BANNER CORP
Form 10-Q
August 09, 2006

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 JUNE 30, 2006. OR [ ]TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM** ___________ to ____________ :

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one)

Large accelerated filer

___

Accelerated filer

_X_

Non-accelerated filer

___

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

Yes

___

No

X

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 July 31, 2006

12,280,823 shares*

* Includes 301,786 shares held by the Employee Stock Ownership Plan that have not been released, committed to be released, or allocated to participant accounts.

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BANNER CORPORATION AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited) (In thousands, except shares)
June 30, 2006 and December 31, 2005

	June 30	December 31
ASSETS	2006	2005
Cash and due from banks		

$	
	105,915
$	
	116,448
Securities available for sale, cost $248,629 and $264,087, respectively	
Encumbered	
	17,533
	19,579
Unencumbered	
	222,956
	240,705
	240,489
	260,284
Securities held to maturity, fair value $50,333 and $52,398, respectively	

	49,657	50,949
Federal Home Loan Bank stock	35,844	35,844
Loans receivable:		
Held for sale, fair value $5,767 and $4,802	5,708	4,779
Held for portfolio	2,818,325	2,434,952
Allowance for loan losses		

	(33,618
)	
	(30,898
)	
	2,790,415
	2,408,833
Accrued interest receivable	
	19,143
	17,395
Real estate owned, held for sale, net	
	401
	315
Property and equipment, net	
	52,177

	50,205
Goodwill and other intangibles, net	
	36,298
	36,280
Deferred income tax asset, net	
	9,780
	7,606
Bank-owned life insurance	
	37,709
	36,930
Other assets	
	19,172
	19,466

$

3,397,000

$

3,040,555

LIABILITIES

Deposits:

Non-interest-bearing

$

317,515

$

328,840

Interest-bearing transactions and savings accounts

873,019

792,370

Interest-bearing certificates

	1,388,923
	1,202,103
	2,579,457
	2,323,313
Advances from Federal Home Loan Bank	
	368,930
	265,030
Other borrowings	
	77,122
	96,849
Junior subordinated debentures (issued in connection with Trust Preferred Securities)	
	97,942
	97,942

Accrued expenses and other liabilities	31,849	29,503
Deferred compensation	6,882	6,253
Income taxes payable	2,316	--
	3,164,498	2,818,890

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY

Common stock - $0.01 par value per share, 27,500,000 shares authorized, 13,201,418 shares issued: 11,967,792 shares and 11,782,356 shares outstanding at June 30, 2006 and December 31, 2005, respectively. 132,284 130,573

Retained earnings

108,626

96,783

Accumulated other comprehensive income (loss):

Unrealized gain (loss) on securities available for sale (5,532) (2,736) Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost: 301,786 and 300,120 restricted shares outstanding at June 30, 2006 and December 31, 2005, respectively

(2,494

)

(2,480

)

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

(7,376

)

(8,464

)

Liability for common stock issued to deferred, stock related, compensation plans

6,994

7,989

(382
)

(475
)

232,502

221,665

$
3,397,000

$
3,040,555

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited) (In thousands except for per share amounts)
For the Quarters and Six Months Ended June 30, 2006 and 2005

	Quarters Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
INTEREST INCOME:				
Loans receivable	$ 55,088	$ 39,842	$ 104,214	$ 75,979

Mortgage-backed securities	
	2,011
	3,586
	4,094
	7,259
Securities and cash equivalents	
	1,834
	2,943
	3,612
	5,792
	58,933
	46,371

	111,920
	89,030
INTEREST EXPENSE:	
Deposits	
	20,828
	12,146
	38,259
	22,560
Federal Home Loan Bank advances	
	4,141
	5,927
	7,267
	11,544

Other borrowings	
	766
	392
	1,464
	724
Junior subordinated debentures	
	1,973
	1,193
	3,801
	2,260
	27,708
	19,658
	50,791

	37,088
Net interest income before provision for loan losses	
	31,225
	26,713
	61,129
	51,942
PROVISION FOR LOAN LOSSES	
	2,300
	1,300
	3,500
	2,503
Net interest income	

	28,925
	25,413
	57,629
	49,439
OTHER OPERATING INCOME:	
Deposit fees and other service charges	
	2,891
	2,401
	5,383
	4,405
Mortgage banking operations	
	1,454
	1,645

	2,606
	2,876
Loan servicing fees	
	334
	232
	724
	671
Miscellaneous	
	321
	339
	789
	662
Gain on sale of securities	

	--
	8
	--
	8
Total other operating income	
	5,000
	4,625
	9,502
	8,622
OTHER OPERATING EXPENSES:	
Salary and employee benefits	
	16,553
	15,263

32,042

29,056

Less capitalized loan origination costs

(3,228

)

(2,753

)

(5,820

)

(4,794

)

Occupancy and equipment

3,938

3,394

7,732

	6,621
Information/computer data services	
	1,285
	1,193
	2,585
	2,310
Professional services	
	534
	818
	1,066
	1,619
Advertising	
	2,074

	1,512
	3,516
	2,863
Insurance recovery, net proceeds	
	(5,350
)	
	--
	(5,350
)	
	--
Miscellaneous	
	4,205
	3,373
	7,438

	6,428
Total other operating expenses	
	20,011
	22,800
	43,209
	44,103
Income before provision for income taxes	
	13,914
	7,238
	23,922
	13,958
PROVISION FOR INCOME TAXES	
	4,555

	2,222
	7,775
	4,235
NET INCOME	
$	9,359
$	5,016
$	16,147
$	9,723
Earnings per common share (see Note 5):	
Basic	
$	0.79

$	0.43
$	1.36
$	0.85
Diluted	
$	0.77
$	0.42
$	1.33
$	0.82
Cumulative dividends declared per common share:	
$	0.18

$ 0.17

$ 0.36

$ 0.34

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited) (In thousands)
For the Quarters and Six Months Ended June 30, 2006 and 2005

	Quarters Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005

NET INCOME

$

9,359

$

5,016

$

16,147

$

9,723

OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:

Unrealized holding gain (loss) during the period, net of deferred income tax (benefit) of $(625), $1,968, $(1,518) and $(582), respectively

(1,148

)

3,666

(2,796

)

(1,059

)

Less adjustment for (gains) losses included in net income, net of income tax
(benefit) of $0, $3, $0 and $3, respectively

--

(5

)

--

(5

)

Other comprehensive income (loss)

(1,148

)

3,661

(2,796

)

(1,064

)

COMPREHENSIVE INCOME

$

8,211

$

8,677

$

13,351

$

8,659

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited) (In thousands, except per share amounts)
For the Six Months Ended June 30, 2006 and 2005

	Common Stock and Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
BALANCE, January 1, 2005	$ 127,460	$ 92,327	$ (888)	$ (3,096)	$ (583)	$ $215,220
Net income		9,723				9,723
Change in valuation of securities available for sale, net of income taxes			(1,064)			(1,064)
Cash dividend on common stock ($.34/share cumulative)		(3,926)				(3,926)
Purchase and retirement of common stock	(2,103)					(2,103)
Proceeds from issuance of common stock for exercise of stock options	2,757					2,757
Net issuance of stock through employees' stock plans, including tax benefit	96				(76)	20
Amortization of compensation related to MRP					91	91
BALANCE, June 30, 2005	$ 128,210	$ 98,124	$ (1,952)	$ (3,096)	$ (568)	$ 220,718
BALANCE, January 1, 2006	$ 130,573	$ 96,783	$ (2,736)	$ (2,480)	$ (475)	$ 221,665
Net income		16,147				16,147
Change in valuation of securities available for			(2,796)			(2,796)

sale, net of income taxes						
Cash dividend on common stock ($.36/share cumulative)		(4,304)				(4,304)
Purchase and retirement of common stock	(2,346)					(2,346)
Proceeds from issuance of common stock for exercise of stock options	3,720					3,720
Net issuance of stock through employees' stock plans, including tax benefit	28			(14)		14
Amortization of compensation related to stock options	309					309
Amortization of compensation related to MRP					93	93
BALANCE, June 30, 2006	$ 132,284	$ 108,626	$ (5,532)	$ (2,494)		

$

(382

)

$

232,502

See notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2006 and 2005

	2006	2005
COMMON STOCK, SHARES ISSUED:		
Number of shares, beginning of period		13,201
		13,201
Number of shares, end of period		

	13,201
	13,201
LESS COMMON STOCK RETIRED:	
Number of shares, beginning of period	
	(1,119)
	(1,344)
Purchase and retirement of common stock	
	(63)
	(76)
Issuance of common stock to exercised stock options and/or employee stock plans	
	251
	210

Number of shares retired, end of period	(931)	(1,210)
SHARES ISSUED AND OUTSTANDING, END OF PERIOD	12,270	11,991
UNEARNED, RESTRICTED ESOP SHARES:		
Number of shares, beginning of period	(300)	(375)
Adjustment of earned shares		

(2
)

--

Number of shares, end of period

(302
)

(375
)

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2006 and 2005

	2006	2005
OPERATING ACTIVITIES:		
Net income		

$

16,147

$

9,723

Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation

2,925

2,375

Deferred income and expense, net of amortization

1,266

2,061

Loss (gain) on sale of securities

--

(8

)

Increase in cash surrender value of bank-owned life insurance

(779
)
(783
)

Gain on sale of loans, excluding capitalized servicing rights

(2,046
)
(2,733
)

Loss (gain) on disposal of real estate held for sale and property and equipment

(47
)
127

Provision for losses on loans and real estate held for sale

3,500
2,509

FHLB stock (dividend) reversal	--
	29
Net change in:	
Loans held for sale	(929)
	(3,692)
Other assets	(1,927)
	(4,317)
Other liabilities	5,733

7,879

Net cash provided by operating activities

23,843

13,170

INVESTING ACTIVITIES:

Purchases of available for sale securities

--

(27,396

)

Principal repayments and maturities of available for sale securities

15,269

39,279

Proceeds from sales of available for sale securities

--

7,102

Purchases of held to maturity securities

--

(1,295

)

Principal repayments and maturities of held to maturity securities

1,255

370

Origination of loans, net of principal repayments

(539,491

)

(402,963

)

Purchases of loans and participating interest in loans

(4,091

)

(1,142

)

Proceeds from sales of loans and participating interest in loans

160,545

184,857

Purchases of property and equipment-net	(4,917)	(8,253)
Proceeds from sale of real estate held for sale-net	179	640
Other	(525)	(315)
Net cash used by investing activities	(371,776)	

(209,116
)

FINANCING ACTIVITIES:

Increase in deposits

256,144

249,006

Proceeds from FHLB advances

1,043,900

1,647,900

Repayment of FHLB advances

(940,000
)

(1,665,000
)

Repayment of repurchase agreement borrowings

(1,748

)

(4,954

)

Increase (decrease) in other borrowings, net

(17,979

)

2,743

Cash dividends paid

(4,244

)

(3,904

)

Repurchases of stock, net of forfeitures

(2,346

)

(2,103

)

ESOP shares earned (returned)

(47

)

--

Exercise of stock options

3,720

2,757

Net cash provided by financing activities

337,400

226,445

NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS

(10,533

)

30,499

CASH AND DUE FROM BANKS, BEGINNING OF PERIOD

	116,448
	51,767
CASH AND DUE FROM BANKS, END OF PERIOD	
$	105,915
$	82,266

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2006 and 2005

	2006	2005
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid in cash		

$	48,239
$	35,647
Taxes paid in cash	3,481
	5
Non-cash investing and financing transactions:	
Loans, net of discounts, specific loss allowances and unearned income, transferred to real estate owned and other repossessed assets	42
	401
Net change in accrued dividends payable	60
	--
Change in other assets/liabilities	

1,436

237

Recognize tax benefit of vested MRP shares

61

20

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BANNER CORPORATION AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation and Critical Accounting Policies

Banner Corporation (BANR or the Company) is a bank holding company incorporated in the State of Washington. The Company is primarily engaged in the business of commercial banking through its wholly owned subsidiary, Banner Bank (the Bank). The Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington, and its 58 branch offices and 12 loan production offices located in 24 counties in Washington, Oregon and Idaho. The Company is subject to regulation by the Federal Reserve Board (FRB). The Bank is subject to regulation by the State of Washington Department of Financial Institutions Division of Banks and the Federal Deposit Insurance Corporation (FDIC).

In the opinion of management, the accompanying consolidated statements of financial condition and related interim consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows reflect all adjustments (which include reclassifications and normal recurring adjustments) that are necessary for a fair presentation in conformity with generally accepted accounting principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Various elements of the Company's accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company'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 and (iii) the valuation of investment securities, goodwill, mortgage servicing rights and real estate held for sale. These policies and the judgments, estimates and assumptions are described in greater detail below in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 1 of the Notes to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission (SEC). Management believes that the judgments, estimates and assumptions used in the preparation of the Company's consolidated 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 different judgments, estimates and assumptions could result in material differences in the Company's results of operations or financial condition.

Certain reclassifications have been made to the 2005 consolidated financial statements and/or schedules to conform to the 2006 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 information included in this Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC. Interim results are not necessarily indicative of results for a full year.

Note 2: Recent Developments and Significant Events

Insurance Recovery:

In June 2006, Banner announced that it had reached a $5.5 million insurance settlement relating to losses incurred in 2001. The net amount of the settlement, after costs, resulted in a $5.4 million credit to other operating expenses and contributed approximately $3.4 million, or $0.28 per share, to second quarter earnings.

Balance Sheet Restructuring:

Late in the fourth quarter of 2005, the Company completed a balance-sheet restructuring designed to pay down high interest rate FHLB borrowings and reduce the size of the investment portfolio. To effect the restructuring, the Company sold $207 million of securities at a $7.3 million net loss before tax and used a portion of the proceeds of the sale to prepay $142 million of high-cost, fixed-term FHLB borrowings, incurring pre-tax prepayment penalties of $6.1 million. The remainder of the proceeds were applied to repay other relatively high-cost, short-term borrowings from the FHLB. The total cost of the transactions was $13.4 million, with a tax benefit of $4.8 million, resulting in an after-tax cost of $8.6 million or $0.72 per diluted share.

Branch Expansion:

Over the past three years, the Company has invested significantly in expanding the Bank's branch and distribution systems with a primary emphasis on the greater Boise, Idaho and Portland, Oregon markets and the Puget Sound region of Washington. This branch expansion is a significant element in the Company's strategy to grow loans, deposits and customer relationships. This emphasis on growth has resulted in an elevated level of operating expenses; however, management believes that over time these new branches should help improve profitability by providing low cost core deposits which will allow the Bank to proportionately reduce higher cost borrowings as a source of funds. Since March 2004, the Bank has opened 16 new branch offices, relocated five additional branch offices and significantly refurbished its main office in Walla Walla.

Long-Term Incentive Plan:

In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan ("Plan") effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is indirectly related to changes in the value of Company stock and changes in the Bank's average earnings rate. The primary objective of the Plan is for executives who remain with the Company or the Bank for a sufficient period of time to share in the increases in the value of Company stock. Although the Plan benefits are tied to the value of Company stock, the Plan benefit is paid in cash rather than Company stock. Detailed information with respect to the plan was disclosed on a Form 8-K filed with SEC on June 19, 2006.

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Adoption of SFAS 123(R):

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment,* which replaces SFAS No. 123, *Accounting for Stock-Based Compensation,* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123(R) requires that the compensation cost relating to share-based payment transactions (for example, stock options granted to employees of the Company) be recognized in the Company's consolidated financial statements. The Company adopted the provisions of SFAS 123(R) effective January 1, 2006, and has recorded $129,000 and $308,900, respectively, of compensation cost relating to share-based transactions for the quarter and six months ended June 30, 2006 (see Note 6).

Recently Issued Accounting Pronouncements:

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an Amendment of FASB Statement No. 140*. The Statement specifies under what situations servicing assets and servicing liabilities must be recognized. It requires these assets and liabilities to be initially measured at fair value and specifies acceptable measurement methods subsequent to their recognition. Separate presentation in the financial statements and additional disclosures are also required. This statement will be effective beginning January 1, 2007. The Company does not expect that adoption of the Statement will have a material effect on its consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is assessing the impact of adopting the new pronouncement, which will become effective January 1, 2007, but it is not expected to have a material impact.

Sale of $25 Million of Trust Preferred Securities:

In August 2005, the Company completed the issuance of $25.8 million of junior subordinated debentures (debentures) in connection with a private placement of pooled trust preferred securities. The trust preferred securities were issued by Banner Capital Trust V, a special purpose business trust formed by the Company. The debentures have been recorded as a liability on the statement of financial condition but, subject to limitation under current Federal Reserve guidelines, a portion of the debentures qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering are expected to be used primarily to fund growth, including acquisitions, by augmenting the Bank's regulatory capital. Under the terms of the transaction, the trust preferred securities and debentures have a maturity of 30 years and are redeemable after five years with certain exceptions. The holders of the trust preferred securities and debentures are entitled to receive cumulative cash distributions at a variable annual rate. The interest rate is reset quarterly to equal three-month LIBOR plus 1.57% and was 5.41% at issuance and 6.76% at June 30, 2006. The Company's previously issued trust preferred securities have similar provisions but carry different interest rates than this most recent issuance. In accordance with Financial Interpretation No. (FIN) 46, the trusts are not consolidated with the Company's financial statements.

Note 3: Business Segments

The Company is managed by legal entity and not by lines of business. The Bank is a community oriented commercial bank chartered in the State of Washington. The Bank's primary business is that of a traditional banking institution, gathering deposits and originating loans for its portfolio in its primary market area. The Bank offers a wide variety of deposit products to its consumer and commercial customers. Lending activities include the origination of real estate, commercial and agricultural business and consumer loans. The 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 Bank receives other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Bank 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 the Bank's executive 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.

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Note 4: Additional Information Regarding Interest-Bearing Deposits and Securities

Encumbered Securities:

Securities labeled "Encumbered" are pledged securities that are subject to certain agreements which may allow the secured party to either sell and replace them with similar but not the same security or otherwise pledge the securities. In accordance with SFAS No. 140, the amounts have been separately identified in the Consolidated Statements of Financial Condition as "Encumbered."

The following table sets forth additional detail on the Company's interest-bearing deposits and securities at the dates indicated (at carrying value) (in thousands):

	June 30 2006	December 31 2005	June 30 2005
Interest-bearing deposits included in cash and due from banks	$ 32,547	$ 35,078	$ 15,619

Mortgage-backed securities	
	160,733
	178,973
	307,589
Other securities-taxable	
	82,365
	83,731
	220,660
Other securities-tax exempt	
	43,609
	44,844
	45,460
Equity securities with dividends	

	3,439
	3,685
	3,721
Total securities	
	290,146
	311,233
	577,430
Federal Home Loan Bank (FHLB) stock	
	35,844
	35,844
	35,844
$	358,537
$	382,155

$

628,893

The following table provides additional detail on income from deposits and securities for the periods indicated (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Mortgage-backed securities interest	$ 2,011	$ 3,586	$ 4,094	

$	7,259
Taxable interest income	
	1,285
	2,397
	2,553
	4,741
Tax-exempt interest income	
	488
	509
	981
	1,012
Other stock-dividend income	
	61

37

78

68

FHLB stock dividends (reversal)

--

--

--

(29
)

1,834

2,943

3,612

5,792

$

	3,845
$	6,529
$	7,706
$	13,051

Note 5: Calculation of Weighted Average Shares Outstanding for Earnings Per Share (EPS)

The following table reconciles total shares originally issued to weighted shares outstanding used to calculate earnings per share data (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Total shares originally issued				

	13,201	13,201	13,201	13,201
Less retired weighted average shares plus unvested weighted average shares allocated to MRP	(1,017)	(1,294)	(1,063)	(1,325)
Less unallocated shares held by the ESOP	(302)	(375)		

)

(302

)

(375

)

Basic weighted average shares outstanding

11,882

11,532

11,836

11,501

Plus unvested MRP and stock option incremental shares considered outstanding for diluted EPS calculations

314

363

325

407

Diluted weighted average shares outstanding

12,196

11,895

12,161

11,908

12

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Note 6: Stock Based Compensation Plans

The Company operates the following stock-based compensation plans as approved by the shareholders: the 1996 Management Recognition and Development Plan (MRP), a restricted stock plan; and the 1996 Stock Option Plan, the 1998 Stock Option Plan and the 2001 Stock Option Plan (together, SOPs).

MRP Stock Grants:

Under the MRP, the Company is authorized to grant up to 528,075 shares of restricted stock to its directors, officers and employees, of which 5,415 shares remain available for future grants at June 30, 2006. On July 26, 2006, this stock program expired with no additional grants issued. Shares granted under the MRP vest ratably over a five-year period. The Consolidated Statements of Income for the quarter and six months ended June 30, 2006 and 2005 reflect an accrual of $46,500 and $46,700, and $93,100 and $90,800, respectively, for these grant awards. The MRP stock grants' fair value equals their intrinsic value on the date of the grant.

A summary of the Company's unvested MRP shares activity with respect to the six months ended June 30, 2006 follows:

	Shares		Weighted-Average Grant-Date Fair Value
Unvested at December 31, 2005	28,080	$	21.80
Granted	--		--
Vested	(8,020)		20.29
Forfeited	--		--
Unvested at June 30, 2006	20,060	$	22.41

Stock Options:

Under the 1996, 1998 and 2001 SOPs, the Company has reserved 2,284,186 shares for issuance pursuant to the exercise of stock options which may be granted to directors and employees. The exercise price of the stock options is set at 100% of the fair market value of the stock price at date of grant. Such options have graded vesting of 20% per year and any unexercised options will expire ten years after date of grant or 90 days after employment or service ends.

There were no stock options granted by the Company during the six months ended June 30, 2006. Also, there were no significant modifications made to any stock 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.

Stock-based compensation costs related to the SOPs were $129,000 and $308,900 for the quarter and six months ended June 30, 2006, respectively. The SOPs' stock option grant compensation costs are generally based on the fair value calculated from the Black-Scholes option pricing on the date of the grant award. Assumptions used in the Black-Scholes model are an expected volatility based on the six-month historical volatility at the date of the grant. The expected term is based on the remaining contractual life of the graded vesting. 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.

	Quarter Ended	
	2006	2005
Annual dividend yield		N/A

2.31

%

Expected volatility

N/A

31.2

%

Risk free interest rates

N/A

3.73 to 4.15

%

Expected lives

N/A

5 to 9

yrs

As part of the requirements of SFAS 123(R), the Company is required to estimate potential forfeitures of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

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A summary of the Company's SOP stock compensation activity for the six months ended June 30, 2006 follows (in thousands, except shares and per share data):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2005	1,023,673	$ 19.38		
Granted	--			
Exercised	(250,524)	14.91		
Forfeited	(8,251)	26.87		
Outstanding at June 30, 2006	764,898	$ 20.77	5.8	$ 13,596
Vested at June 30, 2006 and expected to vest	753,264	$ 20.70	5.8	$ 13,437
Exercisable at June 30, 2006	502,713	$ 18.68	4.9	$ 9,985

The intrinsic value of stock options is calculated as the amount by which the market price of our common stock exceeds the exercise price of the option.

A summary of the Company's unvested stock option activity with respect to the six months ended June 30, 2006 follows:

	Shares	Weighted-Average Grant-Date Fair Value
Unvested at December 31, 2005	340,655	$ 7.71
Granted	--	--
Vested	(70,370)	7.48
Forfeited	(8,100)	7.91
Unvested at June 30, 2006	262,185	$ 7.76

The weighted average fair value per share of stock options granted to employees during the six months ended June 30, 2006 and 2005 was $0 and $8.86, respectively. During the same periods, the total intrinsic value of stock options exercised was $5.3 million and $1.2 million, respectively.

The Company had $750,000 of total unrecognized compensation costs related to stock options at June 30, 2006 that are expected to be recognized over a weighted-average period of 5.8 years.

During the six months ended June 30, 2006, $3.7 million was received for the exercise 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.

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The following are the stock-based compensation costs recognized in the Company's condensed consolidated statements of income (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Salary and employee benefits	$ 174	$ 47	$ 402	

$

91

Total decrease in income before income taxes

174

47

402

91

Decrease in provision for income taxes

(31

)

(17

)

(58

)

(33

)

Decrease in net income	$ 143	$ 30	$ 344	$ 58

As discussed above, results for prior periods have not been restated to reflect the effects of implementing SFAS 123(R). The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock options granted under the Company's stock option plans for the quarter and six months ended June 30, 2005. For purposes of this pro forma disclosure, the value of the stock options was estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' graded vesting periods (in thousands, except per share amounts).

	Quarter Ended June 30 2005	Six Months Ended June 30 2005
Net income available to common stockholders:		
Basic:		

As reported	$ 5,016	9,723
Pro forma	4,735	9,141
Diluted:		
As reported	$ 5,016	9,723
Pro forma	4,735	9,141

Net income per common share:		
Basic:		
As reported	$ 0.43	0.85
Pro forma	0.41	0.79
Diluted:		
As reported	$ 0.42	0.82

Pro forma	
	0.40
	0.77

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

Special Note Regarding Forward-Looking Statements

Management's Discussion and Analysis and other portions of this report contain certain forward-looking statements concerning the future operations of the Company. Management desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing the Company of the protections of such safe harbor with respect to all forward-looking statements contained in this report and our Annual Report on Form 10-K for the year ended December 31, 2005. We have used forward-looking statements to describe future plans and strategies, including our expectations of the Company's future financial results. Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could cause actual results to differ materially include, but are not limited to, regional and general economic conditions, management's ability to maintain acceptable asset quality and to successfully resolve new or existing credit issues, the success of our branch expansion strategy, our ability to control operating costs, competition, changes in interest rates, deposit flows, demand for mortgages and other loans, real estate values, agricultural commodity prices, crop yields and weather conditions, loan delinquency rates, changes in accounting principles, practices, policies or guidelines, changes in legislation or regulation, other economic, competitive, governmental, regulatory and technological factors affecting operations, pricing, products and services. Accordingly, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. The Company undertakes no responsibility to update or revise any forward-looking statements.

Executive Overview

Banner Corporation, a Washington corporation, is primarily engaged in the business of commercial banking through its wholly owned subsidiary, Banner Bank. The Bank is a Washington-chartered commercial bank, the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank conducts business from its main office in Walla Walla, Washington, and its 58 branch offices and 12 loan production offices located in 24 counties in Washington, Oregon and Idaho.

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. The Bank's primary business is that of a traditional banking institution, accepting deposits and originating loans in locations surrounding its offices in portions of Washington, Oregon and Idaho. The Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans. Lending activities include commercial business and commercial real estate loans, agriculture business loans, construction and land development loans, one- to four-family residential loans and consumer loans. A portion of the Bank's construction and mortgage lending activities are conducted through its subsidiary, Community Financial Corporation (CFC), which is located in the Lake Oswego area of Portland, Oregon.

Over the past three years the Company has invested significantly in expanding the Bank's branch and distribution systems with a primary emphasis on the greater Boise, Idaho and Portland, Oregon markets and the Puget Sound region of Washington. This branch expansion is a significant element in the Company's strategy to grow loans, deposits and customer relationships. This emphasis on growth has resulted in an elevated level of operating expenses; however, management believes that over time these new branches should help improve profitability by providing low cost core deposits which will allow the Bank to proportionately reduce higher cost borrowings as a source of funds. Since March 2004, the Bank has opened 16 new branch offices, relocated five additional branch offices and significantly refurbished its main office in Walla Walla. The Company is committed to continuing this branch expansion strategy for the next two to three years and has plans and projects in process for four new offices expected to open in the next twelve months and is exploring other opportunities which likely will result in additional new offices either late in 2006 or in 2007.

The Bank offers a wide range of loan products to meet the demands of its customers. Historically, lending activities have been primarily directed toward the origination of real estate and commercial loans. Real estate lending activities have been significantly focused on residential construction and first mortgages on owner occupied, one- to four-family residential properties. To an increasing extent in recent years, lending activities have also included the origination of multifamily and commercial real estate loans. Commercial lending has been directed toward meeting the credit and related deposit needs of various small- to medium-sized business and agri-business borrowers operating in the Bank's primary market areas. The Bank has also recently increased its emphasis on consumer lending, although the portion of the loan portfolio invested in consumer loans is still relatively small. While continuing its commitment to construction and residential lending, management expects commercial lending, including commercial real estate, agricultural and consumer lending, to become increasingly important activities for the Bank.

Deposits, FHLB advances (or borrowings) and loan repayments are the major sources of the Bank's funds for lending and other investment purposes. The Bank competes with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction balances and savings deposits from commercial banks, credit unions and nonbank corporations, such as securities brokerage companies, mutual funds and other diversified companies, some of which have nationwide networks of offices. Much of the focus of the Bank's recent branch expansion, relocations and renovation has been directed toward attracting additional deposit customer relationships and balances.

The Bank generally attracts deposits from within its primary market areas by offering a broad selection of deposit instruments, including demand checking accounts, negotiable order of withdrawal (NOW) accounts, money market deposit accounts, regular savings accounts, certificates of deposit, cash management services and retirement savings plans. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of deposit accounts, the Bank considers current market interest rates, profitability to the Bank, matching deposit and loan products, and customer preferences and concerns.

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The operating results of the Company depend primarily on its net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits, FHLB advances, junior subordinated debentures and other borrowings. Net interest income is primarily a function of the Company's 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. As more fully explained below, the Company's net interest income before provision for loan losses increased $4.5 million for the quarter ended June 30, 2006, compared to the same period a year earlier, primarily as a result of strong growth in interest-earning assets and interest-bearing liabilities and changes in the mix of both interest-earning assets and interest-bearing liabilities, including the effects of certain balance-sheet restructuring transactions completed in the quarter ended December 31, 2005.

The Company's net income also is affected by provisions for loan losses and the level of its other income, including deposit service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as its operating expenses and income tax provisions. The provision for loan losses was $2.3 million for the quarter ended June 30, 2006, an increase $1.0 million compared to the quarter ended June 30, 2005. The increase was generally in response to the overall growth of the loan portfolio as credit quality and economic conditions remained essentially unchanged. Other operating income increased by $375,000 to $5.0 million for the quarter ended June 30, 2006, from $4.6 million for the quarter ended June 30, 2005, primarily as a result of increased deposit fees and service charges. Other operating expenses decreased $2.8 million to $20.0 million for the quarter ended June 30, 2006, from $22.8 million for the same period in 2005, due to a net $5.4 million insurance recovery in the current quarter. Excluding the insurance recovery, operating expenses were $25.4 million, an increase of 11% from a year earlier, largely reflecting the Company's continued growth.

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

Comparison of Financial Condition at June 30, 2006 and December 31, 2005

General:

For the first six months of the year, total assets increased $356 million, or 12%, from $3.041 billion at December 31, 2005, to $3.397 billion at June 30, 2006. The increase largely resulted from growth in the loan portfolio and was funded primarily by deposit growth and an increase in FHLB advances. Net loans receivable (gross loans less loans in process, deferred fees and discounts, and allowance for loan losses) increased $382 million, or 16%, from $2.409 billion at December 31, 2005, to $2.790 billion at June 30, 2006. Loan portfolio growth was broad-based; however, reflecting continued strong demand for and sales of new homes in many of the markets served by the Bank, by far the most significant growth occurred in construction and land loans. Loans to finance the construction of one- to four-family residential real estate increased by $141 million, or 40%, and land and development loans increased by $82 million, or 36%, since December 31, 2005. In addition, loans for the construction of commercial real estate increased by $43 million, or 83%. Loan growth also included loans to finance existing commercial real estate, which increased by $40 million, or 7%, existing one- to four-family residential properties, which increased by $32 million, or 9%, consumer loans, which increased by $17 million, or 19%, commercial loans, which increased by $30 million, or 7%, and agricultural loan totals, which increased by $8 million, or 6%. As well as reflecting seasonal patterns, the modest increase in agricultural loans also reflects the repayment of a large non-performing loan in the first quarter of the current year which, as noted below, included the collection of a significant amount of delinquent interest.

Securities available for sale and held to maturity decreased $21 million, or 7%, from $311 million at December 31, 2005, to $290 million at June 30, 2006, primarily as a result of prepayments on mortgage-backed securities, but also as a result of modest declines in the fair value of the portion of the portfolio designated as available for sale as a result of changes in the level of market interest rates. As noted in the Consolidated Statements of Financial Condition, higher market interest rates resulted in an unrealized loss of $8.1 million for the Company's available for sale securities at June 30, 2006, compared to an unrealized loss of $3.8 million at December 31, 2005. The Company also had an increase of $779,000 in bank-owned life insurance from the growth of cash surrender values on existing policies. Property and equipment increased by $2.0 million to $52 million at June 30, 2006, from $50 million at December 31, 2005. The increase included additional site, construction and equipment costs associated with new facilities recently opened or in progress as part of the Company's continuing branch expansion strategy.

Deposits grew $256 million, or 11%, from $2.323 billion at December 31, 2005, to $2.579 billion at June 30, 2006. Non-interest-bearing deposits decreased $11 million, or 3%, to $318 million while interest-bearing deposits increased $267 million, or 13%, to $2.262 billion from the December 31, 2005 amounts. In addition to certain seasonal patterns, it is management's belief that the decline in non-interest-bearing deposits in part reflects changes in customer behavior in response to the current increasing interest rate environment. In particular, as interest rates on new certificates of deposits have increased, certain customers have moved balances from both non-interest-bearing and interest-bearing transaction accounts into higher yielding certificate accounts. Nonetheless, the aggregate total of transaction and savings accounts, including money market accounts, increased by $69 million to $1.191 billion, reflecting the Bank's focused efforts to grow these important core deposits. Increasing core deposits is a key element of the Bank's expansion strategy including the recent and planned addition and renovation of branch locations as explained in more detail below. FHLB advances increased $104 million from $265 million at December 31, 2005, to $369 million at June 30, 2006, while other borrowings decreased $20 million to $77 million at June 30, 2006. The increase in FHLB advances was driven by the need to fund particularly strong loan growth, which significantly outpaced deposit growth for the first six months of 2006. The decrease in other borrowings reflects repayment of a $26 million short-term federal funds purchased position that had been established on December 31, 2005, as well as a decrease of $2 million of repurchase agreement borrowings from securities dealers, which were partially offset by an $8 million increase in retail repurchase agreements that are primarily related to customer cash management accounts.

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The following tables provide additional detail on the Company's loans and deposits (dollars in thousands):

June 30
2006

December 31
2005

June 30
2005

Loan Portfolio:

Amount

Percent
of Total

Amount

Percent
of Total

Amount

Percent
of Total

Loans (including loans held for sale):

Commercial real estate

$

595,513

21.1

%

$

555,889

22.8

%

$

562,240

24.3

%

Multifamily real estate	141,996	5.0	144,512	5.9	119,668	5.2
Commercial construction	95,277	3.4	51,931	2.1	49,978	2.2

Multifamily construction	
	56,857
	2.0
	62,624
	2.6
	79,686
	3.4
One- to four-family construction	
	489,187
	17.3
	348,661
	14.3
	311,648

	13.5
Land and land development	
	310,369
	11.0
	228,436
	9.4
	190,245
	8.2
Commercial business	
	472,061
	16.7
	442,232
	18.1
	436,428

18.9

Agricultural business, including
secured by farmland
155,744
5.5
147,562
6.0
149,651
6.5

One-to four-family real estate

397,648

14.1

365,903

15.0

327,249

14.0

Consumer

47,534

42,573

40,865

Consumer secured by one-to four-family	61,847
	49,408
	46,987
Total consumer	109,381
	3.9
	91,981
	3.8
	87,852
	3.8
Total loans outstanding	2,824,033
	100.00 %

2,439,731

100.00

%

2,314,645

100.00

%

Less allowance for loan losses

(33,618

)

(30,898)

(29,788

)

Total net loans outstanding at end of period
$
2,790,415
$
2,408,833

$
2,284,857

June 30 2006

Deposits :	December 31 2005		June 30 2005			
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Demand and NOW checking	$ 655,643	25.4 %	$ 622,235	26.8 %	$ 600,483	

27.6

%

Regular savings accounts

265,942

10.3

153,218

6.6

155,969

7.2

Money market accounts

268,949

10.4

345,757

14.9

275,797

12.7

Total transaction and saving accounts
1,190,534
46.1
1,121,210
48.3
1,032,249
47.5

Certificates which mature or reprice:

Within 1 year

1,118,596

899,617

784,505

After 1 year, but within 3 years

218,814

250,605

300,101

After 3 years

51,513

51,881

58,060

Total certificate accounts

	1,388,923	53.9	1,202,103	51.7	1,142,666	52.5
Total	$ 2,579,457	100.00 %	$ 2,323,313	100.00 %	$ 2,174,915	100.00

%

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Comparison of Results of Operations for the Quarters and Six Months Ended June 30, 2006 and 2005

General.

For the quarter ended June 30, 2006, the Company had net income of $9.4 million, or $0.77 per share (diluted), compared to net income of $5.0 million, or $0.42 per share (diluted), for the quarter ended June 30, 2005. The Company's improved operating results reflect significant growth of assets and liabilities, as well as changes in the mix of those assets and liabilities, including the effects of certain balance-sheet restructuring transactions completed in the quarter ended December 31, 2005, which have resulted in a significant expansion in the Company's net interest margin as more fully explained below. The current quarter's earnings were also positively affected by the collection of a $5.5 million insurance settlement relating to a loss incurred in 2001. The net amount of the settlement, following costs, resulted in a $5.4 million credit to other operating expense and contributed approximately $3.4 million, or $.28 per share, to net income for the quarter ended June 30, 2006. The Company's operating results also reflect substantial increases in other operating expenses, particularly compensation, occupancy, information services, advertising and miscellaneous expenses reflecting the growth in locations, operations and staff as the Company continues to expand. New or relocated locations that contributed to the higher level of operating expenses during the current quarter as compared to the same period a year ago, include: Lynden, Lynnwood, Spokane, East Wenatchee, Walla Walla, Vancouver, Pasco and Burlington, Washington, Beaverton, Oregon and Boise, Twin Falls and Meridian, Idaho.

Compared to levels a year ago, total assets increased 8% to $3.397 billion at June 30, 2006, net loans increased 22% to $2.790 billion, deposits grew 19% to $2.579 billion, while borrowings, including junior subordinated debentures, decreased $161 million, or 23%, to $544 million, reflecting the balance sheet restructuring in the fourth quarter of 2005. Average interest-earning assets were $3.047 billion for the quarter ended June 30, 2006, an increase of $193 million, or 7%, compared to $2.854 billion for the same period a year earlier.

Net Interest Income.

Net interest income before provision for loan losses increased to $31.2 million for the quarter ended June 30, 2006, compared to $26.7 million for the prior year comparative quarter, largely as a result of the growth in average interest-earning assets noted above and the net interest margin expansion as discussed in the remainder of this paragraph. The net interest margin of 4.11% in the current quarter improved 36 basis points from the prior year's comparative quarter, reflecting the balance-sheet restructuring and the Company's success in attracting higher yielding loans and lower cost deposits. For the six months ended June 30, 2006, the net interest margin also improved 44 basis points from 3.73% to 4.17% from the prior year's comparative period. While this improvement in the net interest margin primarily reflects changes in both the asset and liability mix, including those resulting from the balance-sheet restructuring, the lagged effect of increasing market interest rates on deposit costs, as more fully explained below, also contributed to the improvement. In particular, the average asset mix for the quarter and six months ended June 30, 2006 reflected proportionately more loans, including more higher yielding commercial, construction and land development loans, and fewer investment securities than for the same period a year earlier. At the same time, the average funding liability base had proportionately more deposits, including more non-interest-bearing deposits, and proportionately fewer borrowings than in the prior year. Reflecting higher market interest rates as well as these mix changes, the yield on earning assets for the quarter and six months ended June 30, 2006 each increased by 124 basis points compared to the same periods a year ago while funding costs for the quarter and six months ended June 30, 2006 increased by 90 and 82 basis points, respectively, over the same period.

Interest Income.

Interest income for the quarter ended June 30, 2006 was $58.9 million, compared to $46.4 million for the same quarter a year earlier, an increase of $13 million, or 27%. The increase in interest income occurred as a result of a 124 basis point increase in the average yield on interest-earning assets as well as significant growth in those assets. The yield on average interest-earning assets increased to 7.76% for the quarter ended June 30, 2006, compared to 6.52% for the same period a year earlier. Average loans receivable for the quarter ended June 30, 2006 increased by $481 million, or 22%, to $2.705 billion, compared to $2.224 billion for the quarter ended June 30, 2005. Interest income on loans for the quarter increased by $15.2 million, or 38%, to $55.1 million from $39.8 million for the same period in the prior year, reflecting the impact of the increase in average loan balances combined with a 98 basis point increase in the average yield. The increase in average loan yield reflects the increases in the level of market interest rates during the past year, particularly in short-term interest rates including the prime rate and LIBOR indices which affect large portions of construction, land development, commercial and agricultural loans. The increase in average loan yields also reflects changes in the mix of the loan portfolio. The average yield on loans was 8.17% for the quarter ended June 30, 2006, compared to 7.19% for the same period in the prior year. While the recent level of market interest rates was significantly higher than a year earlier, loan yields did not change to the same degree as most fixed-rate loans did not adjust upward. In addition, changes in the average credit risk profile of new borrowers and competitive pricing pressure resulted in lower spreads and yields on new loan originations. These factors were somewhat offset by changes in the loan mix, as growth has been most significant in some of the higher yielding adjustable-rate loan categories.

The combined average balance of mortgage-backed securities, investment securities, daily interest-bearing deposits and FHLB stock decreased by $288 million for the quarter ended June 30, 2006, primarily reflecting the 2005 fourth quarter restructuring transactions, and the interest and dividend income from those investments decreased by $2.7 million compared to the quarter ended June 30, 2005. The average yield on the securities portfolio and cash equivalents increased to 4.51% for the quarter ended June 30, 2006, from 4.16% for the comparable quarter in 2005, largely reflecting the sale of lower yielding securities and the effect of higher market rates on certain adjustable rate securities. Consistent with recent periods and similar to the same quarter a year earlier, the Company did not record any dividend income on its FHLB of Seattle stock in the quarter ended June 30, 2006. Management does not expect that Banner Bank will receive any dividend income on this stock for the foreseeable future.

Interest income for the six months ended June 30, 2006 increased by $22.9 million, or 26%, to $111.9 million, from $89.0 million for the comparable period in 2005. This increase in interest income is the result of the same growth, mix and market interest rate trends which affected the quarterly results explained above. Interest income from loans increased $28.2 million, or 37%, to $104.2 million for the six months ended June 30, 2006, from $76.0 million for the comparable period on in 2005. The increase in loan interest income reflects the impact of $433 million of growth in the average balance of loans receivable in addition to a 102 basis point increase in the yield on the loan balances. Interest

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income from mortgage-backed and investment securities and FHLB stock for the six months ended June 30, 2006 decreased $5.3 million, to $7.7 million in the current period, reflecting a $286 million decrease in average balances which was partially offset by a 32 basis point increase in yield.

Interest Expense.

Interest expense for the quarter ended June 30, 2006 was $27.7 million, compared to $19.7 million for the comparable period in 2005, an increase of $8.1 million, or 41%. The increase in interest expense was the result of the growth in interest-bearing liabilities combined with a 90 basis point increase in the average cost of all interest-bearing liabilities to 3.74% for the quarter ended June 30, 2006, from 2.84% for the comparable period in 2005, reflecting the higher levels of market interest rates and the maturity of certain lower-costing certificates of deposit and fixed-rate borrowings. Deposit interest expense increased $8.7 million, or 71%, to $20.8 million for the quarter ended June 30, 2006 compared to $12.1 million for the same quarter a year ago, as a result of the significant deposit growth over the past twelve months as well as an increase in the cost of interest-bearing deposits. Reflecting the branch expansion and other growth initiatives, average deposit balances increased $377 million, or 18%, to $2.446 billion for the quarter ended June 30, 2006, from $2.069 billion for the quarter ended June 30, 2005, while the average rate paid on deposit balances increased 106 basis points to 3.41%. Although deposit costs are significantly affected by changes in the level of market interest rates, changes in the average rate paid for interest-bearing deposits tend to be less severe and to lag changes in market interest rates. In addition, non-interest-bearing deposits help mitigate the effect of higher market rates on the Company's cost of deposits. This lower degree of volatility and lag effect for deposit pricing has been evident in the modest increase in deposit costs as the Federal Reserve has moved to increase short-term interest rates by 425 basis points from June 2003 to June 2006, including an increase of 200 basis points since June 30, 2005. Nonetheless, competitive pricing pressure for interest-bearing deposits has become quite intense in recent months, as many financial institutions have experienced strong loan growth and related funding needs. As a result, management expects that the cost of deposits will continue to increase in the near term regardless of any changes in market interest rates.

The Company's strong loan growth, which significantly outpaced deposit growth, also resulted in a substantial increase in FHLB advances during the current quarter. Despite their recent increase, average FHLB advances decreased to $345 million for the quarter ended June 30, 2006, compared to $573 million during the quarter ended June 30, 2005, reflecting the fourth quarter 2005 restructuring transactions and resulting in a $1.8 million decrease in the related interest expense. The average rate paid on FHLB advances increased to 4.82%, just 67 basis points higher than the same quarter a year earlier, as the effect of significantly higher market interest rates on the floating rate and short-term portions of the advances was substantially offset by the prepayment of $142 million of higher fixed-rate, fixed-term advances in connection with the balance-sheet restructuring transactions completed in the quarter ended December 31, 2005. Junior subordinated debentures which were issued in connection with trust preferred securities had an average balance of $98 million and an average cost of 8.08% (including amortization of prepaid underwriting costs) for the quarter ended June 30, 2006. Junior subordinated debentures outstanding in the same quarter of the prior year had an average balance of $72 million with a lower average rate of 6.63%. The junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three to six months. The increased cost of the junior subordinated debentures reflects recent increases in short-term market interest rates. Other borrowings consist of retail repurchase agreements with customers and reverse repurchase agreements with investment banking firms secured by certain investment securities. The average balance for other borrowings increased $17 million, or 27%, to $81 million for the quarter ended June 30, 2006, from $64 million for the same period in 2005, while the related interest expense increased $374,000, to $766,000 from $392,000 for the respective periods. The average balance of the wholesale borrowings from brokers decreased $7 million, which was more than offset by a $25 million increase in the average balance of customer retail repurchase agreements, reflecting growth in the Company's customer cash management services. The average rate paid on other borrowings was 3.78% in the quarter ended June 30, 2006, compared to 2.47% for the same quarter in 2005. The Company's other borrowings generally have relatively short terms and therefore reprice to current market levels more quickly than deposits and FHLB advances, which generally lag current market rates, although, similar to deposits, customer retail repurchase agreements have a lower degree of volatility than most market rates.

A comparison of total interest expense for the six months ended June 30, 2006 shows an increase of $13.7 million, or 37%, from the comparable period in 2005. The interest expense reflects an increase in average deposits of $369 million combined with a $218 million decrease in FHLB advances, trust preferred securities and other borrowings. The effect on interest expense of the $151 million increase in average interest-bearing liabilities was also accompanied by a 82 basis point increase in the interest paid on those liabilities. The effect of higher market rates on the cost of these funds was partially mitigated by deposit pricing characteristics noted above and as deposits, including non-interest-bearing deposits, became a proportionately larger source of funds.

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The following tables provide additional comparative data on the Company's operating performance (dollars in thousands):

	Quarters Ended June 30	Six Months Ended June 30
Average Balances		

(in thousands)	2006	2005	2006	2005
Investment securities and cash equivalents	$ 133,843	$ 275,192	$ 133,896	$ 273,199
Mortgage-backed obligations	172,634	319,105	176,000	322,799
FHLB stock	35,844	35,844	35,844	35,773
Total average interest-earning securities and cash equivalents	342,321	630,141	345,740	631,771
Loans receivable	2,704,856	2,224,089	2,607,743	2,175,233
Total average interest-earning assets	3,047,177	2,854,230	2,953,483	2,807,004
Non-interest-earning assets	191,758	175,705	191,058	172,686
Total average assets	$ 3,238,935	$ 3,029,935	$ 3,144,541	$ 2,979,690
Deposits	$ 2,446,316	2,069,062	$ 2,384,112	2,015,104
Advances from FHLB	344,865	572,716	317,350	576,122
Other borrowings	81,251	63,776	81,160	65,782
Junior subordinated debentures	97,942	72,168	97,942	72,168
Total average interest-bearing liabilities	2,970,374	2,777,722	2,880,564	2,729,176
Non-interest-bearing liabilities	35,428	32,409	33,355	30,795
Total average liabilities	3,005,802	2,810,131	2,913,919	2,759,971
Equity	233,133	219,804	230,622	219,719
Total average liabilities and equity	$ 3,238,935	$ 3,029,935	$ 3,144,541	$ 2,979,690
Interest Rate Yield/Expense (rates are annualized)				
Interest Rate Yield:				
Investment securities and cash equivalents	5.50 %	4.29 %	5.44 %	4.30 %
Mortgage-backed obligations	4.67 %	4.51 %	4.69 %	4.53 %
FHLB stock	0.00 %	0.00 %	0.00 %	(0.16)%
Total interest rate yield on securities and cash equivalents	4.51 %	4.16 %	4.49 %	4.17 %

Loans receivable	8.17 %	7.19 %	8.06 %	7.04 %
Total interest rate yield on interest-earning assets	7.76 %	6.52 %	7.64 %	6.40 %
Interest Rate Expense:				
Deposits	3.41 %	2.35 %	3.24 %	2.26 %
Advances from FHLB	4.82 %	4.15 %	4.62 %	4.04 %
Other borrowings	3.78 %	2.47 %	3.64 %	2.22 %
Junior subordinated debentures	8.08 %	6.63 %	7.83 %	6.32 %
Total interest rate expense on interest-bearing liabilities	3.74 %	2.84 %	3.56 %	2.74 %
Interest spread	4.02 %	3.68 %	4.08 %	3.66 %
Net interest margin on interest earning assets	4.11 %	3.75 %	4.17 %	3.73 %
Additional Key Financial Ratios (ratios are annualized)				
Return on average assets	1.16 %	0.66 %	1.04 %	0.66 %
Return on average equity	16.10 %	9.15 %	14.12 %	8.92 %
Average equity / average assets	7.20 %	7.25 %	7.33 %	7.37 %
Average interest-earning assets / interest-bearing liabilities	102.59 %	102.75 %	102.53 %	102.85 %
Non-interest (other operating) expenses / average assets	2.48 %	3.02 %	2.77 %	2.98 %
Efficiency ratio [non-interest (other operating) expenses / revenues]	55.24 %	72.76 %	61.18 %	72.82 %

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Provision and Allowance for Loan Losses

. During the quarter ended June 30, 2006, the provision for loan losses was $2.3 million, an increase of $1.0 million from the quarter ended June 30, 2005, primarily in response to the significant growth of the loan portfolio. As discussed in Note 1 of the Selected Notes to the Consolidated Financial Statements, the provision and allowance for loan losses is one of the most critical accounting estimates included in the Company's 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 as more fully explained below.

The provision in the current quarter reflects lower levels of non-performing loans and net charge offs, balanced against growth in the size of the loan portfolio and continuing changes in the loan mix. Net charge-offs were $576,000 for the current quarter, compared to $1.2 million for the same quarter a year earlier, and non-performing loans decreased $5.4 million to $11 million at June 30, 2006, compared to $16 million at June 30, 2005. However, non-performing loans did increase by $2.3 million during the quarter from $8 million at March 31, 2006, and net charge-offs were also slightly higher in the current quarter than in the immediately preceding quarter. Generally, these non-performing loans reflect unique operating difficulties for the individual borrower rather than weakness in the overall economy of the Pacific Northwest, housing or real estate markets, or depressed farm commodity prices or adverse growing conditions. A comparison of the allowance for loan losses at June 30, 2006 and 2005 shows an increase of $4 million to $34 million at June 30, 2006, from $30 million at June 30, 2005. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) was 1.19% and 1.29% at June 30, 2006 and 2005, respectively. The allowance as a percentage of non-performing loans increased to 318% at June 30, 2006, compared to 187% a year earlier.

In originating loans, the Company recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the collateral for the loan. As a result, the Company maintains an allowance for loan losses consistent with the GAAP guidelines outlined in SFAS No. 5, *Accounting for Contingencies*. The Company has established systematic methodologies for the determination of the adequacy of its 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. The Company increases its allowance for loan losses by charging provisions for probable loan losses against the Company's income and values impaired loans consistent with the guidelines in SFAS No. 114, *Accounting by Creditors for Impairment of a Loan,* and SFAS No. 118, *Accounting by Creditors for Impairment of a Loan?Income Recognition and Disclosure*.

The allowance for losses on loans is maintained at a level sufficient to provide for estimated losses based on evaluating known and inherent risks in the loan portfolio and upon management's continuing analysis of the factors underlying the quality of the loan portfolio. These factors include 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 collectibility 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 c