

BANNER CORP
Form 10-K
March 16, 2010

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

10-K FORM

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ to _____

Commission File Number 0-26584
BANNER CORPORATION

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization)

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

10 South First Avenue, Walla Walla, Washington 99362
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (509) 527-3636

Securities registered pursuant to Section 12(b) of the Act:
Common Stock, par value \$.01 per share (Title of Each Class)
The Nasdaq Stock Market LLC (Name of Each Exchange on Which Registered)

Securities registered pursuant to section 12(g) of the Act:
None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes No
_____ X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes No
_____ X

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulations S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes No

The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant based on the closing sales price of the registrant's common stock quoted on The Nasdaq Stock Market on June 30, 2009, was:
Common Stock - \$70,389,070

(The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the Registrant that such person is an affiliate of the Registrant.)

The number of shares outstanding of the registrant's classes of common stock as of February 26, 2010:
Common Stock, \$.01 par value - 22,509,931 shares

Documents Incorporated by Reference
Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 27, 2010 are incorporated by reference into Part III.

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BANNER CORPORATION AND SUBSIDIARIES

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Forward-Looking Statements

Management's Discussion and Analysis and other portions of this report on Form 10-K 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. 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 and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates and the relative differences between short and long-term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the "FDIC"), the Washington State Department of Financial Institutions, Division of Banks (the "Washington DFI") or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute a formal or informal enforcement action against us or any of the Banks which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules; our ability to attract and retain deposits; further increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect or result in significant declines in valuation; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; the failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common and preferred stock and interest or principal payments on our junior subordinated debentures; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; war or terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; future legislative changes in the United States Department of Treasury ("Treasury") Troubled Asset Relief Program ("TARP") Capital Purchase Program; and other risks detailed from time to time in our filings with the Securities and Exchange Commission. Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to update any forward-looking statements included in this annual report or to update the reasons why actual results could differ from those contained in such statements whether as a result of new information, future events or otherwise. These risks could cause our actual results to differ materially from those expressed in any forward-looking statements by, or on behalf of, us. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this

annual report might not occur, and you should not put undue reliance on any forward-looking statements.

As used throughout this report, the terms “we”, “our”, “us”, or the “Company” refer to Banner Corporation and its consolidated subsidiaries, unless the context otherwise requires.

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PART 1

Item 1 – Business

General

Banner Corporation is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2009, its 86 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System. Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the FDIC. As of December 31, 2009, we had total consolidated assets of \$4.7 billion, total loans of \$3.7 billion, total deposits of \$3.9 billion and total stockholders' equity of \$405 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. Our primary business is that of traditional banking institutions, accepting deposits and originating loans in locations surrounding our offices in portions of Washington, Oregon and Idaho. Banner Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans. Lending activities include commercial business and commercial real estate loans, agriculture business loans, construction and land development loans, one- to four-family residential loans and consumer loans. A portion of Banner Bank's construction and mortgage lending activities are conducted through its subsidiary, Community Financial Corporation (CFC), which is located in the Lake Oswego area of Portland, Oregon. Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol "BANR." As discussed more thoroughly below and in later sections of this report, increased delinquencies and defaults in the residential construction and land development portions of our loan portfolio had a materially adverse effect on our results of operations for the past two years and, while it is difficult to predict when and how the weak housing markets that caused this increase in delinquencies and defaults will improve, we anticipate that an elevated level of non-performing assets will persist for a number of quarters and will have a continuing adverse effect on our earnings during 2010.

Over the past several years, we have invested significantly in expanding our branch and distribution 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 18 new branches through acquisition, opened 27 new branches and relocated eight others in the last five years including four new locations in 2009. In 2007, we completed the acquisitions of three smaller commercial banks in the State of Washington. These acquisitions increased our presence within desirable marketplaces and allow us to better serve existing and future customers. Our 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 now have reached our goal in terms of the number of branches required to generate deposit growth sufficient to fund our expected loan growth and produce significant fee generating opportunities. As a result, we expect that future branch opening will occur at a more moderate pace.

Deteriorating economic conditions and ongoing strains in the financial and housing markets which accelerated throughout 2008 and generally continued in 2009 have presented an unusually challenging environment for banks and their holding companies, including Banner Corporation. This has been particularly evident in our need to provide for credit losses during this period at significantly higher levels than our historical experience and has also affected our net interest income and other operating revenues and expenses. As a result of these factors, for the year ended December 31, 2009, we had a net loss of \$35.8 million which, after providing for the preferred stock dividend and related discount accretion, resulted in a net loss to common shareholders of \$43.5 million, or (\$2.33) per diluted share, compared to a net loss to common shareholders of \$128.8 million, or (\$7.94) per diluted share, for the year ended December 31, 2008. The results in 2008 included a \$121.1 million impairment charge for the write-off of goodwill. Our provision for loan losses was \$109.0 million for the year ended December 31, 2009, compared to \$62.5 million recorded in the prior year. Throughout 2008 and 2009, higher than historical provision for loan losses has been the most significant factor affecting our operating results and, while we are encouraged by the continuing reduction in our exposure to residential construction loans and the recent slowdown in the surfacing of new problem assets, looking forward, we anticipate our credit costs will remain elevated for a number of quarters. (See Note 9, Allowance for Loan Losses, as well as "Asset Quality" below.) Although there are indications of moderation, this stress in the economy has been the most significant challenge impacting our recent operating results and, like most financial institutions, our future operating results will be significantly affected by the course of recovery from the current recession.

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits and borrowings. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. As more fully explained below, our net interest income before provision for loan losses decreased by \$3.2 million for the year ended December 31, 2009 to \$144.6 million compared to \$147.8 million for the prior year, primarily as a result of a contraction in our net interest spread and net interest margin.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value. (See Note 25, Fair Value Accounting and Measurement.) For the year ended December 31, 2009, we recorded a net gain of \$11.0 million (\$7.1 million after tax) in fair value adjustments compared to a net gain of \$9.2 million (\$5.9 million after tax) for the year ended December 31, 2008. Further, reflecting unprecedented difficulties in the operating environment for banking institutions and deteriorating market conditions, for the year

ended December 31, 2008, our net income also included a \$121.1 million non-cash, non-tax-deductible impairment charge for the write-off of goodwill. (See Note 24: Goodwill and Other Intangibles and Mortgage Servicing Rights, as well as “Recent Developments” below.)

See Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for more detailed information about our financial performance and critical accounting policies.

Recent Developments

Regulatory Actions: In light of the current challenging operating environment, along with our elevated level of non-performing assets, delinquencies, and adversely classified assets and our recent operating results, we expect Banner Bank to shortly enter into a Memorandum of Understanding or MOU with the FDIC and Washington DFI. We expect that, under the MOU, Banner Bank will be required, among other things, to develop and implement plans to reduce commercial real estate concentrations; to improve asset quality and reduce classified assets; to improve profitability; and to increase Tier 1 leverage capital to equal or exceed 10% of average assets. In addition, we expect that Banner Bank will not be able to pay cash dividends to Banner Corporation without prior approval from the FDIC and Washington DFI. See Item 1A, Risk Factors—“We are subject to various regulatory requirements, expect to be subject to a memorandum of understanding and may be subject to future additional regulatory restrictions and enforcement actions.”

We also expect that the Company will enter into a similar MOU with the Federal Reserve Bank of San Francisco. In addition, the Company and Banner Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer. Further, the Company may not pay any dividends on common or preferred stock, pay interest or principal on the balance of its junior subordinated debentures or repurchase our common stock without the prior written non-objection of the Federal Reserve Bank.

FDIC Prepayment: On November 12, 2009, the FDIC adopted a final rule that required insured depository institutions to prepay an estimate of their expected quarterly deposit insurance premiums for the fourth quarter of 2009 and for the three years ended December 31, 2010, 2011 and 2012. Insured institutions were required to deposit funds with the FDIC in the amount of the prepaid assessment on December 30, 2009. The insured institutions will not receive interest on the deposited funds. For purposes of calculating an institution’s prepaid assessment amount, for the fourth quarter of 2009 and all of 2010, that institution’s assessment rate was its total base assessment rate in effect on September 30, 2009. That rate was then increased by three basis points for all of 2011 and 2012. Again, for purposes of calculating the prepaid amount, an institution’s third quarter 2009 assessment base was assumed to increase quarterly by an estimated five percent annual growth rate through the end of 2012. Each institution was directed to record the entire amount of its prepaid assessment as a prepaid expense (asset). Thereafter, each institution will record an expense (charge to earnings) for its regular quarterly assessment for the quarter and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, the institution will record an expense and an accrued expense payable each quarter for its regular assessment, which would be paid in arrears to the FDIC at the end of the following quarter. If the prepaid assessment is not exhausted by June 30, 2013, any remaining amount will be returned to the institution. For Banner Corporation, the balance of this prepaid assessment was \$29.5 million at December 31, 2009.

FDIC Special Assessment: On May 22, 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution’s total assets minus Tier 1 capital as of June 30, 2009, with the maximum amount of the special assessment for any institution not to exceed ten basis points times the institution’s

assessment base for the second quarter 2009 risk-based assessment. The special assessment was collected on September 30, 2009 at the same time the regular quarterly risk based assessment for the second quarter of 2009 was collected. For Banner Corporation, this assessment was \$2.1 million, which was recognized in other operating expenses during the quarter ended June 30, 2009. The FDIC Board may vote to impose additional special assessments if the FDIC estimates that the Deposit Insurance Fund reserve ratio will fall to a level that the Board believes would adversely affect public confidence or to a level that will be close to or below zero.

FDIC Temporary Liquidity Guarantee Program: Banner Corporation, Banner Bank and Islanders Bank have chosen to participate in the FDIC's Temporary Liquidity Guarantee Program (the "TLGP"), which applies to all U.S. depository institutions insured by the FDIC and all United States bank holding companies, unless they have opted out. Under the TLGP, the FDIC guarantees certain senior unsecured debt of insured institutions and their holding companies, as well as non-interest-bearing transaction account deposits. Under the transaction account guarantee component of the TLGP, all non-interest-bearing and certain interest-bearing transaction accounts maintained at Banner Bank and Islanders Bank are insured in full by the FDIC until June 30, 2010, regardless of the standard maximum deposit insurance amounts. The Banks are required to pay a fee (annualized) on balances of each covered account in excess of \$250,000 while the extra deposit insurance is in place. The annualized fee for the transaction account guarantee program is 10 basis points through December 31, 2009 and will be within a range from 15 to 25 basis points from January 1 through June 30, 2010. Further, on March 31, 2009, Banner Bank completed an offering of \$50 million of qualifying senior bank notes covered by the TLGP at a fixed rate of 2.625% which mature on March 31, 2012. Under the debt guarantee component of the TLGP, the FDIC will pay the unpaid principal and interest on these senior notes upon the uncured failure of Banner Bank to make a timely payment of principal or interest. Under the terms of the TLGP, Banner Bank was not permitted to use the proceeds from the sale of securities guaranteed under the TLGP to prepay any of its other debt that is not guaranteed by the FDIC. Banner Bank is required to pay a 1.00% fee (annualized) on this debt, which will result in a total fee of \$1.5 million over three years. None of the senior notes are redeemable prior to maturity.

Participation in the U.S. Treasury's Capital Purchase Program: On November 21, 2008, we received \$124 million from the U.S. Treasury Department as part of the Treasury's Capital Purchase Program. We issued \$124 million in senior preferred stock, with a related warrant to purchase up to \$18.6 million in common stock, to the U.S. Treasury. The warrant provides the Treasury the option to purchase up to 1,707,989 shares of Banner Corporation common stock at a price of \$10.89 per share at any time during the next ten years. The preferred stock pays a 5% dividend for the first five years, after which the rate will increase to 9% if the preferred shares are not redeemed by the Company. The terms and conditions of the transaction and the preferred stock conform to those provided by the U.S. Treasury. A summary of the Capital Purchase Program

c a n b e f o u n d o n t h e T r e a s u r y ' s w e b s i t e a t www.financialstability.gov/roadtostability/capitalpurchaseprogram.html. The additional capital enhances our capacity to support the communities we serve through expanded lending activities and economic development. This capital also adds flexibility in considering strategic opportunities that may be available to us.

Goodwill write-off: As a result of the significant decline in our stock price and market capitalization over the course of 2008 and in conjunction with similar declines in the value of most financial institutions and the ongoing disruption in related financial markets, we decided to reduce the carrying value of goodwill in our Consolidated Statements of Financial Condition by recording a \$50 million write-down in the second quarter and, in response to worsening economic indicators and further price declines, an additional \$71 million write-down in the fourth quarter of 2008. The total \$121 million write-off of goodwill was a non-cash charge that did not affect the Company's or the Banks' liquidity or operations. The adjustment brought our book value and tangible book value more closely in line with each other and more accurately reflected current market conditions. Also, since goodwill is excluded from regulatory capital, the impairment charge (which was not deductible for tax purposes) did not have an adverse effect on the regulatory capital ratios of the Company or either of our subsidiary banks, each of which continues to remain "well capitalized" under the regulatory requirements. (See Note 24 of the Selected Notes to Consolidated Financial Statements for additional information with respect to our valuation of intangible assets.)

Lending Activities

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

We offer a wide range of loan products to meet the demands of our customers. Historically, our 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; however, over the past two years our origination of construction and land development loans has declined materially and the proportion of the portfolio invested in these types of loans has declined. By contrast, for the year ended December 31, 2009, residential mortgage loan originations significantly increased, primarily reflecting the impact of exceptionally low interest rates on the demand for loans to refinance existing debt, although loans to finance home purchases also increased. Our real estate lending activities have also included the origination of multifamily and commercial real estate loans. Our commercial business 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. Reflecting the recessionary economy, in recent periods demand for these types of commercial business loans has been weak and total outstanding balances declined modestly compared to a year earlier. We have also increased our emphasis on consumer lending, although demand for consumer loans also has been modest in recent quarters. Still, the portion of the loan portfolio invested in consumer loans has increased and as of December 31, 2009 was 8% of total loans. While continuing our commitment to residential lending, including our mortgage banking activities, we expect commercial lending (including owner-occupied commercial real estate, commercial business and agricultural loans) and consumer lending to become increasingly more important activities

for us. By contrast, we anticipate residential construction and related land development lending, which at December 31, 2009 represented 14% of the loan portfolio, compared to 21% a year earlier, will continue to be restrained by market conditions for the foreseeable future, as well as by our efforts to reduce our concentration in this type of lending, with balances continuing to decline for a number of quarters. We also expect to curtail lending for non-owner-occupied investor commercial real estate and expect balances for this type of loan to decline for the foreseeable future.

At December 31, 2009, our net loan portfolio totaled \$3.7 billion. For additional information concerning our loan portfolio, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2009 and 2008—Loans/Lending." See also Table 7 contained therein, which sets forth the composition of our loan portfolio, and Tables 6 and 6(a), which contain information regarding the loans maturing in our portfolio.

One- to Four-Family Residential Real Estate Lending: At both Banner Bank and Islanders Bank, we originate loans secured by first mortgages on one- to four-family residences in the Northwest communities where we have offices. Banner Bank's mortgage lending subsidiary, CFC, provides residential lending primarily in the greater Portland, Oregon and Pasco (Tri Cities), Washington market areas. While we offer a wide range of products, we have not engaged in any sub-prime lending, which we define as loans to borrowers with poor credit histories or undocumented repayment capabilities and with excessive reliance on the collateral as the source of repayment. However, we have experienced a modest increase in delinquencies on our residential loans in response to the weakened housing market conditions. At December 31, 2009, \$703 million, or 19% of our loan portfolio, consisted of permanent loans on one- to four-family residences.

We offer fixed- and adjustable-rate mortgages (ARMs) at rates and terms competitive with market conditions, primarily with the intent of selling these loans into the secondary market. Fixed-rate loans generally are offered on a fully amortizing basis for terms ranging from 15 to 30 years at interest rates and fees that reflect current secondary market pricing. Most ARM products offered adjust annually after an initial period ranging from one to five years, subject to a limitation on the annual change of 1.0% to 2.0% and a lifetime limitation of 5.0% to 6.0%. For a small portion of the portfolio, where the initial period exceeds one year, the first rate change may exceed the annual limitation on subsequent rate changes. Our ARM products most frequently adjust based upon the average yield on U.S. Treasury securities adjusted to a constant maturity of one year plus a margin or spread above the index. ARM loans held in our portfolio may allow for interest-only payments for an initial period up to five years but do not provide for negative amortization of principal and carry no prepayment restrictions. The retention of ARM loans in our loan portfolio can help reduce our exposure to changes in interest rates. However, borrower demand for ARM loans versus

fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. In recent years, borrower demand for ARM loans has been limited and we have chosen not to aggressively pursue ARM loans by offering minimally profitable, deeply discounted teaser rates or option-payment ARM products. As a result, ARM loans have represented only a small portion of our loans originated during this period and of our portfolio.

Our residential loans are generally underwritten and documented in accordance with the guidelines established by the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) and the Federal National Mortgage Corporation (Fannie Mae or FNMA). Government insured loans are underwritten and documented in accordance with the guidelines established by the Department of Housing and Urban Development (HUD) and the Veterans Administration (VA). In the loan approval process, we assess the borrower's ability to repay the loan, the adequacy of the proposed security, the employment stability of the borrower and the creditworthiness of the borrower. For ARM loans, our standard practice provides for underwriting based upon fully indexed interest rates and payments. Generally, we will lend up to 95% of the lesser of the appraised value of the property or purchase price of the property on conventional loans, although higher loan-to-value ratios are available on certain government insured programs. We require private mortgage insurance on residential loans with a loan-to-value ratio at origination exceeding 80%. A growing number of exceptions to these general underwriting guidelines have been granted in connection with the sale or refinance of properties, particularly new construction, for which we were already providing financing. These exceptions most commonly relate to loan-to-value and mortgage insurance requirements and not to credit underwriting or loan documentation standards. Such exceptions will likely continue in the near term to facilitate troubled loan resolution in the current distressed housing market, and may have performance characteristics different from the rest of our one- to four-family loan portfolio.

Through our mortgage banking activities, we sell residential loans on either a servicing-retained or servicing-released basis. The decision to hold or sell loans is based on asset/liability management goals and policies and market conditions. During the past three years, we have sold a significant portion of our conventional residential mortgage originations and nearly all of our government insured loans into the secondary market.

Construction and Land Lending: We have invested a significant portion of our loan portfolio in residential construction and land loans to professional home builders and developers. To a lesser extent, we also originate construction loans for commercial and multifamily real estate. In years prior to 2008, residential construction and land development lending was an area of major emphasis at Banner Bank and the primary focus of its subsidiary, CFC. Our largest concentration of construction and land development loans is in the Portland/Vancouver market area. We also have a significant amount of construction and land loans for properties in the Puget Sound region and to a much smaller extent in the greater Boise area and certain eastern Washington and eastern Oregon markets. At December 31, 2009, construction and land loans totaled \$705 million, or 19% of total loans of the Company, consisting of \$239 million of one- to four-family construction loans, \$284 million of residential land or land development loans, \$138 million of commercial and multifamily real estate construction loans and \$44 million of commercial land or land development loans.

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

before the construction loan is due. We address these risks by adhering to strict underwriting policies, disbursement procedures and monitoring practices.

Construction loans made by us include those with a sale contract or permanent loan in place for the finished homes and those for which purchasers for the finished homes may be identified either during or following the construction period. We actively monitor the number of unsold homes in our construction loan portfolio and local housing markets to attempt to maintain an appropriate balance between home sales and new loan originations. The maximum number of speculative loans approved for each builder is based on a combination of factors, including the financial capacity of the builder, the market demand for the finished product and the ratio of sold to unsold inventory the builder maintains. We have attempted to diversify the risk associated with speculative construction lending by doing business with a large number of small and mid-sized builders spread over a relatively large geographic area with numerous sub-markets.

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

We also make land loans to developers, builders and individuals to finance the acquisition and/or development of improved lots or unimproved land. In making land loans, we follow underwriting policies and disbursement and monitoring procedures similar to those for construction loans. The initial term on land loans is typically one to three years with interest only payments, payable monthly, and provisions for principal reduction as lots are sold and released from the lien of the mortgage.

We regularly monitor the construction and land loan portfolios and the economic conditions and housing inventory in each of our markets and decrease this type of lending if we perceive unfavorable market conditions such as the existing economic environment. Housing markets in most areas of the Pacific Northwest have significantly deteriorated over the past two years and our origination of new construction loans has declined sharply as a result. We believe that the underwriting policies and internal monitoring systems we have in place mitigate many of the risks inherent in construction and land lending; however, current weak housing market conditions have nonetheless resulted in a material

increase of delinquencies and charge-offs in our construction and land loan portfolios. Construction and land loans represent 19% of our portfolio and are responsible for approximately 76% of our non-performing assets. Although well diversified with respect to sub-markets, price ranges and borrowers, our construction and land loans are significantly concentrated in the greater Puget Sound region of Washington State and the Portland, Oregon market area. Reducing the amount of non-performing construction and land development loans is currently the most critical issue that we face and need to resolve to return to acceptable levels of profitability. The most significant risk in this portfolio relates to the land development loans as demand for building lots is currently weak. (See “Asset Quality” below and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Asset Quality.”)

Commercial and Multifamily Real Estate Lending: We originate loans secured by multifamily and commercial real estate including, as noted above, loans for construction of multifamily and commercial real estate projects. Commercial real estate loans are made for both owner-occupied and investor properties. At December 31, 2009, our loan portfolio included \$153 million in multifamily and \$1.083 billion in commercial real estate loans, including \$509 million in owner-occupied commercial real estate loans and \$573 million in non-owner-occupied commercial real estate loans, which together comprised 33% of our total loans. Multifamily and commercial real estate lending affords us an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multifamily and commercial properties are generally greater in amount, more difficult to evaluate and monitor and, therefore, riskier than one- to four-family residential mortgage loans. Because payments on loans secured by multifamily and commercial properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. In originating multifamily and commercial real estate loans, we consider the location, marketability and overall attractiveness of the properties. Our current underwriting guidelines for multifamily and commercial real estate loans require an appraisal from a qualified independent appraiser and an economic analysis of each property with regard to the annual revenue and expenses, debt service coverage and fair value to determine the maximum loan amount. In the approval process we assess the borrowers’ willingness and ability to manage the property and repay the loan and the adequacy of the collateral in relation to the loan amount.

Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Most multifamily and commercial real estate loans originated in the past five years are linked to various U.S. Treasury indices, Federal Home Loan Bank advance rates, certain prime rates or other market rate indices. Rates on these adjustable-rate loans generally adjust with a frequency of one to five years after an initial fixed-rate period ranging from one to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no large concentrations by property type, location or borrower. At December 31, 2009, the average size of our commercial real estate loans was \$631,000 and the largest commercial real estate loan in our portfolio was \$15.9 million.

Commercial Business Lending: We are active in small- to medium-sized business lending and are engaged to a lesser extent in agricultural lending primarily by providing crop production loans. Our officers devote a great deal of effort to developing customer relationships and the ability to serve these types of borrowers. Management believes that many larger banks have neglected these lending markets, which has contributed to our success. While strengthening our commitment to small business lending, in recent years we have added experienced officers and staff focused on corporate lending opportunities for borrowers with credit needs generally in a \$3 million to \$15 million range. Management has leveraged the past success of these officers with local decision making ability to continue to expand this market niche. In addition to providing earning assets, this type of lending has helped us increase our deposit base. Expanding commercial lending and related commercial banking services is currently an area of significant focus by us and staffing has been increased in the areas of credit administration, business development, and loan and deposit operations.

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

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

Our commercial business loans may be structured as term loans or as lines of credit. Commercial business term loans are generally made to finance the purchase of fixed assets and have maturities of five years or less. Commercial business lines of credit are typically made for the purpose of providing working capital and are usually approved with a term of one year. Adjustable- or floating-rate loans are primarily tied to various prime rate and London Inter-Bank Offering Rate or LIBOR indices. At December 31, 2009, commercial business loans totaled \$638 million, or 17% of our total loans.

Agricultural Lending: Agriculture is a major industry in many parts of our service areas. While agricultural loans are not a large part of our portfolio, we intend to continue to make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operations of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile. At December 31, 2009, agricultural business loans, including collateral secured loans to purchase farm land and equipment, totaled \$205 million, or 5% of our loan portfolio.

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

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

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

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

Consumer and Other Lending: We originate a variety of consumer loans, including home equity lines of credit, automobile loans and loans secured by deposit accounts. While consumer lending has traditionally been a small part of our business, with loans made primarily to accommodate our existing customer base, it has received renewed emphasis in recent years and management anticipates increased activity in future periods. Part of this emphasis has been the reintroduction of a Banner Bank-funded credit card program which we began marketing in the fourth quarter of 2005. Similar to other consumer loan programs, we focus this credit card program on our existing customer base to add to the depth of our customer relationships. As a result of increased marketing efforts, an improved retail delivery network and strong borrower demand, as well as the three bank acquisitions, our consumer loans increased significantly in the past two years. Our underwriting of consumer loans is focused on the borrower's credit history and ability to repay the debt as evidenced by documented sources of income. At December 31, 2009, we had \$302 million, or 8% of our loans receivable, in consumer related loans.

Similar to commercial loans, consumer loans often entail greater risk than residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment

of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. These loans may also give rise to claims and defenses by a consumer loan borrower against an assignee of such loans such as us, and a borrower may be able to assert against the assignee claims and defenses that it has against the seller of the underlying collateral.

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

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

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

Loan Originations, Sales and Purchases

While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. For the years ended December 31, 2009, 2008 and 2007, we originated loans, net of repayments, of \$582 million,

\$562 million and \$607 million, respectively. The level of originations, net of repayments, in the three most recent years has been less than in prior years primarily as a result of a decrease in the origination of new construction and land loans in response to slower new home sales.

We sell many of our newly originated one- to four-family residential mortgage loans to secondary market purchasers as part of our interest rate risk management strategy. Proceeds from sales of loans for the years ended December 31, 2009, 2008 and 2007, totaled \$563 million, \$366 million and \$393 million, respectively. Sales of loans generally are beneficial to us because these sales may generate income at the time of sale, provide funds for additional lending and other investments, increase liquidity or reduce interest rate risk. We sell loans on both a servicing-retained and a servicing-released basis. All loans are sold without recourse. See "Loan Servicing." At December 31, 2009, we had \$4.5 million in loans held for sale.

We periodically purchase whole loans and loan participation interests primarily during periods of reduced loan demand in our primary market area and at times to support our Community Reinvestment Act lending activities. Any such purchases are made consistent with our underwriting standards; however, the loans may be located outside of our normal lending area. During the years ended December 31, 2009, 2008 and 2007, we purchased \$1 million, \$13 million and \$23 million, respectively, of loans and loan participation interests.

Loan Servicing

We receive fees from a variety of institutional owners in return for performing the traditional services of collecting individual payments and managing portfolios of sold loans. At December 31, 2009, we were servicing \$679 million of loans for others. Loan servicing includes processing payments, accounting for loan funds and collecting and paying real estate taxes, hazard insurance and other loan-related items such as private mortgage insurance. In addition to earning fee income, we retain certain amounts in escrow for the benefit of the lender for which we incur no interest expense but are able to invest the funds into earning assets. At December 31, 2009, we held \$7.4 million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2009 was composed of \$388 million of Freddie Mac residential mortgage loans, \$109 million of Fannie Mae residential mortgage loans and \$182 million of both residential and non-residential mortgage loans serviced for a variety of private investors. The portfolio included loans secured by property located primarily in the states of Washington and Oregon. For the year ended December 31, 2009, we recognized \$93,000 of loan servicing fees, which is net of \$2.1 million of servicing rights amortization and an \$800,000 charge for a valuation adjustment to mortgage servicing rights, in our results of operations.

Mortgage Servicing Rights: We record mortgage servicing rights (MSRs) with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. For the years ended December 31, 2009, 2008 and 2007, we capitalized \$5.0 million \$1.6 million and \$781,000, respectively, of MSRs relating to loans sold with servicing retained. No MSRs were purchased in those periods. Amortization of MSRs for the years ended December 31, 2009, 2008 and 2007, was \$2.1 million, \$902,000, and \$658,000, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. These carrying values are adjusted when the valuation indicates the carrying value is impaired. MSRs generally are adversely affected by higher levels of current or anticipated prepayments resulting from decreasing interest rates. At December 31, 2009, our MSRs were carried at a value of \$5.7 million, net of amortization.

Asset Quality

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

For additional information with respect to asset quality and non-performing loans, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2009 and 2008—Asset Quality," and Table 13 contained therein.

Allowance for Loan Losses: In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the 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 U.S. generally acceptable accounting principles (GAAP) guidelines. We increase our allowance for loan losses by charging provisions for possible loan losses against our income. The allowance for losses on loans is maintained at a level which, in management's judgment, is sufficient to provide for 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 December 31, 2009, we had an allowance for loan losses of \$95 million, which represented 2.51% of net loans and 45% of non-performing loans compared to 1.90% and 40%, respectively, at December 31, 2008. For additional information concerning our allowance for loan losses, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Results of Operations for the Years Ended December 31, 2009 and 2008—Provision and Allowance for Loan Losses," and Tables 14 and 15 contained therein.

Investment Activities

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

At December 31, 2009, our consolidated investment portfolio totaled \$318 million and consisted principally of U.S. Government agency obligations, mortgage-backed securities, municipal bonds and corporate debt obligations. From time to time, investment levels may be increased or decreased depending upon yields available on investment alternatives, and management's projections as to the demand for funds to be used in loan originations, deposits and other activities. During the year ended December 31, 2009, holdings of mortgage-backed securities decreased \$28 million to \$106 million, U.S. Treasury and agency obligations increased \$24 million to \$94 million, corporate securities including equities decreased \$5 million (largely as a result of fair value adjustments) to \$44 million, and municipal bonds increased \$10 million to \$74 million.

For detailed information on our investment securities, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2009 and 2008—Investments," and Tables 1 to 6 contained therein.

Off-Balance-Sheet Derivatives: Derivatives include "off-balance-sheet" financial products whose value is dependent on the value of an underlying financial asset, such as a stock, bond, foreign currency, or a reference rate or index. Such derivatives include "forwards," "futures," "options" or "swaps." We generally have not invested in "off-balance-sheet" derivative instruments, although investment policies authorize such investments. However, through our acquisition of F&M we became a party to approximately \$23.0 million (\$20.4 million as of December 31, 2009) in notional amounts of interest rate swaps. These swaps serve as hedges to an equal amount of fixed-rate loans which include market value prepayment penalties that mirror the provision of the specifically matched interest rate swaps. The fair value adjustments for these swaps and the related loans are reflected in other assets or other liabilities as appropriate, and in the carrying value of the hedged loans. Also, as a part of mortgage banking activities, we issue "rate lock" commitments to borrowers and obtain offsetting "best efforts" delivery commitments from purchasers of loans. While not providing any trading or net settlement mechanisms, these off-balance-sheet commitments do have many of the prescribed characteristics of derivatives and as a result are accounted for as such. Accordingly, on December 31, 2009, we recorded an asset of \$362,000 and a liability of \$362,000, representing the estimated market value of those commitments. On December 31, 2009, we had no other investment related off-balance-sheet derivatives.

Deposit Activities and Other Sources of Funds

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

We compete with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction balances and savings deposits from commercial banks, credit unions and 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. In addition, our electronic banking activities including debit card and automated teller machine (ATM) programs, online Internet banking services and, most recently, customer remote deposit and mobile banking capabilities are all directed at providing products and services that enhance customer relationships and result in growing deposit balances. Growing deposits is a fundamental element of our core business strategy.

Deposit Accounts: We generally attract deposits from within our primary market areas by offering a broad selection of deposit instruments, including demand checking accounts, 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 to us, matching deposit and loan products and customer preferences and concerns. At December 31, 2009, we had \$3.9 billion of deposits, including \$1.9 billion of transaction and savings accounts and \$1.9 billion in time deposits. For additional information concerning our deposit accounts, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2009 and 2008—Deposit Accounts." See also Table 9 contained therein,

which sets forth the balances of deposits in the various types of accounts, and Table 10, which sets forth the amount of our certificates of deposit greater than \$100,000 by time remaining until maturity as of December 31, 2009.

Borrowings: While deposits are the primary source of funds for our lending and investment activities and for general business purposes, we also use borrowings to supplement our supply of lendable funds, to meet deposit withdrawal requirements and to more efficiently leverage our capital position. The FHLB-Seattle serves as our primary borrowing source. The FHLB-Seattle provides credit for member financial institutions such as Banner Bank and Islanders Bank. As members, the Banks are required to own capital stock in the FHLB-Seattle and are authorized to apply for advances on the security of that stock and certain of their mortgage loans and securities provided certain credit worthiness standards have been met. Limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. At December 31, 2009, we had \$190 million of borrowings from the FHLB-Seattle. At that date, Banner Bank had been authorized by the FHLB-Seattle to borrow up to \$1.020 billion under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to \$43 million under a similar agreement. More recently, the Federal Reserve Bank of San Francisco (FRBSF) has also served as an important source of borrowings. The FRBSF provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB-Seattle. At December 31, 2009, based upon our available unencumbered collateral, Banner Bank was eligible to borrow \$373 million from the FRBSF, although at that date we had no funds borrowed under this arrangement. Although eligible to participate, Islanders Bank has not applied for approval to borrow from the FRBSF. For additional information concerning our borrowings, see Item 7, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2009 and 2008—Borrowings,” Table 12 contained therein, and Notes 13 and 14 of the Notes to the Consolidated Financial Statements.

We issue retail repurchase agreements, generally due within 90 days, as an additional source of funds, primarily in connection with cash management services provided to our larger deposit customers. At December 31, 2009, we had issued retail repurchase agreements totaling \$124 million, which were secured by a pledge of certain U.S. Agency notes and mortgage-backed securities with a market value of \$147 million.

On March 31, 2009, Banner Bank completed an offering of \$50 million of qualifying senior bank notes that are guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP). These notes require interest only payments for a term of three years with principal payable in full at maturity. These notes provided supplemental funding which strengthened the liquidity position of the Bank; however, going forward we do not anticipate any additional borrowings under the TLGP.

We also may borrow funds through the use of secured wholesale repurchase agreements with securities brokers. However, we did not have any wholesale repurchase borrowings at December 31, 2009.

In addition to our borrowings, we have also issued \$120 million of junior subordinated debentures in connection with the sale of trust preferred securities (TPS). The TPS were issued from 2002 through 2007 by special purpose business trusts formed by Banner Corporation and were sold in private offerings to pooled investment vehicles. The junior subordinated debentures associated with the TPS have been recorded as liabilities and are reported at fair value on our Consolidated Statements of Financial Condition; however, at December 31, 2009, all of the fair value of the debentures qualifies as Tier 1 capital for regulatory capital purposes. We have invested a significant portion of the proceeds from the issuance of the TPS as additional paid in capital at Banner Bank. For additional information about deposits and other sources of funds, see Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources,” and Notes 12, 13, 14 and 15 of the Notes to the Consolidated Financial Statements contained in Item 8.

Personnel

As of December 31, 2009, we had 1,011 full-time and 87 part-time employees. Banner Corporation has no employees except for those who are also employees of Banner Bank, its subsidiaries, and Islanders Bank. The employees are not represented by a collective bargaining unit. We believe our relationship with our employees is good.

Taxation

Federal Taxation

General: For tax reporting purposes, we report our income on a calendar year basis using the accrual method of accounting on a consolidated basis. We are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the reserve for bad debts discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to us. Reference is made to Note 16 of the Notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K for additional information concerning the income taxes payable by us.

Provisions of the Small Business Job Protection Act of 1996 (the Job Protection Act) significantly altered our tax bad debt deduction method and the circumstances that would require a tax bad debt reserve recapture. Prior to enactment of the Job Protection Act, savings institutions (Banner Bank was previously chartered as a savings institution) were permitted to compute their tax bad debt deduction through use of either the reserve method or the percentage of taxable income method. The Job Protection Act repealed both of these methods for large savings institutions and allows bad debt deductions based only on actual current losses. While repealing the reserve method for computing tax bad debt deductions, the Job Protection Act allowed savings institutions to retain their existing base year bad debt reserves but required that reserves in excess of the balance at December 31, 1987, be recaptured into taxable income over six years. The reserves in excess of the base year (December 31, 1987) had been fully recaptured into taxable income as of December 31, 2003.

The base year reserve is recaptured into taxable income only in limited situations, such as in the event of certain excess distributions, complete liquidation or disqualification as a bank. None of the limited circumstances requiring recapture are contemplated by us. The amount of our tax bad debt reserves subject to recapture in these circumstances was approximately \$5.3 million at December 31, 2009. As a result of the remote nature of events that may trigger the recapture provisions, no tax liability has been established in the accompanying Consolidated Financial Statements.

State Taxation

Washington Taxation: We are subject to a Business and Occupation (B&O) tax which is imposed under Washington law at the rate of 1.50% of gross receipts; however, interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities is not subject to such tax. Our B&O tax expense was \$2.2 million, \$2.3 million and \$2.0 million for the years ended December 31, 2009, 2008 and 2007, respectively.

Oregon and Idaho Taxation: Corporations with nexus in the states of Oregon and Idaho are subject to a corporate level income tax. Our operations in those states resulted in corporate income taxes of approximately \$21,000, \$422,000 and \$740,000 (net of federal tax benefit) for the years ended December 31, 2009, 2008 and 2007, respectively. As our operations in these states increase, the state income tax provision will have an increasing effect on our effective tax rate and results of operations.

Competition

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

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

Regulation

Banner Bank and Islanders Bank

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

Federal and state banking laws and regulations govern all areas of the operation of the Banks, including reserves, loans, investments, deposits, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state bank regulatory agencies also have the general authority to limit the dividends paid by insured banks and bank holding companies if such payments should be deemed to constitute an unsafe and unsound practice. Under the expected MOU, Banner Bank will not be able to pay cash dividends to Banner Corporation without the prior approval of the Washington DFI and the FDIC. The respective primary federal regulators of Banner Corporation, Banner Bank and Islanders Bank have authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks from engaging in unsafe or unsound practices.

State Regulation and Supervision: As a Washington state-chartered commercial bank with branches in the States of Washington, Oregon and Idaho, Banner Bank is subject to the applicable provisions of Washington, Oregon and Idaho law and regulations. State law and regulations govern Banner Bank's ability to take deposits and pay interest thereon, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers and to establish branch offices. In a similar fashion, Washington State laws and regulations for state-chartered commercial banks also apply to Islanders Bank.

Deposit Insurance: The FDIC is an independent federal agency that insures the deposits, up to applicable limits, of depository institutions. As insurer of the Banks' deposits, the FDIC has supervisory and enforcement authority over Banner Bank and Islanders Bank.

The deposits of the Banks are insured up to applicable limits by the Deposit Insurance Fund, or DIF, which is administered by the FDIC. The FDIC insures deposits up to the applicable limits and this insurance is backed by the full faith and credit of the United States government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by institutions insured by the FDIC. It also may prohibit any institution insured by the FDIC from engaging in any activity determined by regulation or order to pose a serious risk to the institution and the DIF. The FDIC also has the authority to initiate enforcement actions and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The FDIC assesses deposit insurance premiums on all FDIC-insured institutions quarterly based on annualized rates for one of four risk categories. Each institution is assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF. Under the FDIC's risk-based assessment rules, effective April 1, 2009, the initial base assessment rates prior to adjustments range from 12 to 16 basis points for Risk Category I, and are 22 basis points for Risk Category II, 32 basis points for Risk Category III, and 45 basis points for Risk Category IV. Initial base assessment rates are subject to adjustments based on an institution's unsecured debt, secured liabilities and brokered deposits, such that the total base assessment rates after adjustments range from 7 to 24 basis points for Risk Category I, 17 to 43 basis points for Risk Category II, 27 to 58 basis points for Risk Category III, and 40 to 77.5 basis points for Risk Category IV. Rates increase uniformly by three basis points effective January 1, 2011.

In addition to the regular quarterly assessments, due to losses and projected losses attributed to failed institutions, the FDIC imposed on every insured institution a special assessment of five basis points on the amount of each depository institution's assets reduced by the amount of its Tier 1 capital (not to exceed 10 basis points of its assessment base for regularly quarterly premiums) as of June 30, 2009, which was collected on September 30, 2009.

As a result of a decline in the reserve ratio (the ratio of the DIF to estimated insured deposits) and concerns about expected failure costs and available liquid assets in the DIF, the FDIC adopted a rule requiring each insured institution to prepay on December 30, 2009 the estimated amount of its quarterly assessments for the fourth quarter of 2009 and all quarters through the end of 2012 (in addition to the regular quarterly assessment for the third quarter which was due on December 30, 2009). The prepaid amount is recorded as an asset with a zero risk weight and the institution will continue to record quarterly expenses for deposit insurance. For purposes of calculating the prepaid amount, assessments were measured at the institution's assessment rate as of September 30, 2009, with a uniform increase of 3 basis points effective January 1, 2011, and were based on the institution's assessment base for the third quarter of 2009, with growth assumed quarterly at annual rate of 5%. If events cause actual assessments during the prepayment period to vary from the prepaid amount, institutions will pay excess assessments in cash or receive a rebate of prepaid amounts not exhausted after collection of assessments due on June 30, 2013, as applicable. Collection of the prepayment does not preclude the FDIC from changing assessment rates or revising the risk-based assessment system in the future. The rule includes a process for exemption from the prepayment for institutions whose safety and soundness would be affected adversely. We prepaid \$31.6 million in FDIC assessments during the fourth quarter of 2009 and the balance of the prepaid assessment was \$29.5 million at December 31, 2009.

The FDIC estimates that the reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) will reach the designated reserve ratio of 1.15% by 2017 as required by statute.

Federally insured institutions are required to pay a Financing Corporation assessment in order to fund the interest on bonds issued to resolve thrift failures in the 1980s. For the quarterly period ended December 31, 2009, the Financing Corporation assessment equaled 1.02 basis points for each \$100 in domestic deposits. These assessments, which may be revised based upon the level of DIF deposits, will continue until the bonds mature in the years 2017 through 2019. For 2009, the Banks incurred \$396,000 in FICO assessments.

The FDIC may terminate the deposit insurance of any insured depository institution if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances which

would result in termination of the deposit insurance of either Banner Bank or Islanders Bank.

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

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

At December 31, 2009, both Banner Bank and Islanders Bank were categorized as "well capitalized" under the prompt corrective action regulations of the FDIC.

Standards for Safety and Soundness: The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to internal controls, information systems and internal audit systems; loan documentation; credit underwriting; interest rate risk exposure; asset growth; asset quality; earnings; and compensation, fees and benefits. The guidelines set forth the safety and

soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program also must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Capital Requirements: Federally insured financial institutions, such as Banner Bank and Islanders Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common stockholders' equity and qualifying noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is recognized up to 100% of Tier 1 capital for risk-based capital purposes (after any deductions for disallowed intangibles and disallowed deferred tax assets), includes such items as qualifying general loan loss reserves (up to 1.25% of risk-weighted assets), cumulative perpetual preferred stock, long-term preferred stock, certain perpetual preferred stock, hybrid capital instruments including mandatory convertible debt, term subordinated debt, intermediate-term preferred stock (original average maturity of at least five years), and net unrealized holding gains on equity securities (subject to certain limitations); provided, however, the amount of term subordinated debt and intermediate term preferred stock that may be included in Tier 2 capital for risk-based capital purposes is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% to 5% of total assets. At December 31, 2009, Banner Bank and Islanders Bank had Tier 1 leverage capital ratios of 9.74% and 11.58%, respectively. The FDIC retains the right to require a particular institution to maintain a higher capital level based on an institution's particular risk profile. Under the expected MOU, we anticipate that we will be required to maintain Banner Bank's leverage ratio at 10% within a certain prescribed time period.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of the category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At December 31, 2009, Banner Bank and Islanders Bank had Tier 1 risk-based capital ratios of 11.69% and 12.18%, respectively, and total risk-based capital ratios of 12.95% and 13.17%, respectively.

FDIC capital requirements are designated as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The FDIC capital regulations state that, where the FDIC determines that the financial history or condition, including off-balance-sheet risk, managerial resources and/or the future earnings prospects of a bank are not

adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of capital for the bank is greater than the minimum standards established in the regulation.

We believe that, under the current regulations, Banner Bank and Islanders Bank exceed their minimum capital requirements. However, events beyond the control of the Banks, such as weak or depressed economic conditions in areas where they have most of their loans, could adversely affect future earnings and, consequently, the ability of the Banks to meet their capital requirements. For additional information concerning Banner Bank's and Islanders Bank's capital, see Note 21 of the Notes to the Consolidated Financial Statements.

Emergency Economic Stabilization Act of 2008: In October 2008, the EESA was enacted. The EESA authorizes the U.S. Treasury Department to purchase from financial institutions and their holding companies up to \$700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies in a troubled asset relief program, or TARP. The purpose of TARP is to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. Under the TARP Capital Purchase Program, or CPP, the Treasury may purchase debt or equity securities from participating institutions. The TARP also allows direct purchases or guarantees of troubled assets of financial institutions. Participants in the CPP are subject to executive compensation limits and are encouraged to expand their lending and mortgage loan modifications. Banner completed its TARP CPP transaction on November 21, 2008 and received \$124 million in funding from the U.S. Treasury Department. For additional information regarding the TARP CPP transaction, see "Risk Factors – Risks Related to our Business—Risks specific to our participation in TARP."

EESA also included additional provisions directed at bolstering the economy, which we were able to participate in, such as the temporary increase in FDIC insurance coverage of deposit accounts, which increased from \$100,000 to \$250,000 through December 31, 2013.

Temporary Liquidity Guaranty Program: Following a systemic risk determination, the FDIC established a Temporary Liquidity Guarantee Program, or TLGP, on October 14, 2008. Under the interim rule for the TLGP, there are two parts to the program: the Debt Guarantee Program, or the DGP, and the Transaction Account Guarantee Program, or the TAGP. Eligible entities generally are participants unless they exercised opt out rights in timely fashion. Banner Bank and Islanders Bank did not opt out of these programs.

For the DGP, eligible entities are generally U.S. bank holding companies, savings and loan holding companies, and FDIC-insured institutions. Under the DGP, the FDIC guarantees certain senior unsecured debt of an eligible entity that are issued not later than October 31, 2009. The guarantee is effective through the earlier of the maturity date or June 30, 2012 (for debt issued before April 1, 2009) or December 31, 2012 (for debt issued on or after April 1, 2009). The DGP coverage limit is generally 125% of the eligible entity's eligible debt outstanding on September 30, 2008 and scheduled to mature on or before June 30, 2009, or for certain institutions, 2% of liabilities as of September 30, 2008. The nonrefundable DGP fee ranges from 50 to 100 basis points (annualized), depending on maturity, for covered debt outstanding during the period until the earlier of maturity or June 30, 2012, with various surcharges of 10 to 50 basis points applicable to debt with a maturity of one year or more issued on or after April 1, 2009. Generally, eligible debt of a participating entity becomes covered when and as issued until the coverage limit is reached, except that under some circumstances, participating entities can issue certain nonguaranteed debt. Various features of the DGP require applications, additional fees, and approvals. On March 31, 2009, Banner Bank completed an offering of \$50 million of qualifying senior bank notes that are guaranteed by the FDIC under the DGP. These notes require interest only payments for a term of three years with principal payable in full at maturity. Banner Bank is required to pay a 1.00% fee (annualized) on this debt, which will result in a total fee of \$1.5 million over three years. None of the senior notes are redeemable prior to maturity. We do not anticipate any additional borrowing under the TLGP.

For the TAGP, eligible entities are FDIC-insured institutions. Under the TAGP, the FDIC provides unlimited deposit insurance coverage for noninterest-bearing transaction accounts (typically business checking accounts), NOW accounts bearing interest at 0.5% or less, and certain funds swept into non-interest-bearing savings accounts. Other NOW accounts and money market deposit accounts are not covered. TAGP coverage lasts until December 31, 2009 and, unless the participant has opted out of the extension period, during the extension period of January 1, 2010 through June 30, 2010. Participating institutions pay fees of 10 basis points (annualized) on the balance of each covered account in excess of \$250,000 during the period through December 31, 2009. During the extension period, such fees are 15 basis points for institutions in Risk Category I, 20 basis points for those in Risk Category II and 25 basis points for those in Risk Categories III and IV (Risk Categories are those assigned for deposit insurance purposes).

The American Recovery and Reinvestment Act of 2009: On February 17, 2009, President Obama signed The American Recovery and Reinvestment Act of 2009 ("ARRA") into law. The ARRA is intended to revive the U.S. economy by creating millions of new jobs and stemming home foreclosures. For financial institutions that have received or will receive financial assistance under TARP or related programs, the ARRA significantly rewrites the original executive compensation and corporate governance provisions of Section 111 of the EESA. Among the most important changes instituted by the ARRA are new limits on the ability of TARP recipients to pay incentive compensation to up to 20 of the next most highly-compensated employees in addition to the "senior executive officers," a restriction on termination of employment payments to senior executive officers and the five next most highly-compensated employees and a requirement that TARP recipients implement "say on pay" shareholder votes. For additional information regarding the effects of the ARRA on Banner's senior executive officers as a result of Banner's participation in TARP, see "Risk Factors – Risks Related to our Business—Risks specific to our participation in TARP."

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

commercial real estate loan, or is approaching or exceeding the following supervisory criteria may be identified for further supervisory analysis with respect to real estate concentration risk:

- Total reported loans for construction, land development and other land represent 100% or more of the bank's capital; or
- Total commercial real estate loans (as defined in the guidance) represent 300% or more of the bank's total capital or the outstanding balance of the bank's commercial real estate loan portfolio has increased 50% or more during the prior 36 months.

The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory guidance on evaluation of capital adequacy. As of December 31, 2009, Banner Bank's and Islanders Bank's aggregate loans in excess of the supervisory concentration ratios for construction, land development and land loans were 151% and 73% of total capital. In addition, at December 31, 2009, Banner Bank's and Islanders Bank's loans on commercial real estate were 318% and 361%, respectively, of total capital. As part of the expected MOU, Banner Bank will be required to develop and implement a plan to reduce its commercial real estate concentration.

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

Washington State has enacted a law regarding financial institution parity. Primarily, the law affords Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of the Washington Department of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered commercial banks may exercise any of the powers that the Federal Reserve has determined to be closely related to the business of banking and the powers of national banks, subject to the approval of the Director in certain situations. The law also

provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

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

Federal Reserve System: The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or nonpersonal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. NOW accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any nonpersonal time deposits at a bank. At December 31, 2009, the Banks’ deposits with the Federal Reserve Bank and vault cash exceeded their reserve requirements.

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

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

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

by insured banks if such payments should be deemed to constitute an unsafe and unsound practice. Under the expected MOU, Banner Bank will not be able to pay us dividends without the prior approval of the Washington DFI and the FDIC.

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

Anti-Money Laundering and Customer Identification: In response to the terrorist events of September 11, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”) was signed into law on October 26, 2001. The USA Patriot Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. Bank regulators are directed to consider a holding company’s effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications. Banner Bank’s and Islanders Bank’s policies and procedures comply with the requirements of the USA Patriot Act.

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

penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

The Americans with Disabilities Act requires employers with 15 or more employees and all businesses operating “commercial facilities” or “public accommodations” to accommodate disabled employees and customers. The Americans with Disabilities Act has two major objectives: (i) to prevent discrimination against disabled job applicants, job candidates and employees, and (ii) to provide disabled persons with ready access to commercial facilities and public accommodations. Commercial facilities, such as the Banks, must ensure that all new facilities are accessible to disabled persons, and in some instances may be required to adapt existing facilities to make them accessible.

Banner Corporation

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

The Bank Holding Company Act: Under the BHCA, we are supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company’s failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve’s regulations or both. We are required to file quarterly and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and charge us for the cost of the examination. Banner Corporation and any subsidiaries that it may control are considered “affiliates” within the meaning of the Federal Reserve Act, and transactions between Banner Bank and affiliates are subject to numerous restrictions. With some exceptions, Banner Corporation, and its subsidiaries, are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by Banner Corporation, or by its affiliates.

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

providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

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

Sarbanes-Oxley Act of 2002: The Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act was signed into law on July 30, 2002 in response to public concerns regarding corporate accountability in connection with various accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission (SEC), under the Securities Exchange Act of 1934, or the Exchange Act.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Interstate Banking and Branching: The Federal Reserve must approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the statutory law of the host state. Nor may the Federal Reserve approve an application if the applicant (and its depository institution affiliates) controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch.

Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state which may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

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

Dividends: The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses its view that although there are no specific regulations restricting dividend payments by bank holding companies other than state corporate laws, a bank holding company must maintain an adequate capital position and generally should not pay cash dividends unless the company's net income for the past year is sufficient to fully fund the cash dividends and that the prospective rate of earnings appears consistent with the company's capital needs, asset quality, and overall financial condition. The Federal Reserve policy statement also indicates that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. The Company has been informed that it may not declare or pay any dividends on its common or preferred stock without the prior written non-objection of the Federal Reserve.

Capital Requirements: The Federal Reserve has established capital adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Banks, although the Federal Reserve regulations provide for the inclusion of certain trust preferred securities for up to 25% of Tier 1 capital in determining compliance with the guidelines. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with \$500 million or more in total consolidated assets. The guidelines require that a company's total risk-based capital must equal 8% of risk-weighted assets and one half of the 8% (4%) must consist of Tier 1 (core) capital. As of December 31, 2009, Banner Corporation's total risk-based capital was 12.73% of risk-weighted assets and its Tier 1 (core) capital was 11.47% of risk-weighted assets.

Stock Repurchases: A bank holding company, except for certain "well-capitalized" and highly rated bank holding companies, is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding twelve months, is equal to 10% or more of its consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order or any condition imposed by, or written agreement with, the Federal Reserve. The Company has been informed that it may not repurchase its common stock without the prior written non-objection of the Federal Reserve Bank. For information concerning our repurchase activities during the 2009 fiscal year and for the quarter ended December 31, 2009, see Item 5.

Management Personnel

Executive Officers

The following table sets forth information with respect to the executive officers of Banner Corporation and Banner Bank as of December 31, 2009:

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Name	Age	Position with Banner Corporation	Position with Banner Bank
D. Michael Jones	67	President, Chief Executive Officer, Director	President, Chief Executive Officer, Director
Lloyd W. Baker	61	Executive Vice President, Chief Financial Officer	Executive Vice President, Chief Financial Officer
Cynthia D. Purcell	52		Executive Vice President, Chief Operating Officer
Richard B. Barton	66		Executive Vice President, Chief Lending Officer
Paul E. Folz	55		Executive Vice President, Community Banking
Steven W. Rust	62		Executive Vice President, Chief Information Officer
Douglas M. Bennett	57		Executive Vice President, Real Estate Lending Operations
Tyrone J. Bliss	52		Executive Vice President, Risk Management and Compliance Officer
Gary W. Wagers	49		Executive Vice President Retail Products and Services

Biographical Information

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

D. Michael Jones joined Banner Bank in 2002 following an extensive career in banking, finance and accounting. Mr. Jones served as President and Chief Executive Officer from 1996 to 2001 for Source Capital Corporation, a lending company in Spokane, Washington. From 1987 to 1995, Mr. Jones served as President of West One Bancorp, a large regional banking franchise based in Boise, Idaho.

Lloyd W. Baker joined First Savings Bank of Washington (now Banner Bank) in 1995 as Asset/Liability Manager and has served as its Chief Financial Officer since 2000. His banking career began in 1972.

Cynthia D. Purcell was formerly the Chief Financial Officer of Inland Empire Bank (now Banner Bank), which she joined in 1981, and has served in her current position as Executive Vice President since 2000. Ms. Purcell was named Chief Operating Officer in 2008.

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

Paul E. Folz joined Banner Bank in 2002. Mr. Folz has 31 years of commercial lending experience and, prior to joining Banner, served as Washington Mutual's Senior Vice President in charge of commercial banking operations in the State of Oregon.

Steven W. Rust joined Banner Bank in October 2005. Mr. Rust brings over 32 years of relevant industry experience to Banner Bank's management team. Prior to joining Banner Bank he was founder and president of InfoSoft Technology, through which he worked for nine years as a technology consultant and interim Chief Information Officer for banks and insurance companies. He worked 19 years with US Bank/West One Bancorp as Senior Vice President & Manager of Information Systems.

Douglas M. Bennett, who joined Banner Bank in 1974, has over 34 years of experience in real estate lending. He has served as a member of Banner Bank's executive management committee since 2004.

Tyrone J. Bliss joined Banner Bank in 2002. Mr. Bliss is a Certified Regulatory Compliance Manager with more than 31 years of commercial banking experience. Prior to joining Banner Bank, his career included senior risk management and compliance positions with Bank of America's Consumer Finance Group, Barnett Banks, Inc., and Florida-based community banks.

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

Corporate Information

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

Item 1A – Risk Factors

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

Risks Associated with Our Business

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

Our operations are significantly affected by national and regional economic conditions. Substantially all of our loans are to businesses and individuals in the states of Washington, Oregon and Idaho. All of our branches and most of our deposit customers are also located in these three states. A continuing decline in the economies of the markets in which we operate, in particular the Puget Sound area of Washington State, the Portland, Oregon metropolitan area and the agricultural regions of the Columbia Basin, could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, Washington, Oregon and Idaho have experienced home price declines, increased foreclosures and high unemployment rates. As a result of our high concentration of our customer base in the Puget Sound area of Washington State, the deterioration of businesses in the Puget Sound area, or one or more businesses with a large employee base in that area, also could have a material adverse effect on our business, financial condition, results of operations and prospects. In addition, weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade.

A further deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a material adverse effect on our business, financial condition and results of operations:

- demand for our products and services may decline;
- loan delinquencies, problem assets and foreclosures may increase;
- collateral for loans made may decline further in value; and
- the amount of our low-cost or non-interest bearing deposits may decrease.

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

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

higher rates of delinquencies, defaults and losses.

Our loan portfolio includes loans with a higher risk of loss.

We originate construction and land loans, commercial and multifamily mortgage loans, commercial business loans, consumer loans, agricultural mortgage loans and agricultural loans as well as residential mortgage loans primarily within our market areas. Generally, the types of loans other than the residential mortgage loans have a higher risk of loss than the residential mortgage loans. We had approximately \$3.087 billion outstanding in these types of higher risk loans at December 31, 2009 compared to approximately \$3.362 billion at December 31, 2008. These loans typically have greater credit risk than residential real estate for the following reasons:

- **Construction and Land Loans.** At December 31, 2009, construction and land loans were \$705 million or 19% of our total loan portfolio. This type of lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Loans on land under development or held for future construction also poses additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand conditions. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor to independently repay principal and interest. While our origination of these types of loans has decreased significantly in the last two years, we continue to have significant levels of construction loan balances. Most of our construction loans are for the construction of single family residences. Reflecting the current slowdown in the residential market, the secondary market for land and construction

loans is not readily liquid, so we have less opportunity to mitigate our credit risk by selling part or all of our interest in these loans. If we foreclose on a construction loan, our holding period for the collateral typically may be longer than we have historically experienced because there are fewer potential purchasers of the collateral. The decline in the number of potential purchasers has contributed to the decline in the value of these loans. Accordingly, charge-offs on construction and land loans may be larger than those incurred by other segments of our loan portfolio. At December 31, 2009, construction and land loans that were non-performing were \$159 million or 74% of our total non-performing loans.

- **Commercial and Multifamily Mortgage Loans.** At December 31, 2009, commercial and multifamily loans were \$1.236 billion or 33% of our total loan portfolio. These loans typically involve higher principal amounts than other types of loans. Repayment is dependent upon income being generated from the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. Commercial and multifamily mortgage loans may expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. This risk is exacerbated in the current economic environment. At December 31, 2009, commercial and multifamily loans that were non-performing were \$8 million or 4% of our total non-performing loans.
- **Commercial Business Loans.** At December 31, 2009, commercial business loans were \$638 million or 17% of our total loan portfolio. Our commercial loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise, may be illiquid and may fluctuate in value based on the success of the business. At December 31, 2009, commercial business loans that were non-performing were \$22 million or 10% of our total non-performing loans.
- **Agricultural Loans.** At December 31, 2009, agricultural loans were \$205 million or 5% of our total loan portfolio. Repayment is dependent upon the successful operation of the business, which is greatly dependent on many things outside the control of either us or the borrowers. These factors include weather, commodity prices, and interest rates among others. Collateral securing these loans may be difficult to evaluate, manage or liquidate and may not provide an adequate source of repayment. At December 31, 2009, agricultural loans that were non-performing were \$6 million or 3% of our total non-performing loans.
- **Consumer Loans.** At December 31, 2009, consumer loans were \$302 million or 8% of our total loan portfolio. Consumer loans (such as personal lines of credit) are collateralized, if at all, with assets that may not provide an adequate source of payment of the loan due to depreciation, damage, or loss. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. At December 31, 2009, consumer loans that were non-performing were \$4 million, or 2% of our total non-performing loans.

Our provision for loan losses and net loan charge offs have increased significantly and we may be required to make further increases in our provisions for loan losses and to charge off additional loans in the future, which could adversely affect our results of operations.

For the year ended December 31, 2009, we recorded a provision for loan losses of \$109.0 million, compared to \$62.5 million for the year ended December 31, 2008. We also recorded net loan charge-offs of \$88.9 million for the year ended December 31, 2009, compared to \$33.1 million for the year ended December 31, 2008. We are experiencing elevated levels of loan delinquencies and credit losses. Slower sales, excess inventory and declining prices have been the primary causes of the increase in delinquencies and foreclosures for construction and land development loans which, including related real estate owned, represent 76% of our non-performing assets at December 31, 2009. At December 31, 2009, our total non-performing assets had increased to \$295.9 million compared to \$209.2 million at December 31, 2008. Further, our portfolio is concentrated in construction and land loans, commercial business and commercial real estate loans, all of which generally have a higher risk of loss than residential mortgage loans. If current weak conditions in the housing and real estate markets continue, we expect that we will continue to experience higher than normal delinquencies and credit losses. Moreover, if general economic weakness is prolonged, we expect that could severely impact economic conditions in our market areas and that we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could materially adversely affect our financial condition and results of operations.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business and each loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- cash flow of the borrower and/or the project being financed;
- the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- the duration of the loan;
- the character and creditworthiness of a particular borrower; and
- changes in economic and industry conditions.

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through periodic reviews and consideration of several factors, including, but not limited to:

- our general reserve, based on our historical default and loss experience, certain macroeconomic factors, and management's expectations of future events; and
- our specific reserve, based on our evaluation of non-performing loans and their underlying collateral.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and loss and delinquency experience, and evaluate economic conditions and make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for additions to our allowance through an increase in the provision for loan losses. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. Our allowance for loan losses was 2.51% of total loans outstanding and 45% of non-performing loans at December 31, 2009. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and capital.

We are subject to various regulatory requirements, expect to be subject to a memorandum of understanding and may be subject to future additional regulatory restrictions and enforcement actions.

Under federal and state laws and regulations pertaining to the safety and soundness of insured depository institutions, the Washington DFI and the Federal Reserve Board, and separately the FDIC as insurer of each of the Bank's deposits, have authority to compel or restrict certain actions if either of the Banks' capital should fall below adequate capital standards as a result of operating losses, or if its regulators otherwise determine that it has insufficient capital or is otherwise operating in an unsafe and unsound manner. Among other matters, the corrective actions may include, but are not limited to, requiring us or the Banks to enter into informal or formal enforcement orders, including memoranda of understanding, written agreements, supervisory letters, commitment letters, and consent or cease and desist orders to take corrective action and refrain from unsafe and unsound practices; removing officers and directors and assessing civil monetary penalties; terminating the Banks' FDIC insurance; requiring us to enter into a strategic transaction, whether by merger or otherwise; and taking possession of and closing and liquidating either or both of the Banks. In addition, the FDIC has the authority to impose cross-guarantee liability against Banner Bank or Islanders Bank for any loss incurred by the FDIC, or any loss the FDIC reasonably anticipates incurring, in connection with the failure of one of the Banks or in connection with any assistance provided by the FDIC to one of the Banks in danger of failure.

In light of the current challenging operating environment, along with our elevated level of non-performing assets, delinquencies, and adversely classified assets and our recent operating results, we are subject to increased regulatory scrutiny as well as increased FDIC premiums as a result of the potential risk of loss in our loan portfolio. Following the regulators' most recent examination of Banner Bank as of June 30, 2009, and the Federal Reserve examination of Banner Corporation as of September 30, 2009, we and Banner Bank expect to become subject to a Memorandum of

Understanding (MOU) with the Washington DFI and the FDIC. We expect that, under the MOU, Banner Bank will be required, among other things, to develop and implement plans to reduce commercial real estate concentrations; to improve asset quality and reduce classified assets; to improve profitability; and to increase Tier 1 leverage capital to equal or exceed 10% of average assets. In addition, we expect to be required to retain management and directors acceptable to the Washington DFI and the FDIC. Lastly, it is expected that Banner Bank will not be able to pay cash dividends to Banner Corporation without prior approval from the FDIC and Washington DFI. No assurance can be given that our current management and directors are acceptable to the Washington DFI or the FDIC, that we will be able to retain or engage management and directors who are acceptable to the DFI or the FDIC or that we will be able to meet the requirements of the memoranda in a timely manner.

The Company and Banner Bank must obtain prior regulatory approval before adding any new director or senior executive officer or changing the responsibilities of any current senior executive officer. The Company and Banner Bank also may not pay pursuant to or enter into certain severance and other forms of compensation agreements without regulatory approval. In addition, the Company may not declare or pay any dividends on common or preferred stock, pay interest or principal on the balance of its junior subordinated debentures or repurchase our common stock without the prior written non-objection of the Federal Reserve Bank and must notify the Federal Reserve Bank prior to making any unusual or large payments. Further, Banner Bank requires the approval of the FDIC to participate in any additional borrowings under the Temporary Liquidity Guarantee Program.

If we did not comply with the requirements imposed on us by the Federal Reserve Bank or were unable to meet the requirements of the expected memoranda from the Washington DFI and the FDIC in a timely manner, we could become subject to additional supervisory action, including a consent order. If our banking supervisors were to take such additional supervisory action, we could, among other things, become subject to significant restrictions on our ability to develop any new business, as well as restrictions on our existing business, and we could be required to raise additional capital, dispose of certain assets and liabilities within a prescribed period of time, or both. In addition, the FDIC has the power to deem either of the Banks to be only adequately capitalized even though its capital ratios meet the well capitalized standard. In such event, such Bank would be prohibited from using brokered deposits, which have been a source of funds for us in recent years, and rates on deposits would be limited to market rates determined by the FDIC, potentially adversely affecting our liquidity. The terms of any such corrective action could have a material negative effect on our business, our financial condition and the value of our common stock. Additionally, there can be no assurance that we will not be subject to further supervisory action or regulatory proceedings.

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

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

We may have continuing losses and significant variation in our quarterly results.

We reported a net loss of \$43.5 million available to common shareholders during the year ended December 31, 2009 compared to a net loss of \$128.8 million during the year ended December 31, 2008. The net loss for the year ended December 31, 2009 primarily resulted from our high level of non-performing assets and the resultant reduction in interest income and increased provision for loan losses. All of our goodwill has been written off; however, we may continue to suffer further losses as a result of credit-related factors. In addition, several other factors affecting our business can cause significant variations in our quarterly results of operations. In particular, variations in the volume of our loan originations and sales, the differences between our cost of funds and the average interest rate earned on investments, special FDIC insurance charges, significant changes in real estate valuations and the fair valuation of our junior subordinated debentures or our investment securities portfolio could have a material adverse effect on our results of operations and financial condition.

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

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

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

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

The market for some of the investment securities held in our portfolio has been experiencing volatility and disruption for more than a year. These market conditions have affected and may further detrimentally affect the value of these securities, such as through reduced valuations because of the perception of heightened credit and liquidity risks. There can be no assurance that the declines in market value associated with these disruptions will not result

in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

An increase in interest rates, change in the programs offered by governmental sponsored entities (“GSE”) or our ability to qualify for such programs may reduce our mortgage revenues, which would negatively impact our non-interest income.

Our mortgage banking operations provide a significant portion of our non-interest income. We generate mortgage revenues primarily from gains on the sale of single-family mortgage loans pursuant to programs currently offered by Fannie Mae, Freddie Mac and non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. Any future changes in these programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference, or spread, between the interest earned on loans, securities and other interest-earning assets and the interest paid on deposits, borrowings, and other interest-bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. We principally manage interest rate risk by managing the volume, mix and interest rate sensitivity of our earning assets and funding liabilities. In a changing interest rate environment, we may not be able to manage this risk effectively. Changes in interest rates also can affect: (1) our ability to originate and /or sell loans; (2) the value of our interest-earning assets, which would negatively impact stockholders’ equity, our ability to realize gains from the sale of such assets and the collateral value of pledged assets; (3) our ability to obtain and retain deposits in competition

with other available investment alternatives; and (4) the ability of our borrowers to repay adjustable or variable rate loans. Interest rates are highly sensitive to many factors, including government monetary policies, domestic and international economic and political conditions and other factors beyond our control. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially harmed.

Further, a significant portion of our adjustable rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately 66% of our loan portfolio was comprised of adjustable or floating-rate loans at December 31, 2009, and approximately \$1.7 billion, or 68%, of those loans contained interest rate floors, below which the loans' contractual interest rate may not adjust. At December 31, 2009, the weighted average floor interest rate of these loans was 5.78%. At that date, approximately \$1.5 billion, or 85%, of these loans were at their floor interest rate. The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates, although this result is subject to the risks that borrowers may refinance these loans during periods of declining interest rates. Also, when loans are at their floors, there is a further risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates which could have a material adverse affect on our results of operations.

Our investment in Federal Home Loan Bank stock may be impaired.

At December 31, 2009, we owned \$37.4 million of stock of the Federal Home Loan Bank of Seattle, or FHLB. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. Our FHLB stock has a par value of \$100, is carried at cost, and is subject to recoverability testing. The FHLB announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the "FHFA"), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. As a result, the FHLB has not paid a dividend since the fourth quarter of 2008. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in its balance sheet. As a result, we have not recorded an impairment on our investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

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

Beginning in late 2008, the economic environment caused higher levels of bank failures, which dramatically increased FDIC resolution costs and led to a significant reduction in the Deposit Insurance Fund. As a result, the FDIC has significantly increased the initial base assessment rates paid by financial institutions for deposit insurance. The base assessment rate was increased by seven basis points (seven cents for every \$100 of deposits) for the first quarter of 2009. Effective April 1, 2009, initial base assessment rates were changed to range from 12 basis points to 45 basis points across all risk categories with possible adjustments to these rates based on certain debt-related components. These increases in the base assessment rate have increased our deposit insurance costs and negatively impacted our earnings. In addition, in May 2009, the FDIC imposed a special assessment on all insured institutions due to recent bank and savings association failures. The emergency assessment amounted to five basis points on each institution's assets minus Tier 1 capital as of June 30, 2009, subject to a maximum equal to 10 basis points times the institution's assessment base. Our FDIC deposit insurance expense for the year ended December 31, 2009 was \$10.0 million, including the special assessment of \$2.0 million recorded in June 2009 and paid on September 30, 2009. Any additional emergency special assessment imposed by the FDIC will negatively impact our earnings.

Continued weak or worsening credit availability could limit our ability to replace deposits and fund loan demand, which could adversely affect our earnings and capital levels.

Continued weak or worsening credit availability and the inability to obtain adequate funding to replace deposits and fund continued loan growth may negatively affect asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, maturity of investment securities and loan payments, we rely from time to time on advances from the Federal Home Loan Bank of Seattle, borrowings from the Federal Reserve Bank of San Francisco and certain other wholesale funding sources to fund loans and replace deposits. If the economy does not improve or continues to deteriorate, these additional funding sources could be negatively affected, which could limit the funds available to us. Our liquidity position could be significantly constrained if we are unable to access funds from the Federal Home Loan Bank of Seattle, the Federal Reserve Bank of San Francisco or other wholesale funding sources.

Failure to manage our growth may adversely affect our performance.

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

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

Liquidity is essential to our business and the inability to obtain adequate funding may negatively affect growth and, consequently, our earnings capability and capital levels. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities or the terms of which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the Washington, Oregon or Idaho markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the

prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued uncertainty in credit markets. In addition, recent changes in the collateralization requirements and other provisions of the Washington and Oregon public funds deposit programs have changed the economic benefit associated with accepting public funds deposits, which may affect our need to utilize alternative sources of liquidity.

We may engage in FDIC-assisted transactions, which could present additional risks to our business.

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

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including changes that may restrict our ability to foreclose on single-family home loans and offer overdraft protection.

We are subject to extensive regulation, supervision and examination by federal and state banking authorities. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds, and the banking system as a whole, and not holders of our common stock. These regulations affect our lending practices, capital structure, investment practices, dividend policy, and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations, and policies for possible changes. Changes to statutes, regulations, or regulatory policies, including changes in interpretation or implementation of statutes, regulations, or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, which could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

New legislation proposed by Congress may give bankruptcy courts the power to reduce the increasing number of home foreclosures by giving bankruptcy judges the authority to restructure mortgages and reduce a borrower's payments. Property owners would be allowed to keep their property while working out their debts. Bills placing temporary moratoriums on foreclosure sales or otherwise modifying foreclosure procedures to the benefit of borrowers and the detriment of lenders may be enacted by either Congress or in the States of Washington, Oregon and Idaho in the future. These laws may further restrict our collection efforts on one-to-four single-family mortgage loans. Additional legislation recently enacted by Congress and federal regulations effective in 2010 give current debit card holders the chance to opt out of an overdraft protection program and limit overdraft fees, which could result in additional operational costs and a reduction in our non-interest income.

Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. In this regard, banking regulators are considering additional regulations governing compensation which may adversely affect our ability to attract and retain employees. On June 17, 2009, the Obama Administration published a comprehensive regulatory reform plan that is intended to modernize and protect the integrity of the United States financial system. The reform plan proposes, among other matters, the creation of a new federal agency, the Consumer Financial Protection Agency, that would be dedicated to protecting consumers in the financial products and services market. The creation of this agency could result in new regulatory requirements and raise the cost of regulatory compliance. In addition, legislation stemming from the reform plan could require changes in regulatory capital requirements, and compensation practices. If implemented, the foregoing regulatory reforms may have a material impact on our operations. However, because the legislation needed to implement the President's reform plan has not been introduced, and because the final legislation may differ significantly from the legislation proposed by the Administration, we cannot determine the specific impact of regulatory reform at this time.

Our litigation related costs might continue to increase.

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

Because of our participation in the TARP Capital Purchase Program, we are subject to several restrictions including restrictions on compensation paid to our executives.

Pursuant to the terms of the TARP Capital Purchase Program, we adopted certain standards for executive compensation and corporate governance for the period during which the Treasury holds an investment in us. These standards generally apply to our Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers. The standards include (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibition on making golden parachute payments to senior executives; and (4) agreement not to deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive. Pursuant to the American Recovery and Reinvestment Act, further compensation restrictions, including significant limitations on incentive compensation, have been imposed on our senior executive officers and most highly compensated employees. Such restrictions and any future restrictions on executive compensation which may be adopted, could adversely affect our ability to hire and retain senior executive officers.

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

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

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.

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

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

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

the loss of customers, investors and employees, costly litigation, a decline in revenues and increased governmental regulation.

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

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

Our assets as of December 31, 2009 include a deferred tax asset and we may not be able to realize the full amount of such asset.

We recognize deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax bases of assets and liabilities. At December 31, 2009, the net deferred tax asset was approximately \$14.8 million, an increase from a balance of approximately \$5.5 million at December 31, 2008. The net deferred tax asset results primarily from our provisions for loan losses recorded for financial reporting purposes, which has been significantly larger than net loan charge-offs deducted for tax reporting purposes. The net deferred tax asset is also significantly affected by valuation adjustments for securities and junior subordinated debentures which are recognized for financial reporting purposes, and are not currently deductible for federal income tax reporting purposes.

A consequence of a large sale of our common stock could be that we experience an "ownership change" as defined under Section 382 of the Internal Revenue Code of 1986, as amended (which is generally a greater than a 50 percentage point increase by certain "5% shareholders" over a rolling three year period). Section 382 imposes an annual limitation on the utilization of deferred tax assets, such as net operating loss carryforwards and other tax attributes, once an ownership change has occurred. Depending on the size of the annual limitation (which is in part a function of our market capitalization at the time of the ownership change) and the remaining carryforward period of the tax assets (U.S. federal net operating losses generally may be carried forward for a period of 20 years), we could realize a permanent loss of a portion of our U.S. federal and state deferred tax assets and certain built-in losses that have not been recognized for tax purposes.

We regularly review our deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. We believe the recorded net deferred tax asset at December 31, 2009 is fully realizable; however, we would not know the impact of an ownership change until after the offering is completed. However, based on our preliminary analysis of the impact of such "ownership change" on our deferred tax assets, we believe that the impact on our deferred tax assets is unlikely to be material. This is a preliminary and complex analysis and requires the Company to make certain judgments in determining the annual limitation. As a result, it is possible that we could ultimately lose a significant portion of our deferred tax assets, which could have a material adverse effect on our results of operations and financial condition. If we determine that we will be unable to realize all or part of the net deferred tax asset, we would adjust this deferred tax asset, which would negatively impact our financial condition and results of operations.

If we defer payments of interest on our outstanding junior subordinated debentures or if certain defaults relating to those debentures occur, we will be prohibited from declaring or paying dividends or distributions on, and from making liquidation payments with respect to, our common stock.

As of December 31, 2009, we had outstanding \$123.7 million aggregate principal amount (\$47.7 million at fair value) of junior subordinated debentures issued in connection with the sale of trust preferred securities through statutory business trusts. We have also guaranteed these trust preferred securities. There are currently six separate series of these junior subordinated debentures outstanding, each series having been issued under a separate indenture and with a separate guarantee. Each of these indentures, together with the related guarantee, prohibits us, subject to limited exceptions, from declaring or paying any dividends or distributions on, or redeeming, repurchasing, acquiring or making any liquidation payments with respect to, any of our capital stock at any time when (i) there shall have occurred and be continuing an event of default under such indenture or any event, act or condition that with notice or lapse of time or both would constitute an event of default under such indenture; (ii) we are in default with respect to payment of any obligations under such guarantee; or (iii) we have deferred payment of interest on the junior subordinated debentures outstanding under that indenture. In that regard, we are entitled, at our option but subject to certain conditions, to defer payments of interest on the junior subordinated debentures of each series from time to time for up to five years.

Events of default under the indenture generally consist of our failure to pay interest on the junior subordinated debt securities under certain circumstances, our failure to pay any principal of or premium on such junior subordinated debt securities when due, our failure to comply with certain covenants under the indenture, and certain events of bankruptcy, insolvency or liquidation relating to us or the Bank. As a result of these provisions, if we were to elect to defer payments of interest on any series of junior subordinated debentures, or if any of the other events described in clause (i) or (ii) of the first paragraph of this risk factor were to occur, we would be prohibited from declaring or paying any dividends on our common stock, from repurchasing or otherwise acquiring any such common stock, and from making any payments to holders of common stock in the event of our liquidation, which would likely have a material adverse effect on the market value of our common stock. Moreover, without notice to or consent from the holders of our common stock, we may issue additional series of junior subordinated debentures in the future with terms similar to those of our existing junior subordinated debentures or enter into other financing agreements that limit our ability to purchase or to pay dividends or distributions on our capital stock, including our common stock.

Also, Banner may not pay interest on the junior subordinated debentures without the prior written non-objection of the Federal Reserve. There can be no assurance that the Federal Reserve will continue to allow us to make payments on our junior subordinated debentures.

Item 1B – Unresolved Staff Comments

None.

Item 2 – Properties

Banner Corporation maintains its administrative offices and main branch office, which is owned by us, in Walla Walla, Washington. In total, as of December 31, 2009, we have 89 branch offices located in Washington, Oregon and Idaho. Three of those 89 are Islanders Bank branches and 86 are Banner Bank branches. Sixty-four branches are located in Washington, sixteen in Oregon and nine in Idaho. Of those offices, approximately half are owned and the other half are leased facilities. We also have nine leased locations for loan production offices spread throughout the same three-state area. The lease terms for our branch and loan production offices are not individually material. Lease expirations range from one to 25 years. Administrative support offices are primarily in Washington, where we have nine facilities, of which we own two and lease seven. Additionally, we have one leased administrative support office in Idaho and own one located in Oregon. In the opinion of management, all properties are adequately covered by insurance, are in a good state of repair and are appropriately designed for their present and future use.

Item 3 – Legal Proceedings

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

PART II

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

Price Range of Common Stock and Dividend Information

Our common stock is traded on the NASDAQ Global Select Market under the symbol “BANR.” Shareholders of record as of December 31, 2009 totaled 1,426 based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or “street” name through various brokerage firms. The following tables show the reported high and low sale prices of our common stock for the periods presented, as well as the cash dividends declared per share of common stock for each of those periods.

Year Ended December 31, 2009	High	Low	Cash Dividend Declared
First quarter	\$ 10.39	\$ 1.81	\$ 0.01
Second quarter	6.71	3.04	0.01
Third quarter	4.29	2.51	0.01
Fourth quarter	3.55	2.07	0.01

Year Ended December 31, 2008	High	Low	Cash Dividend Declared
First quarter	\$ 28.91	\$ 19.90	\$ 0.20
Second quarter	24.68	8.80	0.20
Third quarter	21.14	7.12	0.05
Fourth quarter	14.71	8.01	0.05

Year Ended December 31, 2007	High	Low	Cash Dividend Declared
First quarter	\$ 45.41	\$ 38.61	\$ 0.19
Second quarter	41.97	34.06	0.19
Third quarter	36.39	27.63	0.19
Fourth quarter	36.14	27.18	0.20

The timing and amount of cash dividends paid on our common stock depends on our earnings, capital requirements, financial condition and other relevant factors and is subject to the discretion of our board of directors. After consideration of these factors, beginning in 2009, we reduced our dividend payout to preserve our capital. On October 30, 2009, we paid our shareholders a dividend of \$0.01 per share. There can be no assurance that we will pay dividends on our common stock in the future.

The Federal Reserve Bank of San Francisco has also notified us that we may not declare or pay any dividends on common or preferred stock or pay interest or principal on the balance of its junior subordinated debentures without their prior written non-objection.

Our ability to pay dividends on our common stock depends primarily on dividends we receive from Banner Bank and Islanders Bank. Under federal regulations, the dollar amount of dividends the Banks may pay depends upon their capital position and recent net income. Generally, if a bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the conversion. Banner Bank, our primary subsidiary, converted to a stock form of ownership and is therefore subject to the limitation described in the preceding sentence. In addition, under Washington law, no bank may declare or pay any dividend in an amount greater than its retained earnings. The Washington DFI has the power to require any bank to suspend the payment of any and all dividends.

Further, under Washington law, Banner Corporation is prohibited from paying a dividend if, after making such dividend payment, it would be unable to pay its debts as they become due in the usual course of business, or if its total liabilities, plus the amount that would be needed, in the event Banner Corporation were to be dissolved at the time of the dividend payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right of payment to the capital stock on which the applicable distribution is to be made, exceed our total assets.

In addition to the foregoing regulatory considerations, there are numerous governmental requirements and regulations that affect our business activities. A change in applicable statutes, regulations or regulatory policy may have a material effect on our business and on our ability to pay dividends on our common stock.

In addition to the legal and regulatory restrictions described above, certain contractual provisions limit our ability to pay dividends on our common stock. The securities purchase agreement between us and the Treasury, pursuant to which we issued our Series A Preferred Stock and Warrant as part of the TARP Capital Purchase Program, provides that prior to the earlier of (i) November 21, 2011 and (ii) the date on which all

of the shares of the Series A Preferred Stock have been redeemed by us or transferred by Treasury to third parties, we may not, without the consent of the Treasury, (a) pay a quarterly cash dividend on our common stock of more than \$.05 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock or preferred stock, other than the Series A Preferred Stock, or any trust preferred securities then outstanding. In addition, under the terms of the Series A Preferred Stock, we may not pay dividends on our common stock unless we are current in our dividend payments on the Series A Preferred Stock. Dividends on the Series A Preferred Stock are payable quarterly at a rate of 5% per annum for the first five years and a rate of 9% per annum thereafter if not redeemed prior to that time.

Issuer Purchases of Equity Securities

We did not have any repurchases of our common stock from October 1, 2009 through December 31, 2009.

Equity Compensation Plan Information

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

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

Index	Period Ended					
	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
Banner Corporation	100.00	102.53	148.41	98.33	33.51	9.63
NASDAQ Composite	100.00	101.37	111.03	121.92	72.49	104.31
SNL Bank \$1B-\$5B	100.00	98.29	113.74	82.85	68.72	49.26
SNL Bank NASDAQ	100.00	96.95	108.85	85.45	62.06	50.34

*Assumes \$100 invested in Company common stock and each index at the close of business on December 31, 2004 and that all dividends were reinvested. Information for the graph was provided by SNL Financial L.C. © 2010.

Item 6 – Selected Financial Data

The following condensed consolidated statements of operations and financial condition and selected performance ratios as of December 31, 2009, 2008, 2007, 2006, and 2005 and for the years then ended have been derived from our audited consolidated financial statements. Certain information for prior years has been restated in accordance with the U.S. Securities and Exchange Commission Staff Accounting Bulletin No. 108 which addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements.

The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 8, Financial Statement and Supplementary Data.”

FINANCIAL CONDITION DATA:

(In thousands)	At December 31				
	2009	2008	2007	2006	2005
Total assets	\$ 4,722,221	\$ 4,584,368	\$ 4,492,658	\$ 3,495,566	\$ 3,040,555
Loans receivable, net	3,694,852	3,886,211	3,763,790	2,930,455	2,408,833
Cash and securities (1)	640,657	419,718	354,809	347,410	427,681
Deposits	3,865,550	3,778,850	3,620,593	2,794,592	2,323,313
Borrowings	414,315	318,421	372,039	404,330	459,821
Common stockholders’ equity	287,721	317,433	437,846	250,607	220,857
Total stockholders’ equity	\$ 405,128	\$ 433,348	\$ 437,846	\$ 250,607	\$ 220,857
Shares outstanding	21,540	17,152	16,266	12,314	12,082
Shares outstanding excluding unearned, restricted shares held in ESOP	21,299	16,912	16,026	12,074	11,782

OPERATING DATA:

(In thousands)	For the Years Ended December 31				
	2009	2008	2007	2006	2005
Interest income	\$ 237,370	\$ 273,158	\$ 295,497	\$ 243,019	\$ 190,160
Interest expense	92,797	125,345	145,690	116,114	81,377
Net interest income before provision loan losses	144,573	147,813	149,807	126,905	108,783
Provision for loan losses	109,000	62,500	5,900	5,500	4,903
Net interest income	35,573	85,313	143,907	121,405	103,880
Mortgage banking operations	8,893	6,045	6,270	5,824	5,647
Gain (loss) on sale of securities	--	--	--	65	(7,302)
	11,018	9,156	11,574	--	--

Net change in valuation of financial instruments carried at fair value					
Other operating income	23,779	24,428	20,551	14,686	12,199
Insurance recovery, net proceeds	--	--	--	(5,350)	--
FHLB prepayment penalties	--	--	--	--	6,077
Goodwill write-off	--	121,121	--	--	--
Other operating expenses	142,080	138,899	127,489	99,731	91,471
Income (loss) before provision for income tax					
(benefit) expense	(62,817)	(135,078)	54,813	47,599	16,876
Provision for income tax (benefit) expense	(27,053)	(7,085)	17,890	16,055	4,896
Net income (loss)	\$ (35,764)	\$ (127,993)	\$ 36,923	\$ 31,544	\$ 11,980

PER COMMON SHARE
DATA:

	At or for the Years Ended December 31				
	2009	2008	2007	2006	2005
Net income (loss):					
Basic	\$ (2.33)	\$ (7.94)	\$ 2.53	\$ 2.65	\$ 1.04
Diluted	(2.33)	(7.94)	2.49	2.58	1.00
Common stockholders' equity per share (2)	13.51	18.77	27.32	20.76	18.74
Common stockholders' tangible equity per share (2)	12.99	17.96	18.73	17.75	15.67
Cash dividends	0.04	0.50	0.77	0.73	0.69
Dividend payout ratio (basic)	(1.72)%	(6.30)%	30.43%	27.55%	66.35%
Dividend payout ratio (diluted)	(1.72)%	(6.30)%	30.92%	28.29%	69.00%

(footnotes follow tables)

OTHER DATA:

	At December 31				
	2009	2008	2007	2006	2005
Full time equivalent employees	1,060	1,095	1,139	898	856
Number of branches	89	86	84	58	57

KEY FINANCIAL RATIOS:

	At or For the Years Ended December 31				
	2009	2008	2007	2006	2005
Performance Ratios:					
Return on average assets (3)	(0.78)%	(2.78)%	0.91%	0.96%	0.39%
Return on average common equity (4)	(11.69)	(30.90)	10.07	13.29	5.43
Average common equity to average assets	6.71	8.99	9.06	7.19	7.23
Interest rate spread (5)	3.23	3.36	3.86	3.97	3.72
Net interest margin (6)	3.33	3.45	4.00	4.08	3.79
Non-interest income to average assets	0.96	0.86	0.95	0.62	0.35
Non-interest expense to average assets	3.12	5.65	3.15	2.86	3.20
Efficiency ratio (7)	75.47	138.72	67.74	64.00	81.75
Average interest-earning assets to interest-bearing liabilities	104.55	103.21	103.52	102.81	102.66
Selected Financial Ratios:					
	2.51	1.90	1.20	1.20	1.27

Allowance for loan losses as a percent of total loans at end of period					
Net charge-offs as a percent of average outstanding loans during the period	2.28	0.84	0.08	0.03	0.16
Non-performing assets as a percent of total assets	6.27	4.56	0.99	0.43	0.36
Allowance for loan losses as a percent of non-performing loans (8)	0.45	0.40	1.08	2.53	2.96
Tangible common stockholders' equity to tangible assets (9)	5.87	6.64	6.89	6.20	6.14
Consolidated Capital Ratios:					
Total capital to risk-weighted assets	12.73	13.11	11.72	11.80	12.29
Tier 1 capital to risk-weighted assets	11.47	11.86	10.58	9.53	10.17
Tier 1 leverage capital to average assets	9.62	10.32	10.04	8.76	8.59

(1) Includes securities available for sale and held to maturity.

(2) Calculated using shares outstanding excluding unearned restricted shares held in ESOP.

(3) Net income divided by average assets.

(4) Net income divided by average equity.

(5) Difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(6) Net interest income before provision for loan losses as a percent of average interest-earning assets.

(7) Other operating expenses divided by the total of net interest income before loan losses and other operating income (non-interest income).

(8) Non-performing loans consist of nonaccrual and 90 days past due loans.

(9) Excluding preferred stock, goodwill, core deposit and other intangibles.

Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations

Management’s discussion and analysis of results of operations is intended to assist in understanding our financial condition and results of operations. The information contained in this section should be read in conjunction with the Consolidated Financial Statements and accompanying Notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K.

Executive Overview

We are a bank holding company incorporated in the State of Washington and own two subsidiary banks, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2009, its 86 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank and conducts its business from three locations in San Juan County, Washington. As of December 31, 2009, we had total consolidated assets of \$4.7 billion, total loans of \$3.7 billion, total deposits of \$3.9 billion and total stockholders’ equity of \$405 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.

Deteriorating economic conditions and ongoing strains in the financial and housing markets which accelerated throughout 2008 and generally continued in 2009 have presented an unusually challenging environment for banks and their holding companies, including Banner Corporation. This has been particularly evident in our need to provide for credit losses during this period at significantly higher levels than our historical experience and has also affected our net interest income and other operating revenues and expenses. As a result of these factors, for the year ended December 31, 2009, we had a net loss of \$35.8 million which, after providing for the preferred stock dividend and related discount accretion, resulted in a net loss to common shareholders of \$43.5 million, or (\$2.33) per diluted share, compared to a net loss to common shareholders of \$128.8 million, or (\$7.94) per diluted share, for the year ended December 31, 2008. The results in 2008 included a \$121.1 million impairment charge for the write-off of goodwill. Although there are indications of moderation, this stress in the economy has been the most significant challenge impacting our recent operating results and, like most financial institutions, our future operating results will be significantly affected by the course of recovery from the current recession.

Our provision for loan losses was \$109.0 million for the year ended December 31, 2009, compared to \$62.5 million recorded in the prior year. The significant provision for loan losses in both years reflects material levels of delinquencies, non-performing loans and net charge-offs, particularly for loans for the construction of one- to four-family homes and for acquisition and development of land for residential properties. For most of the past two years, housing markets remained weak in many of our primary services areas, resulting in elevated levels of delinquencies and non-performing assets, deterioration in property values, particularly for residential land and building lots, and the need to provide for realized and anticipated losses. By contrast, other non-housing related segments of our loan portfolio, while showing some signs of stress, have performed as expected with only normal

levels of credit problems given the serious economic slowdown. Throughout 2008 and 2009, the higher than historical provision for loan losses has been the most significant factor affecting our operating results and, while we are encouraged by the continuing reduction in our exposure to residential construction loans and the recent slowdown in the surfacing of new problem assets, looking forward we anticipate our credit costs will remain elevated for a number of quarters and will have a continuing adverse effect on our earnings during 2010. (See Note 9, Allowance for Loan Losses, as well as “Asset Quality” below.)

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits and borrowings. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. As more fully explained below, our net interest income before provision for loan losses decreased by \$3.2 million for the year ended December 31, 2009 to \$144.6 million compared to \$147.8 million for the prior year, primarily as a result of a contraction in our net interest spread and net interest margin as asset yields have declined sharply over the past two years in response to the Federal Reserve’s monetary policy actions designed to dramatically lower short-term interest rates. Further, as well as affecting the amount of our loan loss provision, increased delinquencies and the resulting increased levels of non-accrual loans and other non-performing assets have had an adverse impact on our net interest margin. Nonetheless, net interest income and the net interest margin improved meaningfully in the second half of 2009 as rapidly declining interest expense on deposits contributed to significantly lower funding costs and the trend of lower funding costs accelerated in the final quarter of 2009.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value. (See Note 25, Fair Value Accounting and Measurement.) For the year ended December 31, 2009, we recorded a net gain of \$11.0 million (\$7.1 million after tax) in fair value adjustments compared to a net gain of \$9.2 million (\$5.9 million after tax) for the year ended December 31, 2008. Further, reflecting unprecedented difficulties in the operating environment for banking institutions and deteriorating market conditions, for the year ended December 31, 2008, our net income also included a \$121.1 million non-cash, non-tax deductible impairment charge for the write-off of goodwill.

Other operating income, excluding the fair value adjustments, increased \$2.2 million to \$32.7 million for the year ended December 31, 2009 from \$30.5 million for the prior year, primarily as a result of increased gain on the sale of loans from mortgage banking operations somewhat offset by a reduction in loan servicing fees. Revenues (net interest income before the provision for loan losses plus other operating income), excluding fair value adjustments, decreased \$1.0 million to \$177.2 million for the year ended December 31, 2009, compared to \$178.3 million for the year ended December 31, 2008, as the increased non-interest revenues were not sufficient to offset the decrease in net interest income. Other operating expenses were \$142.1 million for the year ended December 31, 2009, an increase from \$138.9 million, excluding the goodwill write-off, for the year ended December 31, 2008. The current year's expenses reflect significantly increased deposit insurance expense, elevated costs associated with problem loan collection activities including professional services and charges related to real estate owned, and increased advertising, which were generally offset by reductions in compensation, occupancy, payment and card processing and miscellaneous expenses.

As noted above, in the year ended December 31, 2009, our net income included an \$11.0 million net gain in the valuation of the selected financial assets and liabilities we record at fair value. The fair value adjustment resulted in a reduction of \$7.1 million (net after tax), or \$0.38 per share (diluted), to the net loss reported for the year ended December 31, 2009. By comparison, the \$9.2 million fair value gain in the prior year resulted in a reduction of \$5.9 million (net after tax), or (\$0.36) per share (diluted) to the net loss. Excluding the net fair value adjustments and the goodwill impairment in 2008, the net loss from core operations was \$42.8 million (\$50.5 million available to common shareholders) for the year ended December 31, 2009, compared to \$12.7 million (\$13.6 million available to common shareholders) for the year ended December 31, 2008. Earnings or loss from core operations and other earnings information excluding the change in valuation of financial instruments carried at fair value and goodwill impairment charges represent non-GAAP financial measures. Management has presented these non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. Where applicable, we have also presented comparable earnings information using GAAP financial measures. The decrease in earnings from core operations primarily reflects the increased loan loss provisioning, narrower net interest margin, higher FDIC insurance charges and increased collection costs. See "Comparison of Results of Operations for the years ended December 31, 2009 and 2008" for more detailed information about our financial performance.

We offer a wide range of loan products to meet the demands of our customers. Historically, our 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; however, over the past two years our origination of construction and land development loans has declined materially and the proportion of the portfolio invested in these types of loans has declined. By contrast, residential mortgage loan originations in 2009 have significantly increased, primarily reflecting the impact of exceptionally low interest rates on the demand for loans to refinance existing debt, although loans to finance home purchases also increased in the two most recent quarters. Our real estate lending activities have also included the origination of multifamily and commercial real estate loans. Our commercial business 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. Reflecting the current recession, in recent periods demand for these types of commercial business loans has been weak; however, total outstanding balances have remained nearly unchanged. We have also increased our emphasis on consumer lending, although demand for consumer loans also has been modest in recent quarters. Still, the portion of the loan portfolio invested in consumer loans has increased and is now 8% of total loans. While continuing our commitment to residential lending, including our mortgage banking activities, we expect commercial lending (including owner-occupied commercial real estate, commercial business and agricultural loans) and consumer lending to become increasingly more important activities for us. By contrast, we anticipate residential construction and related land development lending, which at December 31, 2009 represented 14% of the loan portfolio, compared to 21% a year earlier, will continue to be restrained by market conditions for the foreseeable future, as well as by our efforts to reduce our concentration in this type of lending, with balances

continuing to decline for a number of quarters. We also expect non-owner-occupied investor commercial real estate lending, for both construction and longer-term financing, to be curtailed with balances declining for the foreseeable future.

Deposits, customer retail repurchase agreements and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits. 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 branch expansion, relocations and renovation has been directed toward attracting additional deposit customer relationships and balances. The long-term success of our deposit gathering activities is reflected not only in the growth of deposit balances, but also in increases in the level of deposit fees, service charges and other payment processing revenues compared to periods prior to that expansion. For the year ended December 31, 2009, our deposit balances increased modestly despite our decision to significantly reduce our exposure to public funds deposits, as the new higher collateralization requirements and the shared risk exposure under Washington and Oregon state regulations have made retaining these deposits less desirable than in the past. In addition, although brokered deposits have never been an important component of our funding, we also chose to reduce brokered deposits by \$103 million over the same twelve-month period. Excluding the effects of public and brokered deposits, retail deposit growth for the year ended December 31, 2009 was very strong; however, payment processing revenues declined modestly, reflecting the adverse effect of the soft economy on activity levels for deposit customers, debit and credit cardholders and merchants.

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.

Critical Accounting Policies

In the opinion of management, the accompanying consolidated statements of financial condition and related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows reflect all adjustments (which include reclassification and normal recurring adjustments) that are necessary for a fair presentation in conformity with U.S. Generally Accepted Accounting Principles ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements.

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, (iv) the valuation of intangibles such as goodwill, core deposit intangibles and mortgage servicing rights and (v) the valuation of real estate held-for-sale. These policies and judgments, estimates and assumptions are described in greater detail below. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and our financial condition and operating results in future periods. There have been no significant changes in our application of accounting policies since December 31, 2007. For additional information concerning critical accounting policies, see Notes 1, 8, 9, 24 and 25 of the Notes to the Consolidated Financial Statements and the following:

Interest Income: (Notes 1 & 8) Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the interest may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.

Provision and Allowance for Loan Losses: (Notes 1 & 9) The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. We maintain an allowance for loan losses consistent in all material respects with the GAAP guidelines outlined in ASC 450, Contingencies. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and value impaired loans consistent with the accounting guidelines outlined in ASC 310, Receivables.

The allowance for losses on loans is maintained at a level sufficient to provide for 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 collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loans. Realized losses related to specific assets are applied as a reduction of the carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by us at the time financial statements are prepared. Although we use the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond our control. The adequacy of general and specific reserves is based on our continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, 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 we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

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

based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. This methodology may result in losses or recoveries differing significantly from those provided in the Consolidated Financial Statements.

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

Fair Value Accounting and Measurement: (Notes 1 and 25) We use fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. We include in the Notes to the Consolidated Financial Statements information about the extent to which fair value is used to measure financial assets and liabilities, the valuation methodologies used and the impact on our results of operations and financial condition. Additionally, for financial instruments not recorded at fair value we disclose, where appropriate, our estimate of their fair value.

The accounting standards define fair value, establish a consistent framework for measuring fair value and expand disclosure requirements about fair value measurements. Fair value is defined as the price that would be received to sell the financial asset or paid to transfer the financial liability in an orderly transaction between willing market participants at the measurement date. Among other things, the standards require us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our 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.

In accordance with the standards, it is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. However, in certain instances, when market observable inputs are not available, we are required to make judgments about assumptions market participants would use in estimating the fair value of the financial instruments. In addition, changes in market conditions may reduce the availability of quoted prices or other observable inputs, requiring a change in the method, judgments and assumptions used to estimate fair value for specific instruments from that which was used in prior periods. The disruption of certain financial markets and lack of meaningful transaction activity for certain securities beginning in 2008 and continuing in 2009 has made estimating fair values more difficult and less reliable than in prior years.

Goodwill and Other Intangible Assets: (Notes 1 and 23) Goodwill and other intangible assets consists primarily of goodwill, which represents the excess of the purchase price over the fair value of net assets acquired in a business combination accounted for under the purchase method, and core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Prior to December 31, 2008, the largest component of our intangible assets was goodwill which arose from business combinations completed in previous periods. However, for the year ended December 31, 2008, we recorded \$121.1 million of impairment charges, which

eliminated all of the goodwill previously carried in our Consolidated Statements of Financial Condition. The other major component of our intangible assets is core deposit intangibles, which is the value ascribed to the long-term deposit relationships arising from acquisitions. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

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

Adoption and Pending Adoption of Recent Accounting Pronouncements

Recently Adopted Accounting Standards: In August 2009, FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*. This update amends ASC 820, *Fair Value Measurements and Disclosure*, in regards to the fair value measurement of liabilities. FASB ASC 820 clarifies that in circumstances in which a quoted price for an identical liability in an active market is not available, a reporting entity shall utilize one or more of the following techniques: i) the quoted price of the identical liability when traded as an asset, ii) the quoted price for a similar liability or for a similar liability when traded as an asset, or iii) another valuation technique that is consistent with the principles of ASC 820. In all instances a reporting entity shall utilize the approach that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Also, when measuring the fair value of a liability, a reporting entity shall not include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This update is effective for the Company in the fourth quarter of 2009 and the adoption of ASU 2009-05 did not have a material impact on the Company's Consolidated Financial Statements.

In May 2009, FASB amended the accounting standard for Subsequent Events. The updated standard, ASC 855, established general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The revisions did not result in significant changes in the subsequent events that an entity reports, either through recognition or disclosure in its financial statements. It does require disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. This disclosure should alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented. The Company adopted the provisions of this guidance for the interim period ended June 30, 2009, and the effect of adoption on the Company's Consolidated Financial Statements was not material.

In April 2009, FASB revised accounting standards for Financial Instruments. The revised standard, ASC 825, requires fair value disclosures in the notes of an entity's interim financial statements for all financial instruments, whether or not recognized in the statement of financial position. This revision became effective for the interim reporting period ending after June 15, 2009. The adoption of the revised standards and the increased interim financial statement disclosures did not have a material effect on the Company's consolidated financial statements.

In April 2009, FASB revised accounting standards for Investments—Debt and Equity Securities. The standard, ASC 320, changes the Other-Than-Temporary-Impairment (“OTTI”) model for debt securities. Under previous guidance, an entity was required to assess whether it has the intent and ability to hold a security to recovery in determining whether an impairment of that security is other-than-temporary. If the impairment was deemed other-than-temporarily impaired, the investment was written-down to fair value through earnings. Under the revised guidance, OTTI is triggered if an entity has the intent to sell the security, it is more likely than not that it will be required to sell the security before recovery, or if the entity does not expect to recover the entire amortized cost basis of the security. If the entity intends to sell the security or it is more likely than not it will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the entity does not intend to sell the security and it is not likely that the entity will be required to sell the security but the entity does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings as an OTTI. The credit loss is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected of a security. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment loss related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, would be recognized as a charge to other comprehensive income (“OCI”). Impairment losses related to all other factors are to be presented as a separate category within OCI. For investment securities held to maturity, this amount is accreted over the remaining life of the debt security prospectively based on the amount and timing of future estimated cash flows. The accretion of the OTTI amount recorded in OCI will increase the carrying value of the investment and would not affect earnings. If there is an indication of additional credit losses, the security is reevaluated accordingly based on the procedures described above. Upon adoption of the revised guidance, the noncredit portion of previously recognized OTTI is to be reclassified to accumulated OCI by a cumulative-effect adjustment to the opening balance of retained earnings. These revisions became effective in the interim reporting period ending after June 15, 2009. We adopted these revisions for the quarter ended June 30, 2009 and the effect of the adoption on the Consolidated Financial Statements was not material.

In April 2009, FASB amended accounting standards for Fair Value Measurements and Disclosures. The amended standard, ASC 820, addresses issues related to the determination of fair value when the volume and level of activity for an asset or liability has significantly decreased, and identifying transactions that are not orderly. The revisions affirm the objective that fair value is the price that would be received to sell an asset in an orderly transaction (that is not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions, even if the market is inactive. The amendment provides additional guidance for estimating fair value

when the volume and level of activity for the asset or liability have decreased significantly. It also provides guidance on identifying circumstances that indicate a transaction is not orderly. If it is determined that a quoted price is distressed (not orderly), and thereby not representative of fair value, the entity may need to make adjustments to the quoted price or utilize an alternative valuation technique (e.g., income approach or multiple valuation techniques) to determine fair value. Additionally, an entity must incorporate appropriate risk premium adjustments, reflective of an orderly transaction under current market conditions, due to uncertainty in cash flows. The revised guidance requires disclosures in interim and annual periods regarding the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period. It also requires financial institutions to disclose the fair values of investment securities by major security type. The changes are effective for the interim reporting period ending after June 15, 2009, and are to be applied prospectively. The requirements of these amendments are consistent with the Company's practice of calculating fair value on the various assets and liabilities it carries at fair value. Therefore, there was no material impact on the fair value measurement of any assets or liabilities in the Consolidated Financial Statements.

In January 2009, FASB amended accounting standards for Investments—Other. The amended standard, ASC 325, addresses certain practices or issues related to the recognition of interest income and impairment on purchased beneficial interests and beneficial interests that continue to be held by a transferor in securitized financial assets, by making its OTTI assessment guidance consistent with the accounting standards for Investments—Debt and Equity Securities. The amendment removes the reference to the consideration of a market participant's estimates of cash flows and instead requires an assessment of whether it is probable, based on current information and events, that the holder of the security will be unable to collect all amounts due according to the contractual terms. If it is probable that there has been an adverse change in estimated cash flows, an OTTI is deemed to exist, and a corresponding loss shall be recognized in earnings equal to the entire difference between the investment's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. This amendment became effective for interim and annual reporting periods ending after December 15, 2008, and is applied prospectively. The amendment of these standards did not have a material impact on the Company's Consolidated Financial Statements.

In October 2008, FASB amended accounting standards for Fair Value Measurements and Disclosures. The amended standard, ASC 820, clarifies the application of fair value measurements in a market that is not active. The amendment is intended to address the following application issues: (a) how the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist; (b) how available observable inputs in a market that is not active should be considered when measuring fair value; and (c) how the use of market quotes (for example, broker quotes or pricing

services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value. The changes were effective on issuance, including prior periods for which financial statements had not been issued. We adopted the amendment for the quarter ended December 31, 2008 and the effect of adoption on the Consolidated Financial Statements was not material.

In December 2007, FASB revised accounting standards for Business Combinations. The standard, ASC 805, requires the acquiring entity to recognize and measure in its financial statements all the assets acquired, the liabilities assumed, any non-controlling interest in the acquired entity, and the goodwill acquired and establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed. Furthermore, acquisition-related and other costs will now be expensed rather than treated as cost components of the acquisition. ASC 805 also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The revision to this guidance applies prospectively to business combinations for which the acquisition date occurs on or after January 1, 2009. We do not expect the adoption of these revisions will have a material impact on our consolidated financial statements as related to business combinations consummated prior to January 1, 2009. The adoption of these revisions will increase the costs charged to operations for acquisitions consummated on or after January 1, 2009.

Recently Issued Accounting Pronouncements: In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820)—Improving Disclosures about Fair Value Measurements. FASB ASU No. 2009-06 requires (i) fair value disclosures by each class of assets and liabilities (generally a subset within a line item as presented in the statement of financial position) rather than major category, (ii) for items measured at fair value on a recurring basis, the amounts of significant transfers between Levels 1 and 2, and transfers into and out of Level 3, and the reasons for those transfers, including separate discussion related to the transfers into each level apart from transfers out of each level, and (iii) gross presentation of the amounts of purchases, sales, issuances, and settlements in the Level 3 recurring measurement reconciliation. Additionally, the ASU clarifies that a description of the valuation techniques(s) and inputs used to measure fair values is required for both recurring and nonrecurring fair value measurements. Also, if a valuation technique has changed, entities should disclose that change and the reason for the change. Disclosures other than the gross presentation changes in the Level 3 reconciliation are effective for the first reporting period beginning after December 15, 2009. The requirement to present the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis will be effective for fiscal years beginning after December 15, 2010. The Company is currently evaluating the impact of adoption of FASB ASU No. 2010-06. We do not expect the adoption of this ASU will have a material impact on the Company's Consolidated Financial Statements.

In December 2009, FASB issued ASU No. 2009-17, Transfers and Servicing (Topic 860)—Accounting for Transfers of Financial Assets. This update codifies SFAS No. 166, Accounting for Transfers of Financial Assets—an Amendment of FASB Statement No. 140, which was previously issued by FASB in June 2009 but was not included in the original codification. ASU 2009-17 eliminates the concept of a qualifying special-purpose entity, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, clarifies other sale-accounting criteria, and changes the initial measurement of a transferor's interest in transferred financial assets. This statement is effective for annual reporting periods beginning after November 15, 2009, and for interim periods therein. This standard will primarily impact the Company's accounting and reporting of transfers representing a portion of a financial asset for which the Company has a continuing involvement. In order to recognize the transfer of a portion of a financial asset as a sale, the transferred portion and any portion that continues to be held by the transferor must represent a participating interest, and the transfer of the participating interest must meet the conditions for surrender of control. To qualify as a participating interest, (i) the portions of a financial asset must represent a proportionate ownership interest in an entire financial asset, (ii) from the date of transfer, all cash flows received from the entire financial asset must be divided proportionately among the participating interest holders in an amount equal to their share of ownership, (iii) involve no recourse (other than standard representation and warranties) to, or subordination by, any participating interest holder, and (iv) no party has the right to pledge or exchange the entire financial asset. If the participating interest or surrender of control criteria are not met, the transfer is not accounted for as a sale and

derecognition of the asset is not appropriate. Rather, the transaction is accounted for as a secured borrowing arrangement. The impact of certain participations being reported as secured borrowings rather than derecognizing a portion of a financial asset would increase total assets, liabilities and their respective interest income and expense. An increase in total assets also increases regulatory risk-weighted assets and could negatively impact our capital ratios. The Company does not believe the impact of adoption will have a material impact on the Company's consolidated financial statements.

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

Comparison of Financial Condition at December 31, 2009 and 2008

General. Total assets increased \$138 million, or 3%, from \$4.584 billion at December 31, 2008, to \$4.722 billion at December 31, 2009. Net loans receivable (gross loans less loans in process, deferred fees and discounts, and allowance for loan losses) decreased \$191 million, or 5%, from \$3.886 billion at December 31, 2008, to \$3.695 billion at December 31, 2009. The contraction in net loans was largely due to decreases of

\$182 million in one- to four-family construction loans and \$135 million in land and land development loans, as well as a decrease of \$42 million in commercial business loans and \$24 million in commercial construction loans. These changes were partially offset by increases of \$104 million in one- to four-family mortgage loans, \$69 million in commercial real estate loans, \$24 million in multi-family construction loans. We continue to maintain a significant, although decreasing, investment in construction and land loans; however, new originations of these types of loans during the past two years has declined substantially and is expected to remain modest for the foreseeable future. As a result of the much slower pace of new originations and continuing payoffs on existing loans, transfers to real estate owned and charge offs, loans to finance the construction of one- to four-family residential real estate, which totaled \$239 million at December 31, 2009, have decreased by \$415 million, or 63%, since their peak quarter-end balance of \$655 million at June 30, 2007. In addition, land and development loans have decreased by \$174 million, or 35%, compared to their peak quarter-end balances at March 31, 2008. Given the current housing and economic environment, we anticipate that construction and land loan balances will continue to decline for the foreseeable future, although the pace of decline will be more modest as originations of new construction loans likely will increase somewhat as inventories of completed homes have been reduced and the build out of existing development projects will cautiously resume.

Securities increased marginally, from \$317 million at December 31, 2008, to \$318 million at December 31, 2009, as purchases slightly exceeded repayments and net fair value adjustments. During the year ended December 31, 2009, net fair value adjustments for trading and available-for-sale securities reduced their carrying values by \$5 million. Effective January 1, 2007, we elected to reclassify many of our securities to fair value and, although we have not historically engaged in trading activities, these securities are reported as trading securities for financial reporting purposes. At December 31, 2009, the fair value of our trading securities was \$46 million less than their amortized cost. The reduction reflected in the fair value of these securities compared to their amortized cost primarily was due to a net decrease of \$41 million in the value of single-issuer trust preferred securities and collateralized debt obligations secured by pools of trust preferred securities issued by bank holding companies and insurance companies as well as a decrease of \$7 million in the value of Fannie Mae and Freddie Mac common and preferred equity securities, offset by a small gain in all other trading securities. (See Note 25, Fair Value Accounting and Measurement, in the Selected Notes to the Consolidated Financial Statements.) Periodically, we also acquire securities which are designated as available-for-sale or held-to-maturity. At December 31, 2009, we recorded a decrease of \$590,000 (\$377,000 net of tax) in net fair value adjustments related to available-for-sale securities, which was included as a component of other comprehensive income. Generally, securities designated as held-to-maturity are reported at their amortized cost for financial reporting purposes.

Real estate owned acquired through foreclosures increased \$56 million, from \$22 million at December 31, 2008 to \$78 million at December 31, 2009. The year-ending total included \$64 million in land or land development projects, \$8 million in commercial real estate and \$6 million in single-family homes. During the year ended December 31, 2009, we transferred \$102 million of loans into real estate owned, capitalized additional investments of \$6 million in acquired properties, disposed of approximately \$50 million of properties and recognized \$2 million of charges for valuation adjustments related to currently owned properties. (See "Asset Quality" discussion below.)

Deposits increased \$87 million, or 2%, from \$3.779 billion at December 31, 2008, to \$3.866 billion at December 31, 2009. Non-interest-bearing deposits increased by \$73 million, or 14%, from \$509 million to \$582 million, and interest-bearing deposits increased by \$13 million, to \$3.283 billion at December 31, 2009. In response to the now higher costs of collateralizing public fund deposits and to reduce the shared risk exposure under Washington and Oregon State regulations, we encouraged the runoff of \$173 million in public funds, including \$39 million of interest-bearing transaction accounts, since December 31, 2008. We anticipate further declines in public fund deposits as we continue to adjust to these new regulations. In addition, we elected to reduce brokered deposits by \$103 million during the year ended December 31, 2009. The decrease in public funds and brokered deposits was more than offset by strong growth in retail deposits during the year.

FHLB advances increased \$78 million, from \$111 million at December 31, 2008, to \$190 million at December 31, 2009, while other borrowings increased \$32 million to \$177 million at December 31, 2009. The increase in FHLB advances reflects a temporary increase in overnight borrowings at December 31, 2009 as a part of our short-term cash management activities and was offset by a comparable increase in interest-bearing cash balances. The increase in other borrowings was the result of an offering completed by Banner Bank on March 31, 2009, of \$50 million of qualifying senior bank notes covered by the TLGP with a fixed interest rate of 2.625% and a maturity date of March 31, 2012. This debt, which does not require any collateralization, was issued to strengthen our overall liquidity position as we adjust to a lower level of public funds deposits. Other borrowings at December 31, 2009 also include \$124 million of retail repurchase agreements that are primarily related to customer cash management accounts. Retail repurchase agreements have declined by \$21 million during the year ended December 31, 2009, in part reflecting certain customers' reduced use of collateralized accounts as a result of increased FDIC insurance coverage.

Junior subordinated debentures decreased by \$14 million since December 31, 2008, reflecting the fair value adjustments as changes in credit market conditions, including a sharp reduction in the level of three month LIBOR, had a particularly significant impact on the valuation of this type of security. The change in the fair value of the junior subordinated debentures, while significant, represents a non-cash valuation adjustment, had no effect on our liquidity or ability to fund our operations and was substantially offset by similar adjustments to certain investment securities as noted above. (See Note 25, Fair Value of Financial Instruments.)

During the year ended December 31, 2009, we issued 4,387,552 additional shares of common stock for \$15 million at an average net per share price of \$3.36 through our Dividend Reinvestment and Direct Stock Purchase and Sale Plan. This stock issuance activity was more than offset by the changes in retained earnings as a result of losses from operations and the accrual of preferred stock dividends, resulting in a net \$28 million decrease in stockholders' equity. During the year ended December 31, 2009, we did not issue or repurchase any shares of Banner Corporation common stock in connection with the exercise of vested stock options and grants.

Investments: At December 31, 2009, our consolidated investment portfolio totaled \$318 million and consisted principally of U.S. Government agency obligations, mortgage-backed and mortgage-related securities, municipal bonds, and corporate debt obligations. From time to time, our investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in our loan origination, deposit and other activities. During the year ended December 31, 2009, our aggregate investment in securities was nearly unchanged, increasing by only \$1 million. Holdings of U.S. Treasury and agency obligations increased \$24

million, mortgage-backed securities decreased \$28 million and municipal bonds increased \$10 million. Corporate and other securities decreased \$5 million, largely as a result of fair value accounting adjustments for trust preferred securities issued by other financial institutions.

U.S. Government and Agency Obligations: Our portfolio of U.S. Government and agency obligations had a fair value of \$94 million (\$95 million at amortized cost) at December 31, 2009, a weighted average maturity of 4.2 years and a weighted average coupon rate of 3.04%. Most of the U.S. Government and agency obligations we own include call features which allow the issuing agency the right to call the securities at various dates prior to the final maturity. These securities are primarily pledged as collateral for retail repurchase agreements.

Mortgage-Backed Obligations: At December 31, 2009, our mortgage-backed and mortgage-related securities totaled \$106 million, or 33% of the consolidated investment portfolio. Included within this amount were collateralized mortgage obligations (CMOs) with a net carrying value of \$38 million. The estimated fair value of the mortgage-backed and mortgage-related securities at December 31, 2009 was \$106 million, which was \$3 million more than the amortized cost of \$103 million. At December 31, 2009, our portfolio of mortgage-backed and mortgage-related securities had a weighted average coupon rate of 4.96%. At that date, 85% of the mortgage-backed and mortgage-related securities pay interest at a fixed rate and 15% pay at an adjustable-interest rate. The estimated weighted average remaining life of the portfolio was 3.3 years. We do not believe that any of our mortgage-backed obligations had a meaningful exposure to sub-prime mortgages.

Municipal Bonds: Our tax-exempt municipal bond portfolio at December 31, 2009 totaled \$73 million at estimated fair value (\$70 million at amortized cost), and was comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by revenues from the specific project being financed) issued by cities and counties and various housing authorities, and hospital, school, water and sanitation districts located in the states of Washington, Oregon and Idaho, our primary service area. We also had taxable bonds in our municipal bond portfolio, which at December 31, 2009 totaled \$4 million at estimated fair value (\$4 million at amortized cost). At December 31, 2009, general obligation bonds and revenue bonds had total estimated fair values of \$49 million and \$27 million, respectively. Many of our qualifying municipal bonds are not rated by a nationally recognized credit rating agency due to the smaller size of the total issuance and a portion of these bonds have been acquired through direct private placement by the issuers. At December 31, 2009, our municipal bond portfolio had a weighted average maturity of approximately 12.3 years, an average coupon rate of 4.77% and an average taxable equivalent yield of 6.69%. The largest principal balance of any security in the municipal portfolio was a general obligation bond issued by the Public Hospital District No. 1, Columbia and Walla Walla Counties, Washington, with an amortized cost of \$4.9 million and a fair value of \$4.9 million.

Corporate Bonds: Our corporate bond portfolio, which totaled \$42 million at fair value (\$85 million at amortized cost) at December 31, 2009, was comprised principally of long-term fixed- and adjustable-rate capital securities issued by financial institutions, including pooled trust preferred securities. The market for these capital securities deteriorated significantly in 2008 and 2009 and in our opinion is not currently functioning in a meaningful manner. As a result, the fair value estimates for many of these securities are more subjective than in previous periods. Nonetheless, it is apparent that the values have declined appreciably, which is reflected in our financial statements and results of operations. In addition to the disruption in the market for these securities, the decline in value also reflects deterioration in the financial condition of some of the issuing financial institutions and payment deferrals and defaults by certain institutions. (See Critical Accounting Policies and Note 25 of the Notes to Consolidated Financial Statements.) At December 31, 2009, the portfolio had a weighted average maturity of 25.0 years and a weighted average coupon rate of 2.78%.

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

Table 1: Securities—Trading

	2009		2008		2007	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
U.S. Government Treasury\$ and agency obligations	41,255	28.0%	\$ 70,389	34.5%	\$ 30,015	14.7%
Municipal bonds:						
Taxable	1,034	0.7	2,041	1.0	2,043	1.0
Tax exempt	6,117	4.2	9,988	4.9	7,180	3.5
Corporate bonds	35,017	23.8	40,220	19.7	56,125	27.7
Mortgage-backed or related securities:						
Mortgage-backed securities						
GNMA	--	--	--	--	2,732	1.4
FHLMC	21,657	14.7	28,702	14.1	32,380	16.0
FNMA	28,127	19.1	32,606	16.0	41,377	20.4
Other	--	--	--	--	--	--
Total mortgage-backed securities	49,784	33.8	61,308	30.1	76,489	37.8
Mortgage-related securities						
CMOs—agency backed	13,602	9.3	19,722	9.7	23,285	11.5
CMOs—non-agency	--	--	--	--	--	0.0
Total mortgage-related securities	13,602	9.3	19,722	9.7	23,285	11.5
Total	63,386	43.1	81,030	39.8	99,775	49.3
Equity securities	342	0.2	234	0.1	7,726	3.8
Total securities—trading	\$ 147,151	100.0%	\$ 203,902	100.0%	\$ 202,863	100.0%

Table

2: Securities—Available-for-Sale

	2009		2008		2007		2006	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
U.S. Government Treasury and agency obligations	\$ 53,112	55.5%	\$ --	--%	\$ --	--%	\$ 27,295	12.1%
Municipal bonds:								
Taxable	--	--	--	--	--	--	4,555	2.0
Tax exempt	--	--	--	--	--	--	3,044	1.4
Corporate bonds	--	--	--	--	--	--	37,382	16.5
Mortgage-backed or related securities:								
Mortgage-backed securities								
GNMA	18,457	19.3	33,729	63.3	--	--	--	--
FHLMC	--	--	--	--	--	--	37,412	16.5
FNMA	--	--	--	--	--	--	42,943	19.0
Other	--	--	--	--	--	--	--	--
Total mortgage-backed securities	18,457	19.3	33,729	63.3	--	--	80,355	35.5
Mortgage-related securities								
CMOs—agency backed	17,633	18.4	10,005	18.8	--	--	43,998	19.5
CMOs—non-agency	6,465	6.8	9,538	17.9	--	--	25,814	11.4
Total mortgage-related securities	24,098	25.2	19,543	36.7	--	--	69,812	30.9
Total	42,555	44.5	53,272	100.0	--	--	150,167	66.4
Equity securities	--	--	--	--	--	--	3,710	1.6
Total securities available for sale	\$ 95,667	100.0%	\$ 53,272	100.0%	\$ --	--%	\$ 226,153	100.0%

T a b l e

3: Securities—Held-to-Maturity

	2009		2008		2007		2006	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
Municipal bonds:								
Taxable	\$ 2,683	3.6%	\$ 2,925	4.9%	\$ 2,565	4.8%	\$ 99	0.2%
Tax exempt	63,901	85.4	48,619	81.3	42,701	79.8	39,773	83.1
Corporate bonds	8,250	11.0	8,250	13.8	8,250	15.4	8,000	16.7
Mortgage-backed securities:								
FHLMC certificates	--	--	--	--	--	--	--	--

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FNMA certificates	--	--	--	--	--	--	--	--
Total mortgage-backed securities	--	--	--	--	--	--	--	--
Total	\$ 74,834	100.0%	\$ 59,794	100.0%	\$ 53,516	100.0%	\$ 47,872	100.0%
Estimated market value	\$ 76,489		\$ 60,530		\$ 54,721		\$ 49,008	

The following table shows the maturity or period to repricing of our consolidated portfolio of securities—trading at fair value (dollars in thousands):

Table 4: Securities—Trading Maturity/Repricing and Rates

Securities—Trading at December 31, 2009												
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield (1)
U.S. Government Treasury and agency obligations:												
Fixed-rate	\$ --	--%	\$ 39,804	3.10%	\$ --	--%	\$ 1,451	5.03%	\$ ---	--%	\$ 41,255	3.17%
Adjustable-rate	--	--	--	--	--	--	--	--	---	--	--	--
	--	--	39,804	--	--	--	1,451	5.03	---	--	41,255	3.17
Municipal bonds:												
Taxable	--	--	--	--	--	--	--	--	1,034	6.18	1,034	6.18
Tax exempt	565	6.02	473	6.15	4,875	6.86	204	6.02	---	---	6,117	6.70
	565	---	473	6.15	4,875	6.86	204	6.02	1,034	---	7,151	6.63
Corporate bonds:												
Fixed-rate	--	--	--	--	--	--	4,825	8.15	---	---	4,825	8.15
Adjustable-rate	30,192	4.92	--	--	--	--	--	--	---	---	30,192	4.92
	30,192	4.92	--	--	--	--	4,825	8.15	---	---	35,017	5.37
Mortgage-backed obligations:												
Fixed-rate	--	--	--	--	14,358	4.42	10,451	4.96	8,930	---	33,739	4.79
Adjustable-rate	1,487	2.97	14,558	4.14	--	--	--	--	---	---	16,045	4.03
	1,487	2.97	14,558	4.14	14,358	4.42	10,451	4.96	8,930	---	49,784	4.55
Mortgage-related obligations:												
Fixed-rate	--	--	--	--	2,407	4.24	4,256	4.30	6,930	---	13,602	4.15
Adjustable-rate	--	--	--	--	--	--	--	--	---	---	--	--
	--	--	--	--	2,407	4.24	4,256	4.30	6,930	---	13,602	4.15
T o t a l mortgage-backed or r e l a t e d obligations												
	1,487	2.97	14,558	4.14	16,765	4.40	14,707	4.77	15,868	---	63,386	4.46
Equity securities												
	342	--	--	--	--	--	--	--	---	---	342	--
T o t a l securities—trading—												
	\$ 32,586	4.85	\$ 54,835	3.40	21,640	4.95	\$ 21,187	5.57	\$ 16,908	---	\$ 147,151	4.41

carrying value

T o t a l						
securities—trading—						
amortized cost	\$ 80,170	\$ 54,204	\$ 21,230	\$ 20,945	\$ 16,304	\$ 192,853

(1) Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

The following table shows the maturity or period to repricing of our consolidated portfolio of securities—available for sale at fair value (dollars in thousands):

Table 5: Securities—Available-for-Sale Maturity/Repricing and Rates

Securities—Available for Sale at December 31, 2009												
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		Total Weighted Average Yield (1)	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Yield
Mortgage-backed obligations:												
Fixed-rate	\$ --	--%	\$ 48,257	2.19%	\$ 4,854	3.40%	\$ --	--%	\$ --	--%	\$ 53,111	2.30%
Adjustable-rate	--	--	--	--	--	--	--	--	--	--	--	--
	--	--	48,257	2.19	4,854	3.40	--	--	--	--	53,111	2.30
Mortgage-related obligations:												
Fixed-rate	--	--	--	--	--	--	--	--	18,458	4.90	18,458	4.90
Adjustable-rate	--	--	--	--	--	--	--	--	--	--	--	--
	--	--	--	--	--	--	--	--	18,458	4.90	18,458	4.90
Total mortgage-backed or related obligations:												
	--	--	--	--	--	--	5,196	5.25	18,902	4.66	24,098	4.79
Total securities available for sale—carrying value												
	\$ --	--	\$ 48,257	2.19	\$ 4,854	3.40	\$ 5,196	5.25	\$ 37,360	4.78	\$ 95,667	3.43
Total securities available for sale—amortized cost												
	\$ --	--	\$ 48,748	--	\$ 4,983	--	\$ 5,133	--	\$ 38,310	--	\$ 95,174	--

(1) Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

The following table shows the maturity or period to repricing of our consolidated portfolio of securities held to maturity (dollars in thousands):

Table 6: Securities—Held-to-Maturity Maturity/Repricing and Rates

	Securities—Held to Maturity at December 31, 2009											
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield (1)
Municipal bonds:												
Taxable	\$ 208	5.48%	\$ 1,421	5.75%	\$ --	--%	\$ --	--%	\$ 1,657	5.73%	\$ 2,683	5.72%
Tax exempt	3,848	6.25	11,285	6.05	11,334	6.01	35,352	7.14	2,885	6.85	63,901	6.74
	4,056	6.21	12,706	6.02	11,334	6.01	35,352	7.14	3,760	6.70	66,584	6.70
Corporate bonds:												
Fixed-rate	--	--	750	2.67	500	3.00	4,000	9.88	31,000	9.00	8,250	9.21
Total securities held to maturity—carrying value	\$ 4,056	6.21	\$ 13,456	5.83	\$ 11,834	5.88	\$ 39,352	7.42	\$ 6,936	6.76	\$ 74,834	6.98
Total securities held to maturity—estimated market value	\$ 4,091		\$ 14,041		\$ 12,419		\$ 40,076		\$ 5,862		\$ 76,489	