BANNER CORP
Form 10-Q
August 06, 2010

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, 2010.

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 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). Yes [ ] No [ ]

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 [ ]	Accelerated filer [X]	Non-accelerated filer [ ]	Smaller reporting company [ ]

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:	As of July 31, 2010
Common Stock, $.01 par value per share	110,590,335 shares*

* Includes 240,381 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

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1 - Financial Statements. The Consolidated Financial Statements of Banner Corporation and Subsidiaries filed as a part of the report are as follows:

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited) (In thousands, except shares)
June 30, 2010 and December 31, 2009

ASSETS	June 30 2010	December 31 2009
Cash and due from banks	$ 437,186	$ 323,005
Securities—trading, cost $149,386 and $192,853, respectively	105,381	147,151
Securities—available-for-sale, cost $138,103 and $95,174, respectively	140,342	95,667
Securities—held-to-maturity, fair value $76,996 and $76,489, respectively	73,632	74,834
Federal Home Loan Bank (FHLB) stock	37,371	37,371
Loans receivable:		
Held for sale, fair value $4,888 and $4,534, respectively	4,819	4,497
Held for portfolio	3,626,685	3,785,624
Allowance for loan losses	(95,508)	(95,269)
	3,535,996	3,694,852
Accrued interest receivable	16,930	18,998
Real estate owned, held for sale, net	101,485	77,743
Property and equipment, net	99,536	103,542
Other intangibles, net	9,811	11,070
Deferred income tax asset, net	14,364	14,811
Income taxes receivable, net	22,581	17,436
Bank-owned life insurance (BOLI)	55,477	54,596
Other assets	51,514	51,145
	$ 4,701,606	$ 4,722,221
LIABILITIES		
Deposits:		
Non-interest-bearing	$ 548,251	$ 582,480
Interest-bearing transaction and savings accounts	1,403,231	1,341,145
Interest-bearing certificates	1,887,513	1,941,925
	3,838,995	3,865,550
Advances from FHLB at fair value	47,003	189,779
Other borrowings	172,737	176,842
Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)	49,808	47,694
Accrued expenses and other liabilities	25,440	24,020
Deferred compensation	13,665	13,208
	4,147,648	4,317,093
COMMITMENTS AND CONTINGENCIES (Note 16)		
STOCKHOLDERS' EQUITY		

Preferred stock - $0.01 par value, 500,000 shares authorized; Series A – liquidation preference		
$1,000 per share, 124,000 shares issued and outstanding	118,204	117,407
Common stock and paid in capital - $0.01 par value per share, 200,000,000 shares authorized, 102,954,738 shares		
issued: 102,714,357 shares and 21,299,209 shares outstanding at June 30, 2010 and December 31, 2009, respectively	490,119	331,538
Retained earnings (accumulated deficit)	(53,768)	(42,077)
Accumulated other comprehensive income:		
Unrealized gain on securities available-for-sale and/or transferred to held-to-maturity	1,390	249
Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost:		
240,381 restricted shares outstanding at June 30, 2010 and December 31, 2009	(1,987)	(1,987)
Carrying value of shares held in trust for stock related compensation plans	(9,051)	(9,045)
Liability for common stock issued to deferred, stock related, compensation plans	9,051	9,043
	--	(2)
	553,958	405,128
	$ 4,701,606	$ 4,722,221

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited) (In thousands except for per share amounts)
For the Quarters and Six Months Ended June 30, 2010 and 2009

	Quarters Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
INTEREST INCOME:				
Loans receivable	$52,473	$55,500	$105,232	$111,847
Mortgage-backed securities	1,045	1,569	2,171	3,370
Other securities and cash equivalents	2,116	2,089	4,201	4,272
	55,634	59,158	111,604	119,489
INTEREST EXPENSE:				
Deposits	14,700	21,638	30,498	44,730
FHLB advances	320	675	681	1,395
Other borrowings	626	671	1,260	898
Junior subordinated debentures	1,047	1,249	2,074	2,582
	16,693	24,233	34,513	49,605
Net interest income before provision for loan losses	38,941	34,925	77,091	69,884
PROVISION FOR LOAN LOSSES	16,000	45,000	30,000	67,000
Net interest income (loss)	22,941	(10,075)	47,091	2,884
OTHER OPERATING INCOME:				
Deposit fees and other service charges	5,632	5,408	10,792	10,344
Mortgage banking operations	817	2,860	1,765	5,575
Loan servicing fees (expense)	315	248	628	(22)
Miscellaneous	243	412	869	932
	7,007	8,928	14,054	16,829
Other-than-temporary impairment losses	--	(162)	(1,231)	(162)
Net change in valuation of financial instruments carried at fair value	(821)	11,211	1,087	7,958
Total other operating income	6,186	19,977	13,910	24,625
OTHER OPERATING EXPENSES:				
Salary and employee benefits	16,793	17,528	33,352	35,129
Less capitalized loan origination costs	(1,740)	(2,834)	(3,345)	(4,950)
Occupancy and equipment	5,581	5,928	11,185	11,982
Information/computer data services	1,594	1,599	3,100	3,133
Payment and card processing expenses	1,683	1,555	3,107	3,008
Professional services	1,874	1,183	3,161	2,377
Advertising and marketing	1,742	2,207	3,692	4,039
Deposit insurance	2,209	4,102	4,341	5,599
State/municipal business and use taxes	533	532	1,013	1,072
REO operations	4,166	1,805	7,224	2,428
Amortization of core deposit intangibles	615	661	1,259	1,351
Miscellaneous	2,974	2,625	5,350	5,516

Total other operating expenses	38,024	36,891	73,439	70,684
Income (loss) before provision for (benefit from) income taxes	(8,897)	(26,989)	(12,438)	(43,175)
PROVISION FOR (BENEFIT FROM) INCOME TAXES	(3,951)	(10,478)	(5,975)	(17,401)
NET INCOME (LOSS)	(4,946)	(16,511)	(6,463)	(25,774)
PREFERRED STOCK DIVIDEND AND DISCOUNT ACCRETION				
Preferred stock dividend	1,550	1,550	3,100	3,100
Preferred stock discount accretion	399	373	797	746
NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	$(6,895)	$(18,434)	$(10,360)	$(29,620)
Earnings (loss) per common share:				
Basic	$(0.28)	$(1.04)	$(0.44)	$(1.70)
Diluted	$(0.28)	$(1.04)	$(0.44)	$(1.70)
Cumulative dividends declared per common share:	$0.01	$0.01	$0.02	$0.02

See selected notes to consolidated financial statements

4

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited) (In thousands)
For the Quarters and Six Months Ended June 30, 2010 and 2009

	Quarters Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
NET INCOME (LOSS)	$ (4,946)	$ (16,511)	$ (6,463)	$ (25,774)
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:				
Unrealized holding gain (loss) during the period, net of deferred income tax (benefit) of $323, ($220), $629 and ($70), respectively	576	(802)	1,119	(538)
Amortization of unrealized loss on tax exempt securities transferred from available-for-sale to held-to-maturity	10	14	22	28
Other comprehensive income (loss)	586	(788)	1,141	(510)
COMPREHENSIVE INCOME (LOSS)	$ (4,360)	$ (17,299)	$ (5,322)	$ (26,284)

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2010 and 2009

	Preferred Stock	Common Stock and Paid in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
Balance, January 1, 2010	$ 117,407	$ 331,538	$ (42,077)	$ 249	$ (1,987)	$ (2)	$ 405,128
Net income (loss)			(6,463)				(6,463)
Change in valuation of securities—available-for-sale, net of income tax				1,119			1,119
Amortization of unrealized loss on tax exempt securities transferred from available-for-sale to held-to-maturity, net of income taxes				22			22
Accretion of preferred stock discount	797		(797)				--
Accrual of dividends on preferred stock			(3,100)				(3,100)
Accrual of dividends on common stock ($.02/share cumulative)			(1,331)				(1,331)
Proceeds from issuance of common stock for stockholder reinvestment program, net of registration expenses		10,503					10,503
Proceeds from issuance of common stock, net of offering costs		148,042					148,042

Amortization of compensation related to MRP						2	2
Amortization of compensation related to stock options		36					36
BALANCE, June 30, 2010	$ 118,204	$ 490,119	$ (53,768)	$ 1,390	$ (1,987)	$ --	$ 553,958

See selected notes to consolidated financial statements

6

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2010 and 2009

	Preferred Stock	Common Stock and Paid in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
Balance, January 1, 2009	$ 115,915	$ 316,740	$ 2,150	$ 572	$ (1,987)	$ (42)	$ 433,348
Net income (loss)			(25,774)				(25,774)
Change in valuation of securities—available-for-sale, net of income tax				(538)			(538)
Amortization of unrealized loss on tax exempt securities transferred from available-for-sale to held-to-maturity, net of income taxes				28			28
Additional registration costs for issuance of preferred stock		(46)					(46)
Accretion of preferred stock discount	746		(746)				--
Accrual of dividends on preferred stock			(3,100)				(3,100)
Accrual of dividends on common stock ($.02/share cumulative)			(356)				(356)
Proceeds from issuance of common stock for stockholder reinvestment program, net of		5,814					5,814

registration expenses							
Amortization of compensation related to MRP						24	24
Amortization of compensation related to stock options		74					74
BALANCE, June 30, 2009	$ 116,661	$ 322,582	$ (27,826)	$ 62	$ (1,987)	$ (18)	$ 409,474

See selected notes to consolidated financial statements

7

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2010 and 2009

	Six Months Ended June 30	
	2010	2009
COMMON STOCK—SHARES ISSUED AND OUTSTANDING:		
Common stock, shares issued, beginning of period	21,539	17,152
Purchase and retirement of common stock	--	--
Issuance of common stock for exercised stock options and/or employee stock plans	--	--
Issuance of common stock for stockholder reinvestment program	2,915	1,274
Issuance of common stock, net of offering costs	78,500	--
Net number of shares issued during the period	81,415	1,274
COMMON SHARES ISSUED AND OUTSTANDING, END OF PERIOD	102,954	18,426
UNEARNED, RESTRICTED ESOP SHARES:		
Number of shares, beginning of period	(240)	(240)
Issuance/adjustment of earned shares	--	--
Number of shares, end of period	(240)	(240)
NET COMMON STOCK—SHARES OUTSTANDING	102,714	18,186

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2010 and 2009

	Six Months Ended June 30 2010	2009
OPERATING ACTIVITIES:		
Net income (loss)	$(6,463)	$(25,774)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	4,683	4,998
Deferred income and expense, net of amortization	1,211	(749)
Amortization of core deposit intangibles	1,259	1,351
Other-than-temporary impairment losses	1,231	162
Net change in valuation of financial instruments carried at fair value	(1,088)	(7,958)
Purchases of securities—trading	(2,572)	(64,761)
Principal repayments and maturities of securities—trading	45,970	96,104
Deferred taxes	141	(3,343)
Equity-based compensation	38	98
Increase in cash surrender value of bank-owned life insurance	(881)	(661)
Gain on sale of loans, excluding capitalized servicing rights	(1,348)	(2,294)
Loss (gain) on disposal of real estate held for sale and property and equipment	1,383	607
Provision for losses on loans and real estate held for sale	31,340	67,113
Origination of loans held for sale	(121,652)	(345,007)
Proceeds from sales of loans held for sale	121,330	344,043
Net change in:		
Other assets	(3,631)	(5,855)
Other liabilities	1,025	(3,565)
Net cash provided from operating activities	71,976	54,509
INVESTING ACTIVITIES:		
Purchases of securities available-for-sale	(79,801)	(18,672)
Principal repayments and maturities of securities available-for-sale	34,725	13,992
Proceeds from sales of securities available-for-sale	1,965	6,459
Purchases of securities held-to-maturity	(499)	(17,975)
Principal repayments and maturities of securities held-to-maturity	1,675	408
Principal repayments (originations) of loans, net	84,328	(52,937)
Purchases of loans and participating interest in loans	(129)	(27)
Purchases of property and equipment, net	(698)	(4,415)
Proceeds from sale of real estate held for sale, net	18,886	9,633
Other	(80)	(225)
Net cash provided from (used by) investing activities	60,372	(63,759)
FINANCING ACTIVITIES:		
Decrease in deposits	(26,555)	(29,007)
Proceeds from FHLB advances	--	91,200

Repayment of FHLB advances	(142,502)	(86,203)
Increase (decrease) in other borrowings, net	(4,110)	13,016
Cash dividends paid	(3,545)	(4,016)
Cash proceeds from issuance of stock for stockholder reinvestment program	10,503	5,768
Cash proceeds from issuance of stock in secondary offering, net of offering costs	148,042	--
Net cash used by financing activities	(18,167)	(9,242)
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	114,181	(18,492)
CASH AND DUE FROM BANKS, BEGINNING OF PERIOD	323,005	102,750
CASH AND DUE FROM BANKS, END OF PERIOD	$437,186	$84,258

(Continued on next page)

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2010 and 2009

	Six Months Ended June 30 2010	Six Months Ended June 30 2009
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid in cash	$35,784	$49,668
Taxes paid (received) in cash	(561)	(6,377)
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	45,487	52,160
Real estate owned transferred to property and equipment	--	7,030
Net decrease in accrued dividends payable	(886)	(560)
Change in other assets/liabilities	(42)	169

See selected notes to consolidated financial statements

10

BANNER CORPORATION AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: BASIS OF PRESENTATION AND CRITICAL ACCOUNTING POLICIES

Banner Corporation (Banner or the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly-owned subsidiaries, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of June 30, 2010, its 86 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System. Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the Federal Deposit Insurance Corporation (FDIC).

In the opinion of management, the accompanying consolidated statements of financial condition and related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity and cash flows reflect all adjustments (which include reclassifications and normal recurring adjustments) that are necessary for a fair presentation in conformity with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and the disclosure of contingent assets and liabilities as of the date of the statement of financial condition in the accompanying notes. 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 the 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 losses (OTTI), (iv) the valuation of intangibles, such as goodwill, core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale and (vi) deferred tax assets and liabilities. These policies and the judgments, estimates and assumptions are described in greater detail in 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, 2009 filed with the Securities and Exchange Commission (SEC). Management believes that the judgments, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate based on the factual circumstances at the time. However, because of 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 the Company's financial condition and operating results in future periods.

The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) became effective on July 1, 2009. At that date, the ASC became the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The implementation of the ASC affects the way companies refer to GAAP standards in financial statements and accounting policies, but it has not had a material effect on the Company's Consolidated Financial Statements.

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 2009 Consolidated Financial Statements and/or schedules to conform to the 2010 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 our Annual Report on Form 10-K for the year ended December 31, 2009 filed with the SEC. Interim results are not necessarily indicative of results for a full year.

Note 2: RECENT DEVELOPMENTS AND SIGNIFICANT EVENTS

Regulatory Actions: On March 23, 2010, Banner Bank entered into a Memorandum of Understanding (MOU) with the FDIC and Washington DFI. The Company also entered into a similar MOU with the Federal Reserve Bank of San Francisco on March 29, 2010. Under its MOU, Banner Bank is required, among other things, to develop and implement plans to reduce commercial real estate concentrations; to improve asset quality and reduce classified assets; to improve profitability; and to increase Tier 1 leverage capital to equal or exceed 10% of average assets. In addition, Banner Bank will not be able to pay cash dividends to Banner Corporation without prior approval from the FDIC and Washington DFI and the Company and Banner Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer. Further, the Company may not pay any dividends on common or preferred stock, pay interest or principal on the balance of its junior subordinated debentures or repurchase our common stock without the prior written non-objection of the Federal Reserve Bank. See Item 1A, Risk Factors—"We are required to comply with the terms of memoranda of understanding issued by the FDIC and DFI and the Federal Reserve and lack of compliance could result in additional regulatory actions."

Secondary Offering of Common Stock: On June 30, 2010, the Company announced the completion of its offering of 75,000,000 shares of its common stock and the sale of an additional 3,500,000 shares pursuant to the partial exercise of the underwriters' over-allotment option, at a price to the public of $2.00 per share. On July 2, 2010, the Company further announced the completion of the capital raise as the underwriters had exercised their over-allotment option for an additional 7,139,000 shares, at a price to the public of $2.00 per share. Together with the

78,500,000 shares the Company issued on June 30, 2010 (including 3,500,000 shares issued pursuant to the underwriters' initial exercise of their over-allotment option), the Company issued a total of 85,639,000 shares in the offering, resulting in net proceeds, after deducting underwriting discounts and commissions and estimated offering expenses, of approximately $161.6 million. Of that amount, $13.6 million (related to the 7,139,000 shares) will be recorded in the Consolidated Statements of Changes in Stockholders' Equity during the third quarter of 2010, as that portion of the transaction settled after June 30, 2010.

Banner intends to use a significant portion of the net proceeds from the offering to strengthen Banner Bank's regulatory capital ratios in accordance with the MOU and to support managed growth. To that end, at June 30, 2010, the Company had invested $50 million as additional paid-in common equity in Banner Bank. As a result, the Tier 1 leverage capital of Banner Bank increased to 10.77% of average assets on June 30, 2010. The Company expects to use the remaining net proceeds for general working capital purposes, including additional capital investments in its subsidiary banks if appropriate.

FDIC Prepayment: On November 12, 2009, the FDIC adopted a final rule that required insured depository institutions to prepay an estimate of their expected quarterly deposit insurance premiums for the fourth quarter of 2009 and for the three years ended December 31, 2010, 2011 and 2012. Insured institutions were required to deposit funds with the FDIC in the amount of the prepaid assessment on December 30, 2009. The insured institutions will not receive interest on the deposited funds. For purposes of calculating an institution's prepaid assessment amount, for the fourth quarter of 2009 and all of 2010, that institution's assessment rate was its total base assessment rate in effect on September 30, 2009. That rate was then increased by three basis points for all of 2011 and 2012. For purposes of calculating the prepaid amount, an institution's third quarter 2009 assessment base was also assumed to increase quarterly by an estimated five percent annual growth rate through the end of 2012. Each institution was directed to record the entire amount of its prepaid assessment as a prepaid expense (asset) as of December 30, 2009. Thereafter, each institution will record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution will record an expense and an accrued expense payable each quarter for its regular assessment, which would be paid in arrears to the FDIC at the end of the following quarter. If the prepaid assessment is not exhausted by June 30, 2013, any remaining amount will be returned to the institution. For Banner Corporation, the consolidated balance of the prepaid assessment was $25.4 million at June 30, 2010 and is recorded among "other assets" in the Consolidated Statement of Financial Condition.

FDIC Special Assessment: On May 22, 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution's total assets minus Tier 1 capital as of June 30, 2009, with the maximum amount of the special assessment for any institution not to exceed ten basis points times the institution's assessment base for the second quarter 2009 risk-based assessment. The special assessment was collected on September 30, 2009 at the same time the regular quarterly risk based assessment for the second quarter of 2009 was collected. For Banner Corporation, this assessment was $2.1 million, which was recognized in other operating expenses during the quarter ended June 30, 2009. The FDIC Board may vote to impose additional special assessments if the FDIC estimates that the Deposit Insurance Fund reserve ratio will fall to a level that the FDIC Board believes would adversely affect public confidence or to a level that will be close to or below zero.

FDIC Temporary Liquidity Guarantee Program: Banner Corporation, Banner Bank and Islanders Bank have chosen to participate in the FDIC's Temporary Liquidity Guarantee Program (the TLGP), which applies to all U.S. depository institutions insured by the FDIC and all United States bank holding companies, unless they have opted out. Under the TLGP, the FDIC guarantees certain senior unsecured debt of insured institutions and their holding companies, as well as non-interest-bearing transaction account deposits. Under the transaction account guarantee component of the TLGP, all non-interest-bearing and certain interest-bearing transaction accounts maintained at Banner Bank and Islanders Bank are insured in full by the FDIC until December 31, 2013, regardless of the standard maximum deposit insurance amounts. The Banks are required to pay a fee (annualized) on balances of each covered account in excess of $250,000 while the extra deposit insurance is in place. The annualized fee for the transaction account guarantee program was 10 basis points through December 31, 2009 and will be within a range from 15 to 25 basis points from January 1 through December 31, 2010. On March 31, 2009, Banner Bank completed an offering of $50 million of qualifying senior bank notes covered by the TLGP at a fixed rate of 2.625% which mature on March 31, 2012. Under the debt guarantee component of the TLGP, the FDIC will pay the unpaid principal and interest on an FDIC-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest. Under the terms of the TLGP, the Bank is not permitted to use the proceeds from the sale of securities guaranteed under the TLGP to prepay any of its other debt that is not guaranteed by the FDIC. Banner Bank is required to pay a 1.00% fee (annualized) on this debt, which will result in a total fee of $1.5 million over three years. None of the senior notes are redeemable prior to maturity.

Note 3: ACCOUNTING STANDARDS RECENTLY ADOPTED OR ISSUED

In December 2009, FASB issued ASU No. 2009-17, Transfers and Servicing (Topic 860)—Accounting for Transfers of Financial Assets. This update codifies SFAS No. 166, Accounting for Transfers of Financial Assets—an Amendment of FASB Statement No. 140, which was previously issued by FASB in June 2009 but was not included in the original codification. ASU 2009-17 eliminates the concept of a qualifying special-purpose entity, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, clarifies other sale-accounting criteria, and changes the initial measurement of a transferor’s interest in transferred financial assets. This statement was effective for annual reporting periods beginning after November 15, 2009, and for interim periods therein. This standard will primarily impact the Company’s accounting and reporting of transfers representing a portion of a financial asset for which the Company has a continuing involvement. In order to recognize the transfer of a portion of a financial asset as a sale, the transferred portion and any portion that continues to be held by the transferor must represent a participating interest, and the transfer of the participating interest must meet the conditions for surrender of control. To qualify as a participating interest, (i) the portions of a financial asset must represent a proportionate ownership interest in an entire financial asset, (ii) from the date of transfer, all cash flows received from the entire financial asset must be divided proportionately among the participating interest holders in an amount equal to their share of ownership, (iii) involve no recourse (other than standard representation and warranties) to, or subordination by, any participating interest holder, and (iv) no party has the right to pledge or exchange the entire financial asset. If the participating interest or surrender of control criteria are not met, the transfer is not accounted for as a sale and derecognition of the asset is not appropriate. Rather, the transaction is accounted for as a secured borrowing arrangement. The impact of certain participations being reported as secured borrowings rather than derecognizing a portion of a financial asset would increase total assets, liabilities and their respective interest income and expense. An increase in total assets also increases regulatory risk-weighted assets and could negatively impact our capital ratios. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

In December 2009, FASB issued ASU No. 2009-18, Consolidations (Topic 810)—Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities. This update codifies SFAS No. 167, Amendments to FASB Interpretation No. 46(R), which was previously issued by FASB in June 2009 but was not included in the original codification. ASU 2009-18 eliminates FASB Interpretations 46(R) (FIN 46(R)) exceptions to consolidating qualifying special-purpose entities, contains new criteria for determining the primary beneficiary, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity (VIE). The new guidance also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity’s status as a VIE, a company’s power over a VIE, or a company’s obligation to absorb losses or its right to receive benefits of an entity must be disregarded in applying the previous provisions. The elimination of the qualifying special-purpose entity concept and its consolidation exceptions means more entities will be subject to consolidation assessments and reassessments. This statement requires additional disclosures regarding an entity’s involvement in a VIE. This statement was effective for annual reporting periods beginning after November 15, 2009, and for interim periods therein. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In January 2010, the Board of Governors of the Federal Reserve System issued final risk-based capital rules related to the adoption of FASB ASC Topic 860-10 and FASB ASC Topic 810-10. Banking organizations affected by these recent pronouncements generally will be subject to higher regulatory capital requirements intended to better align risk-based capital levels with the actual risks of certain exposures. The adoption of the new risk-based capital rules in relation to these new pronouncements did not have a material impact on the Company’s consolidated financial statements.

In January 2010, FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820)—Improving Disclosures about Fair Value Measurements. ASU No. 2010-06 requires:

- fair value disclosures by each class of assets and liabilities (generally a subset within a line item as presented in the statement of financial position) rather than major category,
- for items measured at fair value on a recurring basis, the amounts of significant transfers between Levels 1 and 2, and transfers into and out of Level 3, and the reasons for those transfers, including separate discussion related to the transfers into each level apart from transfers out of each level, and
- gross presentation of the amounts of purchases, sales, issuances, and settlements in the Level 3 recurring measurement reconciliation.

Additionally, the ASU clarifies that a description of the valuation techniques(s) and inputs used to measure fair values is required for both recurring and nonrecurring fair value measurements. Also, if a valuation technique has changed, entities should disclose that change and the reason for the change. Disclosures other than the gross presentation changes in the Level 3 reconciliation are effective for the first reporting period beginning after December 15, 2009. The requirement to present the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis will be effective for fiscal years beginning after December 15, 2010. The sections of this ASU already adopted did not have a material impact on the Company’s consolidated financial statements. The further adoption of the requirement to present the Level 3 reconciliation differently is not expected to have a material effect on the Company’s consolidated financial statements.

In February 2010, FASB issued ASU No. 2010-09, Subsequent Events (Topic 855)—Amendments to Certain Recognition and Disclosure Requirements. ASU No. 2010-09 establishes separate subsequent event recognition criteria and disclosure requirements for SEC filers. SEC filers are defined in this update as entities that are required to file or to furnish their financial statements with either the SEC or another appropriate agency, (such as the FDIC or Office of Thrift Supervision) under Section 12(i) of the Securities and Exchange Act of 1934, as amended. Effective with the release date, the financial statements of SEC filers will no longer disclose either the date through with subsequent events were reviewed or that subsequent events were evaluated through the date the financial statements were issued. The requirement to evaluate subsequent events through the date of issuance is still in place; only the disclosure is affected. This ASU also removes the requirement to make those disclosures in financial statements revised for either a correction of an error or a retrospective application of an accounting change. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2010, FASB issued ASU No. 2010-13, Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades – a consensus of the FASB Emerging Issues Task Force. ASU No. 2010-13 addresses whether an employee stock option should be classified as a liability or as an equity instrument if the exercise price is denominated in the currency in which a substantial portion of the entity's equity securities trades. That currency may differ from the entity's functional currency and from the payroll currency of the employee receiving the option. This guidance amends ASC 718, Compensation – Stock Compensation, to clarify that an employee share-based payment award that has an exercise price denominated in the currency of the market in which a substantial portion of the entity's equity shares trades should not be considered to contain a condition that is not a market, performance, or service condition. The guidance in the ASU is effective for fiscal years, and for interim periods within those fiscal years, beginning on or after December 15, 2010, and is not expected to have a material impact on the Company's consolidated financial statements.

In April 2010, FASB issued ASU No. 2010-18, Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force. ASU No. 2010-18 clarifies that a creditor should not apply specific guidance in ASC 310, Receivables, 40, Troubled Debt Restructurings by Creditors, to acquired loans accounted for as a pooled asset under ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. However, that guidance in ASC 310-30 continues to apply to acquired loans within the scope of ASC 310-30 that a creditor accounts for individually. This amended guidance is effective for a modification of a loan(s) accounted for within a pool under ASC 310-30 occurring in the first interim or annual period ending on or after July 15, 2010. The amended guidance must be applied prospectively, and early application is permitted. Upon initial application of the amended guidance, an entity may make a one-time election to terminate accounting for loans as a pool under ASC 310-30. An entity may make the election on a pool-by-pool basis. The election does not preclude an entity from applying pool accounting to future acquisitions of loans with credit deterioration. The implementation of this ASU is not expected to have a material impact 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 its portfolio in its respective primary market areas. The Banks offer a wide variety of deposit products to its 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.

U.S. GAAP establishes 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. We have determined that the Company's current business and operations consist of a single business segment and have presented our financial statements accordingly.

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):

	June 30 2010	December 31 2009	June 30 2009
Interest-bearing deposits included in cash and due from banks	$ 369,864	$ 244,641	$ 16,919
Mortgage-backed or related securities			
GNMA	16,844	18,458	21,186
FHLMC	37,087	43,469	53,153
FNMA	36,691	37,549	43,501
Private issuer	3,949	6,465	7,641
Total mortgage-backed securities	94,571	105,941	125,481
U.S. agency obligations	108,672	94,367	46,704
Taxable municipal bonds	3,221	3,717	4,608
Corporate bonds	43,710	43,267	43,065
Total other taxable securities	155,603	141,351	94,377

Tax-exempt municipal bonds	69,051	70,018	75,573
Equity securities (excludes FHLB stock)	130	342	346
Total securities	319,355	317,652	295,777
FHLB stock	37,371	37,371	37,371
	$ 726,590	$ 599,664	$ 350,067

Securities—Trading: The amortized cost and estimated fair value of securities—trading at June 30, 2010 and December 31, 2009 are summarized as follows (dollars in thousands):

	June 30, 2010			December 31, 2009		
	Amortized Cost	Fair Value	Percent of Total	Amortized Cost	Fair Value	Percent of Total
U.S. Government and agency obligations	$ 4,170	$ 4,472	4.2%	$ 41,178	$ 41,255	28.0%
Municipal bond:						
Taxable	848	862	0.8	1,004	1,034	0.7
Tax exempt	5,753	6,029	5.7	6,065	6,117	4.2
	6,601	6,891	6.5	7,069	7,151	4.9
Corporate bonds	76,373	35,460	33.7	76,411	35,017	23.8
Mortgage-backed securities:						
FHLMC	20,714	21,737	20.7	25,030	25,837	17.6
FNMA	34,613	36,691	34.8	36,250	37,549	25.5
	55,327	58,428	55.5	61,280	63,386	43.1
Equity securities	6,915	130	0.1	6,915	342	0.2
	$ 149,386	$ 105,381	100.0%	$ 192,853	147,151	$ 100.0%

The amortized cost and estimated fair value of securities—trading at June 30, 2010 and December 31, 2009, 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.

	June 30, 2010		December 31, 2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 335	$ 340	$ 550	$ 565
Due after one year through five years	3,124	3,299	40,232	40,277
Due after five years through ten years	22,222	23,389	21,230	21,641
Due after ten years through twenty years	18,958	19,625	20,931	21,186
Due after twenty years	97,832	58,598	102,995	63,140
	142,471	105,251	185,938	146,809
Equity securities	6,915	130	6,915	342
	$ 149,386	$ 105,381	$ 192,853	$ 147,151

Securities—Available-for-Sale: The amortized cost and estimated fair value of securities available-for-sale at June 30, 2010 and December 31, 2009 are summarized as follows (dollars in thousands):

June 30, 2010

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Percent of Total
U.S. Government and agency obligations	$ 103,596	$ 604	$ --	$ 104,200	74.2%
Mortgage-backed or related securities:					
FHLMC collateralized mortgage obligations	14,878	472	--	15,350	11.0
GNMA certificates	15,596	1,248	--	16,844	12.0
Other collateralized mortgage obligations	4,033	--	(85)	3,948	2.8
	$ 138,103	$ 2,324	$ (85)	$ 140,342	100.0%

	December 31, 2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Percent of Total
U.S. Government and agency obligations	$ 53,732	$ 22	$ (642)	$ 53,112	55.5%
Mortgage-backed or related securities:					
FHLMC collateralized mortgage obligations	17,410	223	--	17,633	18.4
GNMA certificates	17,741	716	--	18,457	19.3
Other collateralized mortgage obligations	6,291	174	--	6,465	6.8
	$ 95,174	$ 1,135	$ (642)	$ 95,667	100.0%

At June 30, 2010 and December 31, 2009, an aging of unrealized losses and fair value of related securities—available-for-sale was as follows (in thousands):

	June 30, 2010					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Other collateralized mortgage obligations	$ 3,948	$ (85)	$ --	$ --	$ 3,948	$ (85)
	$ 3,948	$ (85)	$ --	$ --	$ 3,948	$ (85)

	December 31, 2009					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	$ 48,713	$ (642)	$ --	$ --	$ 48,713	$ (642)
	$ 48,713	$ (642)	$ --	$ --	$ 48,713	$ (642)

Management does not believe that any individual unrealized loss as of June 30, 2010 represents an other-than-temporary impairment. The decline in fair market value of these securities is generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. At June 30, 2010, there was one security—available-for-sale with unrealized losses, compared to eight at December 31, 2009.

The amortized cost and estimated fair value of securities—available-for-sale at June 30, 2010 and December 31, 2009, 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.

	June 30, 2010		December 31, 2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ --	$ --	$ --	$ --
Due after one year through five years	78,618	79,070	48,748	48,257
Due after five years through ten years	24,978	25,130	4,983	4,854
Due after ten years through twenty years	4,033	3,948	5,133	5,196
Due after twenty years	30,474	32,194	36,310	37,360
	$ 138,103	$ 140,342	$ 95,174	$ 95,667

Securities—Held-to-Maturity: The amortized cost and estimated fair value of securities held-to-maturity are summarized as follows (dollars in thousands):

	June 30, 2010				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Percent of Total
Municipal bonds:					
Taxable	$ 2,359	$ 147	$ --	$ 2,506	3.3%

Tax exempt		63,023		3,472		(33)		66,462	86.3
		65,382		3,619		(33)		68,968	89.6
Corporate bonds		8,250		10		(232)		8,028	10.4
	$	73,632	$	3,629	$	(265)	$	76,996	100.0%

	December 31, 2009								
		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value	Percent of Total
Municipal bonds:									
Taxable	$	2,683	$	66	$	(30)	$	2,719	3.6%
Tax exempt		63,901		2,731		(72)		66,560	87.0
		66,584		2,797		(102)		69,279	90.6
Corporate bonds		8,250		--		(1,040)		7,210	9.4
	$	74,834	$	2,797	$	(1,142)	$	76,489	100.0%

At June 30, 2010 and December 31, 2009, an aging of unrealized losses and fair value of related securities—held-to-maturity was as follows (in thousands):

	June 30, 2010					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Municipal bonds	$ 4,510	$ (33)	$ --	$ --	$ 4,510	$ (33)
Corporate bonds	7,268	(232)	--	--	7,268	(232)
	$ 11,778	$ (265)	$ --	$ --	$ 11,778	$ (265)

	December 31, 2009					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Municipal bonds	$ 2,920	$ (43)	$ 10,112	$ (59)	$ 13,032	$ (102)
Corporate bonds	2,556	(444)	3,404	(596)	5,960	(1,040)
	$ 5,476	$ (487)	$ 13,516	$ (655)	$ 18,992	$ (1,142)

Management does not believe that any individual unrealized losses as of June 30, 2010 or December 31, 2009 represent an other-than-temporary impairment. 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. There were seven and twelve securities—held-to-maturity with unrealized losses at June 30, 2010 and December 31, 2009, respectively. As of June 30, 2010, there were three held-to-maturity securities in nonaccrual status. One was a trust preferred security with an amortized cost of $3.0 million for which the issuer has exercised their option to defer interest payments. The other two were non-rated corporate bonds issued by a housing authority with an amortized cost of $250,000 each. At this time, management expects to collect all amounts due for these securities.

The amortized cost and estimated fair value of securities—held-to-maturity at June 30, 2010 and December 31, 2009, 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.

	June 30, 2010		December 31, 2009	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$ 994	$ 1,002	$ 2,095	$ 2,131
Due after one year through five years	10,496	11,106	11,017	11,613
Due after five years through ten years	14,166	14,697	13,794	14,379
Due after ten years through twenty years	45,157	47,045	41,792	42,504
Due after twenty years	2,819	3,146	6,136	5,862
	$ 73,632	$ 76,996	$ 74,834	$ 76,489

The following table presents, as of June 30, 2010, investment securities which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law (in thousands):

Fair Value

	Amortized Cost	
Federal Reserve Bank, U.S. Treasury Tax and Loan deposits	$ 1,651	$ 1,707
State and local governments public deposits	85,663	89,348
Pacific Coast Bankers' Bank (PCBB) interest rate swaps	3,845	4,037
Retail repurchase transaction accounts	141,362	145,888
Other	4,538	4,707
Total pledged securities	$ 237,059	$ 245,687

The carrying value of investment securities pledged as of June 30, 2010 was $242.9 million.

Note 6: FHLB STOCK

At June 30, 2010, the Company carried on its books $37.4 million in Federal Home Loan Bank of Seattle (FHLB) stock, which represents our investment in the stock at its par value. Ownership of this stock allows the Banks access to funding for liquidity and other borrowing needs. Ownership of FHLB stock is restricted to FHLB member institutions and can only be purchased and redeemed at par. Shares are not publicly traded and do not have a readily determinable fair value. FHLB stock is generally acknowledged to be a long-term investment. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recovery of the par value.

As of June 30, 2010, the FHLB was classified as "undercapitalized" by its regulator and therefore did not pay a dividend for the first or second quarters of 2010 and will not repurchase capital stock or pay a dividend while it is classified as undercapitalized. The FHLB reported that it did meet all of its regulatory capital targets, including its risk-based capital requirement as of June 30, 2010. The FHLB reported a risk-based capital surplus of $681.7 million as of June 30, 2010 compared to $531.7 million as of December 31, 2009. The FHLB's total capital at June 30, 2010 was $1.089 billion compared to $993.7 million at December 31, 2009.

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 its member institutions or the FHLB itself, and (4) the liquidity position of the FHLB.

Based on the above, the Company has determined there is not an impairment of its FHLB stock investment as of June 30, 2010.

Note 7: LOANS RECEIVABLE

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

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.

Our loans receivable, including loans held for sale, at June 30, 2010 and 2009 and December 31, 2009 are summarized as follows (dollars in thousands):

	June 30 2010		December 31 2009		June 30 2009	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Loans (including loans held for sale):						
Commercial real estate						
Owner occupied	$ 503,796	13.9%	$ 509,464	13.4%	$ 475,749	12.2%

Investment properties	553,689	15.3	573,495	15.1	574,172	14.7
Multifamily real estate	149,980	4.1	153,497	4.1	150,168	3.8
Commercial construction	84,379	2.3	80,236	2.1	90,762	2.3
Multifamily construction	56,573	1.6	57,422	1.5	56,968	1.5
One- to four-family construction	182,928	5.0	239,135	6.3	337,368	8.6
Land and land development						
Residential	228,156	6.3	284,331	7.5	371,247	9.5
Commercial	29,410	0.8	43,743	1.2	32,450	0.8
Commercial business	635,130	17.5	637,823	16.8	678,273	17.3
Agricultural business, including secured by farmland	208,815	5.8	205,307	5.4	215,339	5.5
One- to four-family real estate	702,420	19.3	703,277	18.6	653,513	16.7
Consumer	103,065	2.8	110,937	2.9	91,173	2.3
Consumer secured by one- to four-family real estate	193,163	5.3	191,454	5.1	185,899	4.8
Total consumer	296,228	8.1	302,391	8.0	277,072	7.1
Total loans outstanding	3,631,504	100.0%	3,790,121	100.0%	3,913,081	100.0%
Less allowance for loan losses	(95,508)		(95,269)		(90,694)	
Total net loans outstanding at end of period	$ 3,535,996		$ 3,694,852		$ 3,822,387	

Loans are net of unearned, unamortized loan fees or discounts of $12.1 million, $11.2 million and $8.0 million at June 30, 2010, December 31, 2009 and June 30, 2009, respectively.

The geographic concentration of our loans by state at June 30, 2010 was as follows (dollars in thousands):

	Washington	Oregon	Idaho	Other	Total
Commercial real estate					
Owner occupied	$ 390,085	$ 64,642	$ 45,491	$ 3,578	$ 503,796
Investment properties	397,813	107,790	41,669	6,417	553,689
Multifamily real estate	123,707	12,177	9,580	4,516	149,980
Commercial construction	61,202	11,689	11,488	--	84,379
Multifamily construction	28,324	28,249	--	--	56,573
One- to four-family construction	87,895	84,796	10,237	--	182,928
Land and land development					
Residential	119,268	86,619	22,269	--	228,156
Commercial	25,807	1,144	2,459	--	29,410
Commercial business	447,545	97,569	71,344	18,672	635,130
Agricultural business, including secured by farmland	112,674	39,266	56,875	--	208,815
One- to four-family real estate	458,681	213,069	28,241	2,429	702,420
Consumer	74,522	22,860	5,683	--	103,065
Consumer secured by one- to four-family real estate	136,559	41,598	14,506	500	193,163
Total consumer	211,081	64,458	20,189	500	296,228
Total loans outstanding	$ 2,464,082	$ 811,468	$ 319,842	$ 36,112	$ 3,631,504
Percent of total loans	67.9%	22.3%	8.8%	1.0%	100.0%

The geographic concentration of our land and land development loans by state at June 30, 2010 was as follows (dollars in thousands):

	Washington	Oregon	Idaho	Total
Residential				
Acquisition and development	$ 53,196	$ 52,154	$ 6,219	$ 111,569
Improved land and lots	43,863	27,027	1,568	72,458
Unimproved land	22,209	7,438	14,482	44,129
Commercial and industrial				
Acquisition and development	5,896	--	559	6,455
Improved land	8,857	--	--	8,857
Unimproved land	11,054	1,144	1,900	14,098
Total land and land development loans outstanding	$ 145,075	$ 87,763	$ 24,728	$ 257,566
Percent of total land and land development loans	56.3%	34.1%	9.6%	100.0%

As noted in the tables above, substantially all of our loans are to borrowers in the states of Washington, Oregon and Idaho. Accordingly, their ultimate collectability is particularly susceptible to, among other things, changes in market and economic conditions within these states.

The amount of impaired loans and the related allocated reserve for loan losses are presented in the following table (in thousands). A loan is considered impaired when, based on current information and circumstances, we determine it is probable we will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Impaired loans include loans on non-accrual, 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.

	June 30, 2010		December 31, 2009	
	Loan Amount	Allocated Reserves	Loan Amount	Allocated Reserves
Impaired loans:				
Nonaccrual	$ 175,223	$ 18,625	$ 213,401	$ 18,872
Accrual, including TDRs	46,618	3,277	48,337	3,309
Total impaired loans	$ 221,841	$ 21,902	$ 261,738	$ 22,181

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

Fixed-rate (term to maturity):	June 30 2010	December 31 2009	June 30 2009
Due in one year or less	$ 187,864	$ 162,894	$ 155,756
Due after one year through three years	216,061	198,107	204,129
Due after three years through five years	214,659	239,145	221,595
Due after five years through ten years	124,755	142,900	165,129
Due after ten years	551,897	551,375	497,054
	1,295,236	1,294,421	1,243,663
Adjustable-rate (term to rate adjustment):			
Due in one year or less	1,452,687	1,582,046	1,802,578
Due after one year through three years	457,819	417,777	375,608
Due after three years through five years	382,801	447,228	454,586
Due after five years through ten years	41,760	47,287	36,646
Due after ten years	1,201	1,362	--
	2,336,268	2,495,700	2,669,418
	$ 3,631,504	$ 3,790,121	$ 3,913,081

The adjustable-rate loans may have interest rate adjustment limitations and are generally indexed to various Prime or London Interbank Offered Rates (LIBOR), or One to Five Year Constant Maturity Treasury Indices or FHLB borrowing 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 primarily have been utilized to fund these loans.

Note 8: ALLOWANCE FOR LOAN LOSSES

The following is a schedule of our allocation of the allowance for loan losses at the dates indicated (dollars in thousands):

	June 30 2010	December 31 2009	June 30 2009
Specific or allocated loss allowances:			
Commercial real estate	$ 7,042	$ 8,278	$ 5,333
Multifamily real estate	2,364	90	83
Construction and land	45,601	45,209	55,585
One- to four-family real estate	3,530	2,912	1,333
Commercial business	23,905	22,054	19,474
Agricultural business, including secured by farmland	679	919	1,323
Consumer	1,890	1,809	1,540
Total allocated	85,011	81,271	84,671
Estimated allowance for undisbursed commitments	909	1,594	1,976
Unallocated	9,588	12,404	4,047
Total allowance for loan losses	$ 95,508	$ 95,269	$ 90,694
Allowance for loan losses as a percentage of total loans outstanding	2.63%	2.51%	2.32%

Allowance for loan losses as a percentage of non-performing loans	54%	45%	40%

20

An analysis of the changes in our allowance for loan losses is as follows (dollars in thousands):

	Quarters Ended June 30 2010	2009	Six Months Ended June 30 2010	2009
Balance, beginning of the period	$ 95,733	$ 79,724	$ 95,269	$ 75,197
Provision for loan losses	16,000	45,000	30,000	67,000
Recoveries of loans previously charged off:				
Commercial real estate	--	--	--	--
Multifamily real estate	--	--	--	--
Construction and land	235	266	622	318
One- to four-family real estate	71	89	71	91
Commercial business	595	249	1,885	319
Agricultural business, including secured by farmland	--	22	--	22
Consumer	69	32	128	63
	970	658	2,706	813
Loans charged off:				
Commercial real estate	--	--	(92)	--
Multifamily real estate	--	--	--	--
Construction and land	(12,255)	(27,290)	(19,979)	(39,707)
One- to four-family real estate	(2,128)	(1,181)	(4,243)	(2,272)
Commercial business	(1,447)	(2,438)	(6,231)	(6,232)
Agricultural business, including secured by farmland	(986)	(3,186)	(988)	(3,186)
Consumer	(379)	(593)	(934)	(919)
	(17,195)	(34,688)	(32,467)	(52,316)
Net (charge-offs) recoveries	(16,225)	(34,030)	(29,761)	(51,503)
Balance, end of the period	$ 95,508	$ 90,694	$ 95,508	$ 90,694
Net loan charge-offs to average outstanding loans during the period	0.44%	0.87%	0.80%	1.31%

Note 9: REAL ESTATE OWNED, NET

The following table presents the changes in real estate owned (REO), net of valuation allowance, for the quarters and six months ended June 30, 2010 and 2009 (in thousands):

	Quarters Ended June 30 2010	2009	Six Months Ended June 30 2010	2009
Balance, beginning of the period	$ 95,074	$ 38,951	$ 77,743	$ 21,782

Additions from loan foreclosures	17,966	32,863	45,293	52,038
Additions from capitalized costs	380	1,624	1,516	2,663
Dispositions of REO	(10,451)	(9,082)	(20,366)	(12,176)
Transfers to property and equipment	--	(7,030)	--	(7,030)
Gain (loss) on sale of REO	(660)	(296)	(1,361)	(197)
Valuation adjustments in the period	(824)	(63)	(1,340)	(113)
Balance, end of the period	$ 101,485	$ 56,967	$ 101,485	$ 56,967

The following table shows REO by type and geographic location by state as of June 30, 2010 (in thousands):

	Washington	Oregon	Idaho	Total
Commercial real estate	$ 8,349	$ -	$ --	$ 8,349
One- to four-family construction	891	1,190	--	2,081
Land development- commercial	3,430	6,656	485	10,571
Land development- residential	22,681	24,579	9,731	56,991
Agricultural land	329	-	2,236	2,565
One- to four-family real estate	9,354	7,801	3,773	20,928
Balance, end of period	$ 45,034	$ 40,226	$ 16,225	$ 101,485

REO properties are recorded at the lower of the recorded investment in the loan (prior to foreclosure) or the fair market value of the property, less expected selling costs. Valuation allowances on REO balances are based on updated appraisals of the underlying properties as received during a period or management's authorization to reduce the selling price of a property during the period.

Note 10: OTHER INTANGIBLE ASSETS AND MORTGAGE SERVICING RIGHTS

Other Intangible Assets: At June 30, 2010, 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.

We amortize CDI over their estimated useful life and review them at least annually for events or circumstances that could impact their recoverability. The core deposit intangible 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 core deposit intangible assets are not estimated to have a significant residual value. Other intangible assets are amortized over their useful lives and are also reviewed for impairment.

The following table summarizes the changes in the Company's core deposit intangibles and other intangibles for the six months ended June 30, 2010 and 2009 (in thousands):

	Core Deposit Intangibles	Other	Total
Balance, December 31, 2009	$ 11,057	$ 13	$ 11,070
Amortization	(1,259)	--	(1,259)
Impairment write-off	--	--	--
Balance, June 30, 2010	$ 9,798	$ 13	$ 9,811

	Core Deposit Intangibles	Other	Total
Balance, December 31, 2008	$ 13,701	$ 15	$ 13,716
Amortization	(1,350)	(1)	(1,351)
Impairment write-off	--	--	--
Balance, June 30, 2009	$ 12,351	$ 14	$ 12,365

Estimated annual amortization expense with respect to existing intangibles as of June 30, 2010 is as follows (in thousands):

Year Ended	Core Deposit Intangibles	Other	Total
December 31, 2010	$ 2,459	$ 2	$ 2,461
December 31, 2011	2,276	2	2,278
December 31, 2012	2,092	2	2,094
December 31, 2013	1,908	2	1,910
December 31, 2014	1,724	2	1,726
Thereafter	598	3	601
	$ 11,057	$ 13	$ 11,070

Mortgage Servicing Rights: Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially reported at fair value and are amortized in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Mortgage servicing rights are subsequently evaluated for impairment based upon the fair value of the rights compared to the amortized cost (remaining unamortized initial fair value). If the fair value is less than the amortized cost, a valuation allowance is created through an impairment charge to servicing fee income. However, if the fair value is greater than the amortized cost, the amount above the amortized cost is not recognized in the carrying value. Loans serviced for others totaled $674.7 million and $454.7 million at June 30, 2010 and 2009, respectively. Custodial accounts maintained in connection with this servicing totaled $4.8 million at both June 30, 2010 and 2009. Mortgage servicing rights as a percentage of total loans serviced for others was 0.79% and 1.18 %, respectively, for the same time periods.

An analysis of our mortgage servicing rights for the quarters ended June 30, 2010 and 2009 is presented below (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Balance, beginning of the period	$ 5,562	$ 4,152	$ 5,703	$ 3,554
Amounts capitalized	161	1,771	417	3,281
Amortization (1)	(408)	(559)	(805)	(1,171)
Valuation adjustments in the period	--	--	--	(300)
Balance, end of the period	$ 5,315	$ 5,364	$ 5,315	$ 5,364

(1) Amortization of mortgage servicing rights is recorded as a reduction of loan servicing income and includes any remaining unamortized balance, which is written off if the loan repays in full.

Note 11: DEPOSITS AND CUSTOMER REPURCHASE AGREEMENTS

Deposits consisted of the following at June 30, 2010 and 2009 and December 31, 2009 (dollars in thousands):

	June 30 2010		December 31 2009		June 30 2009	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Non-interest-bearing accounts	$ 548,251	14.3%	$ 582,480	15.1%	$ 508,284	13.6%
Interest-bearing checking	368,418	9.6	360,256	9.3	312,024	8.4
Regular savings accounts	593,591	15.4	538,765	13.9	499,447	13.3
Money market accounts	441,222	11.5	442,124	11.4	319,622	8.5
Total transaction and saving accounts	1,951,482	50.8	1,923,625	49.7	1,639,377	43.8
Certificates which mature or reprice:						
Within 1 year	1,605,190	41.8	1,593,575	41.3	1,354,316	36.1
After 1 year, but within 3 years	241,639	6.3	311,115	8.0	706,464	18.8
After 3 years	40,684	1.1	37,235	1.0	49,686	1.3
Total certificate accounts	1,887,513	49.2	1,941,925	50.3	2,110,466	56.2
Total deposits	$ 3,838,995	100.0%	$ 3,865,550	100.0%	$ 3,749,843	100.0%
Included in total deposits:						
Public transaction accounts	$ 85,292	2.2%	$ 78,202	2.0%	$ 48,644	1.3%
Public interest-bearing certificates	81,668	2.1	88,186	2.3	134,213	3.5
Total public deposits	$ 166,960	4.3%	$ 166,388	4.3%	$ 182,857	4.8%
Total brokered deposits	$ 145,571	3.8%	$ 165,016	4.3%	$ 247,514	6.6%

Geographic Concentration of Deposits at June 30, 2010	Washington	Oregon	Idaho	Total
	$ 2,943,408	$ 615,790	$ 279,797	$ 3,838,995

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 customer repurchase agreement balances as of June 30, 2010 and 2009 and December 31, 2009 (in thousands):

		June 30 2010		December 31 2009		June 30 2009
Retail Repurchase Agreements	$	122,755	$	124,330	$	108,277

Note 12: FAIR VALUE ACCOUNTING AND MEASUREMENT

We have 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 standards require 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 our 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.

Items Measured at Fair Value on a Recurring Basis:

We record 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 Agency obligations, municipal bonds, corporate bonds, single issue trust preferred securities (TPS), pooled trust preferred collateralized debit obligation securities (TRUP CDO), mortgage-backed securities, equity securities and certain other financial instruments. At June 30, 2010, management used inputs from each of the three fair value hierarchy levels to value these assets. The Level 1 measurements are based upon quoted prices in active markets. The 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. The 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 June 30, 2010, we owned approximately $33 million in current par value of these securities, exclusive of those securities we elected to write-off completely. The market for these 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 currently 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.

Given these conditions in the debt markets and the absence of observable transactions in the secondary and new issue markets, management determined that for TRUP CDOs:

o The few observable transactions and market quotations that were available are not reliable for purposes of determining fair value at June 30, 2010,

- o An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs is equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, and

- o The Company's TRUP CDOs are 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 prepared by an independent third party who used its proprietary cash flow model recognized as the industry standard for analyzing all types of collateralized debt obligations. Its approach to determining fair value involves considering the credit quality of the collateral using average risk-neutral probability of default values, assumes a level of defaults based on the probability of default of each underlying trust preferred security and assumed level of correlation among the assets, and creates an expected cash flows for each security, discounted at the risk-free rate plus a liquidity premium.

Where possible, management reviewed the valuation methodology and assumptions used by the independent third party providers, determined that with respect to performing securities the fair value estimates were reasonable and utilized those estimates in our reported financial statements. However, beginning with the quarter ended June 30, 2009 and continuing with the quarter ended June 30, 2010, for two securities for which we currently are not receiving any cash payments, management elected to override the third party fair value estimates and to reflect the fair value of these securities at zero, resulting in an OTTI charge.

At June 30, 2010, we also directly owned approximately $20 million in current par value of TPS securities issued by three individual financial institutions for which no market data or independent valuation source is available. Additionally, we have one TPS security with a par value of $5 million that is not actively traded, but for which more market data 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. Management, therefore, utilized a discounted cash-flow model to calculate the present value of each security's expected future cash flows to determine their respective fair values. Management took into consideration what little market data was available regarding discount rates, but concluded that most of the available information represented dated transactions and/or was not representative of active market transactions. Since these three TPS securities are also concentrated in the financial institutions sector, which continues to be under significant pricing pressure at June 30, 2010, management applied credit factors to differentiate these issues based upon its judgment of the risk profile of the various issuers. These credit factors were then incorporated into the model at June 30, 2010, and discount rates equal to three-month LIBOR plus 600 to 800 basis points were used to calculate the respective fair values of these securities. In addition to the three TPS considered Level 3 and one TPS considered Level 2, on its credit analysis, management determined that collection of two specific TPS securities was highly unlikely and therefore elected to write off the balance of these securities as OTTI charges—one in the third quarter of 2009 and one during the first quarter of 2010. The single TPS security considered Level 2 was transferred to Level 2 during the quarter due to the security not being actively traded.

- 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 debt that the Company has issued) were valued using discounted cash flows to maturity or to the next available call date, if based upon the current interest rate and credit market environment it was considered likely that we would elect early redemption. The majority, $98 million, of these debentures carry interest rates that reset quarterly, using the three-month LIBOR index plus spreads of 1.38% to 3.35%. The remaining $26 million issue has a current interest rate of 6.56%, which is fixed through December 2011 and then resets quarterly to equal three-month LIBOR plus a spread of 1.62%. In valuing the debentures at June 30, 2010, management evaluated discounted cash flows to maturity and for the discount rate used the June 30, 2010 three-month LIBOR plus 800 basis points. While the quarterly reset of the index on this debt would seemingly keep it close to market values, the disparity in the fixed spreads above the index and the inability to determine realistic current market spreads, due to lack of new issuances and trades, resulted in having to rely more heavily on assumptions about what spread would be appropriate if market transactions were to take place. In periods prior to third quarter of 2008, the discount rate used was based on recent issuances or quotes from brokers on the date of valuation for comparable bank holding companies and was considered to be a Level 2 input method. However, as noted above in the discussion of TPS and TRUP CDOs, due to the unprecedented disruption of certain financial markets, management concluded that there were insufficient transactions or other indicators to continue to reflect these measurements as Level 2 inputs. Due to this reliance on assumptions and not on directly observable transactions, management considers this to be a Level 3 input method.

The following tables present financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 and December 31, 2009 (in thousands):

June 30, 2010

	Total	Level 1	Level 2	Level 3
Assets:				
Securities—available-for-sale				
U.S. government and agency	$ 104,200	$ --	$ 104,200	$ --
Mortgage-backed securities	36,142	--	36,142	--
	140,342	--	140,342	--
Securities—trading				
U.S. government and agency	4,472	--	4,472	--
Municipal bonds	6,891	--	6,891	--
TPS and TRUP CDOs	35,460	--	4,870	30,590
Mortgage-backed securities	58,428	--	58,428	--
Equity securities and other	130	--	130	--
	105,381	--	74,791	30,590
	$ 245,723	$ --	$215,133	$ 30,590
Liabilities				
Advances from FHLB at fair value	$ 47,003	$ --	$ 47,003	$ --
Junior subordinated debentures net of unamortized deferred issuance costs at fair value	49,808	- --	--	49,808
	$ 96,811	$ --	$ 47,003	$ 49,808

December 31, 2009

	Total	Level 1	Level 2	Level 3
Assets:				
Securities—available-for-sale				
U.S. government and agency	$ 53,112	$ --	$ 53,112	$ --
Mortgage-backed securities	42,555	--	42,555	--
	95,667	--	95,667	--
Securities—trading				
U.S. government and agency	41,255	--	41,255	--
Municipal bonds	7,151	--	7,151	--
TPS and TRUP CDOs	35,017	4,825	--	30,192
Mortgage-backed securities	63,386	--	63,386	--
Equity securities and other	342	328	14	--
	147,151	5,153	111,806	30,192

	$	242,818	$	5,153	$	207,473	$	30,192
Liabilities								
Advances from FHLB at fair value	$	189,779	$	--	$	189,779	$	--
Junior subordinated debentures net of unamortized deferred issuance costs at fair value		47,694	-	--		--		47,694
	$	237,473	$	--	$	189,779	$	47,694

26

The following tables provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the six months ended June 30, 2010 and 2009 (in thousands):

	Level 3 Fair Value Inputs	
	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures
Beginning balance at December 31, 2009	$ 30,192	$ 47,694
Total gains or losses recognized		
Asset gains (losses)	398	--
Liability (gains) losses	--	2,114
Purchases, issuances and settlements	--	--
Paydowns and maturities	--	--
Transfers in and/or out of Level 3	--	--
Ending balance at June 30, 2010	$ 30,590	$ 49,808

	Level 3 Fair Value Inputs	
	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures
Beginning balance at December 31, 2008	$ 36,295	$ 61,776
Total gains or losses recognized		
Asset gains (losses)	(5,805)	--
Liability (gains) losses	--	(12,213)

Purchases, issuances and settlements	--		--
Paydowns and maturities	--		--
Transfers in and/or out of Level 3	--		--
Ending balance at June 30, 2009	$ 30,490	$	49,563

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 that are on non-accrual 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 we determine that the value of the impaired loan is less than the carrying value of the loan, we either establish an impairment reserve as a specific component of the allowance for loan and lease losses (ALLL) or charge off the impaired amount. The remaining impaired loans are evaluated for reserve needs in homogenous pools within our ALLL methodology. As of June 30, 2010, the Company reviewed all of its classified loans totaling $392 million for potential impairment and identified $222 million which were considered impaired. Of those $222 million in impaired loans, $153 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 $153 million had original carrying values of $183 million which have already been reduced by partial write-downs totaling $30 million. Of the $153 million individually evaluated, $79 million are carried at fair value after netting out charge-offs already recognized or specific impairment reserves totaling $17 million.

The Company also records 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 or less than the 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. We consider 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 June 30, 2010, we recognized $824,000 of additional impairment charges related to these types of assets, compared to $63,000 for the same quarter one year earlier. For the six months ended June 30, 2010, these impairment charges totaled $1.3 million, compared to $113,000 for the same period in 2009.

The following tables present the fair value measurement of assets and liabilities measured at fair value on a non-recurring basis and the level within the ASC 820 fair value hierarchy of the fair value measurements for those assets at June 30, 2010 and December 31, 2009 (in thousands):

	June 30, 2010			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans	$ 79,201	--	--	$ 79,201
REO	101,485	--	--	101,485
Mortgage servicing rights	5,315	--	--	5,315

	December 31, 2009			
	Fair Value	Level 1	Level 2	Level 3
Impaired loans	$ 111,945	--	--	$ 111,945
REO	77,743			