

BANNER CORP  
Form 10-Q  
November 09, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007.**

**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)

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**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**

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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  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):

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Large accelerated filer  Accelerated filer  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

**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.

| <u>Title of class:</u>                         | <u>As of October 31, 2007</u> |
|--|-------------------------------|
| <b>Common Stock, \$.01 par value per share</b> | <b>16,206,058 shares*</b>     |

\* Includes 240,381 shares held by the Employee Stock Ownership Plan that have not been released, committed to be released, or allocated to participant.

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**BANNER CORPORATION AND SUBSIDIARIES**

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**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
(In thousands, except shares)  
**September 30, 2007 and December 31, 2006**

| <b>ASSETS</b>  | <b>September 30<br/>2007</b> | December 31<br>2006 |
|--|------------------------------|---------------------|
|  | (Unaudited)                  | (Audited)           |
| Cash and due from banks  | \$ 146,561                   | \$ 73,385           |
| Securities at fair value, cost \$160,767 and \$0, respectively; encumbered \$0 and \$0, respectively           | 158,932                      | -                   |
| Securities available for sale, cost \$0 and \$230,189, respectively; encumbered \$0 and \$27,107, respectively | -                            | 226,153             |
| Securities held to maturity, fair value \$53,352 and \$49,008, respectively                                    | 53,259                       | 47,872              |
| Federal Home Loan Bank stock   | 37,291                       | 35,844              |
| Loans receivable:  |                              |                     |
| Held for sale, fair value \$4,176 and \$5,136  | 4,121                        | 5,080               |
| Held for portfolio   | 3,617,130                    | 2,960,910           |
| Allowance for loan losses  | (44,212)                     | (35,535)            |
|  | <u>3,577,039</u>             | <u>2,930,455</u>    |
| Accrued interest receivable  | 26,376                       | 23,272              |
| Real estate owned, held for sale, net  | 3,072                        | 918                 |
| Property and equipment, net  | 95,816                       | 58,003              |
| Goodwill and other intangibles, net  | 128,868                      | 36,287              |
| Deferred income tax asset, net   | 3,660                        | 7,533               |
| Bank-owned life insurance  | 51,024                       | 38,527              |
| Other assets   | 18,463                       | 17,317              |
|  | <u>\$ 4,300,361</u>          | <u>\$ 3,495,566</u> |
| <b>LIABILITIES</b>   |                              |                     |
| Deposits:  |                              |                     |
| Non-interest-bearing   | \$ 473,571                   | \$ 332,372          |
| Interest-bearing transactions and savings accounts   | 1,299,232                    | 905,746             |
| Interest-bearing certificates  | 1,825,096                    | 1,556,474           |
|  | <u>3,597,899</u>             | <u>2,794,592</u>    |
| Advances from Federal Home Loan Bank   | -                            | 177,430             |
| Advances from Federal Home Loan Bank at fair value   | 24,577                       | -                   |
| Other borrowings   | 78,511                       | 103,184             |
| Junior subordinated debentures (issued in connection with Trust Preferred Securities)                          | -                            | 123,716             |
| Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)            | 122,220                      | -                   |
| Accrued expenses and other liabilities   | 47,577                       | 36,888              |
| Deferred compensation  | 10,830                       | 7,025               |
| Income taxes payable   | 5,163                        | 2,504               |

3,886,777 3,245,339

**COMMITMENTS AND CONTINGENCIES****STOCKHOLDERS' EQUITY**

|   |                     |                     |
|---|---------------------|---------------------|
| Preferred stock - \$0.01 par value, 500,000 shares authorized, none issued                                    |                     | -                   |
| Common stock - \$0.01 par value per share, 25,000,000 shares authorized, 15,821,067 shares issued:            |                     |                     |
| 15,580,686 shares and 12,073,889 shares outstanding at September 30, 2007 and December 31, 2006, respectively | 282,636             | 135,149             |
| Retained earnings   | 133,278             | 120,206             |
| Accumulated other comprehensive income (loss):  |                     |                     |
| Unrealized loss on securities available for sale and/or transferred to held to maturity                       | (189)               | (2,852)             |
| Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost:                 |                     |                     |
| 240,381 and 240,381 restricted shares outstanding at September 30, 2007 and December 31, 2006, respectively   | (1,987)             | (1,987)             |
| Carrying value of shares held in trust for stock related compensation plans                                   | (8,010)             | (7,262)             |
| Liability for common stock issued to deferred, stock related, compensation plans                              | 7,856               | 6,973               |
|   | <u>(154)</u>        | <u>(289)</u>        |
|   | <u>413,584</u>      | <u>250,227</u>      |
|   | <u>\$ 4,300,361</u> | <u>\$ 3,495,566</u> |

See selected 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 Nine Months Ended September 30, 2007 and 2006**

|  | Quarters Ended<br>September 30 |               | Nine Months Ended<br>September 30 |                |
|--|--------------------------------|---------------|-----------------------------------|----------------|
|  | 2007                           | 2006          | 2007                              | 2006           |
| <b>INTEREST INCOME:</b>  |                                |               |                                   |                |
| Loans receivable   | \$ 75,668                      | \$ 60,933     | \$ 208,543                        | \$ 165,147     |
| Mortgage-backed securities   | 1,343                          | 1,921         | 4,653                             | 6,015          |
| Securities and cash equivalents  | 2,199                          | 2,046         | 5,871                             | 5,658          |
|  | <u>79,210</u>                  | <u>64,900</u> | <u>219,067</u>                    | <u>176,820</u> |
| <b>INTEREST EXPENSE:</b>   |                                |               |                                   |                |
| Deposits   | 35,341                         | 24,661        | 95,329                            | 62,920         |
| Federal Home Loan Bank advances  | 292                            | 4,392         | 3,733                             | 11,659         |
| Other borrowings   | 730                            | 1,112         | 2,448                             | 2,576          |
| Junior subordinated debentures   | 2,177                          | 2,074         | 6,600                             | 5,875          |
|  | <u>38,540</u>                  | <u>32,239</u> | <u>108,110</u>                    | <u>83,030</u>  |
| Net interest income before provision for loan losses                   | 40,670                         | 32,661        | 110,957                           | 93,790         |
| <b>PROVISION FOR LOAN LOSSES</b>                                       | <u>1,500</u>                   | <u>1,000</u>  | <u>3,900</u>                      | <u>4,500</u>   |
| Net interest income  | 39,170                         | 31,661        | 107,057                           | 89,290         |
| <b>OTHER OPERATING INCOME:</b>   |                                |               |                                   |                |
| Deposit fees and other service charges                                 | 4,750                          | 3,036         | 11,803                            | 8,419          |
| Mortgage banking operations  | 1,782                          | 1,744         | 4,945                             | 4,350          |
| Loan servicing fees  | 457                            | 315           | 1,205                             | 1,039          |
| Miscellaneous  | 483                            | 276           | 1,536                             | 1,065          |
|  | <u>7,472</u>                   | <u>5,371</u>  | <u>19,489</u>                     | <u>14,873</u>  |
| Gain on sale of securities   | -                              | 65            | -                                 | 65             |
| Net change in valuation of financial instruments carried at fair value | 3,062                          | -             | 2,365                             | -              |
| Total other operating income   | 10,534                         | 5,436         | 21,854                            | 14,938         |
| <b>OTHER OPERATING EXPENSES:</b>                                       |                                |               |                                   |                |
| Salary and employee benefits   | 20,431                         | 16,705        | 56,534                            | 48,747         |
| Less capitalized loan origination costs                                | (2,455)                        | (2,956)       | (8,224)                           | (8,776)        |
| Occupancy and equipment  | 5,484                          | 3,927         | 14,942                            | 11,659         |
| Information/computer data services                                     | 2,031                          | 1,193         | 5,167                             | 3,778          |
| Professional services  | 993                            | 807           | 2,275                             | 1,873          |
| Advertising  | 2,423                          | 1,780         | 6,147                             | 5,296          |

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|   |                   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|-------------------|
| Insurance recovery, net proceeds                | -                 | -                 | -                 | (5,350)           |
| Miscellaneous                                   | 5,939             | 3,880             | 15,375            | 11,318            |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Total other operating expenses                  | 34,846            | 25,336            | 92,216            | 68,545            |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Income before provision for income taxes        | 14,858            | 11,761            | 36,695            | 35,683            |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| PROVISION FOR INCOME TAXES                      | 4,871             | 3,752             | 11,784            | 11,527            |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| NET INCOME                                      | \$ 9,987          | \$ 8,009          | \$ 24,911         | \$ 24,156         |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Earnings per common share (see Note 7):         |                   |                   |                   |                   |
| Basic   | \$ 0.64           | \$ 0.67           | \$ 1.76           | \$ 2.03           |
| Diluted   | \$ 0.64           | \$ 0.65           | \$ 1.73           | \$ 1.98           |
| Cumulative dividends declared per common share: | \$ 0.19           | \$ 0.18           | \$ 0.57           | \$ 0.54           |

See selected notes to consolidated financial statements



**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**(Unaudited) (In thousands)**  
**For the Quarters and Nine Months Ended September 30, 2007 and 2006**

|  | Quarters Ended<br>September 30 |                  | Nine Months Ended<br>September 30 |                  |
|--|--------------------------------|------------------|-----------------------------------|------------------|
|  | 2007                           | 2006             | 2007                              | 2006             |
| <b>NET INCOME</b>  | \$ 9,987                       | \$ 8,009         | \$ 24,911                         | \$ 24,156        |
| <b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:</b>   |                                |                  |                                   |                  |
| Unrealized holding gain (loss) during the period, net of deferred income tax expense (benefit) of \$0, \$1,486, \$0 and \$(32), respectively                                   | -                              | 2,759            | -                                 | (60)             |
| Less adjustment for (gains) losses included in net income, net of income tax (benefit) of \$0, \$23, \$0 and \$23, respectively  | -                              | (42)             | -                                 | (42)             |
| Amortization of unrealized gain (loss) on securities transferred from available-for-sale to held-to-maturity net of deferred income tax of \$0, \$0, \$0 and \$0, respectively | 13                             | (1)              | 40                                | 22               |
| Other comprehensive income (loss)  | 13                             | 2,716            | 40                                | (80)             |
| <b>COMPREHENSIVE INCOME</b>  | <b>\$ 10,000</b>               | <b>\$ 10,725</b> | <b>\$ 24,951</b>                  | <b>\$ 24,076</b> |

See selected 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 Nine Months Ended September 30, 2007 and 2006**

|   | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Unearned<br>Restricted<br>ESOP<br>Shares | Carrying Value,<br>Net of Liability,<br>Of Shares Held<br>in Trust for<br>Stock-Related<br>Compensation<br>Plans | Stockholders'<br>Equity |
|---|-----------------|----------------------|--|--|--|-------------------------|
| BALANCE, January 1, 2006  | \$ 130,573      | \$ 96,783            | \$ (2,736)   | \$ (2,480)                               | \$ (475)   | \$ 221,665              |
| Net income  |                 | 24,156               |  |  |  | 24,156                  |
| Change in valuation of securities available for sale, net of income taxes   |                 |                      | (80)   |  |  | (80)                    |
| Cash dividend on common stock (\$.54/share cumulative)  |                 | (6,460)              |  |  |  | (6,460)                 |
| Purchase and retirement of common stock   | (2,346)         |                      |  |  |  | (2,346)                 |
| Proceeds from issuance of common stock for exercise of stock options  | 4,189           |                      |  |  |  | 4,189                   |
| Net issuance of stock through employer's stock plans, including tax benefit   | 28              |                      |  | (14)                                     |  | 14                      |
| Accrual of compensation expense related to stock options  | 443             |                      |  |  |  | 443                     |
| Accrual of compensation expense related to MRP  |                 |                      |  |  | 139  | 139                     |
| BALANCE, September 30, 2006   | \$ 132,887      | \$ 114,479           | \$ (2,816)   | \$ (2,494)                               | \$ (336)   | \$ 241,720              |
| BALANCE, January 1, 2007  | \$ 135,149      | \$ 120,206           | \$ (2,852)   | \$ (1,987)                               | \$ (289)   | \$ 250,227              |
| Net income  |                 | 24,911               |  |  |  | 24,911                  |
| Cumulative effect of early adoption of SFAS Nos. 157 & 159 Fair Value Option  |                 | (3,520)              | 2,623  |  |  | (897)                   |
| Amortization of discount on securities transferred from available for sale to held to maturity, net of income taxes |                 |                      | 40   |  |  | 40                      |
| Cash dividend on common stock (\$.57/share cumulative)  |                 | (8,319)              |  |  |  | (8,319)                 |

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|   |                   |                   |                 |                   |                 |                   |
|---|-------------------|-------------------|-----------------|-------------------|-----------------|-------------------|
| Purchase and retirement of common stock   | (430)             |                   |                 |                   |                 | (430)             |
| Proceeds from issuance of common stock for exercise of stock options              | 1,568             |                   |                 |                   |                 | 1,568             |
| Proceeds from issuance of common stock for stockholder reinvestment program       | 32,921            |                   |                 |                   |                 | 32,921            |
| Acquisitions:   |                   |                   |                 |                   |                 |                   |
| Shares issued to the shareholders of F&M Bank ("F&M")                             | 77,993            |                   |                 |                   |                 | 77,993            |
| Shares issued to the shareholders of San Juan Financial Holding Company ("SJFHC") | 35,134            |                   |                 |                   |                 | 35,134            |
| Recognition of tax benefit related to the release of MRP shares                   | 58                |                   |                 |                   |                 | 58                |
| Accrual of compensation expense related to stock options                          | 243               |                   |                 |                   |                 | 243               |
| Accrual of compensation expense related to MRP                                    |                   |                   |                 |                   | 135             | 135               |
| <b>BALANCE, September 30, 2007</b>  | <b>\$ 282,636</b> | <b>\$ 133,278</b> | <b>\$ (189)</b> | <b>\$ (1,987)</b> | <b>\$ (154)</b> | <b>\$ 413,584</b> |

See selected notes to consolidated financial statements

**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (continued)**  
(Unaudited) (In thousands)  
**For the Nine Months Ended September 30, 2007 and 2006**

|  | <u>2007</u>       | <u>2006</u>       |
|--|-------------------|-------------------|
| Common stock, shares issued, beginning of period                                 | 12,314            | 12,082            |
| Purchase and retirement of common stock  | (11)              | (63)              |
| Issuance of common stock for bank acquisitions                                   | 2,593             | -                 |
| Issuance of common stock for exercised stock options and/or employee stock plans | 84                | 281               |
| Issuance of common stock for stockholder reinvestment program                    | 841               | -                 |
|  | <u>          </u> | <u>          </u> |
| Number of shares (retired) issued during the period                              | 3,507             | 218               |
|  | <u>          </u> | <u>          </u> |
| <b>SHARES ISSUED AND OUTSTANDING, END OF PERIOD</b>                              | <b>15,821</b>     | <b>12,300</b>     |
|  | <u>          </u> | <u>          </u> |
| <b>UNEARNED, RESTRICTED ESOP SHARES:</b>   |                   |                   |
| Number of shares, beginning of period  | (240)             | (300)             |
| Adjustment of earned shares  | -                 | (2)               |
|  | <u>          </u> | <u>          </u> |
| Number of shares, end of period  | (240)             | (302)             |
|  | <u>          </u> | <u>          </u> |
| <b>NET SHARES OUTSTANDING</b>  | <b>15,581</b>     | <b>11,998</b>     |
|  | <u>          </u> | <u>          </u> |

See selected notes to consolidated financial statements

**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited) (In thousands)  
**For the Nine Months Ended September 30, 2007 and 2006**

|   | <u>2007</u>     | <u>2006</u>      |
|---|-----------------|------------------|
| <b>OPERATING ACTIVITIES:</b>  |                 |                  |
| Net income  | \$ 24,911       | \$ 24,156        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                 |                  |
| Depreciation  | 5,832           | 4,465            |
| Deferred income and expense, net of amortization                                  | (1,303)         | (917)            |
| Loss (gain) on sale of securities   | -               | (65)             |
| Net change in valuation of financial instruments carried at fair value            | (2,365)         | -                |
| Deferred taxes  | (1,765)         | 497              |
| Equity-based compensation   | 657             | 582              |
| Tax benefits realized from equity-based compensation                              | (58)            | (61)             |
| Increase in cash surrender value of bank-owned life insurance                     | (1,520)         | (1,184)          |
| Gain on sale of loans, excluding capitalized servicing rights                     | (4,328)         | (2,863)          |
| Loss (gain) on disposal of real estate owned and fixed assets                     | (168)           | (84)             |
| Provision for losses on loans and real estate held for sale                       | 3,900           | 4,500            |
| Net change in:  |                 |                  |
| Loans held for sale   | 959             | (2,356)          |
| Other assets  | 1,718           | (1,122)          |
| Other liabilities   | 1,691           | 9,198            |
| Net cash provided by operating activities   | <u>28,161</u>   | <u>34,746</u>    |
| <b>INVESTING ACTIVITIES:</b>  |                 |                  |
| Purchases of securities at fair value   | (4,141)         | -                |
| Principal repayments and maturities of securities at fair value                   | 28,451          | -                |
| Proceeds from sales of securities at fair value                                   | 76,462          | -                |
| Purchase of available for sale securities   | -               | (7,435)          |
| Principal repayments and maturities of securities available for sale              | -               | 22,049           |
| Proceeds from sales of available for sale securities                              | -               | 3,065            |
| Purchases of securities held to maturity  | (5,957)         | (258)            |
| Principal repayments and maturities of securities held to maturity                | 508             | 2,857            |
| Origination of loans, net of principal repayments                                 | (452,722)       | (786,854)        |
| Purchases of loans and participating interest in loans                            | (2,379)         | (19,101)         |
| Proceeds from sales of loans and participating interest in loans                  | 312,980         | 347,614          |
| Purchases of property and equipment, net  | (25,354)        | (8,665)          |
| Proceeds from sale of real estate held for sale, net                              | 1,029           | 345              |
| Acquisition of F&M and SJFHC net of cash acquired                                 | (6,839)         | -                |
| Other   | (151)           | (594)            |
| Net cash used by investing activities   | <u>(78,113)</u> | <u>(446,977)</u> |
| <b>FINANCING ACTIVITIES:</b>  |                 |                  |

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|  |                   |                   |
|--|-------------------|-------------------|
| Increase in deposits   | 330,221           | 421,038           |
| Proceeds from FHLB advances  | 116,500           | 1,523,900         |
| Repayment of FHLB advances   | (304,917)         | (1,575,000)       |
| Increase (decrease) in repurchase agreement borrowings, net              | (17,939)          | 8,630             |
| Increase (decrease) in other borrowings, net                             | (26,359)          | 5,191             |
| Proceeds from issuance of junior subordinated debentures                 | 25,774            | -                 |
| Investment in trust securities related to junior subordinated debentures | (774)             | -                 |
| Repayment of trust securities  | (25,774)          | -                 |
| Cash dividends paid  | (7,641)           | (6,395)           |
| Repurchases of stock, net of forfeitures                                 | (430)             | (2,346)           |
| Tax benefits realized from equity-based compensation                     | 58                | 61                |
| ESOP shares earned (returned)  | -                 | (47)              |
| Issuance of stock-net of costs   | 32,841            | -                 |
| Exercise of stock options  | 1,568             | 4,189             |
|  | <u>          </u> | <u>          </u> |
| Net cash provided by financing activities                                | 123,128           | 379,221           |
|  | <u>          </u> | <u>          </u> |
| <br>   |                   |                   |
| NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS                       | 73,176            | (33,010)          |
| <br>   |                   |                   |
| CASH AND DUE FROM BANKS, BEGINNING OF PERIOD                             | 73,385            | 116,448           |
|  | <u>          </u> | <u>          </u> |
| CASH AND DUE FROM BANKS, END OF PERIOD                                   | \$ 146,561        | \$ 84,438         |
|  | <u>          </u> | <u>          </u> |

(Continued on next page)

**BANNER CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**(Unaudited) (In thousands)**  
**For the Nine Months Ended September 30, 2007 and 2006**

|  | 2007       | 2006      |
|--|------------|-----------|
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>  |            |           |
| Interest paid in cash  | \$ 105,444 | \$ 78,542 |
| Taxes paid in cash   | 8,309      | 6,906     |
| 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 | 3,306      | 999       |
| Net change in accrued dividends payable  | 678        | 65        |
| Change in other assets/liabilities   | 1,688      | 1,111     |
| Cash paid out in acquisitions  | (26,719)   | -         |
| Fair value of assets acquired  | 690,660    | -         |
| Liabilities assumed in acquisition   | 550,733    | -         |
| Stock based consideration issued for acquisition   | (113,207)  | -         |
| Adoption of SFAS Nos. 157 and 159:   |            |           |
| Securities available for sale transferred to fair value  | 226,153    | -         |
| FHLB advances adjustment to fair value   | 678        | -         |
| Junior subordinated debentures including unamortized origination costs adjustment to fair value                                      | 2,079      | -         |
| Deferred tax asset related to fair value adjustments   | (504)      | -         |

See selected notes to consolidated financial statements

**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, subsequent to May 1, 2007, Islanders Bank, a recent acquisition, as explained below. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of September 30, 2007, its 80 branch offices and 13 loan production offices located in 29 counties 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 are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the Federal Deposit Insurance Corporation (FDIC). The consolidated financial statements and results of operation presented in this report on Form 10-Q include financial information for Islanders Bank and our other recent acquisition, F&M Bank, Spokane, Washington (F&M) which was merged into Banner Bank, in connection with our acquisition of those banks on May 1, 2007. (See Note 3 of the Selected Notes to the Consolidated Financial Statements for additional information with respect to these acquisitions.)

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 our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses and (iii) the valuation of financial assets and liabilities recorded at fair value, 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 our Annual Report on Form 10-K for the year ended December 31, 2006 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, 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 our results of operations or financial condition. There have been no significant changes in our application of accounting policies since December 31, 2006, except for the adoption of SFAS No. 157 and 159 (for additional information, see Notes 2 and 6 of the Selected Notes to the Consolidated Financial Statements).

Certain information and disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the rules and regulations of the SEC. Certain reclassifications have been made to the 2006 Consolidated Financial Statements and/or schedules to conform to the 2007 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, 2006 filed with the SEC. Interim results are not necessarily indicative of results for a full year.

**Note 2: Recent Developments and Significant Events**

*Sale of \$25 Million of Trust Preferred Securities:* On July 31, 2007, the Company completed the issuance of \$25.8 million of junior subordinated debentures in connection with a private placement of a similar amount of trust preferred securities. The trust preferred securities were issued by Banner Capital Trust VII, a special purpose business trust formed by Banner Corporation, and sold to pooled investment vehicles sponsored by various investment banking firms. The debentures are recorded as a liability on the consolidated statement of financial condition and, subject to the limitations under current Federal Reserve guidelines, a portion of the trust preferred securities are also expected to qualify as either Tier 1 or Tier 2 capital for regulatory capital purposes. The proceeds from this offering are expected to be used primarily to fund growth, including acquisitions, or may also be used to fund the Company's stock repurchase program and other general corporate purposes as necessary. 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 will be entitled to receive cumulative cash distributions at a variable annual rate, with a current interest rate of 6.7375%, reset quarterly equal to three month LIBOR plus 1.38%. Our previously issued trust preferred securities and debentures have similar reset provisions but carry different spreads to LIBOR and interest rates than this issuance. At September 30, 2007, the interest rates on the other trust preferred securities ranged from 6.74% to 8.71%. In accordance with Financial Interpretation No. (FIN) 46, the trusts are not consolidated with our financial statements. Since January 1, 2007, our junior subordinated debentures are being recorded at fair value.



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*Acquisition of NCW Community Bank:* On October 10, 2007, Banner completed the acquisition of NCW Community Bank, Wenatchee, Washington, in a transaction valued at approximately \$18.5 million, with \$6.5 million of cash and 339,860 shares of Banner common stock being exchanged for all of the outstanding common shares and stock options of NCW Community Bank. Founded in 1999, NCW Community Bank was a state chartered commercial community bank with approximately \$99 million in assets, \$91 million in loans, \$88 million in deposits and shareholders' equity of \$10 million as of September 30, 2007. NCW Community Bank operated one branch in Wenatchee, Washington and

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had another branch under construction in East Wenatchee. NCW Community Bank merged into Banner Bank in connection with this transaction during the fourth quarter of 2007; however, the financial statements included in this report do not reflect the assets, liabilities or results of operations for NCW Community Bank. The merger added to Banner's customer base and market share in the North Central Washington area.

*Adoption of SFAS Nos. 157 and 159:* Banner Corporation elected early adoption of Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157, *Fair Value Measurements*, effective January 1, 2007. SFAS No. 159, which was issued in February 2007, generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurement. We made this election to allow more flexibility with respect to the management of our investment securities, wholesale borrowings and interest rate risk position in future periods.

Upon adoption of SFAS No. 159, we selected fair value measurement for all of our "available for sale" investment securities, Federal Home Loan Bank advances and junior subordinated debentures, which had fair values of approximately \$226.2 million, \$176.8 million and \$124.4 million, respectively, on January 1, 2007. The initial fair value measurement of these instruments resulted in a \$3.5 million adjustment for the cumulative effect, net of tax, as a result of the change in accounting, which was recorded as a reduction in retained earnings as of January 1, 2007, and which under SFAS No. 159 has not been recognized in current earnings. While the adjustment to retained earnings is permanent, approximately \$2.6 million of the amount was previously reported as accumulated other comprehensive loss at December 31, 2006, so the reduction in total stockholders' equity was \$897,000 on January 1, 2007. Following the initial election, changes in the value of financial instruments recorded at fair value are recognized as gains or losses in earnings in subsequent financial reporting periods. As a result of the adoption of SFAS No. 159 and changes in the fair value measurement of the financial assets and liabilities noted above, we recorded a net gain of \$1.2 million (\$755,000 after tax) in the quarter ended March 31, 2007, a net loss of \$1.9 million (\$1.2 million after tax) in the quarter ended June 30, 2007, and a net gain of \$3.1 million (\$2.0 million after tax) in the quarter ended September 30, 2007, resulting in a cumulative gain of \$2.4 million (\$1.6 million after tax) for the nine months ended September 30, 2007. (For further information, see Note 6 of the Selected Notes to the Consolidated Financial Statements.)

*Early redemption of \$25 million of Trust Preferred Securities:* Effective April 22, 2007, we repaid \$25.8 million of junior subordinated debentures (debentures) issued in connection with Banner Capital Trust I as provided for under the early redemption provisions of the governing indenture at a price of 100% of the outstanding principal balance. For the six months immediately prior to repayment, the interest rate on the debentures supporting Banner Capital Trust I was 9.09%. The adjustable rate provisions of those debentures provided for changes in the interest rate every six months such that the rate would be equal to six month LIBOR plus 3.70%. The cash required to redeem the debentures came from our general operating funds.

*Sale of \$25 Million of Trust Preferred Securities:* In December 2006, we 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 VI, a special purpose business trust formed by Banner Corporation. The debentures have been recorded as a liability on the Consolidated Statement of Financial Condition and, subject to limitation under current Federal Reserve guidelines, a portion of the trust preferred securities qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering were retained by us to provide future flexibility with respect to regulatory capital requirements. 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 fixed at 6.56% until March 1, 2012 and subsequent to that date will reset quarterly to equal the three month London Interbank Offered Rate Index (LIBOR) plus 1.62%.

*Issuance of Shares through Dividend Reinvestment and Direct Stock Purchase and Sale Plan and Exercise of Options:* During the nine months ended September 30, 2007, we added to our capital structure by issuing 841,251 new shares of our common stock at an average net price of \$39.13 through our Dividend Reinvestment and Direct Stock Purchase and Sale Plan. In addition, we issued a net 73,635 shares in connection with the exercise of vested stock options. This combined stock issuance provided a net \$34.0 million in capital during the nine months ended September 30, 2007. The additional capital will be available to support our continued growth initiatives, including the just-completed acquisition of NCW Community Bank.

*Branch Expansion:* Over the past four years, we have invested significantly in expanding Banner Bank's branch and distribution systems with a primary emphasis on the greater Boise, Idaho and Portland, Oregon markets, the Puget Sound region of Washington and, more recently, with the acquisition of F&M Bank, Spokane, Washington. This branch expansion is a significant element in our 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 Banner Bank to proportionately reduce higher cost borrowings as a source of funds. Since July 2003, Banner Bank has opened 25 new branch offices, relocated 9 additional branch offices and significantly refurbished its main office in Walla Walla. We have also added 17 branches through the acquisitions of F&M Bank, Islanders Bank and NCW Community Bank as explained in other sections of this report.

*Recently Issued Accounting Pronouncements:* We elected early adoption of Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157, *Fair Value Measurements*, effective January 1, 2007. (See the earlier discussion above and Note 6 of the Selected Notes to the Consolidated Financial Statements for further information.)

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In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140, *Accounting for Transfers of Financial Assets and Extinguishment of Liabilities*. The Statement specifies under what situations servicing assets

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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 became effective January 1, 2007. The adoption of the Statement has not had a material effect on our 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. On January 1, 2007, we adopted FIN 48. Currently, we are subject to U.S. federal income tax and income tax of the States of Idaho and Oregon. The years 2004 through 2006 remain open to examination for federal income taxes, and years 2004 through 2006 remain open for State examination. As of January 1, 2007 and September 30, 2007, we believe we had insignificant unrecognized tax benefits or uncertain tax positions. In addition, we have no material accrued interest or penalties as of January 1, 2007 or September 30, 2007. It is our policy to record interest and penalties as a component of income tax expense. The amount of interest and penalties for the nine months ended September 30, 2007 was immaterial. The adoption of this accounting standard did not have a material impact on our Consolidated Financial Statements.

### **Note 3: Acquisitions of F&M Bank and San Juan Financial Holding Company**

On May 1, 2007, we completed the acquisition of F&M Bank (F&M) Spokane, Washington, in a stock and cash transaction valued at approximately \$98.3 million, with \$19.4 million of cash and 1,773,402 shares of Banner common stock, for 100% of the outstanding common shares of F&M Bank. F&M Bank was merged into Banner Bank and the results of its operations are included in those of Banner Bank starting in the quarter ended June 30, 2007. The purchase of F&M Bank allowed us to immediately expand Banner Bank's franchise in the Spokane, Washington area, the fourth largest metropolitan market in the Pacific Northwest, by the addition of 13 branches and one loan office.

The acquisition was accounted for as a purchase in accordance with SFAS 141. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the acquisition date as summarized in the following table:

|  | May 1, 2007    |    |        |
|--|----------------|----|--------|
|  | (in thousands) |    |        |
| Cash paid to F&M's shareholders  | \$ 19,404      |    |        |
| Total value of the Banner's common stock exchanged with F&M's Shareholders | 78,030         |    |        |
| Transaction closing costs  | 665            |    |        |
|  |                |    |        |
| Total purchase price   |                | \$ | 98,099 |
| Allocation of purchase price:  |                |    |        |
| F&M shareholders' equity   | \$ 32,849      |    |        |
| Estimated adjustments to adjust assets and liabilities to fair value       |                |    |        |
| Loans  | (195)          |    |        |
| Premises and equipment   | 3,315          |    |        |
| Core deposit intangible  | 10,867         |    |        |
| Deposits   | (336)          |    |        |
| Deferred taxes-net   | (4,916)        |    |        |
|  |                |    |        |
| Estimated fair value of net assets acquired                                |                |    | 41,584 |
| Goodwill resulting from acquisition  |                | \$ | 56,515 |

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Additional adjustments to the purchase price allocation may be required, specifically related to other assets and taxes, upon completion of certain pending valuation analyses. The core deposit intangible asset shown in the table above represents the value ascribed to the long-term deposit relationships acquired. This intangible asset is being amortized on an accelerated basis over an estimated useful life of eight years. The core deposit intangible asset is not estimated to have a significant residual value. Goodwill represents the excess of the total purchase price paid for F&M Bank over the fair values of the assets acquired, net of the fair values of the liabilities assumed. Goodwill is not amortized, but is evaluated for possible impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. No impairment losses were recognized in connection with core deposit intangible or goodwill assets during the period from acquisition on May 1, 2007 to the end of the current reporting period.

|   | May 1, 2007    |
|---|----------------|
|   | (in thousands) |
| The fair value of the assets and liabilities of F&M Bank at the date of acquisition |                |
| Cash  | \$ 12,056      |
| Securities available for sale   | 6,768          |
| Federal funds sold  | 137            |
| Loans-net of allowance for loan losses of \$4,528                                   | 388,696        |
| Premises and equipment-net  | 12,466         |
| Bank-owned life insurance (BOLI)  | 8,662          |
| Other assets  | 18,396         |
| Goodwill  | 56,515         |
|   | 503,696        |
|   |                |
| Deposits  | (348,822)      |
| Advances from Federal Home Loan Bank  | (20,000)       |
| Federal funds purchased and other borrowings  | (19,625)       |
| Other liabilities   | (17,150)       |
|   | (405,597)      |
| Net assets acquired   | \$ 98,099      |

On May 1, 2007, we also completed the acquisition of San Juan Financial Holding Company (SJFHC), the parent company of Islanders Bank, Friday Harbor, Washington, in a stock and cash transaction valued at approximately \$41.6 million, with \$6.2 million of cash and 819,209 shares of Banner common stock, for 100% of the outstanding common shares of SJFHC. SJFHC was merged into Banner Corporation and Islanders Bank has continued to operate as a separate subsidiary of Banner Corporation. The results of its operations are included in Banner's consolidated operations beginning in the quarter ended June 30, 2007. The acquisition of Islanders Bank, with its three branches located in the San Juan Islands, added to Banner Corporation's presence in the North Puget Sound region.

The acquisition was accounted for as a purchase in accordance with SFAS 141. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the acquisition date as summarized in the following table.

|  | May 1, 2007    |
|--|----------------|
|  | (in thousands) |
| Cash paid to SJFHC shareholders  | \$ 6,159       |
| Total value of the Banner's common stock exchanged with SJFHC shareholders | 35,177         |

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|  |    |                   |                   |
|--|----|-------------------|-------------------|
| Closing costs  |    | 253               |                   |
|  |    | <u>          </u> |                   |
| Total purchase price   |    |                   | \$ 41,589         |
| Allocation of purchase price   |    |                   |                   |
| SJFHC shareholders' equity   | \$ | 16,782            |                   |
| Estimated adjustments to adjust assets and liabilities to fair value |    |                   |                   |
| Loans  |    | (604)             |                   |
| Premises and equipment   |    | 1,800             |                   |
| Core deposit intangible-net increase                                 |    | 6,147             |                   |
| Deposits   |    | 37                |                   |
| Deferred taxes-net   |    | (2,659)           |                   |
| Estimated fair value of net assets acquired                          |    | <u>          </u> | 21,503            |
|  |    |                   | <u>          </u> |
| Goodwill resulting from acquisition                                  |    |                   | \$ 20,086         |
|  |    |                   | <u>          </u> |

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Additional adjustments to the purchase price allocation may be required, specifically related to other assets and taxes. The core deposit intangible asset shown in the table above represents the value ascribed to the long-term deposit relationships acquired. This intangible asset is being amortized on an accelerated basis over an estimated useful life of eight years. The core deposit intangible asset is not estimated to have a significant residual value. Goodwill represents the excess of the total purchase price paid for SJFHC over the fair values of the assets acquired, net of the fair values of the liabilities assumed. Goodwill is not amortized, but is evaluated for possible impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. No impairment losses were recognized in connection with core deposit intangible or goodwill assets during the period from acquisition on May 1, 2007 to the end of the current reporting period.

|  | May 1, 2007    |
|--|----------------|
|  | (in thousands) |
| The fair value of the assets and liabilities of SJFHC at the date of acquisition |                |
| Cash   | \$ 7,449       |
| Securities available for sale  | 26,263         |
| Loans-net of allowance for loan losses of \$1,429                                | 116,999        |
| Premises and equipment-net   | 5,756          |
| BOLI   | 2,315          |
| Other assets   | 8,380          |
| Goodwill   | 20,086         |
|  | 187,248        |
|  |                |
| Deposits   | (124,264)      |
| Advances from Federal Home Loan Bank   | (15,726)       |
| Other liabilities  | (5,669)        |
|  | (145,659)      |
|  |                |
| Net assets acquired  | \$ 41,589      |

The following tables present unaudited pro forma condensed results of operations for the quarters and nine months ended September 30, 2007 and 2006 prepared as if the acquisitions of F&M Bank and SJFHC had occurred on January 1, 2006. Any cost savings realized as a result of the acquisitions are not reflected in the pro forma condensed statements of income as no assurance can be given with respect to the final amount of such cost savings. The pro forma results have been prepared for comparison purposes only and are not necessarily indicative of the results that would have been obtained had the acquisitions actually occurred on January 1, 2006.

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Pro Forma Financial Information - Unaudited  
(in thousands except per share data)

Quarter Ended September 30, 2007

|  | Banner    | F&M Bank | SJFHC | F&M Bank<br>Pro Forma<br>Adjustments | SJFHC Pro<br>Forma<br>Adjustments | Pro Forma<br>Consolidated |
|--|-----------|----------|-------|--------------------------------------|-----------------------------------|---------------------------|
| Net interest income before provision for loan losses | \$ 40,670 | \$ -     | \$ -  | \$ 25 (A)                            | \$ (22) (A)                       | \$ 40,673                 |
| Provision for loan losses                            | 1,500     | -        | -     | -                                    | -                                 | 1,500                     |
| Other operating income                               | 10,534    | -        | -     | -                                    | -                                 | 10,534                    |
| Other operating expense                              | 34,846    | -        | -     | 1,698 (B)                            | (471) (C)                         | 32,677                    |
| Income before provision for income taxes             | 14,858    | -        | -     | 1,723                                | 449                               | 17,030                    |
| Provision for income taxes (benefits)                | 4,871     | -        | -     | 621 (D)                              | 161 (D)                           | 5,653                     |
| Net income   | \$ 9,987  | \$ -     | \$ -  | \$ 1,102                             | \$ 288                            | \$ 11,377                 |
| Basic earnings per share                             | \$ 0.64   |          |       |                                      |                                   | \$ 0.73                   |
| Diluted earning per share                            | \$ 0.64   |          |       |                                      |                                   | \$ 0.72                   |
| Basic weighted average shares outstanding            | 15,497    |          |       |                                      |                                   | 15,497                    |
| Diluted weighted average shares outstanding          | 15,720    |          |       |                                      |                                   | 15,720                    |

- (A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M and SJFHC assuming acquired January 1, 2006.
- (B) Reversal of merger related expenses of \$748,000 and additional core deposit amortization of \$950,000 assuming acquired January 1, 2006.
- (C) Reversal of additional core deposit amortization of \$471,000 assuming acquired January 1, 2006.
- (D) Income tax effect of pro forma adjustments at 36%.

Nine Months Ended September 30, 2007

|  | Banner     | F&M Bank | SJFHC    | Four Months Ended<br>April 30, 2007 | F&M Bank<br>Pro Forma<br>Adjustments | SJFHC Pro<br>Forma<br>Adjustments | Pro Forma<br>Consolidated |
|--|------------|----------|----------|-------------------------------------|--------------------------------------|-----------------------------------|---------------------------|
| Net interest income before provision for loan losses | \$ 110,957 | \$ 5,803 | \$ 2,074 | \$ 58 (A)                           | \$ (32) (A)                          | \$ 118,860                        |                           |
| Provision for loan losses                            | 3,900      | 1,028    | 20       | -                                   | -                                    | 4,948                             |                           |
| Other operating income                               | 21,854     | 1,375    | 599      | -                                   | (22) (B)                             | 23,806                            |                           |
| Other operating expense                              | 92,216     | 13,425   | 3,109    | (8,308) (C)                         | (1,497) (D)                          | 98,945                            |                           |



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|   |           |            |          |          |     |        |     |           |
|---|-----------|------------|----------|----------|-----|--------|-----|-----------|
| Income before provision for income taxes    | 36,695    | (7,275)    | (456)    | 8,366    |     | 1,443  |     | 38,773    |
| Provision for income taxes (benefits)       | 11,784    | (2,612)    | 270      | 3,012    | (E) | 519    | (E) | 12,973    |
| Net income                                  | \$ 24,911 | \$ (4,663) | \$ (726) | \$ 5,354 |     | \$ 924 |     | \$ 25,800 |
| Basic earnings per share                    | \$ 1.76   |            |          |          |     |        |     | \$ 1.69   |
| Diluted earning per share                   | \$ 1.73   |            |          |          |     |        |     | \$ 1.66   |
| Basic weighted average shares outstanding   | 14,125    | 917        | 160      | 779      | (F) | 360    | (F) | 15,264    |
| Diluted weighted average shares outstanding | 14,399    | 917        | 160      | 779      | (F) | 360    | (F) | 15,538    |

- (A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M Bank and SJFHC assuming acquired January 1, 2006.
- (B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition.
- (C) Reversal of merger related expenses of \$7.8 million and additional core deposit amortization of \$497,000 assuming acquired January 1, 2006.
- (D) Reversal of merger related expenses of \$1.3 million and additional core deposit amortization of \$240,000 assuming acquired January 1, 2006.
- (E) Income tax effect of pro forma adjustments at 36%.
- (F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M Bank and 2.2503 to 1 for SJFHC.

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Pro Forma Financial Information - Unaudited  
(in thousands except per share data)

Quarter Ended September 30, 2006

|  | Banner    | F&M Bank | SJFHC    | F&M Bank<br>Pro Forma<br>Adjustments | SJFHC Pro<br>Forma<br>Adjustments | Pro Forma<br>Consolidated |
|--|-----------|----------|----------|--------------------------------------|-----------------------------------|---------------------------|
| Net interest income before provision for loan losses | \$ 32,661 | \$ 4,326 | \$ 1,850 | \$ (65) (A)                          | \$ (44) (A)                       | \$ 38,728                 |
| Provision for loan losses                            | 1,000     | 140      | 15       | -                                    | -                                 | 1,155                     |
| Other operating income                               | 5,436     | 1,098    | 396      | -                                    | (50) (B)                          | 6,880                     |
| Other operating expense                              | 25,336    | 3,833    | 1,340    | 625 (C)                              | 346 (D)                           | 31,480                    |
| Income before provision for income taxes             | 11,761    | 1,451    | 891      | (690)                                | (440)                             | 12,973                    |
| Provision for income taxes (benefits)                | 3,752     | 438      | 261      | (249) (E)                            | (159) (E)                         | 4,043                     |
| Net income   | \$ 8,009  | \$ 1,013 | \$ 630   | \$ (441)                             | \$ (281)                          | \$ 8,930                  |
| Basic earnings per share                             | \$ 0.67   |          |          |                                      |                                   | \$ 0.62                   |
| Diluted earning per share                            | \$ 0.65   |          |          |                                      |                                   | \$ 0.60                   |
| Basic weighted average shares outstanding            | 11,964    | 2,026    | 364      | 1,722 (F)                            | 819 (F)                           | 14,505                    |
| Diluted weighted average shares outstanding          | 12,293    | 2,074    | 364      | 1,763 (F)                            | 819 (F)                           | 14,875                    |

- (A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M Bank and SJFHC assuming acquired January 1, 2006.
- (B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition.
- (C) Core deposit amortization assuming acquired January 1, 2006.
- (D) Additional core deposit amortization assuming acquired January 1, 2006.
- (E) Income tax effect of pro forma adjustments at 36%.
- (F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M Bank and 2.2503 to 1 for SJFHC.

Nine Months Ended September 30, 2006

|  | Banner    | F&M Bank  | SJFHC    | F&M Bank<br>Pro Forma<br>Adjustments | SJFHC Pro<br>Forma<br>Adjustments | Pro Forma<br>Consolidated |
|--|-----------|-----------|----------|--------------------------------------|-----------------------------------|---------------------------|
| Net interest income before provision for loan losses | \$ 93,790 | \$ 12,270 | \$ 5,286 | \$ (267) (A)                         | \$ (168) (A)                      | \$ 110,911                |
| Provision for loan losses                            | 4,500     | 455       | 27       | -                                    | -                                 | 4,982                     |
| Other operating income                               | 14,938    | 3,338     | 1,141    | -                                    | (123) (B)                         | 19,294                    |
| Other operating expense                              | 68,545    | 11,121    | 3,909    | 1,304 (C)                            | 708 (D)                           | 85,587                    |
|  | 35,683    | 4,032     | 2,491    | (1,571)                              | (999)                             | 39,636                    |

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|   |           |          |          |            |           |           |  |
|---|-----------|----------|----------|------------|-----------|-----------|--|
| Income before provision for income taxes    |           |          |          |            |           |           |  |
| Provision for income taxes (benefits)       | 11,527    | 1,217    | 783      | (566) (E)  | (360) (E) | 12,601    |  |
| Net income                                  | \$ 24,156 | \$ 2,815 | \$ 1,708 | \$ (1,005) | \$ (639)  | \$ 27,035 |  |
| Basic earnings per share                    | \$ 2.03   |          |          |            |           | \$ 1.87   |  |
| Diluted earning per share                   | \$ 1.98   |          |          |            |           | \$ 1.83   |  |
| Basic weighted average shares outstanding   | 11,879    | 2,028    | 364      | 1,724 (F)  | 819 (F)   | 14,422    |  |
| Diluted weighted average shares outstanding | 12,206    | 2,076    | 364      | 1,765 (F)  | 819 (F)   | 14,790    |  |

- (A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M Bank and SJFHC assuming acquired January 1, 2006.
- (B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition.
- (C) Core deposit amortization assuming acquired January 1, 2006.
- (D) Core deposit amortization assuming acquired January 1, 2006.
- (E) Income tax effect of pro forma adjustments at 36%.
- (F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M Bank and 2.2503 to 1 for SJFHC.

**Note 4: Business Segments**

We are managed by legal entity and not by lines of business; however, both of our primary subsidiaries are engaged in the same line of business, commercial banking. Banner Bank and Islanders Bank (together "the Banks") are community oriented commercial banks chartered in the State of Washington. The Banks' primary business is that of traditional banking institutions, gathering deposits and originating loans for their portfolios in their primary market areas. The Banks offer a wide variety of deposit products to their consumer and commercial customers. Lending activities include the origination of real estate, commercial and agricultural business and consumer loans. The Banks do not engage and have not engaged in any sub-prime lending programs. 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 Banner Corporation's executive management and Board of Directors on a monthly basis. All of the executive officers of Banner Corporation are members of the Banner Bank executive management team and one director of Banner Corporation and one executive officer of Banner Bank are members of the Board of Directors of Islanders Bank. None of the officers of Islanders Bank are officers or directors of Banner Corporation.

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 shareholders. We have determined that our current business and operations consist of a single business segment.

**Note 5: 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 our interest-bearing deposits and securities at the dates indicated (at carrying value) (in thousands):

|   | September 30<br>2007 | December 31<br>2006 | September 30<br>2006 |
|---|----------------------|---------------------|----------------------|
| Interest-bearing deposits included in Cash and due from banks | \$ 62,628            | \$ 5,068            | \$ 24,696            |
| Mortgage-backed securities                                    | 98,064               | 150,166             | 157,014              |
| Other securities-taxable                                      | 62,481               | 77,332              | 85,987               |
| Other securities-tax exempt                                   | 49,195               | 42,817              | 43,758               |
| Equity securities with dividends                              | 2,451                | 3,710               | 3,788                |
| Total securities  | 212,191              | 274,025             | 290,547              |
| FHLB stock  | 37,291               | 35,844              | 35,844               |
|   | \$ 312,110           | \$ 314,937          | \$ 351,087           |

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

| Quarters Ended<br>September 30 |      | Nine Months Ended<br>September 30 |      |
|--------------------------------|------|-----------------------------------|------|
| 2007                           | 2006 | 2007                              | 2006 |
|                                |      |                                   |      |

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|                                     |                   |                   |                   |                   |
|-------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Mortgage-backed securities interest | \$ 1,343          | \$ 1,921          | \$ 4,653          | \$ 6,015          |
|                                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Taxable interest income             | 1,568             | 1,519             | 4,114             | 4,071             |
| Tax-exempt interest income          | 548               | 488               | 1,516             | 1,470             |
| Other stock-dividend income         | 27                | 39                | 94                | 117               |
| FHLB stock dividends                | 56                | -                 | 147               | -                 |
|                                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
|                                     | 2,199             | 2,046             | 5,871             | 5,658             |
|                                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
|                                     | \$ 3,542          | \$ 3,967          | \$ 10,524         | \$ 11,673         |
|                                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

**Note 6: Fair Value Accounting and Measurement**

Banner elected early adoption of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157, *Fair Value Measurements*, effective January 1, 2007. SFAS No. 159, which was issued in February 2007, generally permits the measurement of selected eligible financial instruments at fair value (FV) at specified election dates. Upon adoption of SFAS No. 159, we selected fair value measurement for all of our "available for sale" investment securities, FHLB advances and junior subordinated debentures, which had fair values of approximately \$226.2 million, \$176.8 million and \$124.4 million, respectively, on January 1, 2007. The initial fair value measurement of these instruments resulted in a \$3.5 million adjustment for the cumulative effect, net of tax, as a result of the change in accounting, which was recorded as a reduction in retained earnings as of January 1, 2007, and which under SFAS No. 159 has not been recognized in current earnings. While the adjustment to retained earnings is permanent, approximately \$2.6 million of the amount was previously reported as accumulated other comprehensive loss at December 31, 2006, so the reduction in the January 1, 2007 opening stockholders' equity was \$897,000 when SFAS No. 159 was adopted.

The following table details the financial instruments carried at fair value to the dates indicated (in thousands):

|   | Cumulative Adjustment on Adoption of SFAS 159 |                                  |            |               |                               | September 30, 2007 |                                  |            |
|---|---|----------------------------------|------------|---------------|-------------------------------|--------------------|----------------------------------|------------|
|   | January 1, 2007                               |                                  |            |               |                               |                    |                                  |            |
|   | Amortized Cost                                | Fair Market Valuation Adjustment | Fair Value | Related Taxes | Cumulative Effect of Adoption | Amortized Cost     | Fair Market Valuation Adjustment | Fair Value |
| <b>Assets:</b>  |   |                                  |            |               |                               |                    |                                  |            |
| Securities - available for sale reclassified to fair value  | \$ 230,189                                    | \$ (4,036)                       | \$ 226,153 | \$ 1,413      | \$ (2,623)                    | \$ 160,767         | \$ (1,835)                       | \$ 158,932 |
| <b>Liabilities:</b>   |   |                                  |            |               |                               |                    |                                  |            |
| Advances from FHLB  | \$ 177,430                                    | \$ (678)                         | \$ 176,752 | \$ 244        | \$ 434                        | \$ 24,739          | \$ (162)                         | \$ 24,577  |
| Junior subordinated debentures, net of unamortized deferred origination costs                         | 122,287                                       | 2,079                            | 124,366    | (748)         | (1,331)                       | 122,860            | (640)                            | 122,220    |
|   | \$ 299,717                                    | \$ 1,401                         | \$ 301,118 | \$ (504)      | \$ (897)                      | \$ 147,599         | \$ (802)                         | \$ 146,797 |
| Total adjustment  |   |                                  |            |               | \$ (3,520)                    |                    |                                  |            |
| Less transfer from accumulated other comprehensive loss to retained earnings                          |   |                                  |            |               | (2,623)                       |                    |                                  |            |
| Cumulative reduction of opening stockholders' equity at January 1, 2007 upon adoption of SFAS No. 159 |   |                                  |            |               | \$ (897)                      |                    |                                  |            |

**Note 6: Fair Value Accounting and Measurement (continued)**

SFAS No. 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS No. 157, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our own market assumptions. These two types of inputs create the following fair value hierarchy:

- \* Level 1 - Quoted prices for identical instruments in active markets
- \* Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.
- \* Level 3 - Instruments whose significant value drivers are unobservable.

We hold fixed and variable rate interest bearing securities, investments in marketable equity securities and certain other financial instruments, which are carried at fair value. Fair value is determined based upon quoted prices when available or through the use of alternative approaches, such as matrix or model pricing, when market quotes are not readily accessible or available.

We also carry our FHLB advances and junior subordinated debentures at fair value. In determining the fair value of our obligations, various factors are considered including: price activity for equivalent or similar instruments, discounting the expected cash flows using market interest rates and our credit standing.

Fair values are determined as follows:

- \* Securities at fair value are priced using matrix pricing based on the securities' relationship to other benchmark quoted prices and under the provisions of SFAS No. 157 are considered a Level 2 input method.
- \* Advances from FHLB are priced using discounted cash flows to the date of maturity based on the FHLB of Seattle's current rate sheet for member bank advances on the date of valuation and is considered a Level 2 input method.
- \* Junior subordinated debentures are priced using discounted cash flows to the next available redemption date on the date of valuation based on recent issuances or quotes from brokers for comparable bank holding companies and are considered a Level 2 input method.

The following table outlines the net change in fair values recorded at the dates indicated (in thousands):

|   | Quarters Ended<br>September 30 |      | Nine Months Ended<br>September 30 |      |
|---|--------------------------------|------|-----------------------------------|------|
|   | 2007                           | 2006 | 2007                              | 2006 |
| <b>Assets:</b>  |                                |      |                                   |      |
| Securities - available for sale reclassified as carried at fair value     | \$ 1,301                       | \$ - | \$ 768                            | \$ - |
| <b>Liabilities</b>  |                                |      |                                   |      |
| Advances from FHLB  | (182)                          | -    | (516)                             | -    |
| Junior subordinated debentures net of unamortized deferred issuance costs | 1,943                          | -    | 2,113                             | -    |
| Net change in fair value  | \$ 3,062                       | \$ - | \$ 2,365                          | \$ - |

We have 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 rate 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.

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**Note 7: Calculation of Weighted Average Shares Outstanding for Earnings Per Share (EPS)**

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

|  | Quarters Ended<br>September 30 |        | Nine Months Ended<br>September 30 |        |
|--|--------------------------------|--------|-----------------------------------|--------|
|  | 2007                           | 2006   | 2007                              | 2006   |
| Basic weighted average shares outstanding  | 15,497                         | 11,964 | 14,124                            | 11,879 |
| Plus unvested MRP and stock option incremental shares considered<br>outstanding for diluted EPS calculations | 223                            | 329    | 275                               | 327    |
| Diluted weighted average shares outstanding  | 15,720                         | 12,293 | 14,399                            | 12,206 |

**Note 8: Stock Based Compensation Plans**

Banner Corporation 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 (collectively, SOPs).

*MRP Stock Grants:* Under the MRP, Banner was authorized to grant up to 528,075 shares of restricted stock to its directors, officers and employees. On July 26, 2006, this stock program expired with 522,660 shares having been granted and no additional shares eligible to be granted. Shares granted under the MRP vest ratably over a five-year period from the date of grant. The Consolidated Statements of Income for the quarters and nine months ended September 30, 2007 and 2006 reflect accruals of \$34,000 and \$46,000, and \$122,000 and \$139,000, respectively, for these grant awards. The MRP stock grants' fair value equals their intrinsic value on the date of grant.

A summary of unvested MRP share activity during the nine months ended September 30, 2007 follows:

|                                | Shares | Weighted-<br>Average<br>Grant-Date<br>Fair Value |
|--------------------------------|--------|--|
| Unvested at December 31, 2006  | 19,360 | \$ 22.07   |
| Granted                        | -      | -  |
| Vested                         | 8,020  | 20.29  |
| Forfeited                      | 700    | 24.92  |
| Unvested at September 30, 2007 | 10,640 | \$ 23.23   |

*Stock Options:* Under the SOPs, we reserved 2,284,186 shares for issuance pursuant to the exercise of stock options to be granted to directors and employees. Authority to grant additional options under the 1996 Stock Option Plan terminated on July 26, 2006 with 6,613 stock options remaining ungranted at the time of termination. As of September 30, 2007, there were 4,047 options eligible for grants under the 1998 and 2001 plans. The exercise price of the stock options is set at 100% of the fair market value of the stock price on the date of grant. Such options have graded vesting of 20% per year from the date of grant and any unexercised incentive stock options will expire ten years after date of grant or 90 days after employment or service ends.



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During the quarter and nine months ended September 30, 2007 the Company awarded 52,500 stock options. We did not grant any stock options during the nine months ended September 30, 2006. Also, there were no significant modifications made to any stock option grants during the period. The fair values of stock options granted are amortized as compensation expense on a straight-line basis over the vesting period of the grant.

Stock-based compensation costs related to the SOPs were \$87,000 and \$134,000, and \$243,000 and \$443,000 for the quarters and nine months ended September 30, 2007 and 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 historical volatility at the date of the grant. The expected term is based on the remaining contractual life of the vesting period. We base 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.

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|                          | Nine Months Ended<br>September 30 |      |
|--------------------------|-----------------------------------|------|
|                          | 2007                              | 2006 |
| Annual dividend yield    | 2.46%                             | N/A  |
| Expected volatility      | 15.70%                            | N/A  |
| Risk free interest rates | 4.64 to 4.82%                     | N/A  |
| Expected lives           | 5 to 9 years                      | N/A  |

As part of the provisions of SFAS 123(R), *Share-Based Payment*, we are 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. A summary of our SOP stock compensation activity for the nine months ended September 30, 2007 follows (in thousands, except shares and per share data):

|   | Shares         | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term, In Years | Aggregate<br>Intrinsic<br>Value |
|---|----------------|---|--|---------------------------------|
| Outstanding at December 31, 2006                  | 713,460        | \$ 20.49                                  |  |                                 |
| Granted   | 52,500         | 30.88                                     |  |                                 |
| Exercised   | (84,244)       | 18.60                                     |  | \$ 1,619                        |
| Forfeited   | (2,800)        | 25.98                                     |  |                                 |
| <b>Outstanding at September 30, 2007</b>          | <b>678,916</b> | <b>\$ 21.51</b>                           | <b>5.3</b>   | <b>\$ 8,745</b>                 |
| Vested at September 30, 2007 and expected to vest | 671,987        | \$ 21.45                                  | 5.3  | \$ 8,697                        |
| Exercisable at September 30, 2007                 | 491,476        | \$ 19.15                                  | 4.4  | \$ 7,488                        |

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 stock option.

A summary of our unvested stock option activity with respect to the nine months ended September 30, 2007 follows:

|                               | Shares  | Weighted-<br>Average<br>Grant-Date<br>Fair Value |
|-------------------------------|---------|--|
| Unvested at December 31, 2006 | 211,810 | \$ 7.57  |

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|                                |          |         |
|--------------------------------|----------|---------|
| Granted                        | 52,500   | 5.97    |
| Vested                         | (74,040) | 7.10    |
| Forfeited                      | (2,800)  | 7.94    |
|                                | <hr/>    |         |
| Unvested at September 30, 2007 | 187,440  | \$ 7.31 |

During the nine months ended September 30, 2007 and 2006, the total intrinsic value of stock options exercised was \$1.6 million and \$6.0 million, respectively.

We had \$521,000 of total unrecognized compensation expense related to stock options at June 30, 2007 that is expected to be recognized over a period of 4.8 years.

During the nine months ended September 30, 2007, we received \$1.6 million from the exercise of stock options. Cash was not used to settle any equity instruments previously granted. Upon the exercise of stock options, we issue shares from authorized but unissued shares. We do not currently expect to repurchase shares from any source to satisfy our obligations under the SOPs.

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The following are the stock-based compensation costs we recognized in our Consolidated Statements of Income (in thousands):

|  | Quarters Ended<br>September 30 |        | Nine Months Ended<br>September 30 |        |
|--|--------------------------------|--------|-----------------------------------|--------|
|  | <b>2007</b>                    | 2006   | <b>2007</b>                       | 2006   |
| Salary and employee benefits                 | \$ 133                         | \$ 180 | \$ 378                            | \$ 582 |
| Total decrease in income before income taxes | 133                            | 180    | 378                               | 582    |
| Decrease in provision for income taxes       | (30)                           | (25)   | (75)                              | (83)   |
| Decrease in net income                       | \$ 103                         | \$ 155 | \$ 303                            | \$ 499 |

*Banner Corporation 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 directly related to changes in the value of Company stock, dividends declared on Company stock and changes in Banner Bank's average earnings rate and under SFAS 123(R) is considered a stock appreciation right ("SAR"). Each SAR entitles the holder to receive cash, upon vesting, equal to the excess of the fair market value of a share of the Company's common stock on the date of exercise over the fair market value of such share on the date granted plus the dividends declared on the stock from the date of grant to the date of vesting. Vesting is upon the completion of 60 months of continuous service from the date of grant, provided that at the time the SAR holder directly owns (other than through a qualified plan) Banner Corporation Stock equal in value to at least 50 percent of his base salary. The primary objective of the Plan is for executives who remain with the Company or Banner Bank for a sufficient period of time to share in the increases in the value of Company stock. Detailed information with respect to the plan was disclosed on a Form 8-K filed with SEC on July 19, 2006. SFAS 123 (R) requires the Company to remeasure the fair value of SARs each reporting period until the award is settled. In addition, compensation expense must be recognized each reporting period for changes in fair value and vesting. The Consolidated Statements of Income for the quarters and nine months ended September 30, 2007 and 2006 reflect accruals of \$230,000 and \$33,000, and \$279,000 and \$33,000, respectively for these plan awards.

**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 on Form 10-Q contain certain forward-looking statements concerning our future operations. Management desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement so that we may rely on 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, 2006. We have used forward-looking statements to describe future plans and strategies, including expectations of our future financial results. Our 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, the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans and in real estate values in our market areas; fluctuations in agricultural commodity prices, crop yields and weather conditions; our ability to control operating costs and expenses; our ability to successfully implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames; our ability to manage loan delinquency rates; our ability to retain key members of our senior management team; costs and effects of litigation; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board; war or terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission. We caution readers not to place undue reliance on any forward-looking statements. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for 2007 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Banner Corporation and our consolidated subsidiaries.

**Executive Overview**

We are 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, subsequent to May 1, 2007, Islanders Bank, a recent acquisition, as explained below. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of September 30, 2007, its 80 branch offices and 13 loan production offices located in 29 counties 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 are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the FDIC. As of September 30, 2007, we had total consolidated assets of \$4.3 billion, total deposits of \$3.6 billion and total stockholders' equity of \$414 million.

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

Over the past several years, we have invested significantly in expanding our branch and distributions systems with a primary emphasis on expanding our presence in the four largest areas of commerce in the Northwest: the Puget Sound region of Washington and the greater Boise, Idaho, Portland, Oregon, and Spokane, Washington markets. As a result of our aggressive franchise expansion, we have added 17 new branches through acquisition, opened 25 new branches and relocated nine others since July 2003. Most recently, we opened branches in Tualatin, Oregon and Bellingham, Washington, and on October 10, 2007, closed our acquisition of NCW Community Bank of Wenatchee, Washington. NCW Community Bank had approximately \$99 million in assets, \$91 million in total loans and \$88 million in deposit balances at September 30, 2007. This acquisition increases our presence within a desirable marketplace and allows us to better serve existing and future customers. Branch expansion has been a significant element in our strategy to grow loans, deposits and customer relationships. This emphasis on growth has resulted in an elevated level of operating expenses; however, we believe that over time these new branches should help improve profitability by providing lower cost core deposits which will allow us to proportionately reduce higher cost borrowings as a source of funds. We have three additional branches scheduled to open in the fourth quarter of 2007; however, we are rapidly reaching a size in terms of number of branches that

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will generate deposit growth sufficient to fund our expected loan growth and payoff FHLB borrowings. As a result, we anticipate that we will slow down our de novo branch expansion to a more moderate pace beginning in 2008.

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We completed the acquisitions of F&M Bank and San Juan Financial Holding Company effective May 1, 2007. On that date, San Juan Financial Holding Company was merged into Banner Corporation and its wholly owned subsidiary, Islanders Bank, has continued operations as a subsidiary of Banner Corporation. On the same date, F&M Bank merged into Banner Bank and now operates under the Banner Bank name. The financial results for the quarter and nine months ended September 30, 2007 include the assets, liabilities and results of operations for both of the acquired companies from the date of acquisition on May 1, 2007. As noted above, we also completed the acquisition of NCW Community Bank effective October 10, 2007; however, the financial results presented in this report on Form 10-Q do not include the assets, liabilities or results of operations for NCW Community Bank.

For the quarter ended September 30, 2007, we had net income of \$10.0 million, or \$0.64 per share (diluted), compared to \$8.0 million, or \$0.65 per share (diluted), for the quarter ended September 30, 2006. In the quarter ended September 30, 2007, our net income was significantly affected by the net increase in the valuation of the selected financial assets and liabilities we record at fair value pursuant to the early adoption of SFAS No. 159. These fair value adjustments resulted in an increase of \$2.0 million, or \$0.13 per share (diluted), to net income reported for the quarter ended September 30, 2007. Excluding the net fair value adjustments in the current quarter, net income from recurring operations was unchanged at \$8.0 million for the quarter ended September 30, 2007, compared to \$8.0 million for the quarter ended September 30, 2006. However, as a result of the significant increase in the average number of shares outstanding, primarily as a result of the acquisitions and the issuance of shares through our stock reinvestment plan, earnings per share (diluted) declined to \$0.51 for the quarter ended September 30, 2007, compared to \$0.65 per share (diluted) for the quarter ended September 30, 2006.

Our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits, FHLB advances, other borrowings and junior subordinated debentures. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. As more fully explained below, our net interest income before provision for loan losses increased \$8.0 million for the quarter ended September 30, 2007, compared to the prior year, primarily as a result of significant growth in interest-earning assets and interest-bearing liabilities, including growth resulting from the two acquisitions, and as a result of changes in the mix of both interest-earning assets and interest-bearing liabilities.

Our net income also is affected by provisions for loan losses and the level of our 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 our operating expenses and income tax provisions. The provision for loan losses was \$1.5 million for the quarter ended September 30, 2007, an increase of \$500,000 compared to the quarter ended September 30, 2006. Other operating income, excluding fair value adjustments, increased by \$2.1 million, or 39%, to \$7.5 million for the quarter ended September 30, 2007 from \$5.4 million for the quarter ended September 30, 2006, primarily as a result of increased deposit fees and other service charges reflecting in part the recent acquisitions. Revenues (net interest income before the provision for loan losses plus other operating income), excluding the fair value adjustments, increased 26% to \$48.1 million for the quarter ended September 30, 2007 compared to \$38.1 million for the quarter ended September 30, 2006. Other operating expenses increased \$9.5 million to \$34.8 million for the quarter ended September 30, 2007 from \$25.3 million for the same period in 2006, an increase of 38% from a year earlier, largely reflecting our continued growth and the effect of our acquisitions.

We offer a wide range of loan products to meet the demands of our customers; however, we do not now and have not previously engaged in any sub-prime lending. 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 our primary market areas. We have also recently increased our emphasis on consumer lending, although the portion of the loan portfolio invested in consumer loans is still relatively small. While continuing our commitment to construction and residential lending, we expect commercial lending, including commercial real estate, commercial business, agricultural and consumer lending, to become increasingly important activities for us.

Deposits, including customer retail repurchase agreements, and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits. 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 our recent branch expansion, relocations and renovation has been directed toward attracting additional deposit customer relationships and balances.

We generally attract deposits from within our 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, we consider current market interest rates, profitability, matching deposit and loan products, and customer preferences and concerns.

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



**Comparison of Financial Condition at September 30, 2007 and December 31, 2006**

**General:** For the first nine months of the year, total assets increased \$805 million, or 23%, from \$3.496 billion at December 31, 2006, to \$4.300 billion at September 30, 2007. Recent acquisitions contributed \$691 million in assets (as of May 1, 2007), while the remaining increase largely resulted from growth in the loan portfolio and was funded primarily by deposit growth. Net loans receivable (gross loans less loans in process, deferred fees and discounts, and allowance for loan losses) increased \$647 million, or 22%, from \$2.930 billion at December 31, 2006, to \$3.577 billion at September 30, 2007. Internal loan growth was meaningful and broad-based; however, the portfolio growth largely reflects the \$506 million (as of May 1, 2007) addition in net loans from the SJFHC and F&M Bank acquisitions. Although production of new loans declined in the most recent quarter, we continue to maintain a significant investment in construction and land loans, reflecting continued demand for and sales of new homes in many of the markets we serve as well as a strength and core competency of Banner Bank. Including the effect of the acquisitions, loans to finance the construction of one- to four-family residential real estate increased by \$54 million, or 9%, and land and development loans increased by \$61 million, or 15%, since December 31, 2006. In addition, and largely reflecting the acquisitions, loans to finance commercial real estate increased by \$215 million, or 36%, while loans secured by multi-family real estate increased by \$23 million, or 16%. Loan growth also included commercial business loans, which increased by \$163 million, or 35%, consumer loans, which increased by \$74 million, or 63%, and loans to finance existing one- to four-family residential properties, which increased by \$62 million, or 17%, at September 30, 2007 compared to December 31, 2006. By contrast, at September 30, 2007 loans to finance commercial and multifamily construction decreased by \$12 million, or 9%, from December 31, 2006.

Securities decreased \$62 million, or 23%, from \$274 million at December 31, 2006, to \$212 million at September 30, 2007, as sales and repayments exceeded purchases and the \$33 million added as a result of the acquisitions of F&M Bank and San Juan Financial Holding Company. Effective January 1, 2007, we elected to reclassify all our securities available for sale to fair value following our adoption of SFAS No. 159. Property and equipment increased by \$38 million to \$96 million at September 30, 2007, from \$58 million at December 31, 2006. The increase included additional site, construction and equipment costs associated with new facilities recently opened or in progress as part of our continuing branch expansion strategy, and \$18 million added through recent acquisitions. We also had an increase of \$11 million in bank-owned life insurance, with nearly \$1.5 million coming from the growth of cash surrender values on existing policies and the remainder due to acquisition.

Deposits increased \$803 million, or 29%, from \$2.795 billion at December 31, 2006, to \$3.598 billion at September 30, 2007. The acquisitions of F&M Bank and Islanders Bank resulted in the addition of \$473 million in total deposits as of May 1, 2007. Non-interest-bearing deposits increased \$141 million, or 42%, to \$474 million, while interest-bearing deposits increased \$662 million, or 27%, to \$3.124 billion from the December 31, 2006 amounts. The aggregate total of transaction and savings accounts, including money market accounts, increased by \$535 million, or 43%, to \$1.773 billion, reflecting Banner Bank's focused efforts to grow these important core deposits, as well as the effects of the acquisitions. Increasing core deposits is a key element of our expansion strategy, including the recent and planned additions and renovations of branch locations as explained in more detail below. Reflecting internally generated growth and the effects of the acquisitions, transaction and savings accounts represent 49.3% of total deposits at September 30, 2007, compared to 43.1% a year earlier. FHLB advances decreased \$153 million from \$177 million at December 31, 2006, to \$25 million at September 30, 2007, while other borrowings decreased \$25 million to \$79 million at September 30, 2007. The decrease in other borrowings reflects an increase of \$2 million in retail repurchase agreements that are primarily related to customer cash management accounts, as well as a decrease of \$27 million of repurchase agreement borrowings from securities dealers. Junior subordinated debentures decreased by \$2 million, primarily reflecting the cumulative fair value adjustments recorded subsequent to the adoption of SFAS 159, and the replacement of debentures issued five years ago with a new issuance which, reflecting current market conditions, will have a much more favorable interest cost in future periods.

During the nine months ended September 30, 2007, we increased our capital by issuing 841,251 new shares of Banner Common Stock at an average net price of \$39.13 through our Dividend Reinvestment and Direct Stock Purchase and Sale Plan. In addition, we issued a net 73,635 shares in connection with the exercise of vested stock options and 2,592,611 shares were issued in the acquisition of F&M Bank and San Juan Financial Holding Company. This stock issuance, combined with the changes in retained earnings as a result of operations and the effects of fair value accounting, net of quarterly dividend distributions, resulted in a \$163.4 million increase in stockholders' equity. The additional capital will be available to support our continued growth initiatives and the just-completed acquisition of NCW Community Bank.

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The following tables provide additional detail on our loans and deposits (dollars in thousands):

|   | <b>September 30<br/>2007</b> |                     | December 31<br>2006 |                     | September 30<br>2006 |                     |
|---|------------------------------|---------------------|---------------------|---------------------|----------------------|---------------------|
|   | Amount                       | Percent of<br>Total | Amount              | Percent of<br>Total | Amount               | Percent<br>of Total |
| <b>Loan Portfolio:</b>                                  |                              |                     |                     |                     |                      |                     |
| Loans (including loans held for sale):                  |                              |                     |                     |                     |                      |                     |
| Commercial real estate                                  | \$ 811,816                   | 22.4%               | \$ 596,488          | 20.1%               | \$ 584,832           | 20.2%               |
| Multifamily real estate                                 | 170,316                      | 4.7                 | 147,311             | 5.0                 | 146,094              | 5.0                 |
| Commercial construction                                 | 84,176                       | 2.3                 | 98,224              | 3.3                 | 94,231               | 3.2                 |
| Multifamily construction                                | 41,814                       | 1.2                 | 39,908              | 1.3                 | 49,986               | 1.7                 |
| One- to four-family construction                        | 624,280                      | 17.2                | 570,501             | 19.2                | 550,285              | 19.0                |
| Land and land development                               | 463,514                      | 12.8                | 402,665             | 13.6                | 371,626              | 12.8                |
| Commercial business                                     | 630,827                      | 17.4                | 467,745             | 15.8                | 469,293              | 16.2                |
| Agricultural business, including<br>secured by farmland | 178,158                      | 4.9                 | 163,518             | 5.5                 | 169,349              | 5.8                 |
| One-to four-family real estate                          | 424,122                      | 11.7                | 361,625             | 12.2                | 349,808              | 12.1                |
| Consumer  | 87,286                       | 2.4                 | 50,826              | 1.7                 | 67,073               | 2.3                 |
| Consumer secured by one-to<br>four-family               | 104,942                      | 2.9                 | 67,179              | 2.3                 | 49,662               | 1.7                 |
| Total consumer  | 192,228                      | 5.3                 | 118,005             | 4.0                 | 116,735              | 4.0                 |
| Total loans outstanding                                 | 3,621,251                    | 100.00%             | 2,965,990           | 100.00%             | 2,902,239            | 100.00%             |
| Less allowance for loan losses                          | (44,212)                     |                     | (35,535)            |                     | (35,160)             |                     |
| Total net loans outstanding at end of<br>period         | \$ 3,577,039                 |                     | \$ 2,930,455        |                     | \$ 2,876,079         |                     |

|                               | <b>September 30<br/>2007</b> |                     | December 31<br>2006 |                     | September 30<br>2006 |                     |
|-------------------------------|------------------------------|---------------------|---------------------|---------------------|----------------------|---------------------|
|                               | Amount                       | Percent<br>of Total | Amount              | Percent<br>of Total | Amount               | Percent<br>of Total |
| <b>Deposits:</b>              |                              |                     |                     |                     |                      |                     |
| Non-interest-bearing accounts | \$ 473,571                   | 13.2%               | \$ 332,372          | 11.9%               | \$ 327,093           | 11.9%               |
| Interest-bearing checking     | 438,974                      | 12.2                | 327,836             | 11.7                | 311,056              | 11.3                |
| Regular savings accounts      | 602,190                      | 16.7                | 364,957             | 13.1                | 306,822              | 11.2                |
| Money market accounts         | 258,068                      | 7.2                 | 212,953             | 7.6                 | 239,476              | 8.7                 |

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|                                       |              |         |              |         |              |         |
|---------------------------------------|--------------|---------|--------------|---------|--------------|---------|
| Total transaction and saving accounts | 1,772,803    | 49.3    | 1,238,118    | 44.3    | 1,184,447    | 43.1    |
| Certificates which mature or reprice: |              |         |              |         |              |         |
| Within 1 year                         | 1,597,311    | 44.4    | 1,351,922    | 48.4    | 1,319,068    | 48.1    |
| After 1 year, but within 3 years      | 178,191      | 5.0     | 152,306      | 5.5     | 181,785      | 6.6     |
| After 3 years                         | 49,594       | 1.3     | 52,246       | 1.8     | 59,051       | 2.2     |
| Total certificate accounts            | 1,825,096    | 50.7    | 1,556,474    | 55.7    | 1,559,904    | 56.9    |
| Total                                 | \$ 3,597,899 | 100.00% | \$ 2,794,592 | 100.00% | \$ 2,744,351 | 100.00% |

**Comparison of Results of Operations for the Quarters and Nine Months Ended September 30, 2007 and 2006**

**General.** For the quarter ended September 30, 2007, we had net income of \$10.0 million, or \$0.64 per share (diluted), compared to net income of \$8.0 million, or \$0.65 per share (diluted), for the quarter ended September 30, 2006. Further, our operating results for the quarter ended September 30, 2007 include a \$2.0 million net after-tax gain as a result of changes in the valuation of financial instruments carried at fair value pursuant to the early adoption of fair value accounting under SFAS No. 159. Excluding the net fair value adjustments in the current quarter, net income from recurring operations was \$8.0 million, or \$0.51 per share (diluted), for the quarter ended September 30, 2007, compared to \$8.0 million, or \$0.65 per share (diluted) for the quarter ended September 30, 2006. Net income from recurring operations reflects continued growth of loans and deposits, including growth from acquisitions, as well as changes in the mix of those assets and liabilities. Our operating results also included substantial increases in other operating expenses, particularly compensation, occupancy, information services, advertising and miscellaneous expenses, reflecting the recent acquisitions, growth in locations, operations and staff as we continue to expand. In addition to the 16 branches added on May 1, 2007 as a result of the acquisitions of F&M Bank and Islanders Bank, new or relocated offices that contributed to the higher level of operating expenses during the nine months as compared to the same period a year ago include: Boise (2) and Meridian, Idaho; Baker City, Beaverton, La Grande, Portland and Tualatin, Oregon; plus Bellingham (2) and Redmond, Washington. The current quarter's operating expense was also burdened with approximately \$700,000 of one-time costs associated with completing the conversion of the former F&M Bank branches onto the Banner Bank data processing platform.

Compared to levels a year ago, total assets increased 23% to \$4.300 billion at September 30, 2007, net loans increased 22% to \$3.577 billion, deposits grew 29% to \$3.598 billion, while borrowings, including junior subordinated debentures, decreased \$179 million, or 44%, to \$225 million. The average balance of interest-earning assets was \$3.940 billion for the quarter ended September 30, 2007, an increase of \$690 million, or 21%, compared to \$3.250 billion for the same quarter a year earlier.

**Net Interest Income.** Net interest income before provision for loan losses increased to \$40.7 million for the quarter ended September 30, 2007, compared to \$32.7 million for the prior year comparative quarter, primarily as a result of the growth in average interest-earning assets noted above and despite market pressures on the net interest margin as discussed below. The net interest margin of 4.10% in the current quarter improved 11 basis points from the prior year's comparative quarter, largely reflecting the effects of the two acquisitions but also reflecting other changes in the mix of assets and liabilities. By contrast, for the nine months ended September 30, 2007, the net interest margin declined 5 basis points from 4.11% to 4.06% from the prior year's comparative period, primarily as a result of the effect of higher deposit costs. Subsequent to the Federal Reserve's decision to stop increasing short-term interest rates after June 2006 and as a result of the lag effect on deposit pricing, increases in deposit costs generally exceeded increases in loan yields for the twelve months ended June 30, 2007. In the most recent quarter, following the Federal Reserve's decision to lower interest rates, loan yields have declined more significantly than deposit costs. Mitigating in part the adverse effects of these market forces on loan and deposit pricing, our average asset mix for the quarter and nine months ended September 30, 2007 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, our average funding liability base had proportionately more deposits, including more non-interest-bearing deposits, and proportionately fewer borrowings than in the prior year. Reflecting generally higher market interest rates as well as these mix changes, the yield on earning assets for the quarter and nine months ended September 30, 2007 increased by 6 basis points and 27 basis points, respectively, compared to the same periods a year earlier, while funding costs for the quarter and nine months ended September 30, 2007 fell by 4 basis points and increased by 36 basis points, respectively, over the same period. We believe the relatively stable nature of our net interest margin despite the volatility in market rates reflected in our asset yields and funding costs over these periods is a notable accomplishment.

**Interest Income.** Interest income for the quarter ended September 30, 2007 was \$79.2 million, compared to \$64.9 million for the same quarter a year earlier, an increase of \$14.3 million, or 22%. The increase in interest income occurred as a result of a \$690 million increase in the average balance of interest earning assets as well as a 6 basis point increase in the average yield on those assets. The yield on average interest-earning assets increased to 7.98% for the quarter ended September 30, 2007, compared to 7.92% for the same period a year earlier. The increase in the yield on earning assets was achieved despite modestly lower loan yields as a result of significant growth in loans coupled with a reduction in lower yielding securities balances. Average loans receivable for the quarter ended September 30, 2007 increased by \$727 million, or 25%, to \$3.627 billion, compared to \$2.900 billion for the quarter ended September 30, 2006. Interest income on loans for the quarter increased by \$14.7 million, or 24%, to \$75.7 million from \$60.9 million for the same period in the prior year, reflecting the impact of the increase in average loan balances offset by a 6 basis point decrease in the average yield on loans. The decrease in average loan yield reflects the lower average level of market interest rates during the current quarter, particularly in short-term interest rates including the prime rate and LIBOR indices which affect the yield on large portions of our construction, land development, commercial and agricultural loans following the Federal Reserve's recent actions designed to lower those rates. The decrease in average loan yields also reflects changes in the mix of the loan portfolio. The average yield on loans was 8.28% for the quarter ended September 30, 2007, compared to 8.34% for the same period in the prior year. While the recent level of market interest rates was lower than the same quarter a year earlier, loan yields did not change to the same degree as most fixed-rate loans and certain adjustable-rate loans did not adjust downward. In addition, yields were supported by changes in the loan mix, as growth has been most significant in some of the higher yielding adjustable-rate loan categories, particularly construction and land development loans. These factors were somewhat offset by changes in the average credit risk profile of new borrowers and competitive pricing pressure which resulted in lower spreads and yields on new loan originations.

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The combined average balance of mortgage-backed securities, investment securities, daily interest-bearing deposits and FHLB stock decreased by \$37 million for the quarter ended September 30, 2007, and, as a result, the interest and dividend income from those investments decreased by \$425,000 compared to the quarter ended September 30, 2006. The average yield on the securities portfolio and cash equivalents declined slightly to 4.48% for the quarter ended September 30, 2007, from 4.50% for the comparable quarter in 2006. While insignificant in amount, we received \$56,000 in dividend income on our FHLB of Seattle stock in the third quarter of 2007, as the FHLB of Seattle received approval to

resume paying its members cash dividends on a quarterly basis in the fourth quarter of 2006. The FHLB of Seattle ceased the payment of dividends beginning in the fourth quarter of 2004 through the third quarter of 2006 to improve its capital position.

Interest income for the nine months ended September 30, 2007 increased by \$42.2 million, or 24%, to \$219.1 million, from \$176.8 million for the comparable period in 2006. 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 \$43.4 million, or 26%, to \$208.5 million for the nine months ended September 30, 2007, from \$165.1 million for the comparable period in 2006. The increase in loan interest income reflects the impact of \$638 million of growth in the average balance of loans receivable in addition to an 18 basis point increase in the yield on the loan balances. Interest income from mortgage-backed and investment securities and FHLB stock for the nine months ended September 30, 2007 decreased \$1.1 million, to \$10.5 million during the nine months ended September 30, 2007, reflecting a \$34 million decrease in average balances, while yields remained nearly unchanged at 4.50% compared to 4.49% in the prior period.

**Interest Expense.** Interest expense for the quarter ended September 30, 2007 was \$38.5 million, compared to \$32.2 million for the comparable period in 2006, an increase of \$6.3 million, or 20%. The increase in interest expense was the result of the substantial growth in interest-bearing liabilities, slightly offset by a 4 basis point decrease in the average cost of all interest-bearing liabilities to 4.01% for the quarter ended September 30, 2007, from 4.05% for the comparable period in 2006. The decreased cost of interest-bearing liabilities in the current quarter primarily reflects the significant shift in the funding mix to proportionately more deposits and fewer borrowings. Deposit interest expense increased \$10.7 million, or 43%, to \$35.3 million for the quarter ended September 30, 2007 compared to \$24.7 million for the same quarter a year ago, largely as a result of the significant deposit growth during the past twelve months, as well as an increase in the cost of interest-bearing deposits. Reflecting the acquisitions, branch expansion and other growth initiatives, average deposit balances increased \$972 million, or 37%, to \$3.594 billion for the quarter ended September 30, 2007, from \$2.622 billion for the quarter ended September 30, 2006, while the average rate paid on deposit balances increased 17 basis points to 3.90%. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits 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 our 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 moved to increase short-term interest rates by 425 basis points from September 2004 to June 2006, including increases of 100 basis points from January 1, 2006 to September 30, 2006. Nonetheless, competitive pricing pressure for interest-bearing deposits has been quite intense in recent quarters, as many financial institutions until very recently experienced strong loan growth and related funding needs. However, in recent weeks following the Federal Reserve's decision to lower short-term interest rates, deposit market pricing has moderated and, as a result, we expect that the cost of deposits will decline over the near term.

Average FHLB advances decreased to \$32 million for the quarter ended September 30, 2007, compared to \$336 million during the quarter ended September 30, 2006, resulting in a \$4.1 million decrease in the related interest expense. The average rate paid on FHLB advances for the quarter ended September 30, 2007 decreased to 3.57%, a decrease of 162 basis points compared to the same quarter a year earlier, as the remaining advances carry fixed rates negotiated in a much lower rate environment. All of these advances are scheduled to mature within the next six months. Junior subordinated debentures which were issued in connection with trust preferred securities had an average balance of \$115 million and an average cost of 7.49% (including amortization of prepaid underwriting costs) for the quarter ended September 30, 2007. Junior subordinated debentures outstanding in the same quarter of the prior year had an average balance of \$98 million with a higher average rate of 8.40%. The junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months. The lower average cost of the junior subordinated debentures in the current quarter reflects a lower spread on the most recently issued debentures and the early redemption of a higher costing tranche of debentures, which was partially offset by the effect of increases in short-term market interest rates on earlier issues. Effective April 22, 2007, we exercised the early redemption provision with respect to approximately \$26 million of the junior subordinated debentures which had a spread of 3.70% to six-month LIBOR and an average cost of 9.09% during the six months preceding redemption. We replaced the redeemed debentures with a new \$26 million tranche of junior subordinated debentures issued on July 31, 2007 with an initial rate of 6.74% and a repricing spread of 1.38% to three-month LIBOR. 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 decreased \$29.8 million to \$74 million for the quarter ended September 30, 2007, from \$104 million for the same period in 2006, while the related interest expense decreased \$382,000, to \$730,000 from \$1.1 million for the respective periods. The average balance of customer retail repurchase agreements decreased slightly by \$4 million while the average balance of the wholesale borrowings from brokers decreased approximately \$26 million. The average rate paid on other borrowings was 3.91% in the quarter ended September 30, 2007, compared to 4.25% for the same quarter in 2006. 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 nine months ended September 30, 2007 shows an increase of \$25.1 million, or 30%, from the comparable period in 2006. The interest expense reflects a large increase in average deposits of \$769 million, partially offset by a \$213 million decrease in FHLB advances, junior subordinated debentures and other borrowings. The effect on interest expense of the \$555 million increase in average interest-bearing liabilities was also accompanied by a 36 basis point increase in the interest paid on the liabilities, reflecting higher market rates during the current period. 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 our operating performance (dollars in thousands):

| <b>Average Balances</b><br>(in thousands)                             | Quarters Ended<br>September 30 |                     | Nine Months Ended<br>September 30 |                     |
|---|--------------------------------|---------------------|-----------------------------------|---------------------|
|   | <b>2007</b>                    | 2006                | <b>2007</b>                       | <b>2006</b>         |
| Investment securities and cash equivalents                            | \$ 159,462                     | \$ 148,700          | \$ 142,596                        | \$ 138,885          |
| Mortgage-backed obligations   | 116,573                        | 165,577             | 133,652                           | 172,488             |
| FHLB stock  | 37,290                         | 35,844              | 36,655                            | 35,844              |
| <b>Total average interest-earning securities and cash equivalents</b> | <b>313,325</b>                 | <b>350,121</b>      | <b>312,903</b>                    | <b>347,217</b>      |
| Loans receivable  | 3,626,541                      | 2,899,848           | 3,343,901                         | 2,706,181           |
| <b>Total average interest-earning assets</b>                          | <b>3,939,866</b>               | <b>3,249,969</b>    | <b>3,656,804</b>                  | <b>3,053,398</b>    |
| Non-interest-earning assets   | 346,762                        | 192,822             | 277,587                           | 191,653             |
| <b>Total average assets</b>   | <b>\$ 4,286,628</b>            | <b>\$ 3,442,791</b> | <b>\$ 3,934,391</b>               | <b>\$ 3,245,051</b> |
| Deposits  | \$ 3,593,722                   | 2,622,215           | \$ 3,232,959                      | 2,464,352           |
| Advances from FHLB  | 32,462                         | 336,038             | 101,999                           | 323,648             |
| Other borrowings  | 74,064                         | 103,897             | 80,926                            | 88,822              |
| Junior subordinated debentures  | 115,311                        | 97,942              | 114,369                           | 97,942              |
| <b>Total average interest-bearing liabilities</b>                     | <b>3,815,559</b>               | <b>3,160,092</b>    | <b>3,530,253</b>                  | <b>2,974,764</b>    |
| Non-interest-bearing liabilities                                      | 62,054                         | 42,551              | 57,029                            | 36,455              |
| <b>Total average liabilities</b>                                      | <b>3,877,613</b>               | <b>3,202,643</b>    | <b>3,587,282</b>                  | <b>3,011,219</b>    |
| Equity  | 409,015                        | 240,148             | 347,109                           | 233,832             |
| <b>Total average liabilities and equity</b>                           | <b>\$ 4,286,628</b>            | <b>\$ 3,442,791</b> | <b>\$ 3,934,391</b>               | <b>\$ 3,245,051</b> |
| <b><u>Interest Rate Yield/Expense (rates are annualized)</u></b>      |                                |                     |                                   |                     |
| <b>Interest Rate Yield:</b>   |                                |                     |                                   |                     |
| Investment securities and cash equivalents                            | 5.33%                          | 5.46%               | 5.37%                             | 5.45%               |
| Mortgage-backed obligations   | 4.57%                          | 4.60%               | 4.65%                             | 4.66%               |
| FHLB stock  | 0.60%                          | 0.00%               | 0.54%                             | 0.00%               |
| <b>Total interest rate yield on securities and cash equivalents</b>   | <b>4.48%</b>                   | <b>4.50%</b>        | <b>4.50%</b>                      | <b>4.49%</b>        |
| Loans receivable  | 8.28%                          | 8.34%               | 8.34%                             | 8.16%               |
| <b>Total interest rate yield on interest-earning assets</b>           | <b>7.98%</b>                   | <b>7.92%</b>        | <b>8.01%</b>                      | <b>7.74%</b>        |

Interest Rate Expense:



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|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Deposits  | 3.90%        | 3.73%        | 3.94%        | 3.41%        |
| Advances from FHLB  | 3.57%        | 5.19%        | 4.89%        | 4.82%        |
| Other borrowings  | 3.91%        | 4.25%        | 4.04%        | 3.88%        |
| Junior subordinated debentures                              | 7.49%        | 8.40%        | 7.72%        | 8.02%        |
|   | <u>4.01%</u> | <u>4.05%</u> | <u>4.09%</u> | <u>3.73%</u> |
| Total interest rate expense on interest-bearing liabilities |              |              |              |              |
| Interest spread   | <u>3.97%</u> | <u>3.87%</u> | <u>3.92%</u> | <u>4.01%</u> |
|   |              |              |              |              |
| Net interest margin on interest earning assets              | <u>4.10%</u> | <u>3.99%</u> | <u>4.06%</u> | <u>4.11%</u> |

**Additional Key Financial Ratios (ratios are annualized)**

|   |         |         |         |         |
|---|---------|---------|---------|---------|
| Return on average assets  | 0.92%   | 0.92%   | 0.85%   | 1.00%   |
| Return on average equity  | 9.69%   | 13.23%  | 9.60%   | 13.81%  |
| Average equity / average assets   | 9.54%   | 6.98%   | 8.82%   | 7.21%   |
| Average interest-earning assets / interest-bearing liabilities  | 103.26% | 102.84% | 103.58% | 102.64% |
| Non-interest income/average assets  | 0.97%   | 0.63%   | 0.74%   | 0.62%   |
| Non-interest (other operating) expenses / average assets  | 3.23%   | 2.92%   | 3.13%   | 2.82%   |
| Efficiency ratio<br>[non-interest (other operating) expenses / revenues]  | 68.05%  | 66.50%  | 69.43%  | 63.04%  |
| Efficiency ratio<br>Excluding adjustment in the fair value of financial instruments<br>2007 and the 2006 insurance recovery | 72.38%  | 66.50%  | 70.69%  | 67.96%  |

**Provision and Allowance for Loan Losses.** During the quarter ended September 30, 2007, the provision for loan losses was \$1.5 million compared to \$1.0 million from the quarter ended September 30, 2006. 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 our Consolidated Financial Statements. The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves as more fully explained below.

The provision for loan losses in the quarter ended September 30, 2007 reflects an increase in delinquencies and non-performing loans, balanced against slower growth in the size of the loan portfolio, excluding the effects of the mergers, continuing changes in the loan mix and a modest level of net charge-offs. There were net charge-offs of \$536,000 for the quarter ended September 30, 2007, compared to \$542,000 of net recoveries for the same quarter a year earlier, and non-performing loans increased \$8.9 million to \$20 million at September 30, 2007, compared to \$11 million at September 30, 2006. Generally, these non-performing loans reflect unique operating difficulties for the individual borrower rather than weakness in the overall economy of the Pacific Northwest, although slower sales in certain housing markets are clearly a significant contributing factor and the greatest increase in delinquencies and non-performing loans was centered in construction and land development lending. A comparison of the allowance for loan losses at September 30, 2007 and 2006 shows an increase of \$8.7 million, including \$6 million added through the acquisitions, to \$44 million at September 30, 2007, from \$36 million at September 30, 2006. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) was 1.22% and 1.21% at September 30, 2007 and 2006, respectively. The allowance as a percentage of non-performing loans decreased to 222% at September 30, 2007, compared to 319% a year earlier.

In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the 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, we maintain an allowance for loan losses consistent in all material respects with the GAAP guidelines outlined in SFAS No. 5, *Accounting for Contingencies*. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and 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 our 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 carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by us at the time financial statements are prepared. Although we use the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond our control. The adequacy of general and specific reserves is based on our continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience and current economic conditions, as well as individual review of certain large balance loans. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment. Loans are considered impaired when, based on current information and events, we determine that it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported. As of September 30, 2007, we had identified \$19.8 million of impaired loans as defined by SFAS No. 114 and had established \$3.8 million of loss allowances related to these loans.

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

financial statements.

We believe that the allowance for loan losses as of September 30, 2007 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our

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financial condition and results of operations. In addition, the determination of the amount of the Banks' allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

The following tables provide additional detail on our allowance for loan losses (dollars in thousands):

| <b>Allowance for Loan Losses:</b>                    | Quarters Ended<br>September 30 |           | Nine Months Ended<br>September 30 |           |
|--|--------------------------------|-----------|-----------------------------------|-----------|
|  | <b>2007</b>                    | 2006      | <b>2007</b>                       | 2006      |
| Balance, beginning of the period                     | \$ 43,248                      | \$ 33,618 | \$ 35,535                         | \$ 30,898 |
| Allowance added through business combination         | -                              | -         | 5,957                             | -         |
| Provision for loan losses                            | 1,500                          | 1,000     | 3,900                             | 4,500     |
| Recoveries of loans previously charged off:          |                                |           |                                   |           |
| One- to four-family real estate                      | 1                              | 77        | 338                               | 77        |
| Commercial real estate                               | -                              | -         | -                                 | 75        |
| Multifamily real estate                              | -                              | -         | -                                 | -         |
| Construction and land                                | 62                             | 496       | 62                                | 507       |
| Commercial business                                  | 344                            | 619       | 584                               | 790       |
| Agricultural business, including secured by farmland | 8                              | 20        | 263                               | 62        |
| Consumer   | 54                             | 7         | 117                               | 33        |
|  | 469                            | 1,219     | 1,364                             | 1,544     |
| Loans charged off:                                   |                                |           |                                   |           |
| One- to four-family real estate                      | (30)                           | -         | (385)                             | (62)      |
| Commercial real estate                               | -                              | -         | -                                 | -         |
| Multifamily real estate                              | -                              | -         | -                                 | -         |
| Construction and land                                | (129)                          | -         | (129)                             | -         |
| Commercial business                                  | (120)                          | (422)     | (869)                             | (1,125)   |
| Agricultural business, including secured by farmland | (458)                          | (191)     | (650)                             | (404)     |
| Consumer   | (268)                          | (64)      | (511)                             | (191)     |
|  | (1,005)                        | (677)     | (2,544)                           | (1,782)   |
| Net (charge-offs) recoveries                         | (536)                          | 542       | (1,180)                           | (238)     |
| Balance, end of the period                           | \$ 44,212                      | \$ 35,160 | \$ 44,212                         | \$ 35,160 |

Net charge-offs (recoveries) as a percentage of average net book value of loans outstanding for the period

|       |         |       |       |
|-------|---------|-------|-------|
| 0.01% | (0.02)% | 0.04% | 0.01% |
|-------|---------|-------|-------|

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

|                              |                     |                      |
|------------------------------|---------------------|----------------------|
| <b>September 30<br/>2007</b> | December 31<br>2006 | September 30<br>2006 |
|------------------------------|---------------------|----------------------|

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|   |                  |                  |                  |
|---|------------------|------------------|------------------|
| Specific or allocated loss allowances:  |                  |                  |                  |
| One- to four-family real estate   | \$ 1,164         | \$ 1,420         | \$ 866           |
| Commercial real estate  | 5,393            | 5,129            | 5,655            |
| Multifamily real estate   | 1,504            | 886              | 866              |
| Construction and land   | 16,527           | 11,717           | 11,231           |
| Commercial business   | 14,424           | 10,513           | 10,665           |
| Agricultural business, including secured by farmland  | 2,575            | 2,417            | 2,959            |
| Consumer  | 1,572            | 903              | 838              |
| <b>Total allocated</b>  | <b>43,159</b>    | <b>32,895</b>    | <b>33,080</b>    |
| Estimated allowance for undisbursed commitments   | 407              | 513              | 458              |
| Unallocated   | 646              | 2,037            | 1,622            |
| <b>Total allowance for loan losses</b>  | <b>\$ 44,212</b> | <b>\$ 35,535</b> | <b>\$ 35,160</b> |
| Allowance for loan losses as a percentage of total loans outstanding (loans receivable excluding allowance for loan losses) | 1.22%            | 1.20%            | 1.21%            |
| Ratio of allowance for loan losses to non-performing loans  | 222%             | 253%             | 319%             |

**Other Operating Income.** Other operating income was \$10.5 million for the quarter ended September 30, 2007, compared to \$5.4 million for the quarter ended September 30, 2006. Excluding fair value adjustments recorded pursuant to the adoption of SFAS No. 159 and the gain on the sale of securities, recurring other operating income increased 39% to \$7.5 million compared to \$5.4 million in the third quarter last year, largely as a result of increased deposit fees and service charges. Deposit fees and other service charge income increased by \$1.7 million, or 56%, to \$4.8 million for the quarter ended September 30, 2007, compared to \$3.0 million for the quarter ended September 30, 2006, largely influenced by the increase in deposit balances from bank acquisitions, yet also reflecting internally generated growth in customer transaction accounts and increased merchant credit card services. Changes in certain pricing schedules also contributed to the increased fee income. Loan servicing fees increased to \$457,000 for the current quarter, compared to \$315,000 for the quarter ended September 30, 2006. Although loan sales declined, gain on sale of loans increased by \$38,000 to \$1.8 million for the quarter ended September 30, 2007, compared to \$1.7 million for the same quarter a year earlier as the average gain per sale improved from an abnormally low level in the year-ago quarter. Loan sales for the quarter ended September 30, 2007 totaled \$114.0 million, compared to \$167.4 million for the quarter ended September 30, 2006. Gain on sale of loans in the current quarter included \$286,000 of fees on \$30.9 million of loans which were brokered and are not reflected in the volume of loans sold. By comparison, in the quarter ended September 30, 2006, gain on sale of loans included \$213,000 of fees on \$29.1 million of brokered loans. As noted above, other income also includes a net gain of \$3.1 million for the change in valuation of financial instruments now carried at fair value pursuant to the early adoption of fair value accounting under SFAS No. 159.

Other operating income for the nine months ended September 30, 2007 increased \$6.9 million to \$21.9 million, from \$14.9 million for the comparable period in 2006. Similar to the quarter's results, this includes a \$3.4 million increase in deposit fee and service charge income along with a \$595,000 increase in the gain on sale of loans. Loan servicing fees increased by a modest \$166,000 compared to the first nine months of 2006. Loan sales decreased from \$347.6 million for the nine months ended September 30, 2006 to \$313.0 million for the nine months ended September 30, 2007. The cumulative effect of the net changes in the valuation of financial instruments carried at fair value under SFAS No. 159 was a net gain of \$2.4 million for the nine months ended September 30, 2007. Excluding the fair value adjustments, recurring other operating income increased by 31% for the first nine months of 2007 compared to the same period in 2006.

**Other Operating Expenses.** Other operating expenses increased \$9.5 million, or 38%, to \$34.8 million for the quarter ended September 30, 2007, from \$25.3 million for the quarter ended September 30, 2006, largely reflecting the growth resulting from our branch expansion strategy and the two acquisitions. Other operating expense from recurring operations increased by 38% from \$25.3 million for the quarter ended September 30, 2006, to \$34.8 million for the current quarter. Besides the acquisitions, the increase in expenses includes operating costs associated with the opening of ten new branch offices in Boise (2) and Meridian, Idaho, Baker City, Beaverton, La Grande, Portland and Tualatin, Oregon, and Bellingham (2), Washington and the relocation and upgrading of our branch offices in College Place, Redmond and Selah, Washington. Primarily reflecting the additional branches and bank acquisitions, salary and employee benefits expense increased by \$3.7 million, or 22%, and occupancy costs increased by \$1.6 million, or 40%, compared to the same period a year earlier. In addition, compensation was higher as a result of general wage and salary increases, as well as increased per employee costs associated with benefit programs and employer-paid taxes. Further, direct expenses associated with merchant credit card services increased as a result of growth in this fee generating activity. We also continued our strong commitment to advertising and marketing expenditures, which were \$2.4 million in the quarter ended September 30, 2007, compared to \$1.8 million for the same period in the prior year. The current quarter's operating expenses were also burdened with \$787,000 for amortization of the core deposit intangibles recorded in connection with the acquisitions of F&M Bank and San Juan Financial Holding Company and approximately \$700,000 of one-time costs associated with completing the conversion of the former F&M Bank branches onto the Banner Bank data processing platform. Other operating expenses from recurring operations (including the conversion costs) as a percentage of average assets increased to 3.23% for the quarter ended September 30, 2007, from 2.92% for the quarter one year earlier, reflecting the impact of the acquisitions, integration and conversion costs and continuing startup costs associated with branch growth. Our efficiency ratio increased to 68.05% (72.38% excluding fair value adjustments) for the quarter ended September 30, 2007 from 66.50% for the comparable period in 2006. We expect continued increases in the absolute level of operating expenses as a result of our expansion plans; however, the pace of increase should slow as we reduce the number of new branch openings beginning in 2008. Further, we believe that this investment in our branch network will lead to a lower relative cost of funds and enhanced revenues over time which, combined with expected cost savings from the acquisitions, should result in an improved efficiency ratio and stronger operating results.

Other operating expenses for the nine months ended September 30, 2007 increased \$23.7 million, or 35%, from \$68.5 million for the first nine months of 2006, to \$92.2 million in the current period. Excluding the \$5.4 million insurance recovery, other operating expenses in the prior year would have been \$73.9 million. As explained above, the increase is primarily a result of the recent bank acquisitions and branch expansion evidenced by the increase in compensation, occupancy and miscellaneous expenses as locations, staffing and the volume of activity have expanded. Also contributing to those expenses was a decrease in capitalized loan origination costs reflecting decreased origination volumes.

**Income Taxes.** Income tax expense was \$4.9 million for the quarter ended September 30, 2007, compared to \$3.8 million for the comparable period in 2006. Our effective tax rates for the quarters ended September 30, 2007 and 2006 were 32.8% and 31.9%, respectively. The effective tax rates in both periods reflect the recording of tax credits related to certain Community Reinvestment Act (CRA) investments as well as certain tax exempt income. The slightly higher effective tax rate in the current period was primarily a result of a decrease in the relative combined effect of the tax credits from CRA investments, tax-exempt income from interest on municipal securities and earnings on bank-owned life insurance, compared to other taxable net revenue.

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Income tax expense for the nine months ended September 30, 2007 increased to \$11.8 million, compared to \$11.5 million in the comparable period in 2006. The Company's effective tax rates for the nine months ended September 30, 2007 and 2006 were 32.1% and 32.3%, respectively. The slightly higher effective tax rate in 2006 primarily reflects the impact of the fully taxable non-recurring insurance recovery recorded in that period and the lower effect of tax-exempt income for the 2006 year-to-date period.

## Asset Quality

*Classified Assets:* State and federal regulations require us to review and classify our problem assets on a regular basis. In addition, in connection with examinations of insured institutions, state and federal examiners have authority to identify problem assets and, if appropriate, require them to be classified. Banner Bank's Credit Policy Division reviews detailed information with respect to the composition and performance of the loan portfolio, including information on risk concentrations, delinquencies and classified assets. The Credit Policy Division approves all recommendations for new classified assets or changes in classifications, and develops and monitors action plans to resolve the problems associated with the assets. The Credit Policy Division also approves recommendations for establishing the appropriate level of the allowance for loan losses. Significant problem loans are transferred to Banner Bank's Special Assets Department for resolution or collection activities. Banner Bank's Board of Directors is given a detailed report on classified assets and asset quality at least quarterly. Islanders Bank employs similar monitoring procedures scaled to its lesser portfolio size and organizational structure.

*Allowance for Loan Losses:* In originating loans, we recognize that we will have losses 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 security for the loan. As a result, we maintain an allowance for loan losses consistent with GAAP guidelines. We increase our allowance for loan losses by charging provisions for probable loan losses against our income. The allowance for losses on loans is maintained at a level which, in our judgment, is sufficient to provide for estimated losses based on evaluating known and inherent risks in the loan portfolio and upon continuing analysis of the factors underlying the quality of the loan portfolio. At September 30, 2007, we had an allowance for loan losses of \$44.2 million, which represented 1.22% of total loans and 222% of non-performing loans, compared to 1.21% and 319%, respectively, at September 30, 2006.

*Non-Performing Assets:* Non-performing assets increased to \$23 million, or 0.54% of total assets, at September 30, 2007, compared to \$12 million, or 0.36% of total assets, at September 30, 2006. Generally, asset quality remained satisfactory and non-performing loans and assets reflect unique operating difficulties for the individual borrower rather than weakness in the overall economy of the Pacific Northwest, although slowing sales in certain housing markets clearly was a significant factor contributing to the increase in non performing loans as well as increased delinquencies. We have not engaged in any sub-prime lending programs and have not been significantly affected by the asset quality issues emanating directly from that market segment. However, we share others' heightened concerns relative to home values, housing markets and construction lending as a result of the problems associated with sub-prime and other mortgage lending programs, and are currently exercising extra monitoring vigilance with respect to our asset quality. At September 30, 2007, our largest non-performing loan exposure was for a land development loan totaling \$5.8 million secured by a project in Salem, Oregon. The second largest non-performing loan exposure was for commercial loans totaling \$2.4 million to a non-farm operating business which are primarily secured by ranch land in western Idaho and processing equipment and which were repaid in full subsequent to quarter end. The third largest non-performing loan exposure was for five loans totaling 2.4 million to a new home builder operating in the Portland, Oregon market which are secured by four houses and one developed lot. At September 30, 2007, we had \$3.1 million of real estate owned and other repossessed assets which primarily consisted of a \$2.0 million commercial real estate property in northwestern Washington and a parcel of undeveloped land in Federal Way, Washington with a book value of \$918,000. We were awarded the undeveloped land in 2006 as a result of litigation relative to certain previously charged off loans. While this award resulted in an increase in real estate owned, since the loans had been fully charged off in prior periods, it also was recognized as a recovery in the quarter ended September 30, 2006. Management is optimistic about the prospects for a near-term disposal of these properties. Most of our asset quality indicators have remained relatively sound, reflecting improved asset selection and credit monitoring practices, as well as the relatively strong performance of the Pacific Northwest economy. Despite the significant increase in non-performing loans and delinquencies in the most recent quarter, we are confident in the quality of our loan portfolio and are proactively managing our credit exposures.



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The following table sets forth information with respect to our non-performing assets and restructured loans within the meaning of SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring*, at the dates indicated (dollars in thousands):

|  | <u>September 30<br/>2007</u> | <u>December 31<br/>2006</u> | <u>September 30<br/>2006</u> |
|--|------------------------------|-----------------------------|------------------------------|
| <b>Non-performing assets at end of the period:</b>   |                              |                             |                              |
| <b>Nonaccrual Loans:</b>   |                              |                             |                              |
| <b>Secured by real estate:</b>   |                              |                             |                              |
| One- to four-family  | \$ 1,070                     | \$ 1,198                    | \$ 830                       |
| Commercial   | 544                          | 4,215                       | 2,111                        |
| Multifamily  | 1,250                        | 792                         | -                            |
| Construction and land  | 10,699                       | 2,056                       | 1,164                        |
| Commercial business  | 5,713                        | 4,498                       | 4,736                        |
| Agricultural business, including secured by farmland   | 512                          | 703                         | 1,310                        |
| Consumer   | -                            | 1                           | 2                            |
|  | <u>19,788</u>                | <u>13,463</u>               | <u>10,153</u>                |
| <b>Loans more than 90 days delinquent, still on accrual:</b>   |                              |                             |                              |
| <b>Secured by real estate:</b>   |                              |                             |                              |
| One- to four-family  | 54                           | 593                         | 234                          |
| Commercial   | -                            | -                           | 383                          |
| Multifamily  | -                            | -                           | -                            |
| Construction and land  | -                            | -                           | 23                           |
| Commercial business  | -                            | -                           | 213                          |
| Agricultural business, including secured by farmland   | -                            | -                           | -                            |
| Consumer   | 98                           | -                           | -                            |
|  | <u>132</u>                   | <u>593</u>                  | <u>853</u>                   |
| Total non-performing loans   | 19,920                       | 14,056                      | 11,006                       |
| Real estate owned, held for sale, and other repossessed assets, net  | 3,294                        | 918                         | 1,352                        |
|  | <u>23,214</u>                | <u>14,974</u>               | <u>12,358</u>                |
| Total non-performing assets at the end of the period   | \$ 23,214                    | \$ 14,974                   | \$ 12,358                    |
| <b>Non-performing loans as a percentage of total net loans before allowance for loan losses at end of the period</b> |                              |                             |                              |
|  | 0.55%                        | 0.47%                       | 0.38%                        |
| <b>Non-performing assets as a percentage of total assets at end of the period</b>                                    |                              |                             |                              |
|  | 0.54%                        | 0.43%                       | 0.36%                        |
| <b>Troubled debt restructuring at end of the period</b>  |                              |                             |                              |
|  | \$ -                         | \$ -                        | \$ -                         |

### Liquidity and Capital Resources

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

Our primary investing activity is the origination and purchase of loans. During the nine months ended September 30, 2007, we had loan originations, net of principal repayments and excluding acquisitions, of \$452 million and purchased loans in the amount of \$2.4 million. This activity was funded primarily by sales of loans and deposit growth. During the nine months ended September 30, 2007, we sold \$313 million of

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loans and generated net deposit growth of \$803 million, \$330 million excluding acquisitions, while FHLB advances decreased \$153 million and other borrowings decreased \$26 million.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to accommodate deposit withdrawals, to support loan growth, to satisfy financial commitments and to take advantage of investment opportunities. During the nine months ended September 30, 2007, we used our sources of funds primarily to fund loan commitments, repay FHLB advances and other borrowings, and pay maturing savings certificates and deposit withdrawals. At September 30, 2007, we had outstanding loan commitments totaling \$1.150 billion, including undisbursed loans in process totaling \$1.109 billion. We generally maintain sufficient cash, marketable securities and readily available borrowing lines to meet short-term liquidity needs. We maintain a credit facility with the FHLB of Seattle, which provides for advances which, in aggregate, may equal the lesser of 35% of Banner Bank's assets or unencumbered qualifying collateral, which at September 30, 2007 would allow up to a total possible credit line of \$672 million. As a result of changes in our asset mix, advances from the FHLB are more likely to be limited by available qualifying collateral than by the 35% of assets calculation. Advances under this credit facility totaled \$25 million, or 1% of our assets, at September 30, 2007. Islanders Bank has a similar credit facility with the FHLB of Seattle, which provides for advances which at September 30, 2007 would allow up to a total credit line of \$22.6, none of which was outstanding at that date. We also have in place borrowing lines with certain correspondent banks which in aggregate total \$95 million, none of which was drawn upon as of September 30, 2007.

At September 30, 2007, certificates of deposit amounted to \$1.825 billion, or 51% of our total deposits, including \$1.597 billion which were scheduled to mature within one year. While no assurance can be given as to future periods, historically we have been able to retain a significant

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amount of customer deposits as they mature. We believe we have adequate resources to fund all loan commitments from customer deposits, FHLB advances, other borrowings, principal and interest payments and sale of mortgage loans, and that we can adjust the offering rates for savings certificates to retain deposits in changing interest rate environments.

### Financial Instruments with Off-Balance-Sheet Risk

We enter into financial instruments with off-balance-sheet risk generated in the normal course of business to meet the financing needs of our customers. These financial instruments primarily include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Statements of Financial Condition.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument from commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. We use the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. As of September 30, 2007, outstanding commitments consist of the following (in thousands):

|   | <u>Contract or<br/>Notional<br/>Amount</u> |
|---|--|
| Financial instruments whose contract amounts represent credit risk:             |  |
| Commitments to extend credit  |  |
| Real estate secured for commercial, construction or land development            | \$ 456,060                                 |
| Revolving open-end lines secured by one- to four-family residential properties  | 93,309                                     |
| Credit card lines   | 45,256                                     |
| Other, primarily business and agricultural loans                                | 520,778                                    |
| Real estate secured by one- to four-family residential properties               | 22,561                                     |
| Standby letters of credit and financial guarantees                              | <u>12,416</u>                              |
| <br>  |  |
| Total   | <br><u>\$ 1,150,380</u>                    |
| <br>  |  |
| Commitments to sell loans secured by one- to four-family residential properties | <br><u>\$ 22,561</u>                       |

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Many of the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. The type of collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income producing commercial properties.

Standby letters of credit are conditional commitments issued to guarantee a customer's performance or payment to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Interest rates on residential one- to four-family mortgage loan applications are typically rate locked (committed) to customers during the application stage for periods ranging from 15 to 45 days, the most typical period being 30 days. Typically, pricing for the sale of these loans is locked with various qualified investors under a best-efforts delivery program at or near the time the interest rate is locked with the customer. We make every effort to deliver these loans before their rate locks expire. This arrangement generally requires us to deliver the loans prior to the expiration of the rate lock. Delays in funding the loans can require a lock extension. The cost of a lock extension at times is borne by the customer and at times by us. The lock extension costs we pay are managed daily and are not expected to have a material impact to operations. Changes in the value of rate lock commitments are recorded as other assets and liabilities. See "Derivative Instruments" under 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, 2006 filed with the SEC.

**Capital Requirements**

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

The capital adequacy requirements are quantitative measures established by regulation that require Banner Corporation and the Banks to maintain minimum amounts and ratios of capital. The Federal Reserve requires Banner Corporation to maintain capital adequacy that generally parallels the FDIC requirements. The FDIC requires the Banks to maintain minimum ratios of Tier 1 total capital to risk-weighted assets as well as Tier 1 leverage capital to average assets. At September 30, 2007, Banner Corporation, Banner Bank and Islanders Bank exceeded all current regulatory capital requirements. However, events beyond our control, such as weak or depressed economic conditions in areas where we have most of our loans, could adversely affect future earnings and, consequently, our ability to meet our capital requirements. Further, rapid growth in our assets and liabilities could exceed growth in our retained earnings and necessitate other actions designed to augment our capital base. As a result, we regularly explore alternative financing arrangements that could provide additional regulatory capital to support future growth. See Item 1, "Business-

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Regulation," and Note 18 of the Notes to the Consolidated Financial Statements included in Banner Corporation's Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC for additional information regarding our regulatory capital requirements.

The actual regulatory capital ratios calculated for Banner Corporation, Banner Bank and Islanders Bank as of September 30, 2007, along with the minimum capital amounts and ratios, were as follows (dollars in thousands):

|   | Actual     |        | Minimum for capital adequacy purposes |       | Minimum to be categorized as "well-capitalized" under prompt corrective action provisions |        |
|---|------------|--------|---------------------------------------|-------|---|--------|
|   | Amount     | Ratio  | Amount                                | Ratio | Amount  | Ratio  |
| <b>September 30, 2007:</b>                |            |        |                                       |       |   |        |
| <b>Banner Corporation-consolidated</b>    |            |        |                                       |       |   |        |
| Total capital to risk-weighted assets     | \$ 452,667 | 11.97% | \$ 302,554                            | 8.00% | N/A   | N/A    |
| Tier 1 capital to risk-weighted assets    | 408,905    | 10.81  | 151,277                               | 4.00  | N/A   | N/A    |
| Tier 1 leverage capital to average assets | 408,905    | 9.82   | 166,538                               | 4.00  | N/A   | N/A    |
| <b>Banner Bank</b>                        |            |        |                                       |       |   |        |
| Total capital to risk-weighted assets     | 392,153    | 10.81  | 290,325                               | 8.00  | \$ 362,906  | 10.00% |
| Tier 1 capital to risk-weighted assets    | 349,383    | 9.63   | 145,162                               | 4.00  | 217,744   | 6.00   |
| Tier 1 leverage capital to average assets | 349,383    | 8.73   | 160,158                               | 4.00  | 200,197   | 5.00   |
| <b>Islanders Bank</b>                     |            |        |                                       |       |   |        |
| Total capital to risk-weighted assets     | 20,047     | 16.57  | 9,679                                 | 8.00  | \$ 12,099   | 10.00% |
| Tier 1 capital to risk-weighted assets    | 18,605     | 15.38  | 4,840                                 | 4.00  | 7,259   | 6.00   |
| Tier 1 leverage capital to average assets | 18,605     | 12.08  | 6,161                                 | 4.00  | 7,701   | 5.00   |

### ITEM 3 - Quantitative and Qualitative Disclosures About Market Risk

#### Market Risk and Asset/Liability Management

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

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

The greatest source of interest rate risk to us results from the mismatch of maturities or repricing intervals for rate sensitive assets, liabilities and off-balance-sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets, although the significant amount of variable-rate loans in our portfolio tends to mitigate this maturity mismatch. Additional interest rate risk results from mismatched repricing indices and formulae (basis risk and yield curve risk), and product caps and floors and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to us. An exception to this generalization in past periods has been the beneficial effect of interest rate floors on many of our floating rate loans, which helped maintain higher loan yields despite declining levels of market interest rates. An additional exception to the generalization has been the beneficial effect of lagging and somewhat inelastic pricing adjustments for interest rates on certain deposit products in rising market interest rate environments. This beneficial effect was particularly relevant to the administered rates paid on certain checking, savings and money market accounts and contributed to our expanded net interest margin during 2005 and 2006. However, for recent quarters this lag effect has had a negative impact on our net interest margin as deposit costs have continued to increase while loan yields have generally stabilized following the Federal Reserve's decision to stop increasing short-term interest rates in June 2006. Moreover, this lag effect may have a near-term detrimental impact on our net interest margin following the Federal Reserve's more recent decisions to reduce short-term interest rates.

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

#### Sensitivity Analysis

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

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

The table of *Interest Rate Risk Indicators* sets forth, as of September 30, 2007, the estimated changes in our net interest income over a one-year time horizon and the estimated changes in market value of equity based on the indicated interest rate environments.



## Interest Rate Risk Indicators

| Change (in Basis Points) in<br>Interest Rates (1) | Estimated Change in                   |       |                  |         |
|---|---------------------------------------|-------|------------------|---------|
|   | Net Interest Income<br>Next 12 Months |       | Net Market Value |         |
|   | (dollars in thousands)                |       |                  |         |
| +300  | \$ 9,001                              | 5.5%  | \$ (50,204)      | (10.6)% |
| +200  | 6,295                                 | 3.8   | (29,334)         | (6.2)   |
| +100  | 3,330                                 | 2.0   | (9,941)          | (2.1)   |
| 0   | 0                                     | 0     | 0                | 0       |
| -100  | (2,966)                               | (1.8) | 3,872            | 0.8     |
| -200  | (5,889)                               | (3.6) | (21,196)         | (4.5)   |
| -300  | (6,584)                               | (4.0) | (52,206)         | (11.1)  |

(1) Assumes an instantaneous and sustained uniform change in market interest rates at all maturities.

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

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

The table of *Interest Sensitivity Gap* presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at September 30, 2007. The table sets forth the amounts of interest-earning assets and interest-bearing liabilities which are anticipated by us, based upon certain assumptions, to reprice or mature in each of the future periods shown. At September 30, 2007, total interest-bearing liabilities maturing or repricing within one year were greater than total interest-earning assets maturing or repricing in the same time period by \$16.4 million, representing a one-year cumulative gap to total assets ratio of (0.38%).



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**Interest Sensitivity Gap as of September 30, 2007**

|  | Within<br>6 Months | After 6<br>Months<br>Within 1 Year | After 1 Year<br>Within 3<br>Years | After 3<br>Years<br>Within 5<br>Years | After 5<br>Years<br>Within 10<br>Years | Over<br>10 Years | Total            |
|--|--------------------|------------------------------------|-----------------------------------|---------------------------------------|--|------------------|------------------|
| (dollars in thousands)   |                    |                                    |                                   |                                       |  |                  |                  |
| Interest-earning assets: (1)   |                    |                                    |                                   |                                       |  |                  |                  |
| Construction loans   | \$ 786,458         | \$ 14,452                          | \$ 32,281                         | \$ 3,171                              | \$ 240                                 | \$ -             | \$ 836,602       |
| Fixed-rate mortgage loans  | 85,806             | 80,119                             | 175,737                           | 102,660                               | 122,862                                | 44,944           | 612,128          |
| Adjustable-rate mortgage loans   | 449,905            | 162,335                            | 454,494                           | 164,573                               | 5,347                                  | 97               | 1,236,751        |
| Fixed-rate mortgage-backed securities  | 5,602              | 5,245                              | 17,814                            | 13,606                                | 23,560                                 | 10,050           | 75,877           |
| Adjustable-rate mortgage-backed securities   | 1,621              | 1,532                              | 5,323                             | 5,593                                 | 12,850                                 | -                | 26,919           |
| Fixed-rate commercial/agricultural loans   | 45,029             | 38,784                             | 92,798                            | 32,116                                | 17,125                                 | 89               | 225,941          |
| Adjustable-rate commercial/agricultural loans  | 467,143            | 12,793                             | 32,775                            | 26,178                                | 2,125                                  | 18               | 541,032          |
| Consumer and other loans   | 79,272             | 11,842                             | 28,436                            | 38,975                                | 15,684                                 | 1,015            | 175,224          |
| Investment securities and interest-earning deposits                                  | 102,302            | 125                                | 17,711                            | 8,041                                 | 15,194                                 | 58,660           | 202,033          |
| <b>Total rate sensitive assets</b>   | <b>2,023,138</b>   | <b>327,227</b>                     | <b>857,369</b>                    | <b>394,913</b>                        | <b>214,987</b>                         | <b>114,873</b>   | <b>3,932,507</b> |
| Interest-bearing liabilities: (2)  |                    |                                    |                                   |                                       |  |                  |                  |
| Regular savings and NOW accounts   | 246,934            | 140,158                            | 327,036                           | 327,036                               | -                                      | -                | 1,041,164        |
| Money market deposit accounts  | 129,034            | 77,420                             | 51,614                            | -                                     | -                                      | -                | 258,068          |
| Certificates of deposit  | 869,975            | 728,282                            | 178,379                           | 39,415                                | 9,039                                  | 6                | 1,825,096        |
| FHLB advances  | 24,739             | -                                  | -                                 | -                                     | -                                      | -                | 24,739           |
| Other borrowings   | -                  | -                                  | -                                 | -                                     | -                                      | -                | -                |
| Junior subordinated debentures   | 72,168             | -                                  | -                                 | 25,774                                | 25,774                                 | -                | 123,716          |
| Retail repurchase agreements   | 78,083             | -                                  | -                                 | 428                                   | -                                      | -                | 78,511           |
| <b>Total rate sensitive liabilities</b>  | <b>1,420,933</b>   | <b>945,860</b>                     | <b>557,029</b>                    | <b>392,653</b>                        | <b>34,813</b>                          | <b>6</b>         | <b>3,351,294</b> |
| Excess (deficiency) of interest-sensitive assets over interest-sensitive liabilities | \$ 602,205         | \$ (618,633)                       | \$ 300,340                        | \$ 2,260                              | \$ 180,174                             | \$ 114,867       | \$ 581,213       |
| Cumulative excess (deficiency) of interest-sensitive assets                          | \$ 602,205         | \$ (16,428)                        | \$ 283,912                        | \$ 286,172                            | \$ 466,346                             | \$ 581,213       | \$ 581,213       |
| Cumulative ratio of interest-earning assets to interest-bearing liabilities          | 142.38%            | 99.31%                             | 109.71%                           | 108.63%                               | 113.92%                                | 117.34%          | 117.34%          |
| Interest sensitivity gap to total assets   | 14.00%             | (14.39)%                           | 6.98%                             | 0.05%                                 | 4.19%                                  | 2.67%            | 13.52%           |
| Ratio of cumulative gap to total assets  | 14.00%             | (0.38)%                            | 6.60%                             | 6.65%                                 | 10.84%                                 | 13.52%           | 13.52%           |



(footnotes on following page)

Footnotes for Table of Interest Sensitivity Gap

(1) Adjustable-rate assets are included in the period in which interest rates are next scheduled to adjust rather than in the period in which they are due to mature, and fixed-rate assets are included in the periods in which they are scheduled to be repaid based upon scheduled amortization, in each case adjusted to take into account estimated prepayments. Mortgage loans and other loans are not reduced for allowances for loan losses and non-performing loans. Mortgage loans, mortgage-backed securities, other loans and investment securities are not adjusted for deferred fees and unamortized acquisition premiums and discounts.

(2) Adjustable- and variable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, NOW and money market deposit accounts are subject to immediate withdrawal, management considers a substantial amount of such accounts to be core deposits having significantly longer maturities. For the purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of these accounts had been assumed to be short-term, the one year cumulative gap of interest-sensitive assets would have been negative \$722.1 million, or (16.79%) of total assets. Interest-bearing liabilities for this table exclude certain non-interest-bearing deposits which are included in the average balance calculations in the table contained in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Comparison of Results of Operations for the Quarters and Nine Months Ended September 30, 2007 and 2006" of this report on Form 10-Q.

**ITEM 4 - Controls and Procedures**

The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (Exchange Act). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

(a) *Evaluation of Disclosure Controls and Procedures:* An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2007, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) *Changes in Internal Controls:* In the quarter ended September 30, 2007, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II - OTHER INFORMATION****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There have been no material changes in the risk factors previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 0-26584).

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the quarter ended September 30, 2007, we did not sell any securities that were not registered under the Securities Act of 1933.

The table below represents our purchases of equity securities during the quarter covered by this report.

| Period            |                    | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Number of Shares that May yet be Purchased Under the Plan (1) |
|-------------------|--------------------|----------------------------------|------------------------------|---|---|
| Beginning         | Ending             |                                  |                              |   |   |
| July 1, 2007      | July 31, 2007      | -                                | \$ -                         | -   | 100,000   |
| August 1, 2007    | August 31, 2007    | -                                | \$ -                         | -   | 100,000   |
| September 1, 2007 | September 30, 2007 | -                                | \$ -                         | -   | 100,000   |
| Total             |                    | -                                | \$ -                         | -   | -   |

(1) No shares were purchased during the period.

(2) On July 26, 2007, the Board of Directors authorized the repurchase of up to 750,000 shares of our outstanding common stock over the next twelve months. As of September 30, 2007, no shares had been purchased under this program or the prior program which expired July 25, 2007.

**Item 3. Defaults upon Senior Securities**

Not Applicable.

**Item 4. Submission of Matters to a Vote of Stockholders**

None.

**Item 5. Other Information**

Not Applicable.



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### Item 6. Exhibits

#### Exhibits

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- 3{a} Articles of Incorporation of Registrant [incorporated by reference to Exhibit B to the Proxy Statement for the Annual Meeting of Stockholders dated June 10, 1998].
- 3{b} Bylaws of Registrant [incorporated by reference to Exhibit 3.2 filed with the Current Report on Form 8-K dated July 24, 1998 (File No. 0-26584)].
- 10{a} Employment Agreement with Gary L. Sirmon, dated as of January 1, 2004 [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 10{b} Executive Salary Continuation Agreement with Gary L. Sirmon [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{c} Employment Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{d} Executive Salary Continuation Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{e} 1996 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].
- 10{f} 1996 Management Recognition and Development Plan [incorporated by reference to Exhibit 99.2 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].
- 10{g} Consultant Agreement with Jesse G. Foster, dated as of December 19, 2003. [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-23584)].
- 10{h} Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1997 (File No. 0-26584)].
- 10{i} Towne Bank of Woodinville 1992 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated April 2, 1998 (File No. 333-49193)].
- 10{j} Whatcom State Bank 1991 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (File No. 333-71625)].
- 10{k} Employment Agreement with Lloyd W. Baker [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].
- 10{l} Employment Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].
- 10{m} Supplemental Executive Retirement Program Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 10{n} Form of Supplemental Executive Retirement Program Agreement with Gary Sirmon, Michael K. Larsen, Lloyd W. Baker and Cynthia D. Purcell [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].

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- 10{o} 1998 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (File No. 333-71625)].
- 10{p} 2001 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 8, 2001 (File No. 333-67168)].
- 10{q} Form of Employment Contract entered into with Cynthia D. Purcell, Richard B. Barton, Paul E. Folz, John R. Neill and Douglas M. Bennett [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 10{r} 2004 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)].
- 10{s} 2004 Executive Officer and Director Investment Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)].
- 10{t} Long-Term Incentive Plan. [Incorporated by reference to the exhibits filed with the Form 8-K on June 19, 2006]
- 14 Code of Ethics [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 0-26584)].
- 31.1 Certification of Chief Executive Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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- 32 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Banner Corporation

November 9, 2007

/s/ D. Michael Jones

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D. Michael Jones  
President and Chief Executive Officer  
(Principal Executive Officer)

November 9, 2007

/s/ Lloyd W. Baker

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Lloyd W. Baker  
Treasurer and Chief Financial Officer  
(Principal Financial and Accounting Officer)

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**Exhibit Index**

- 31.1 Certification of Chief Executive Officer Pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certificate of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**EXHIBIT 31.1**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER OF BANNER CORPORATION  
PURSUANT TO RULES 13a-14(a) AND 15d-14(a) UNDER THE SECURITIES ACT OF 1934**

I, D. Michael Jones, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007 of Banner Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 9, 2007

/s/ D. Michael Jones

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D. Michael Jones  
Chief Executive Officer

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**EXHIBIT 31.2**

**CERTIFICATION OF CHIEF FINANCIAL OFFICER OF BANNER CORPORATION  
PURSUANT TO RULES 13a-14(a) AND 15d-14(a) UNDER THE SECURITIES ACT OF 1934**

I, Lloyd W. Baker, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007 of Banner Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 9, 2007

/s/ Lloyd W. Baker

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Lloyd W. Baker  
Chief Financial Officer

**EXHIBIT 32**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
OF BANNER CORPORATION  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and in connection with this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007, that:

the Report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, and

the information contained in the Report fairly presents, in all material respects, the Company's financial condition and results of operations as of the dates and for the periods presented in the financial statements included in such report.

November 9, 2007

/s/ D. Michael Jones

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D. Michael Jones  
Chief Executive Officer

November 9, 2007

/s/ Lloyd W. Baker

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Lloyd W. Baker  
Chief Financial Officer

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