,185 | 4.00 | \% | 11,481 | 5.00 | \% |
| 61 |  |  |  |  |  |  |  |  |  |

ITEM 3 - Quantitative and Qualitative Disclosures About Market Risk

## 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 March 31, 2013, our loans with interest rate floors totaled approximately $\$ 1.5$ billion and had a weighted average floor rate of $5.01 \%$. 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 March 31, 2013, 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):

|  | Estimated Change in <br> Net Interest Income |  |  |  | Net Economic Value |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

(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 $0.25 \%$. 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.

The following table presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at March 31, 2013 (dollars in thousands). The table sets 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 March 31, 2013, total interest-earning assets maturing or repricing within one year exceeded total interest-bearing liabilities maturing or repricing in the same time period by $\$ 436$ million, representing a one-year cumulative gap to total assets ratio of $10.30 \%$. 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 March 31, 2013 are within our internal policy guidelines and management considers that our current level of interest rate risk is reasonable.

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

Interest-earning assets:
(1)

| Construction loans | $\$ 185,587$ | $\$ 10,388$ | $\$ 24,043$ | $\$ 6,061$ | $\$ 2,684$ | $\$ 87$ | $\$ 228,850$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Fixed-rate mortgage <br> loans | 152,089 | 71,233 | 242,386 | 142,544 | 150,587 | 59,280 | 818,119 |
| Adjustable-rate <br> mortgage loans | 435,028 | 129,585 | 316,711 | 289,063 | 13,104 | - | $1,183,491$ |
| Fixed-rate <br> mortgage-backed | 30,103 | 28,583 | 104,721 | 70,899 | 26,567 | 21,028 | 281,901 |

securities
Adjustable-rate
mortgage-backed
$4,052 \quad 437$
securities
Fixed-rate
$\begin{array}{lllllll}\text { commercial/agricultural } 41,743 & 38,565 & 83,737 & 37,037 & 11,937 & 350 & 213,369\end{array}$
loans
Adjustable-rate

| commercial/agricultural <br> loans <br> Consumer and other <br> loans | 1686,565 | 10,756 | 35,741 | 15,716 | 51 | - | 548,829 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Investment securities <br> and interest-earning <br> deposits | 199,574 | 34,527 | 71,120 | 41,787 | 64,526 | 63,479 | 475,013 |
| Total rate sensitive <br> assets | $1,700,385$ | 336,429 | 913,946 | 624,428 | 287,216 | 145,712 | $4,008,116$ |
| Interest-bearing <br> liabilities: (2) |  |  |  |  |  |  |  |
| Regular savings and <br> interest checking | 184,831 | 172,170 | 401,731 | 401,731 | - | - |  |
| accounts |  |  |  |  |  |  |  |
| Money market deposit <br> accounts | 207,531 | 124,518 | 83,012 | - | - | - | $1,160,463$ |
| Certificates of deposit | 447,104 | 251,809 | 227,529 | 52,380 | 4,049 | 32 | 415,061 |
| FHLB advances <br> Other borrowings | 209 | - | - | - | - | - | 982,903 |

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(Footnotes on following page)

Footnotes for Table of Interest Sensitivity Gap
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, 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 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 purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of
${ }^{(2)}$ these accounts had been assumed to be short-term, the one-year cumulative gap of interest-sensitive assets would have been $\$(450)$ million, or $(10.62) \%$ of total assets at March 31, 2013. Interest-bearing liabilities for this table exclude certain non-interest-bearing deposits which are included in the average balance calculations in the table contained in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Comparison of Results of Operations for the Three Months Ended March 31, 2013 and 2012" of this report on Form 10-Q.

ITEM 4 - 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.

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
(a)Financial Officer concluded that, as of March 31, 2013, 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.

Changes in Internal Controls Over Financial Reporting: In the quarter ended March 31, 2013, there was no change (b) in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

Item 1. 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 actions to enforce liens on properties in which we hold a security interest. We are not a party to any pending legal proceedings that management believes would have a material adverse effect on our financial condition or operations.

## Item 1A. Risk Factors

There have been no material changes in the risk factors previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 (File No. 0-26584) or otherwise previously disclosed in our Form 10-Q reports filed subsequently.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
During the quarter ended March 31, 2013, we did not sell any securities that were not registered under the Securities Act of 1933.

We did not have any repurchases of our common stock from January 1, 2013 through March 31, 2013.
Item 3. Defaults upon Senior Securities
Not Applicable.
Item 4. Mine Safety Disclosures
Not Applicable
Item 5. Other Information
Not Applicable.

Item 6. Exhibits

## Exhibit Index of Exhibits

$3\{\mathrm{a}\}$ Amended and Restated Articles of Incorporation of Registrant [incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 28, 2010 (File No. 000-26584)].

Certificate of designation relating to the Company's Fixed Rate Cumulative Perpetual Preferred Stock
$3\{b\} \quad$ Series A [incorporated by reference to the Registrant's Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].
$3\{\mathrm{c}\} \quad$ Bylaws of Registrant [incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed on April 1, 2011 (File No. 0-26584)].

Warrant to purchase shares of Company's common stock dated November 21, 2008 [incorporated by $4\{\mathrm{a}\} \quad$ 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)].
$10\{\mathrm{a}\} \quad$ 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)].

Amended Employment Agreement 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
$10\{\mathrm{~g}\} \quad$ exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. $0-23584)$ ].

Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed 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 Executive Retirement Program Agreement with D. Michael Jones [incorporated by $10\{\mathrm{k}\} \quad$ reference 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,

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
$10\{\mathrm{o}\}$ 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
$10\{\mathrm{p}\} \quad$ reference 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 $10\{\mathrm{q}\} \quad$ reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)].
$10\{\mathrm{t}\} 2005$ Executive Officer and Director Stock Account Deferred Compensation Plan. June 30, 2012, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Statements of Financial Condition; (b) Consolidated Statements of Operations; (c) Consolidated 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)].

Entry into an Indemnification Agreement with each of the Company's Directors [incorporated by reference to exhibits filed with the Form 8-K on January 29, 2010].

2012 Restricted Stock Plan [incorporated by reference as Appendix B to the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 21, 2012].

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.

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.

The following materials from Banner Corporation's Quarterly Report on Form 10-Q for the quarter ended Statements of Comprehensive Income (Loss); (d) Consolidated Statements of Stockholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Selected Notes to Consolidated Financial Statements.* * Pursuant to Rule 406T of Regulations 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. * Pursuant to Rule 406T of Regulations 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
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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.

## SIGNATURES

Pursuant to the requirements 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.

## Banner Corporation

May 7, 2013

May 7, 2013
/s/ Mark J. Grescovich
Mark J. Grescovich
President and Chief Executive Officer
(Principal Executive Officer)
/s/ Lloyd W. Baker
Lloyd W. Baker
Treasurer and Chief Financial Officer
(Principal Financial and Accounting
Officer)


[^0]:    ${ }_{(1)}$ Since most loans were already considered classified and/or on nonaccrual 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.

