

NORTHWEST BANCORPORATION INC  
Form 10-Q  
August 12, 2011

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2011.

**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: 000-24151

**NORTHWEST BANCORPORATION, INC.**

(Exact name of registrant as specified in its charter)

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Washington  
(State or other jurisdiction of

91-1574174  
(I.R.S. Employer

incorporation or organization)

Identification No.)

421 West Riverside, Spokane, WA 99201-0403

(Address of principal executive offices) (Zip Code)

(509) 456-8888

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

The Registrant has a single class of common stock, of which there were 3,081,748 shares issued and outstanding as of July 31, 2011.

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NORTHWEST BANCORPORATION, INC.

FORM 10-Q

For the three-month and six-month periods ended June 30, 2011

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Financial Condition**

(\$ in thousands)

|  | June 30,<br>2011  | December 31,<br>2010 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Cash and due from banks  | \$ 12,892         | \$ 10,813            |
| Interest bearing deposits  | 14                | 13                   |
| Federal funds sold   | 5,645             | 5,015                |
| <b>Total cash and cash equivalents</b>   | <b>18,551</b>     | <b>15,841</b>        |
| Securities available for sale, at fair value   | 64,618            | 69,730               |
| Federal Home Loan Bank stock, at cost  | 1,261             | 1,261                |
| Loans receivable, net of allowance for loan losses \$7,257 and \$6,918   | 267,293           | 274,416              |
| Loans held for sale  | 1,682             | 2,371                |
| Premises and equipment, net  | 16,912            | 17,316               |
| Accrued interest receivable  | 1,501             | 1,507                |
| Foreclosed real estate   | 3,329             | 3,963                |
| Bank owned life insurance  | 3,852             | 3,792                |
| Other assets   | 2,886             | 4,378                |
| <b>TOTAL ASSETS</b>  | <b>\$ 381,885</b> | <b>\$ 394,575</b>    |
| <b>LIABILITIES</b>   |                   |                      |
| Deposits   | \$ 327,087        | \$ 346,237           |
| Securities sold under agreements to repurchase   |                   | 135                  |
| Accrued interest payable   | 467               | 464                  |
| Borrowed funds   | 14,095            | 9,518                |
| Other liabilities  | 3,077             | 2,534                |
| <b>Total liabilities</b>   | <b>344,726</b>    | <b>358,888</b>       |
| <b>SHAREHOLDERS EQUITY</b>   |                   |                      |
| Preferred stock Series A Cumulative Perpetual; \$1,000 par value; \$1,000 liquidation value; 10,500 shares authorized and issued | 10,190            | 10,131               |
| Preferred stock Series B Cumulative Perpetual; \$0.01 par value; \$1,000 liquidation value; 525 shares authorized and issued     | 560               | 566                  |
| Common stock, no par value, 5,000,000 shares authorized; 3,081,748 shares issued and outstanding                                 | 25,943            | 25,896               |
| Accumulated deficit  | (163)             | (175)                |
| Accumulated other comprehensive income (loss), net of tax effect of \$-324 and \$376   | 629               | (731)                |
| <b>Total shareholders equity</b>   | <b>37,159</b>     | <b>35,687</b>        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>   | <b>\$ 381,885</b> | <b>\$ 394,575</b>    |

See accompanying notes.



## NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

## Consolidated Statements of Operations

(\$ in thousands, except per share data)

|  | Three months ended<br>June 30, |               | Six months ended<br>June 30, |               |
|--|--------------------------------|---------------|------------------------------|---------------|
|  | 2011                           | 2010          | 2011                         | 2010          |
| <b>Interest income:</b>                                    |                                |               |                              |               |
| Loans, including fees                                      | \$ 4,213                       | \$ 4,788      | \$ 8,883                     | \$ 9,862      |
| Investment securities                                      | 587                            | 380           | 1,180                        | 707           |
| Federal funds sold and interest bearing deposits           | 3                              | 6             | 6                            | 13            |
| <b>Total interest income</b>                               | <b>4,803</b>                   | <b>5,174</b>  | <b>10,069</b>                | <b>10,582</b> |
| <b>Interest expense:</b>                                   |                                |               |                              |               |
| Deposits   | 1,001                          | 1,468         | 2,097                        | 3,032         |
| Borrowed funds   | 78                             | 170           | 148                          | 366           |
| <b>Total interest expense</b>                              | <b>1,079</b>                   | <b>1,638</b>  | <b>2,245</b>                 | <b>3,398</b>  |
| <b>Net interest income</b>                                 | <b>3,724</b>                   | <b>3,536</b>  | <b>7,824</b>                 | <b>7,184</b>  |
| Provision for loan losses                                  | 1,531                          | 950           | 2,362                        | 1,450         |
| <b>Net interest income after provision for loan losses</b> | <b>2,193</b>                   | <b>2,586</b>  | <b>5,462</b>                 | <b>5,734</b>  |
| <b>Noninterest income:</b>                                 |                                |               |                              |               |
| Service charges on deposits                                | 371                            | 326           | 723                          | 633           |
| Gain from sale of loans, net                               | 167                            | 152           | 310                          | 316           |
| Gain on investment securities, net                         | 33                             | 312           | 33                           | 318           |
| Other noninterest income                                   | 333                            | 254           | 648                          | 693           |
| <b>Total noninterest income</b>                            | <b>904</b>                     | <b>1,044</b>  | <b>1,714</b>                 | <b>1,960</b>  |
| <b>Noninterest expense:</b>                                |                                |               |                              |               |
| Salaries and employee benefits                             | 1,658                          | 1,535         | 3,331                        | 3,100         |
| Occupancy and equipment                                    | 319                            | 302           | 648                          | 613           |
| Depreciation and amortization                              | 301                            | 294           | 603                          | 570           |
| Advertising and promotion                                  | 104                            | 95            | 174                          | 162           |
| Loss on foreclosed real estate, net                        | 112                            | 124           | 83                           | 203           |
| FDIC assessments   | 118                            | 213           | 322                          | 416           |
| Other noninterest expenses                                 | 965                            | 728           | 1,695                        | 1,443         |
| <b>Total noninterest expense</b>                           | <b>3,577</b>                   | <b>3,291</b>  | <b>6,856</b>                 | <b>6,507</b>  |
| <b>Income (loss) before income taxes</b>                   | <b>(480)</b>                   | <b>339</b>    | <b>320</b>                   | <b>1,187</b>  |
| Income tax expense (benefit)                               | (231)                          | 70            | (31)                         | 332           |
| <b>Net income (loss)</b>                                   | <b>(\$ 249)</b>                | <b>\$ 269</b> | <b>\$ 351</b>                | <b>\$ 855</b> |
| Preferred stock dividends and discount accretion, net      | 169                            | 169           | 339                          | 338           |
| <b>Net income (loss) applicable to common shares</b>       | <b>(\$ 418)</b>                | <b>\$ 100</b> | <b>\$ 12</b>                 | <b>\$ 517</b> |
| Earnings (loss) per common share basic                     | \$ (0.14)                      | \$ 0.04       | \$                           | \$ 0.22       |
| Earnings (loss) per common share diluted                   | \$ (0.14)                      | \$ 0.04       | \$                           | \$ 0.22       |
| Weighted average shares outstanding basic                  | 3,080,133                      | 2,384,078     | 3,078,499                    | 2,382,444     |

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|                                     |         |                         |           |           |           |
|-------------------------------------|---------|-------------------------|-----------|-----------|-----------|
| Weighted average shares outstanding | diluted | 3,080,133               | 2,385,963 | 3,090,737 | 2,383,716 |
|                                     |         | See accompanying notes. |           |           |           |

## NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

## Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income (Loss)

(\$ in thousands)

|  | Total     | Preferred<br>Stock | Common<br>Stock | (Accumulated<br>Deficit)<br>Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Comprehensive<br>Income<br>(Loss) |
|--|-----------|--------------------|-----------------|--|---|-----------------------------------|
| Balance, December 31, 2009   | \$ 33,806 | \$ 10,592          | \$ 23,269       | (\$ 443)   | \$ 388  |                                   |
| Net income   | 945       | 0                  | 0               | 945  | 0   | \$ 945                            |
| Stock issued to directors  | 22        | 0                  | 22              | 0  | 0   |                                   |
| Issuance of common stock, net of issuance costs of \$162                 | 2,585     | 0                  | 2,585           | 0  | 0   |                                   |
| Dividends on preferred stock   | (572)     | 0                  | 0               | (572)  | 0   |                                   |
| Accretion of preferred stock discount, net                               | 0         | 105                | 0               | (105)  | 0   |                                   |
| Equity-based compensation expense  | 34        | 0                  | 34              | 0  | 0   |                                   |
| Tax effect of vested stock awards  | (14)      | 0                  | (14)            | 0  | 0   |                                   |
| Change in unrealized gain on securities available for sale, net of taxes | (1,119)   | 0                  | 0               | 0  | (1,119)   | (1,119)                           |
| Comprehensive loss   |           |                    |                 |  |   | (\$ 174)                          |
| Balance, December 31, 2010   | 35,687    | 10,697             | 25,896          | (175)  | (731)   |                                   |
| Net income   | 351       | 0                  | 0               | 351  | 0   | 351                               |
| Stock issued to directors  | 21        | 0                  | 21              | 0  | 0   |                                   |
| Dividends on preferred stock   | (286)     | 0                  | 0               | (286)  | 0   |                                   |
| Accretion of preferred stock discount, net                               |           | 53                 | 0               | (53)   | 0   |                                   |
| Equity-based compensation expense  | 26        | 0                  | 26              | 0  | 0   |                                   |
| Change in unrealized loss on securities available for sale, net of taxes | 1,360     | 0                  | 0               | 0  | 1,360   | 1,360                             |
| Comprehensive income   |           |                    |                 |  |   | \$ 1,711                          |
| Balance, June 30, 2011   | \$ 37,159 | \$ 10,750          | \$ 25,943       | (\$ 163)   | \$ 629  |                                   |
| Disclosure of 2011 reclassification amount:                              |           |                    |                 |  |   |                                   |
| Net change in unrealized holding losses on available for sale securities | \$ 2,028  |                    |                 |  |   |                                   |
| Reclassification adjustment for net gains realized in income             | 33        |                    |                 |  |   |                                   |
| Net change in unrealized losses  | 2,061     |                    |                 |  |   |                                   |
| Tax effect   | (701)     |                    |                 |  |   |                                   |
| Net of tax amount  | \$ 1,360  |                    |                 |  |   |                                   |

See accompanying notes.



## NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

## Consolidated Statements of Cash Flows

(\$ in thousands)

|   | Six months ended<br>June 30, |              |
|---|------------------------------|--------------|
|   | 2011                         | 2010         |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                   |                              |              |
| Net income  | \$ 351                       | \$ 855       |
| Adjustments to reconcile net income to cash provided by operating activities: |                              |              |
| Amortization of securities discounts and premiums, net                        | 179                          | 2            |
| Gain on sale of securities, net   | (33)                         | (318)        |
| Accretion of net deferred loan fees   | (156)                        | (120)        |
| Provision for loan losses   | 2,362                        | 1,450        |
| Origination of loans held for sale  | (15,360)                     | (15,921)     |
| Proceeds from sales of loans held for sale                                    | 16,359                       | 17,682       |
| Gain on sale of loans held for sale, net                                      | (310)                        | (316)        |
| Depreciation and amortization   | 603                          | 570          |
| Provision for losses on foreclosed real estate and other property owned       | 196                          | 300          |
| Gain on sale of foreclosed real estate, net                                   | (113)                        | (97)         |
| Increase in cash surrender value of bank owned life insurance                 | (60)                         | (61)         |
| Increase in deferred income taxes, net  | (51)                         | (28)         |
| Equity-based compensation expense   | 26                           | 17           |
| Issuance of common stock under directors' compensation arrangements           | 21                           | 22           |
| Change in assets and liabilities:   |                              |              |
| Accrued interest receivable   | 6                            | (11)         |
| Other assets  | 842                          | 1,219        |
| Accrued interest payable  | 3                            | (145)        |
| Other liabilities   | 256                          | (231)        |
| Net cash provided by operating activities                                     | 5,121                        | 4,869        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                   |                              |              |
| Securities available for sale:  |                              |              |
| Purchases   | (6,185)                      | (22,715)     |
| Proceeds from maturities, calls and principal repayments                      | 10,718                       | 4,329        |
| Proceeds from sale  | 2,494                        | 5,345        |
| Proceeds from sale of equity investment                                       |                              | 189          |
| Net decrease in loans   | 4,881                        | 14,679       |
| Purchase of premises and equipment  | (199)                        | (340)        |
| Proceeds from sale of foreclosed real estate, net of capital improvements     | 588                          | 1,453        |
| Net cash provided by investing activities                                     | 12,297                       | 2,940        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                   |                              |              |
| Net decrease in deposits  | (19,150)                     | (1,561)      |
| Decrease in securities sold under agreement to repurchase                     | (135)                        | (186)        |
| Proceeds from borrowed funds  | 7,000                        |              |
| Repayment of borrowed funds   | (2,423)                      | (4,704)      |
| Proceeds from common stock subscription                                       |                              | 792          |
| Dividends paid on preferred stock   |                              | (72)         |
| Net cash used by financing activities   | (14,708)                     | (5,731)      |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                                | <b>2,710</b>                 | <b>2,078</b> |
| Cash and cash equivalents, beginning of period                                | 15,841                       | 18,119       |
| Cash and cash equivalents, end of period                                      | \$ 18,551                    | \$ 20,197    |

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SUPPLEMENTAL DISCLOSURES:

Cash paid during the year for:

|   |          |          |
|---|----------|----------|
| Interest  | \$ 2,241 | \$ 3,543 |
| Income taxes  |          | 405      |
| Noncash investing and financing activities:                             |          |          |
| Increase (decrease) in fair value of securities available for sale, net | 1,360    | (34)     |
| Acquisition of real estate in settlement of loans                       | 271      | 1,895    |
| Foreclosed real estate financed in-house                                | 234      | 99       |
| Preferred stock dividend accrued but not paid                           | 286      | 215      |

See accompanying notes.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1. Summary of Significant Accounting Policies**

**Basis of presentation and consolidation:** The consolidated financial statements include the accounts of Northwest Bancorporation, Inc. (the Company ) and its wholly-owned subsidiary, Inland Northwest Bank (the Bank ). All material intercompany balances and transactions have been eliminated.

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC ). Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America ( GAAP ) for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the accompanying notes as disclosed in the annual report on Form 10-K for the year ended December 31, 2010.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of the Company s consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of the Company s consolidated financial position and results of operations.

In preparing these financial statements, the Company has evaluated events and transactions subsequent to June 30, 2011 for potential recognition or disclosure. In management s opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made. The adjustments include normal and recurring accruals considered necessary for a fair and accurate presentation. The results for interim periods are not necessarily indicative of results for the full year or any other interim period. Certain reclassifications of prior period amounts have been made to conform to current classifications. These reclassifications had no effect on retained earnings or net income as previously presented.

**Segment reporting:** The Company has not established any independent business activity apart from acting as the parent company of the Bank. The Company and the Bank are managed as a single entity and not by departments or lines of business. Based on management s analysis, no department or line of business meets the criteria established in Financial Accounting Standards Board Accounting Standards Codification ( FASB ASC ) 280, Segment Reporting, for reporting of selected information about operating segments.

**New accounting pronouncements:** In addition to other established accounting policies, the following is a discussion of recent accounting pronouncements:

*ASU No. 2011-03, Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements.* In a typical repurchase transaction, an entity transfers financial assets to a counterparty in exchange for cash with an agreement for the counterparty to return the same or equivalent financial assets for a fixed price in the future. This ASU prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred financial assets. One of the relevant considerations for assessing effective control is the transferor s ability to repurchase or redeem financial assets before maturity. Under this criterion, an entity must consider whether there is an exchange of collateral in sufficient amount so as to reasonably assure the arrangement s completion on substantially the agreed terms, even in the event of the transferee s default. That is, in order for the transferor to assert that it maintained effective control over the transferred assets, the transferor must have the ability to repurchase the same or substantially the same assets. The FASB determined that the criterion pertaining to an exchange of collateral should not be a determining factor in assessing effective control; the assessment of effective control should focus on a transferor s contractual rights and obligations with respect to transferred financial assets, not on whether the transferor has the practical ability to perform in accordance with those rights or obligations. The FASB also concluded that the remaining criteria are sufficient to determine effective control. Consequently, the amendments remove the transferor s ability criterion from the consideration of effective control for repurchase agreements and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. This ASU is not expected to have a significant impact on the Company s consolidated financial statements.

*ASU No. 2011-04, Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in this ASU result in common fair value measurement and disclosure requirements between GAAP and International Financial Reporting Standards ( IFRS ). Consequently, the amendments change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in this ASU to result in a change in the application of the requirements in Topic 820. Some of the amendments clarify the FASB's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this ASU explain how to measure fair value. They do not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied prospectively. This ASU is not expected to have a significant impact on the Company's consolidated financial statements.

*ASU No. 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income.* Current GAAP provides three alternatives for presenting other comprehensive income and its components in financial statements. One of those presentation options is to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This ASU eliminates that option and also requires consecutive presentation of the statement of net income and other comprehensive income. Finally, this ASU also requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income, rather than presenting other comprehensive income in a footnote. The provisions of this ASU are effective beginning in the first quarter of 2012 and will be applied retrospectively. The Company's presentation of consolidated comprehensive income will change in order to comply with the provisions of this ASU.

**NOTE 2. Investment Securities**

Securities held by the Bank have been classified in the consolidated statements of financial condition according to management's intent, and all securities were classified as available for sale at June 30, 2011 and December 31, 2010.

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The amortized cost of securities and their approximate fair values at June 30, 2011 and December 31, 2010 were as follows:

|                                     | Amortized<br>Cost | June 30, 2011                |                               | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
|                                     |                   | (\$ in thousands)            |                               |               |
| U.S. government agency securities   | \$ 20,491         | \$ 78                        | \$ (79)                       | \$ 20,490     |
| State and municipal securities      | 24,105            | 735                          | (82)                          | 24,758        |
| Corporate debt obligations          | 10,980            | 244                          | (38)                          | 11,186        |
| SBA participation certificates      | 3,595             | 24                           | (8)                           | 3,611         |
| Mortgage backed securities          | 2,076             | 90                           |                               | 2,166         |
| Collateralized mortgage obligations | 2,417             | 6                            | (16)                          | 2,407         |
|                                     | \$ 63,664         | \$ 1,177                     | \$ (223)                      | \$ 64,618     |

|                                     | Amortized<br>Cost | December 31, 2010            |                               | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
|                                     |                   | (\$ in thousands)            |                               |               |
| U.S. government agency securities   | \$ 30,787         | \$ 16                        | \$ (679)                      | \$ 30,124     |
| State and municipal securities      | 23,332            | 343                          | (676)                         | 22,999        |
| Corporate debt obligations          | 11,060            | 40                           | (302)                         | 10,798        |
| SBA participation certificates      | 3,243             | 135                          |                               | 3,378         |
| Mortgage backed securities          | 2,146             | 47                           | (28)                          | 2,165         |
| Collateralized mortgage obligations | 269               |                              | (3)                           | 266           |
|                                     | \$ 70,837         | \$ 581                       | \$ (1,688)                    | \$ 69,730     |

The following tables show the investments' gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position:

|                                     | Less Than 12 Months |                      | June 30, 2011<br>12 Months or More |                      | Total         |                      |
|-------------------------------------|---------------------|----------------------|------------------------------------|----------------------|---------------|----------------------|
|                                     | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value                      | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|                                     | (\$ in thousands)   |                      |                                    |                      |               |                      |
| U.S. government agency securities   | \$ 7,284            | \$ 79                | \$ 653                             | \$ 19                | \$ 7,284      | \$ 79                |
| State and municipal securities      | 5,507               | 63                   |                                    |                      | 6,160         | 82                   |
| Corporate debt obligations          | 2,832               | 38                   |                                    |                      | 2,832         | 38                   |
| SBA participation certificates      | 996                 | 8                    |                                    |                      | 996           | 8                    |
| Mortgage backed securities          |                     |                      |                                    |                      |               |                      |
| Collateralized mortgage obligations | 1,061               | 16                   |                                    |                      | 1,061         | 16                   |
|                                     | \$ 17,680           | \$ 204               | \$ 653                             | \$ 19                | \$ 18,333     | \$ 223               |

|                                   | Less Than 12 Months |                      | December 31, 2010<br>12 Months or More |                      | Total         |                      |
|-----------------------------------|---------------------|----------------------|--|----------------------|---------------|----------------------|
|                                   | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value                          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
|                                   | (\$ in thousands)   |                      |  |                      |               |                      |
| U.S. government agency securities | \$ 22,098           | \$ 679               | \$ 878                                 | \$ 51                | \$ 22,098     | \$ 679               |
| State and municipal securities    | 13,313              | 625                  |  |                      | 14,191        | 676                  |

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|                                     |           |          |        |       |           |          |
|-------------------------------------|-----------|----------|--------|-------|-----------|----------|
| Corporate debt obligations          | 9,223     | 302      |        |       | 9,223     | 302      |
| Mortgage backed securities          | 1,728     | 28       |        |       | 1,728     | 28       |
| Collateralized mortgage obligations | 266       | 3        |        |       | 266       | 3        |
|                                     | \$ 46,628 | \$ 1,637 | \$ 878 | \$ 51 | \$ 47,506 | \$ 1,688 |

Management has evaluated the above securities and does not believe that any individual unrealized loss as of June 30, 2011, represents an other-than-temporary impairment ( OTTI ). The decline in fair market value of these securities was generally due to changes in market interest rates or the widening of market spreads since purchase and was not related to any known decline in the creditworthiness of the issuer. Management does not intend to sell any impaired securities nor does available evidence suggest it is more likely than not that management will be required to sell any impaired securities. Management believes there is a high probability of collecting all contractual amounts due, because the majority of the securities in the Bank's investment portfolio are backed by government agencies or government-sponsored enterprises. However, a recovery in value may not occur for some time, if at all, and may be delayed for greater than the one-year time horizon or perhaps even until maturity. At June 30, 2011, 42 of the Bank's securities had unrealized losses. At December 31, 2010, 112 of the Bank's securities had unrealized losses.

Scheduled maturities of securities available for sale at June 30, 2011, are listed below according to contractual maturity date. Expected or actual maturities may differ from contractual maturities, because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Amortized<br>Cost        | Fair<br>Value |
|--|--------------------------|---------------|
|  | <i>(\$ in thousands)</i> |               |
| Due within one year                    | \$ 675                   | \$ 681        |
| Due after one year through five years  | 11,399                   | 11,727        |
| Due after five years through ten years | 23,442                   | 23,947        |
| Due after ten years                    | 28,148                   | 28,263        |
|  | \$ 63,664                | \$ 64,618     |

At June 30, 2011 and December 31, 2010, securities with an amortized cost of \$6.6 million and \$11.2 million, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required or permitted by law. The market value for these securities was \$6.7 million and \$11.0 million at June 30, 2011 and December 31, 2010, respectively.

Three securities were sold in the six-month period ended June 30, 2011, resulting in gross gains of \$35 thousand. Nine securities were sold in the six-month period ended June 30, 2010, resulting in gross gains of \$379 thousand and gross losses of \$61 thousand.

When a security is called by the issuer prior to maturity, any remaining premium or discount is reported in noninterest income as a gain or loss. During the six-month period ended June 30, 2011, one security was called and the unamortized premium of \$2 thousand was included in the total gain on sale of securities. During the six month period ended June 30, 2010, all securities with early calls had no remaining unamortized premiums or discounts and therefore, the early calls had no impact on income.

Management reviews investment securities on an ongoing basis for the presence of OTTI, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend to sell a security or if it is likely that we will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity, and other factors. The evaluation includes a consideration of the risk profile specific to each class of security; for example, the contractual terms of U.S. government agency securities do not permit the issuer to settle the securities at a price less than par. The Bank's securities portfolio does not include any private label mortgage backed securities or investments in trust preferred securities.

For debt securities, if we intend to sell the security or it is likely that we 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 we do not intend to sell the security and it is not likely that we will be required to sell the security but we do 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. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. 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 related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ( OCI ). Impairment losses related to all other factors are presented as separate categories 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 re-evaluated accordingly to the procedures described above.

At June 30, 2011, the Bank owned \$1.3 million of stock of the Federal Home Loan Bank of Seattle ( FHLB ). As a condition of membership in the FHLB, the Bank is required to purchase and hold a certain amount of FHLB stock, which 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. FHLB stock has a par value of \$100 per share, is carried at cost, and is subject to impairment testing per Accounting Standards Codification ( ASC ) 320-10-35. The FHLB has a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency ( FHFA ), its primary regulator, and therefore has suspended future dividends and the repurchase and redemption of outstanding capital stock. 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 the FHLB's balance sheet. As a result, an OTTI has not been recorded for the Bank's investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. Management will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of the Bank's investment.

### **NOTE 3. Loans Receivable and Allowance for Loan Losses**

The Bank originates residential mortgage loans intended for sale in the secondary market. Loans held for sale are stated at the lower of cost or estimated fair value determined on an aggregate basis. Any net unrealized losses on loans held for sale are recognized through a valuation allowance by charges to income. The Bank also originates construction and land, commercial and multifamily real estate, commercial business, agricultural and consumer loans for portfolio investment. Loans receivable that have not been designated as held for sale are recorded at the principal amount outstanding. Deferred loan fees, net of costs, are amortized to maturity using the level-yield method.



Interest is accrued as earned unless management determines that the collectability of the loan or the unpaid interest is doubtful. Interest accruals are generally discontinued when loans become 90 days past due on scheduled interest payments. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is included in interest income based upon an assessment of the likelihood that the loans will be repaid or recovered.

The following table presents the Bank's loan balances for the periods indicated:

|                                   | June 30,<br>2011         | December 31,<br>2010 |
|-----------------------------------|--------------------------|----------------------|
|                                   | <i>(\$ in thousands)</i> |                      |
| <b>Real estate:</b>               |                          |                      |
| Commercial                        | \$ 154,874               | \$ 150,373           |
| Construction and land development | 30,747                   | 40,145               |
| Residential                       | 34,207                   | 35,061               |
| Commercial and industrial         | 46,892                   | 47,345               |
| Consumer                          | 8,352                    | 9,026                |
|                                   | <b>\$ 275,072</b>        | <b>\$ 281,950</b>    |
| Allowance for loan losses         | (7,257)                  | (6,918)              |
| Net deferred loan fees            | (522)                    | (616)                |
|                                   | <b>\$ 267,293</b>        | <b>\$ 274,416</b>    |

**Loan origination/risk management:** The Bank has lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, nonperforming loans and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions. In general, loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently and to repay their obligations as agreed. Cash flows of borrowers, however, may not be as expected, and the collateral securing these loans may fluctuate in value. Most loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and typically incorporate a personal guarantee. However, some short-term loans may be made on an unsecured basis. 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. In the case of loans secured by real estate, the properties are diverse in terms of type, but are concentrated to a large extent in the Bank's primary market area, which is Spokane County, Washington and Kootenai County, Idaho. This concentration may increase the Bank's exposure to adverse economic events that affect a single market or industry. Construction loans are generally based upon estimates of costs and value associated with the complete project with repayment substantially dependent on the success of the ultimate project such as sales of developed property or an interim loan commitment from the Bank until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Bank originates consumer loans utilizing an individualized underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified as needed. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk.

The Bank's internal audit department performs an independent review to validate the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by the Bank's loan officers and credit personnel, as well as the Bank's policies and procedures.

**Past due and nonaccrual loans:** The following table presents an age analysis of past due loans, segregated by class of loans:

|                                   | June 30, 2011                      |                                 |                                      |                            |                  |                |
|-----------------------------------|------------------------------------|---------------------------------|--------------------------------------|----------------------------|------------------|----------------|
|                                   | Loans<br>30-59 Days<br>Past<br>Due | Loans<br>60-89 Days<br>Past Due | Loans 90 or<br>More Days<br>Past Due | Total<br>Past Due<br>Loans | Current<br>Loans | Total<br>Loans |
| <i>(\$ in thousands)</i>          |                                    |                                 |                                      |                            |                  |                |
| Real estate:                      |                                    |                                 |                                      |                            |                  |                |
| Commercial                        | \$ 103                             | \$                              | \$ 6,170                             | \$ 6,273                   | \$ 148,601       | \$ 154,874     |
| Construction and land development |                                    |                                 | 1,146                                | 1,146                      | 29,601           | 30,747         |
| Residential                       | 254                                |                                 | 116                                  | 370                        | 33,837           | 34,207         |
| Commercial and industrial         | 139                                |                                 | 1,813                                | 1,952                      | 44,940           | 46,892         |
| Consumer                          | 102                                | 48                              | 3                                    | 153                        | 8,199            | 8,352          |
|                                   | \$ 598                             | \$ 48                           | \$ 9,248                             | \$ 9,894                   | \$ 265,178       | \$ 275,072     |

|                                   | December 31, 2010                  |                                 |   |                            |                  |                |
|-----------------------------------|------------------------------------|---------------------------------|---|----------------------------|------------------|----------------|
|                                   | Loans<br>30-59 Days<br>Past<br>Due | Loans<br>60-89 Days<br>Past Due | Loans 90<br>or<br>More Days<br>Past Due | Total<br>Past Due<br>Loans | Current<br>Loans | Total<br>Loans |
| <i>(\$ in thousands)</i>          |                                    |                                 |   |                            |                  |                |
| Real estate:                      |                                    |                                 |   |                            |                  |                |
| Commercial                        | \$ 1,202                           | \$ 132                          | \$ 3,394                                | \$ 4,728                   | \$ 145,645       | \$ 150,373     |
| Construction and land development | 272                                | 262                             | 1,691                                   | 2,225                      | 37,920           | 40,145         |
| Residential                       | 662                                | 31                              | 269                                     | 962                        | 34,099           | 35,061         |
| Commercial and industrial         |                                    |                                 | 21                                      | 21                         | 47,324           | 47,345         |
| Consumer                          | 49                                 | 96                              | 3                                       | 148                        | 8,878            | 9,026          |
|                                   | \$ 2,185                           | \$ 521                          | \$ 5,378                                | \$ 8,084                   | \$ 273,866       | \$ 281,950     |

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No loans over 90 days past due were still on accrual status as of June 30, 2011 and December 31, 2010.

Nonaccrual loans, segregated by class of loans, were as follows:

|                                   | June 30,<br>2011 | December 31,<br>2010 |
|-----------------------------------|------------------|----------------------|
| (\$ in thousands)                 |                  |                      |
| <b>Real estate:</b>               |                  |                      |
| Commercial                        | \$ 7,086         | \$ 8,661             |
| Construction and land development | 1,146            | 2,613                |
| Residential                       | 1,109            | 1,362                |
| Commercial and industrial         | 1,813            | 21                   |
| Consumer                          | 77               | 56                   |
|                                   | \$ 11,231        | \$ 12,713            |

If the Bank's nonaccrual loans had performed in accordance with their original contract terms, additional interest income of \$338 thousand and \$374 thousand would have been recognized for the six-month periods ended June 30, 2011 and 2010, respectively.

**Impaired loans:** Loans are considered impaired when, based on current information and events, it is improbable the Bank will be able to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are applied to principal if the loan is on nonaccrual. Impaired loans, or portions thereof, are charged off if management determines them to be uncollectible. As of June 30, 2011, the Bank's impaired loan balances were as follows:

|  | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | June 30, 2011<br>Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|---|--|--|---------------------------------|----------------------|
| (\$ in thousands)                      |   |  |  |                                 |                      |
| <b>Real estate:</b>                    |   |  |  |                                 |                      |
| Commercial                             | \$ 19,060                                     | \$ 4,398                                       | \$ 13,256  | \$ 17,654                       | \$ 2,659             |
| Construction and land development      | 12,036  | 10,166   | 1,210  | 11,376                          | 314                  |
| Residential                            | 2,811   | 122  | 2,596  | 2,718                           | 788                  |
| Commercial and industrial <sup>1</sup> | 2,971   | 64   | 1,494  | 1,558                           | 504                  |
| Consumer                               | 155   | 2  | 148  | 150                             | 77                   |
|  | \$ 37,033                                     | \$ 14,752                                      | \$ 18,704  | \$ 33,456                       | \$ 4,342             |

|                                   | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | December 31, 2010<br>Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|-----------------------------------|---|--|--|---------------------------------|----------------------|
| (\$ in thousands)                 |   |  |  |                                 |                      |
| <b>Real estate:</b>               |   |  |  |                                 |                      |
| Commercial                        | \$ 22,586                                     | \$ 2,478                                       | \$ 19,664  | \$ 22,142                       | \$ 2,393             |
| Construction and land development | 12,697  | 8,582  | 2,432  | 11,014                          | 678                  |
| Residential                       | 2,777   | 95   | 2,379  | 2,474                           | 641                  |
| Commercial and industrial         | 1,585   | 717  | 707  | 1,424                           | 416                  |
| Consumer                          | 170   | 4  | 137  | 141                             | 89                   |

|           |           |           |           |          |
|-----------|-----------|-----------|-----------|----------|
| \$ 39,815 | \$ 11,876 | \$ 25,319 | \$ 37,195 | \$ 4,217 |
|-----------|-----------|-----------|-----------|----------|

<sup>1</sup> One loan with a USDA guarantee was included in this category net of the guarantee.

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The average recorded investment in impaired loans and the related interest income recognized for cash payments received were as follows:

|                                   | Three months ended June 30,       |   |                                   |   |
|-----------------------------------|-----------------------------------|---|-----------------------------------|---|
|                                   | 2011                              | 2010  |                                   | 2010  |
|                                   | Average<br>Recorded<br>Investment | Interest Income<br>Recorded for<br>Cash<br>Payments<br>Received | Average<br>Recorded<br>Investment | Interest Income<br>Recorded for<br>Cash<br>Payments<br>Received |
|                                   | <i>(\$ in thousands)</i>          |   |                                   |   |
| Real estate:                      |                                   |   |                                   |   |
| Commercial                        | \$ 21,281                         | \$ 263  | \$ 14,037                         | \$ 210  |
| Construction and land development | 11,607                            | 79  | 13,849                            | 86  |
| Residential                       | 2,983                             | 33  | 2,586                             | 26  |
| Commercial and industrial         | 2,507                             | 23  | 1,709                             | 25  |
| Consumer                          | 159                               | 3   | 93                                | 1   |
|                                   | \$ 38,537                         | \$ 401  | \$ 32,274                         | \$ 348  |

|                                   | Six months ended June 30,         |   |                                   |   |
|-----------------------------------|-----------------------------------|---|-----------------------------------|---|
|                                   | 2011                              | 2010  |                                   | 2010  |
|                                   | Average<br>Recorded<br>Investment | Interest Income<br>Recorded for<br>Cash<br>Payments<br>Received | Average<br>Recorded<br>Investment | Interest Income<br>Recorded for<br>Cash<br>Payments<br>Received |
|                                   | <i>(\$ in thousands)</i>          |   |                                   |   |
| Real estate:                      |                                   |   |                                   |   |
| Commercial                        | \$ 21,716                         | \$ 550  | \$ 12,230                         | \$ 320  |
| Construction and land development | 11,318                            | 224   | 14,044                            | 197   |
| Residential                       | 3,085                             | 64  | 2,204                             | 55  |
| Commercial and industrial         | 1,931                             | 45  | 1,856                             | 48  |
| Consumer                          | 147                               | 8   | 88                                | 2   |
|                                   | \$ 38,197                         | \$ 891  | \$ 30,422                         | \$ 622  |

**Troubled debt restructuring ( TDR ):** A troubled debt restructuring occurs when, due to a borrower's financial difficulties, the Bank grants a concession that it would not otherwise consider. The concession can take the form of an interest rate or principal reduction or an extension of payments of principal or interest, or both. Restructured loans are included in impaired loans until such time as the restructured loan performs according to the new terms for an acceptable duration, typically one year or longer depending on the circumstances specific to each credit. Restructured loans performing in accordance with their new terms are not included in nonaccrual loans unless there is uncertainty as to the ultimate collection of principal or interest. The recorded investment in restructured loans was as follows:

|                                   | June 30, 2011                     |   | December 31, 2010                 |   |
|-----------------------------------|-----------------------------------|---|-----------------------------------|---|
|                                   | Accruing<br>Restructured<br>Loans | Restructured<br>Loans Included<br>in<br>Nonaccrual<br>Loans<br><i>(\$ in thousands)</i> | Accruing<br>Restructured<br>Loans | Restructured<br>Loans Included<br>in<br>Nonaccrual<br>Loans |
| Real estate:                      |                                   |   |                                   |   |
| Commercial                        | \$ 10,162                         | \$ 814  | \$                                | \$ 3,972  |
| Construction and land development |                                   |   |                                   |   |
| Residential                       |                                   | 920   |                                   | 705   |
| Commercial and industrial         | 570                               |   | 397                               |   |
| Consumer                          |                                   |   |                                   |   |
|                                   | \$ 10,732                         | \$ 1,734  | \$ 397                            | \$ 4,677  |

For the six-month periods ended June 30, 2011 and 2010, the Bank recognized interest income of approximately \$320 thousand and \$28 thousand, respectively, in connection with restructured accruing loans.

Troubled debt restructurings which occurred during the six-month periods ending June 30, 2011 and 2010, were as follows:

|                                   | June 30, 2011             |   |   | June 30, 2010             |  |  |
|-----------------------------------|---------------------------|---|---|---------------------------|--|--|
|                                   | Number<br>of<br>Contracts | Pre -<br>modification<br>Recorded<br>Investment | Post - modification<br>Recorded<br>Investment | Number<br>of<br>Contracts | Pre - modification<br>Recorded<br>Investment | Post -<br>modification<br>Recorded<br>Investment |
| Real estate:                      |                           |   |   |                           |  |  |
| Commercial                        | 6                         | \$ 7,653  | \$ 7,653                                      |                           | \$   | \$   |
| Construction and land development |                           |   |   |                           |  |  |
| Residential                       | 1                         | 920   | 920   | 1                         | 705  | 705  |
| Commercial and industrial         | 2                         | 312   | 312   | 4                         | 436  | 436  |
| Consumer                          |                           |   |   |                           |  |  |
|                                   | 9                         | \$ 8,885  | \$ 8,885                                      | 5                         | \$ 1,141                                     | \$ 1,141   |

In each case, the loans listed above were modified to allow the borrower an additional period of interest-only payments, and in some cases, the interest rate was decreased. The Bank is not committed to lend additional funds to debtors whose loans have been restructured. As a result of adopting the amendments in ASU No. 2011-02, the Bank reassessed all restructurings that occurred on or after the beginning of the the current fiscal year for identification as troubled debt restructurings. No newly impaired loans resulted from this assessment.

Troubled debt restructurings for which there was a payment default during the six-month periods ending June 30, 2011 and 2010, were as follows:

|                                   | June 30, 2011       |  | June 30, 2010       |                     |
|-----------------------------------|---------------------|--|---------------------|---------------------|
|                                   | Number of Contracts | Recorded Investment<br>(\$ in thousands) | Number of Contracts | Recorded Investment |
| <b>Real estate:</b>               |                     |  |                     |                     |
| Commercial                        | 5                   | \$ 6,375                                 | 1                   | \$ 2,798            |
| Construction and land development |                     |  |                     |                     |
| Residential                       | 1                   | 920                                      |                     |                     |
| Commercial and industrial         |                     |  | 1                   | 26                  |
| Consumer                          |                     |  |                     |                     |
|                                   | 6                   | \$ 7,295                                 | 2                   | \$ 2,824            |

All troubled debt restructurings are accounted for as impaired loans and are factored into the allowance for loan losses accordingly.

**Credit Quality Indicators:** The Bank utilizes a risk grading matrix to assign a risk grade to each loan. Loans are graded on a scale of 1 to 10. The ten risk rating categories can be generally described by the following groupings for non-homogeneous loans:

*Pass/Watch* These loans range from minimal credit risk to lower than average, but still acceptable, credit risk.

*Special Mention* A Special Mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or the Bank's credit position at some future date. They contain unfavorable characteristics and are generally undesirable. Loans in this category are currently protected but are potentially weak and constitute an undue and unwarranted credit risk, but not to the point of a Substandard classification. A Special Mention loan has potential weaknesses such as inadequate working capital or underperformance compared to plan, which if not checked or corrected, weaken the asset or inadequately protect the Bank's position at some future date. Unlike a Substandard credit, there should be a reasonable expectation that these temporary issues will be corrected in a reasonable period of time, without liquidation of assets and within the normal course of business.

**Substandard** A Substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard loans, does not have to exist in individual assets classified as Substandard. Loans are classified as Substandard when they have unsatisfactory characteristics causing unacceptable levels of risk, such as cash flow trends that are of a magnitude as to jeopardize current and future payments, or prolonged unsuccessful business operations or economic trends to which the borrower has not been able to adjust. The likely need to liquidate assets to correct the problem, rather than repayment from successful operations is a key distinction between Special Mention and Substandard.

**Doubtful/Loss** Loans classified as Doubtful have all the same weaknesses inherent in loans classified as Substandard with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions and values. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work towards strengthening of the loan, classification as a Loss (and immediate charge-off) is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition, liquidation procedures, capital injection, and perfection of liens on additional collateral and refinancing plans. A Loss rating is assigned to loans considered uncollectible and of such little value that the continuance as an active Bank asset is not warranted. This rating does not mean that the loan has no recovery or salvage value, but rather that the loan should be charged off now, even though partial or full recovery may be possible in the future.

The following table summarizes the Bank's internal risk rating by loan class:

|                                   | Pass/Watch | Special Mention | June 30, 2011<br>Substandard<br>(\$ in thousands) | Doubtful/Loss | Total Loans |
|-----------------------------------|------------|-----------------|---|---------------|-------------|
| <b>Real estate:</b>               |            |                 |   |               |             |
| Commercial                        | \$ 117,460 | \$ 9,628        | \$ 27,786   | \$            | \$ 154,874  |
| Construction and land development | 11,858     | 2,876           | 16,013  |               | 30,747      |
| Residential                       | 29,317     | 2,009           | 2,881   |               | 34,207      |
| Commercial and industrial         | 41,461     | 2,136           | 3,295   |               | 46,892      |
| Consumer                          | 8,081      | 101             | 170   |               | 8,352       |
|                                   | \$ 208,177 | \$ 16,750       | \$ 50,145   | \$            | \$ 275,072  |

|                                   | Pass/Watch | Special Mention | December 31, 2010<br>Substandard<br>(\$ in thousands) | Doubtful/Loss | Total Loans |
|-----------------------------------|------------|-----------------|---|---------------|-------------|
| <b>Real estate:</b>               |            |                 |   |               |             |
| Commercial                        | \$ 113,338 | \$ 9,075        | \$ 27,960   | \$            | \$ 150,373  |
| Construction and land development | 22,650     | 1,257           | 16,238  |               | 40,145      |
| Residential                       | 30,372     | 2,143           | 2,546   |               | 35,061      |
| Commercial and industrial         | 38,717     | 7,221           | 1,407   |               | 47,345      |
| Consumer                          | 8,829      | 47              | 149   | 1             | 9,026       |
|                                   | \$ 213,906 | \$ 19,743       | \$ 48,300   | \$ 1          | \$ 281,950  |



**Allowance for Loan Losses:** The allowance for loan losses is a reserve established through a provision for loan losses charged to expense. The allowance for loan losses represents management's best estimate of probable losses within the existing loan portfolio. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Bank's allowance for loan loss methodology is based on guidance from ASC Topic 310, *Receivables*, and ASC Topic 450, *Contingencies*. The Bank's process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The amount of the provision reflects not only the necessary increases in the allowance for possible loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Bank's control, including, among other things, the performance of the Bank's loan portfolio, the economy, changes in interest rates and the view of regulatory authorities toward loan classifications.

The Bank's allowance for loan losses consists of two elements: (i) general valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted as necessary to reflect the impact of current economic conditions and other qualitative risk factors both internal and external to the Bank; and (ii) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans.

The allowances established for expected losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the borrower's ability to repay; (ii) the financial condition of the borrower; (iii) the quality of the borrower's management; (iv) the underlying collateral, if any; (v) the strength of the guarantors; (vi) the structure of the loan; (vii) the quality, availability and timeliness of financial information; and (viii) the industry and economic environment in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has been classified as Substandard or worse, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Impairment is determined in accordance with ASC Topic 310, which specifies that a loan is impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement, including principal and interest, as scheduled in the loan agreement. Indicators of impairment include evidence the borrower is experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions; loans that are secured with collateral that is no longer readily marketable or that is subject to deterioration in realizable value; loans to borrowers in industries that are currently experiencing economic instability; and other factors. If a loan is determined to be impaired, the balance is segregated from the pool of loans and a specific valuation allowance is established by measuring the impairment. Most loans are collateral dependent and as such, impairment is measured by comparing the loan balance with the current market value of the collateral, less selling and holding costs. A deficiency is recorded as a specific valuation allowance, and is included as a component of the allowance for loan losses.

General valuation allowances are calculated based on the historical loss experience of specific types of loans, plus general economic conditions and other qualitative internal and external risk factors. The Bank calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced compared to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool.

Added to the Bank's historical loss experience are metrics of general economic conditions and other qualitative risk factors both internal and external to the Bank. The risk factors believed by management to be most relevant to the loan portfolio are: (i) current unemployment levels in our operating areas, as compared to normal levels of unemployment; (ii) the current level of past due and nonaccrual loans as compared to levels during years of low charge-offs; (iii) a consideration of the trend of median home prices and foreclosure rates as they relate to construction and land loans; (iv) a consideration of the trend of new housing starts and absorption rates as they relate to construction loans; (v) commercial and apartment vacancy rates and their relationship to multi-family and other commercial real estate loans; and (vi) the change in the average risk rating of our portfolio, by loan type, as it relates to charge-off experience. Each component is used to calculate a risk factor, which is input into a general reserve matrix along with the historical loss rates discussed above. The total combined risk factor for each loan type is then applied to the loan balances that remain after impaired loans are segregated from the pool to determine an appropriate general valuation allowance. Management evaluates the change each one of these components has on the quality of the loan portfolio on a quarterly basis. In addition, management evaluates and documents intangible factors such as: (i) the experience, ability and effectiveness of the Bank's lending management and staff; (ii) the effectiveness of the Bank's loan policies, procedures and internal controls; (iii) the composition and concentrations of credit; and, (iv) the effectiveness of the internal loan review function.

Activity in the allowance for loan losses was as follows for the quarters ended June 30, 2011 and 2010:

|                                   | Balance,<br>Beginning<br>of<br>Period | Quarter ended June 30, 2011  |                                  |            | Balance, End<br>of Period |
|-----------------------------------|---------------------------------------|------------------------------|----------------------------------|------------|---------------------------|
|                                   |                                       | Provision for<br>Loan Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                           |
| Real estate:                      |                                       |                              |                                  |            |                           |
| Commercial                        | \$ 1,949                              | \$ 1,391                     | \$                               | \$         | \$ 3,340                  |
| Construction and land development | 1,066                                 | 73                           | (215)                            |            | 924                       |
| Residential                       | 1,366                                 | 52                           | (55)                             |            | 1,363                     |
| Commercial and industrial         | 1,239                                 | (222)                        | (129)                            |            | 888                       |
| Consumer                          | 280                                   | (7)                          | (47)                             | 1          | 227                       |
| Unallocated                       | 271                                   | 244                          |                                  |            | 515                       |
|                                   | \$ 6,171                              | \$ 1,531                     | \$ (446)                         | \$ 1       | \$ 7,257                  |

|                                   | Balance,<br>Beginning<br>of<br>Period | Quarter ended June 30, 2010  |                                  |            | Balance,<br>End<br>of Period |
|-----------------------------------|---------------------------------------|------------------------------|----------------------------------|------------|------------------------------|
|                                   |                                       | Provision for<br>Loan Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                              |
| Real estate:                      |                                       |                              |                                  |            |                              |
| Commercial                        | \$ 1,893                              | \$ 515                       | \$ (40)                          | \$         | \$ 2,368                     |
| Construction and land development | 1,668                                 | (54)                         | (540)                            | 25         | 1,099                        |
| Residential                       | 966                                   | 481                          | (231)                            | 2          | 1,218                        |
| Commercial and industrial         | 2,456                                 | (344)                        | (20)                             | 10         | 2,102                        |
| Consumer                          | 169                                   | 63                           | (81)                             | 1          | 152                          |
| Unallocated                       | 23                                    | 289                          |                                  |            | 312                          |
|                                   | \$ 7,175                              | \$ 950                       | \$ (912)                         | \$ 38      | \$ 7,251                     |

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Activity in the allowance for loan losses was as follows for the six-month periods ended June 30, 2011 and 2010:

|                                   | Balance,<br>Beginning of<br>Period | Six months ended June 30, 2011  |                                  |            | Balance, End<br>of Period |
|-----------------------------------|------------------------------------|---------------------------------|----------------------------------|------------|---------------------------|
|                                   |                                    | Provision for<br>Loan<br>Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                           |
| <b>Real estate:</b>               |                                    |                                 |                                  |            |                           |
| Commercial                        | \$ 2,779                           | \$ 1,889                        | \$ (1,328)                       | \$         | \$ 3,340                  |
| Construction and land development | 1,341                              | (90)                            | (327)                            |            | 924                       |
| Residential                       | 1,081                              | 426                             | (160)                            | 16         | 1,363                     |
| Commercial and industrial         | 1,162                              | (104)                           | (171)                            | 1          | 888                       |
| Consumer                          | 347                                | (66)                            | (55)                             | 1          | 227                       |
| Unallocated                       | 208                                | 307                             |                                  |            | 515                       |
|                                   | \$ 6,918                           | \$ 2,362                        | \$ (2,041)                       | \$ 18      | \$ 7,257                  |

|                                   | Balance,<br>Beginning<br>of<br>Period | Six months ended June 30, 2010     |                                  |            | Balance,<br>End<br>of Period |
|-----------------------------------|---------------------------------------|------------------------------------|----------------------------------|------------|------------------------------|
|                                   |                                       | Provision<br>for<br>Loan<br>Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                              |
| <b>Real estate:</b>               |                                       |                                    |                                  |            |                              |
| Commercial                        | \$ 1,269                              | \$ 1,219                           | \$ (120)                         | \$         | \$ 2,368                     |
| Construction and land development | 1,801                                 | (24)                               | (705)                            | 27         | 1,099                        |
| Residential                       | 604                                   | 840                                | (231)                            | 5          | 1,218                        |
| Commercial and industrial         | 2,660                                 | (408)                              | (160)                            | 10         | 2,102                        |
| Consumer                          | 134                                   | 125                                | (109)                            | 2          | 152                          |
| Unallocated                       | 614                                   | (302)                              |                                  |            | 312                          |
|                                   | \$ 7,082                              | \$ 1,450                           | \$ (1,325)                       | \$ 44      | \$ 7,251                     |

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The Bank's recorded investment in loans and the related allowance for loan losses by portfolio segment, disaggregated on the basis of the Bank's impairment methodology, was as follows:

|                                   | June 30, 2011                         |                   |                                       |                   |
|-----------------------------------|---------------------------------------|-------------------|---------------------------------------|-------------------|
|                                   | Collectively Evaluated for Impairment |                   | Individually Evaluated for Impairment |                   |
|                                   | Loans                                 | Related Allowance | Loans                                 | Related Allowance |
| <i>(\$ in thousands)</i>          |                                       |                   |                                       |                   |
| Real estate:                      |                                       |                   |                                       |                   |
| Commercial                        | \$ 137,220                            | \$ 681            | \$ 17,654                             | \$ 2,659          |
| Construction and land development | 19,371                                | 610               | 11,376                                | 314               |
| Residential                       | 31,489                                | 575               | 2,718                                 | 788               |
| Commercial and industrial         | 45,334                                | 384               | 1,558                                 | 504               |
| Consumer                          | 8,202                                 | 150               | 150                                   | 77                |
| Unallocated                       |                                       | 515               |                                       |                   |
|                                   | \$ 241,616                            | \$ 2,915          | \$ 33,456                             | \$ 4,342          |

|                                   | December 31, 2010                     |                   |                                       |                   |
|-----------------------------------|---------------------------------------|-------------------|---------------------------------------|-------------------|
|                                   | Collectively Evaluated for Impairment |                   | Individually Evaluated for Impairment |                   |
|                                   | Loans                                 | Related Allowance | Loans                                 | Related Allowance |
| <i>(\$ in thousands)</i>          |                                       |                   |                                       |                   |
| Real estate:                      |                                       |                   |                                       |                   |
| Commercial                        | \$ 128,231                            | \$ 386            | \$ 22,142                             | \$ 2,393          |
| Construction and land development | 29,131                                | 663               | 11,014                                | 678               |
| Residential                       | 32,587                                | 440               | 2,474                                 | 641               |
| Commercial and industrial         | 45,920                                | 747               | 1,424                                 | 416               |
| Consumer                          | 8,886                                 | 258               | 141                                   | 89                |
| Unallocated                       |                                       | 207               |                                       |                   |
|                                   | \$ 244,755                            | \$ 2,701          | \$ 37,195                             | \$ 4,217          |

Management also evaluates the risk of loss associated with commitments to lend funds, such as with a letter or line of credit. A reserve has been established to absorb inherent losses with unfunded commitments using a blended rate of historical charge-off experience, and is monitored on a regular basis.

**NOTE 4. Foreclosed Real Estate**

The following table presents the changes in foreclosed real estate, net of any related valuation allowance:

|                                  | Quarter ended June 30, |          | Six months ended June 30, |          |
|----------------------------------|------------------------|----------|---------------------------|----------|
|                                  | 2011                   | 2010     | 2011                      | 2010     |
|                                  | (\$ in thousands)      |          | (\$ in thousands)         |          |
| Balance, beginning of period     | \$ 3,972               | \$ 3,401 | \$ 3,963                  | \$ 3,672 |
| Transfers from loans             |                        | 1,625    | 271                       | 1,895    |
| Capital improvements to property |                        |          | 50                        |          |
| Dispositions of property         | (447)                  | (1,015)  | (759)                     | (1,456)  |
| Provision charged to income      | (196)                  |          | (196)                     | (100)    |
| Balance, end of period           | \$ 3,329               | \$ 4,011 | \$ 3,329                  | \$ 4,011 |

Foreclosed real estate is carried at the lower of the recorded investment in the loan (prior to foreclosure) or the fair market value of the property less expected selling costs. Valuation allowances on foreclosed real estate are based on updated appraisals of the underlying collateral as received during the period or management's authorization to reduce the selling price of a property during the period.

**NOTE 5. Deposits**

Classifications of deposits were as follows:

|  | June 30,          | December 31, |
|--|-------------------|--------------|
|  | 2011              | 2010         |
|  | (\$ in thousands) |              |
| Noninterest bearing demand deposits              | \$ 62,650         | \$ 69,145    |
| Money market accounts                            | 38,049            | 39,148       |
| NOW accounts                                     | 56,558            | 57,878       |
| Savings accounts                                 | 54,241            | 47,142       |
| Time certificates of deposit, \$100,000 and over | 64,292            | 72,170       |
| Time certificates of deposit, under \$100,000    | 51,297            | 60,754       |
|  | \$ 327,087        | \$ 346,237   |

**NOTE 6. Borrowed Funds**

Borrowed funds consist of the following:

|                                 | June 30,          | December 31, |
|---------------------------------|-------------------|--------------|
|                                 | 2011              | 2010         |
|                                 | (\$ in thousands) |              |
| Federal Home Loan Bank advances | \$ 8,355          | \$ 3,771     |
| Junior subordinated debentures  | 5,155             | 5,155        |
| Capital lease obligation        | 585               | 592          |
|                                 | \$ 14,095         | \$ 9,518     |

FHLB advances are secured by a blanket pledge on Bank assets as well as certain specific loans.

**Junior subordinated debentures:** In June 2005, the Company issued junior subordinated debentures with an aggregate value of \$5.16 million to Northwest Bancorporation Capital Trust I (the Trust), with interest fixed at 5.95% through June 30, 2010, thereafter re-pricing quarterly at three-month LIBOR plus 1.70%, which was 1.95% at June 30, 2011. The Trust issued \$155 thousand of common securities to the Company and capital securities with an aggregate liquidation amount of \$5 million to third-party investors. The common securities are included in Other assets on the consolidated statements of financial condition; the subordinated debentures are included in Borrowed funds on the consolidated statements of financial condition. The subordinated debentures are includable as Tier I capital for regulatory purposes. The subordinated debentures and the capital securities pay interest and dividends, respectively, on a quarterly basis, which are included in interest expense. The subordinated debentures will mature on June 30, 2035, at which time the capital securities must be redeemed. The subordinated debentures and capital securities can be redeemed prior to maturity, at the Company's discretion, in whole or in part, beginning June 30, 2010, at par value. The Company has provided a full and unconditional guarantee of the obligations of the Trust under the capital securities in the event of default. Pursuant to ASC 810, *Consolidation*, the Trust is not consolidated in these financial statements.

On June 4, 2010, the Company gave written notice to the holders of its outstanding junior subordinated debentures that regularly scheduled interest payments would be deferred. Under the terms of the related trust documents, the Company is allowed to defer payments of interest for up to 20 consecutive quarterly periods without default. During the deferral period, the respective trust will likewise suspend the declaration and payment of dividends on the trust preferred securities. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Fixed Rate Cumulative Perpetual Preferred Stock, Series A and Series B, issued by the Company under the U.S. Department of the Treasury's Capital Purchase Program. In addition, the Company will be restricted from making any payment on outstanding debt obligations that rank equally with, or junior to, the junior subordinated notes. As of June 30, 2011 and December 31, 2010, the accumulated deferred interest that was accrued on these securities was \$188 thousand and \$135 thousand, respectively.

**Capital lease obligation:** The capital lease obligation is related to a ground lease, with a purchase option, that the Bank entered into in early 2005 (a copy of the ground lease was filed as an Exhibit to the Company's annual report on Form 10-KSB filed with the SEC on March 24, 2005). As a capitalized lease, the value of the property is included as an asset on the consolidated statements of financial condition in Premises and equipment, net, and the net present value of future payments is included in Borrowed funds.

**Lines of credit:** The Bank has operating lines of credit with various correspondent banks, which are detailed as follows:

|                            | June 30, 2011     |                        | December 31, 2010 |                        |
|----------------------------|-------------------|------------------------|-------------------|------------------------|
|                            | Line<br>Amount    | Outstanding<br>Balance | Line<br>Amount    | Outstanding<br>Balance |
|                            | (\$ in thousands) |                        |                   |                        |
| Federal Home Loan Bank     | \$ 54,675         | \$                     | \$ 65,968         | \$                     |
| Pacific Coast Bankers Bank | 10,000            |                        | 10,000            |                        |
| Zions Bank                 | 5,000             |                        | 5,000             |                        |

The FHLB line is secured by a blanket pledge on Bank assets as well as certain specific loans; advances on the FHLB line may require additional purchases of FHLB stock. The Pacific Coast Bankers Bank line is unsecured. The Zions Bank line includes \$1 million that is unsecured, and the rest of the line is secured by certain investment securities.

**NOTE 7. Commitments**

The Bank has an agreement with the Spokane Public Facilities District ( PFD ) for the purchase of naming rights to the INB Performing Arts Center in Spokane. Under the agreement, the Bank will pay the PFD \$150 thousand per year for a period of ten years. The contract expires in July 2016, however the Bank has the right to extend the contract for an additional ten years at an annual rate that will not exceed the current annual rate by more than twenty percent. Expenses related to the agreement are recognized as Other noninterest expenses in the consolidated statements of operations.

The Bank leases its principal office and main branch, which is located in the Paulsen Center Building in downtown Spokane. The lease is for a 10-year term with additional renewal options. The initial lease rate is \$30,839 per month and escalates approximately 3% per year. A copy of the lease agreement has been filed as Exhibit 99.1 to the current report on Form 8-K filed by the Company with the SEC on May 11, 2009.

**NOTE 8. Income Taxes**

The Company's normal, expected statutory income tax rate is 36.0%, representing a blend of the statutory federal income tax rate of 34.0% and apportioned effects of the Idaho income tax rate of 7.6%. Our effective tax rates have historically been lower than statutory tax rates due to permanent differences arising primarily from nontaxable interest income on state and municipal securities and nontaxable gains in bank owned life insurance. The effect of these permanent differences, combined with adjustments related to certain state deferred tax benefits, has resulted in a consolidated effective tax rate of (9.7%) and 28.0% for the six-month periods ended June 30, 2011 and 2010.

During 2009, the Company recorded a valuation allowance of \$742 thousand against a portion of its deferred tax assets due to uncertainty about the Company's ability to generate future taxable income sufficient to realize the benefits of temporary deductible differences that could not have been realized through carry-backs to prior years or through the reversal of future temporary taxable differences. Due to the ongoing weakness in the economy and its affect on credit quality, uncertainty remains about the extent to which a pattern of future taxable income will be established. Accordingly, the Company continued to maintain a valuation allowance of \$742 thousand as of June 30, 2011.

The Company follows the provisions of ASC 740, *Income Taxes*, relating to the accounting for uncertainty in income taxes. The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

The Company had no unrecognized tax benefits at June 30, 2011 or December 31, 2010. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the periods ended June 30, 2011 and December 31, 2010, the Company recognized no interest and penalties. The Company is no longer subject to U.S. federal or Idaho State tax authority examinations for tax years before 2008.

**NOTE 9. Common and Preferred Stock**

***Common Stock:***

No cash dividends on common stock were declared during the six-month periods ended June 30, 2011 and 2010.

On July 15, 2010, the Company concluded a rights offering to the holders of its common stock, raising \$2.7 million in exchange for 686,805 shares of the Company's common stock. Net proceeds to the Company, after expenses, were \$2.6 million.

***Preferred Stock:***

On February 14, 2009, as part of the Capital Purchase Program of the U.S. Department of the Treasury ( Treasury ), the Company entered into a Letter Agreement incorporating an attached Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement ) with the Treasury. Under the Purchase Agreement, the Company agreed to issue and sell to the Treasury (i) 10,500 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock ), having no par value per share, and (ii) a warrant (the Warrant ) to purchase 525,005,25 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Series B Preferred Stock ), having no par value per share, for an aggregate purchase price of \$10.5 million. The Treasury immediately exercised the warrant.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series B Preferred Stock pays a cumulative dividend of 9% per year. The Series A Preferred Stock and the Series B Preferred Stock (together, the Preferred Stock ) may not be redeemed by the Company during the first three years following the investment by the Treasury, except with the proceeds from a Qualified Equity Offering (as defined in the Company's Articles of Amendment). After three years, the Company may, at its option, redeem the Preferred Stock at the issue price, plus accrued and unpaid dividends. The Preferred Stock is generally non-voting and qualifies as Tier 1 capital.

As a result of the Company's participation in the Capital Purchase Program, the Company is restricted from paying any dividend on its common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock. During the three year period from February 13, 2009, payment of dividends on common stock by the Company may not exceed the last annual cash dividend of \$0.20 per share. Prior consent of the Treasury will be required after February 13, 2012 until February 13, 2019, for any annual increase of 3% or more in aggregate common dividends per share. After February 13, 2019, the Company will be prohibited from paying any common dividends or repurchasing any equity securities or trust preferred securities until all of the Preferred Stock has been redeemed in whole or the Treasury has transferred all of the Preferred Stock to third parties.

During the six-month periods ended June 30, 2011 and 2010, the Company declared preferred stock dividends totaling \$286 thousand each period. Subsequent to the payment made on February 16, 2010, the Company began deferring payment of dividends on its preferred stock but continues to accrue the liability for the dividends. As of June 30, 2011 and December 31, 2010, accrued and unpaid dividends totaled \$787 thousand and \$500 thousand, respectively.

**NOTE 10. Fair Values**

The Company determines the fair market value of its financial instruments based on the fair value hierarchy established in ASC 820 *Fair Value Measurements and Disclosures*. The Standard provides enhanced guidance for measuring assets and liabilities using fair value and applies to situations where other standards require or permit assets or liabilities to be measured at fair value. ASC 820 also requires expanded disclosure of items that are measured at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings.



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The following table presents estimated fair values of the Company's financial instruments:

|   | June 30, 2011   |                      | December 31, 2010 |                      |
|---|-----------------|----------------------|-------------------|----------------------|
|   | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| <i>(\$ in thousands)</i>                          |                 |                      |                   |                      |
| <b>Financial Assets:</b>                          |                 |                      |                   |                      |
| Cash and due from banks/interest bearing deposits | \$ 12,906       | \$ 12,906            | \$ 10,826         | \$ 10,826            |
| Federal funds sold                                | 5,645           | 5,645                | 5,015             | 5,015                |
| Securities available for sale                     | 64,618          | 64,618               | 69,730            | 69,730               |
| Federal Home Loan Bank stock                      | 1,261           | 1,261                | 1,261             | 1,261                |
| Loans receivable, net                             | 267,293         | 273,446              | 274,416           | 280,075              |
| Loans held for sale                               | 1,682           | 1,682                | 2,371             | 2,371                |
| Bank owned life insurance                         | 3,852           | 3,852                | 3,792             | 3,792                |
| <b>Financial Liabilities:</b>                     |                 |                      |                   |                      |
| Deposits  | 327,087         | 328,287              | 346,237           | 347,504              |
| Securities sold under agreements to repurchase    |                 |                      | 135               | 135                  |
| Borrowed funds                                    | 14,095          | 11,594               | 9,518             | 7,010                |

The following table summarizes the Company's financial instruments that were measured at fair value on a recurring basis:

|                                       | Total     | June 30, 2011 |           |         |
|---------------------------------------|-----------|---------------|-----------|---------|
|                                       |           | Level 1       | Level 2   | Level 3 |
| <i>(\$ in thousands)</i>              |           |               |           |         |
| <b>Securities available for sale:</b> |           |               |           |         |
| U.S. government agency securities     | \$ 20,490 | \$            | \$ 20,490 | \$      |
| State and municipal securities        | 24,758    |               | 24,758    |         |
| Corporate debt obligations            | 11,186    |               | 11,186    |         |
| SBA participation certificates        | 3,611     |               | 3,611     |         |
| Mortgage backed securities            | 2,166     |               | 2,166     |         |
| Collateralized mortgage obligations   | 2,407     |               | 2,407     |         |

|                                       | Total     | December 31, 2010 |           |         |
|---------------------------------------|-----------|-------------------|-----------|---------|
|                                       |           | Level 1           | Level 2   | Level 3 |
| <i>(\$ in thousands)</i>              |           |                   |           |         |
| <b>Securities available for sale:</b> |           |                   |           |         |
| U.S. government agency securities     | \$ 30,124 | \$                | \$ 30,124 | \$      |
| State and municipal securities        | 22,999    |                   | 22,999    |         |
| Corporate debt obligations            | 10,798    |                   | 10,798    |         |
| SBA participation certificates        | 3,378     |                   | 3,378     |         |
| Mortgage backed securities            | 2,165     |                   | 2,165     |         |
| Collateralized mortgage obligations   | 266       |                   | 266       |         |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

*Cash and due from banks*, interest bearing deposits and federal funds sold: The carrying amount approximates fair value because of the short maturity of these investments.

*Securities*: The fair values of marketable securities are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

*FHLB stock*: The fair value is based upon the par value of the stock, which equates to its carrying value.

*Loans*: Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as real estate, commercial and industrial, and consumer. Each loan category is further segmented into fixed and adjustable rate interest terms. The fair values for fixed-rate loans are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values.

*Loans held for sale*: Loans held for sale are considered to have a fair value that approximates carrying value.

*Bank owned life insurance*: The carrying amount approximates fair value.

*Deposits and securities sold under agreements to repurchase*: The fair value of deposits with no stated maturity, such as demand deposits, savings accounts, NOW accounts, money market accounts and securities sold under agreements to repurchase, is equal to the amount payable on demand at the reporting date. The fair value of fixed-maturity time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

*Borrowed funds*: The fair value of term debt and junior subordinated debentures is estimated using the discounted value of contractual cash flow based on the Company's current incremental borrowing rate for similar types of borrowing arrangements.

*Off-balance sheet instruments*: Fair values for off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings. The fair value of these commitments were not significant as of June 30, 2011 and December 31, 2010.

Valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect management's assumptions about market value. These two types of inputs create a fair value hierarchy. Level 1 includes quoted prices for identical instruments in active markets. Level 2 includes 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. Level 3 includes instruments whose significant value drivers are unobservable. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Amounts could be transferred between levels if the inputs used for valuation change and become more or less observable. The Company's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer. There were no transfers between levels during the periods ended June 30, 2011 and December 31, 2010.

Certain assets are measured at fair value on a nonrecurring basis. Adjustments to fair value generally result from the application of lower-of-cost-or-market accounting or write downs of individual assets due to impairment. The following table summarizes the Company's assets measured at fair value on a nonrecurring basis:

|                        | Total     | June 30, 2011 |         |           |
|------------------------|-----------|---------------|---------|-----------|
|                        |           | Level 1       | Level 2 | Level 3   |
| (\$ in thousands)      |           |               |         |           |
| Impaired loans         | \$ 14,362 | \$            | \$      | \$ 14,362 |
| Foreclosed real estate | 3,329     |               |         | 3,329     |

  

|                        | Total     | December 31, 2010 |         |           |
|------------------------|-----------|-------------------|---------|-----------|
|                        |           | Level 1           | Level 2 | Level 3   |
| (\$ in thousands)      |           |                   |         |           |
| Impaired loans         | \$ 21,102 | \$                | \$      | \$ 21,102 |
| Foreclosed real estate | 2,126     |                   |         | 2,126     |

The (gains) and losses resulting from nonrecurring fair value adjustments were as follows:

|                        | June 30, | June 30, |
|------------------------|----------|----------|
|                        | 2011     | 2010     |
| (\$ in thousands)      |          |          |
| Impaired loans         | \$ 1,915 | \$ 1,929 |
| Foreclosed real estate | 83       | (97)     |

*Loans:* The loan amount above represents impaired, collateral dependent loans held by the Bank at the balance sheet date that have been adjusted to fair value. When collateral dependent loans are identified as impaired, the impairment is measured using the current fair value of the collateral securing these loans, less selling costs. The fair value of real estate collateral is determined using independent appraisals. The fair value of business equipment, inventory and accounts receivable collateral is typically based on the net book value on the business' financial statements, but in some cases, an appraisal is obtained for equipment and inventory. Appraised and reported values are discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the client and the client's business. The loss represents charge-offs or impairments on collateral dependent loans for adjustments made based on the fair value of the collateral.

*Foreclosed real estate:* The amount shown above represents impaired real estate properties that have been adjusted to fair value, which is typically determined using an independent appraisal. At the time of foreclosure, these assets are measured and recorded at the lower of carrying amount of the loan or fair value less costs to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically re-assesses the value so that the property is carried at the lower of its new cost basis or fair value, net of estimated costs to sell. Appraised values may be discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the client and the client's business. Fair value adjustments on foreclosed real estate are recognized in the consolidated statements of operations. The net (gain) loss represents impairments on foreclosed real estate made based on the fair value of the property.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Northwest Bancorporation, Inc. (the "Company") is a bank holding company headquartered in Spokane, Washington, and was incorporated in 1991 under the laws of the State of Washington. The Company's wholly-owned subsidiary, Inland Northwest Bank (the "Bank"), is a Washington state-chartered bank, through which substantially all business is conducted. The Bank offers a broad range of banking services to businesses and consumers throughout Spokane County, Washington, and Kootenai County, Idaho.

**Forward-Looking Statements**

From time to time, the Company and its senior managers have made and will make forward-looking statements that are not historical facts and that are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, but are not limited to, statements about the Company's plans, objectives, expectations and intentions and other statements contained in this release that are not historical facts and pertain to the Company's future operating results. When used in this report, the words expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions are generally intended to identify forward-looking statements. Management may make forward-looking statements regarding projected sources of funds, use of proceeds, availability of acquisition and growth opportunities, ability to repay government funds, payment of dividends, adequacy of the Company's allowance for loan losses and provision for loan losses, the Company's real estate portfolio and subsequent charge-offs. Such statements may be contained in this report and in other documents that the Company files with the SEC. Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others.

Actual results may differ materially from the results discussed in these forward-looking statements, because such statements are inherently subject to significant assumptions, risks and uncertainties, many of which are difficult to predict and are generally beyond the Company's control. These include but are not limited to:

the inflation, interest rate levels and market and monetary fluctuations;

trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;

applicable laws and regulations and legislative or regulatory changes;

the timely development and acceptance of new products and services of the Company;

the willingness of customers to substitute competitors' products and services for the Company's products and services;

the financial condition of the Company's borrowers and lenders;

the Company's success in gaining regulatory approvals, when required;

technological and management changes;

growth and acquisition strategies;

the Company's critical accounting policies and the implementation of such policies;

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lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;

changes in consumer spending and saving habits;

the strength of the United States economy in general and the strength of the local economies in which the Company conducts its operations; and

the Company's success at managing the risks involved in the foregoing.

This list of factors is not complete and additional information about risks of the Company achieving results suggested by any forward-looking statements may be found under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K, as updated regularly in the Company's filings with the SEC. Unless legally required, the Company disclaims any obligation to update any forward-looking statements. You should consider any forward-looking statements in light of this explanation, and we caution you about relying on forward-looking statements.

*Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in the Company's 2010 Annual Report on Form 10-K.*

### Summary of Critical Accounting Policies

The SEC defines "critical accounting policies" as those that require the application of management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. The accounting policies that the Company's management have identified as critical to understanding the Company's financial statements and operating results are described in Note 1 of the Notes to Consolidated Financial Statements in the Company's annual report on Form 10-K for the year ended December 31, 2010. There have been no significant changes in our application of accounting policies since December 31, 2010.

### Financial Highlights

The table below summarizes the Company's financial performance for the three-month and six-month periods ended June 30, 2011 and 2010:

|   | Three months ended June 30,                     |          |             | Six months ended June 30, |           |             |
|---|---|----------|-------------|---------------------------|-----------|-------------|
|   | 2011  | 2010     | %<br>Change | 2011                      | 2010      | %<br>Change |
|   | <i>(\$ in thousands, except per share data)</i> |          |             |                           |           |             |
| <b>Results of Operations:</b>                         |   |          |             |                           |           |             |
| Interest income                                       | \$ 4,803  | \$ 5,174 | -7.2%       | \$ 10,069                 | \$ 10,582 | -4.8%       |
| Interest expense                                      | 1,079   | 1,638    | -34.1%      | 2,245                     | 3,398     | -33.9%      |
| Net interest income                                   | 3,724   | 3,536    | 5.3%        | 7,824                     | 7,184     | 8.9%        |
| Provision for loan losses                             | 1,531   | 950      | 61.2%       | 2,362                     | 1,450     | 62.9%       |
| Net interest income after provision for loan losses   | 2,193   | 2,586    | -15.2%      | 5,462                     | 5,734     | -4.7%       |
| Noninterest income                                    | 904   | 1,044    | -13.4%      | 1,714                     | 1,960     | -12.6%      |
| Noninterest expense                                   | 3,577   | 3,291    | 8.7%        | 6,856                     | 6,507     | 5.4%        |
| Income before income taxes                            | (480)   | 339      | -241.6%     | 320                       | 1,187     | -73.0%      |
| Income tax expense                                    | (231)   | 70       | -430.0%     | (31)                      | 332       | -109.3%     |
| Net income  | (249)   | 269      | -192.6%     | 351                       | 855       | -58.9%      |
| Preferred stock dividends and discount accretion, net | 169   | 169      | 0.0%        | 339                       | 338       | 0.3%        |
| Net income applicable to common shares                | \$ (418)  | \$ 100   | -518.0%     | \$ 12                     | \$ 517    | -97.7%      |
| <b>Per Share Data:</b>                                |   |          |             |                           |           |             |
| Basic earnings per common share                       | \$ (0.14)                                       | \$ 0.04  |             | \$                        | \$ 0.22   |             |
| Diluted earnings per common share                     | \$ (0.14)                                       | \$ 0.04  |             | \$                        | \$ 0.22   |             |
| Book value per common share at period end             | \$ 8.57   | \$ 9.49  |             |                           |           |             |
| <b>Selected Ratios:</b>                               |   |          |             |                           |           |             |
| Return on average assets                              | -0.43%  | 0.10%    |             | 0.01%                     | 0.26%     |             |
| Return on average equity                              | -4.55%  | 1.15%    |             | 0.07%                     | 3.00%     |             |
| Net interest margin                                   | 4.21%   | 3.85%    |             | 4.39%                     | 3.92%     |             |
| Efficiency ratio                                      | 77.29%  | 71.86%   |             | 71.88%                    | 71.16%    |             |
| Noninterest income to average assets                  | 0.93%   | 1.04%    |             | 0.87%                     | 0.98%     |             |
| Noninterest expense to average assets                 | 3.66%   | 3.28%    |             | 3.49%                     | 3.25%     |             |

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|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Ending shareholders equity to average assets | 9.51% | 8.76% | 9.45% | 8.77% |
| Nonperforming loans to gross loans           | 4.08% | 3.74% | 4.08% | 3.74% |
| Allowance for loan losses to gross loans     | 2.64% | 2.38% | 2.64% | 2.38% |

## Results of Operations

### *Earnings*

The Company reported a net loss applicable to common shares of \$418 thousand for the three months ended June 30, 2011, compared to net income applicable to common shares of \$100 thousand for the comparable period in 2010. The second quarter loss resulted in net income applicable to common shares of \$12 thousand for the first six months of 2011, compared to net income applicable to common shares of \$517 thousand for first six months of 2010. Operating results during the second quarter of 2011 were hampered by increases to the provision for loan losses due to higher levels of loan delinquencies and net charge-offs. The provision for loan losses increased to \$2.4 million for the six months ended June 30, 2011, compared to \$1.5 million for the same period in 2011.

The return on average assets was -0.43% and 0.10% for the three-month periods ended June 30, 2011 and 2010, and 0.01% and 0.26% for the six-month periods ending on the same dates, respectively. The return on average equity was -4.55% and 1.15% for the three-month periods ended June 30, 2011 and 2010, and 0.07% and 3.00% for the six-month periods ending on the same dates, respectively.

### *Net Interest Income*

The principal component of the Company's earnings is its net interest income. Net interest income is the difference between the income earned on assets and the interest paid on deposits and on borrowings used to support such assets. Net interest income is determined by the yields earned on the Company's interest earning assets and the rates paid on its interest bearing liabilities, the relative amounts of interest earning assets and interest bearing liabilities, and the degree of mismatch and the maturity and re-pricing characteristics of its interest earning assets and interest bearing liabilities. The total interest earning assets yield less the total interest bearing liabilities rate represents the Company's net interest rate spread.

*Average Balances, Rates, and Interest Income and Expenses.* The tables below set forth certain information related to the Company's average balance sheet and its average yields on assets and average costs of liabilities. Such yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities.



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The following table presents an analysis of the net interest income and net interest margin for the three months ended June 30, 2011 and 2010:

|  | Three months ended June 30, |   |  |                    |   |                                |
|--|-----------------------------|---|--|--------------------|---|--------------------------------|
|  | 2011                        |   |  | 2010               |   |                                |
|  | Average<br>Balance          | Interest<br>Income or<br>Expense <sup>(1)</sup> | Average<br>Yield<br>or<br>Cost<br><i>(\$ in thousands)</i> | Average<br>Balance | Interest<br>Income or<br>Expense <sup>(1)</sup> | Average<br>Yield<br>or<br>Cost |
| <b>ASSETS</b>  |                             |   |  |                    |   |                                |
| Loans, gross <sup>(2) (3)</sup>                        | \$ 277,777                  | \$ 4,213  | 6.07%  | \$ 317,469         | \$ 4,788  | 6.03%                          |
| Investment securities                                  | 69,356                      | 587   | 3.39%  | 39,307             | 380   | 3.87%                          |
| FHLB stock   | 1,261                       |   | 0.00%  | 1,261              |   | 0.00%                          |
| Federal funds sold and interest bearing deposits       | 5,420                       | 3   | 0.22%  | 8,970              | 6   | 0.27%                          |
| Total interest earning assets                          | 353,814                     | 4,803   | 5.43%  | 367,007            | 5,174   | 5.64%                          |
| Allowance for loan losses                              | (6,318)                     |   |  | (7,440)            |   |                                |
| Cash and due from banks                                | 13,027                      |   |  | 11,051             |   |                                |
| Other non-earning assets                               | 30,034                      |   |  | 30,700             |   |                                |
| Total assets   | \$ 390,557                  |   |  | \$ 401,318         |   |                                |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>             |                             |   |  |                    |   |                                |
| NOW accounts   | 57,527                      | 277   | 1.93%  | 49,040             | 203   | 1.66%                          |
| Money market accounts                                  | 41,479                      | 63  | 0.61%  | 30,248             | 79  | 1.04%                          |
| Savings accounts                                       | 53,673                      | 99  | 0.74%  | 45,374             | 103   | 0.91%                          |
| Time certificates of deposit                           | 118,934                     | 562   | 1.89%  | 156,207            | 1,083   | 2.77%                          |
| Total interest bearing deposits                        | 271,613                     | 1,001   | 1.47%  | 280,869            | 1,468   | 2.09%                          |
| Securities sold under repurchase agreements            | 1                           |   | 0.00%  | 174                |   | 0.00%                          |
| Borrowed funds   | 5,245                       | 50  | 3.81%  | 9,710              | 92  | 3.79%                          |
| Junior subordinated debentures                         | 5,155                       | 28  | 2.17%  | 5,155              | 78  | 6.05%                          |
| Total borrowed funds                                   | 10,401                      | 78  | 3.00%  | 15,039             | 170   | 4.52%                          |
| Total interest bearing liabilities                     | 282,014                     | 1,079   | 1.53%  | 295,908            | 1,638   | 2.21%                          |
| Demand deposits  | 68,633                      |   |  | 62,261             |   |                                |
| Other liabilities                                      | 3,152                       |   |  | 8,460              |   |                                |
| Shareholders equity                                    | 36,758                      |   |  | 34,689             |   |                                |
| Total liabilities and shareholders equity              | \$ 390,557                  |   |  | \$ 401,318         |   |                                |
| Net interest income                                    |                             | \$ 3,724  |  |                    | \$ 3,536  |                                |
| Net interest spread                                    |                             |   | 3.90%  |                    |   | 3.43%                          |
| Net interest income to average earning assets (margin) |                             |   | 4.21%  |                    |   | 3.85%                          |

Comments:

- (1) There are no tax equivalency adjustments.
- (2) Nonaccrual loans are included in average loan balances.
- (3) Loan fee income in the amount of \$107 thousand and \$96 thousand is included in loan interest income for 2011 and 2010, respectively. During the three months ended June 30, 2011 and 2010, net interest income was \$3.7 million and \$3.5 million, respectively. This \$188 thousand, or 5.3%, increase in net interest income resulted from interest expense declining at a faster rate than interest income as well as from a change in

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the mix of interest earning assets and interest bearing liabilities. The net interest margin improved 36 basis points from 3.85% to 4.21% for the three-month periods ending June 30, 2010 and 2011, respectively.

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The following table presents an analysis of the net interest income and net interest margin for the six months ended June 30, 2011 and 2010:

|  | 2011            |   | Six months ended June 30,                  |                 | 2010                                      |                       |
|--|-----------------|---|--|-----------------|---|-----------------------|
|  | Average Balance | Interest Income or Expense <sup>(1)</sup> | Average Yield or Cost<br>(\$ in thousands) | Average Balance | Interest Income or Expense <sup>(1)</sup> | Average Yield or Cost |
| <b>ASSETS</b>  |                 |   |  |                 |   |                       |
| Loans, gross <sup>(2) (3)</sup>                        | \$ 280,537      | \$ 8,883                                  | 6.33%                                      | \$ 320,664      | \$ 9,862                                  | 6.15%                 |
| Investment Securities                                  | 69,611          | 1,180                                     | 3.39%                                      | 33,947          | 707                                       | 4.17%                 |
| FHLB stock   | 1,261           |   | 0.00%                                      | 1,261           |   | 0.00%                 |
| Federal funds sold and interest bearing deposits       | 5,052           | 6   | 0.24%                                      | 10,651          | 13  | 0.24%                 |
| Total interest earning assets                          | 356,461         | 10,069                                    | 5.65%                                      | 366,523         | 10,582                                    | 5.77%                 |
| Allowance for loan losses                              | (6,603)         |   |  | (7,385)         |   |                       |
| Cash and due from banks                                | 13,022          |   |  | 10,516          |   |                       |
| Other non-earning assets                               | 30,539          |   |  | 31,228          |   |                       |
| Total assets   | \$ 393,419      |   |  | \$ 400,882      |   |                       |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>             |                 |   |  |                 |   |                       |
| NOW accounts   | 58,463          | 591                                       | 2.02%                                      | 43,738          | 326                                       | 1.49%                 |
| Money market accounts                                  | 41,739          | 133                                       | 0.64%                                      | 28,333          | 147                                       | 1.04%                 |
| Savings accounts                                       | 51,492          | 185                                       | 0.72%                                      | 45,749          | 240                                       | 1.05%                 |
| Time certificates of deposit                           | 122,570         | 1,188                                     | 1.94%                                      | 161,953         | 2,319                                     | 2.86%                 |
| Total interest bearing deposits                        | 274,264         | 2,097                                     | 1.53%                                      | 279,773         | 3,032                                     | 2.17%                 |
| Securities sold under repurchase agreements            | 26              |   | 0.00%                                      | 250             |   | 0.00%                 |
| Borrowed funds   | 4,510           | 94  | 4.17%                                      | 11,291          | 211                                       | 3.74%                 |
| Junior subordinated debentures                         | 5,155           | 54  | 2.10%                                      | 5,155           | 155                                       | 6.01%                 |
| Total borrowed funds                                   | 9,691           | 148                                       | 3.05%                                      | 16,696          | 366                                       | 4.38%                 |
| Total interest bearing liabilities                     | 283,955         | 2,245                                     | 1.58%                                      | 296,469         | 3,398                                     | 2.29%                 |
| Demand deposits  | 70,133          |   |  | 61,516          |   |                       |
| Other liabilities                                      | 2,930           |   |  | 8,407           |   |                       |
| Shareholders equity                                    | 36,401          |   |  | 34,490          |   |                       |
| Total liabilities and shareholders equity              | \$ 393,419      |   |  | \$ 400,882      |   |                       |
| Net interest income                                    |                 | \$ 7,824                                  |  |                 | \$ 7,184                                  |                       |
| Net interest spread                                    |                 |   | 4.07%                                      |                 |   | 3.48%                 |
| Net interest income to average earning assets (margin) |                 |   | 4.39%                                      |                 |   | 3.92%                 |

Comments:

- (1) There are no tax equivalency adjustments.
- (2) Nonaccrual loans are included in average loan balances.
- (3) Loan fee income in the amount of \$225 thousand and \$205 thousand is included in loan interest income for 2011 and 2010, respectively. During the six months ended June 30, 2011 and 2010, net interest income was \$7.8 million and \$7.2 million, respectively. This \$640 thousand, or 8.9%, increase in net interest income resulted from interest expense declining at a faster rate than interest income as well as from a change in the mix of interest earning assets and interest bearing liabilities. The net interest margin improved 47 basis points from 3.92% to 4.39% for the

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six-month periods ending June 30, 2010 and 2011, respectively.

Interest income for the six months ended June 30, 2011 was \$10.1 million, representing a decrease of \$513 thousand, or 4.8%, compared to the same period in 2010. The decrease in interest income is related to a change in the mix of interest earning assets and a decrease in yield on investments, but was offset by an increase in the yield on loans. Loans, the highest yielding component of earning assets, represented 78.7% of average earning assets during the first six months of 2011, compared to 87.5% during the first six months of 2010. The average yield on loans increased 18 basis points to 6.33% for the first six months of 2011 from 6.15% for the comparable period in 2010. The increase in loan yield was offset by a \$40.1 million, or 12.5%, decrease in average loan balances. As a result, interest income on loans decreasing \$979 thousand, or 9.9%. Average investment securities increased \$35.7 million, or 105.1%, from June 30, 2010 to June 30, 2011, as a result of management's efforts to improve the Bank's on-balance sheet liquidity and because of moderate loan demand. The yield on securities decreased 78 basis points from 4.17% for the six months ended June 30, 2010, to 3.39% for the comparable period in 2011. The increase in investment securities combined with the decrease in yield on securities resulted in an improvement in investment income of \$473 thousand, or 66.9%.

Interest expense for the six months ended June 30, 2011, was \$2.2 million, representing a decrease of \$1.2 million, or 33.9%, compared to \$3.4 million for the same period in 2010. This improvement in interest expense was impacted by reductions in and re-pricing of time certificates of deposit along with paydowns of borrowed funds. The decrease in interest expense was partially offset by an increase in interest expense for NOW accounts, which was the result of a campaign to increase core deposits by offering higher than market rates on these accounts. The Bank expects to continue to see reductions in interest expense in the near-term as time certificates of deposit continue to re-price to the lower rates currently offered by the Bank. Overall, the average cost of deposits improved 64 basis points from 2.17% for the six months ended June 30, 2010, to 1.53% for the comparable period in 2011. Interest expense on junior subordinated debentures decreased \$101 thousand, or 65.2%, because the interest rate, which had been fixed at 5.95% through June 30, 2010, now re-prices quarterly at the 3-month LIBOR rate plus 170 basis points.

*Rate/Volume Analysis.* The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The rate/volume column shows the effects attributable to changes in both rate and volume (changes in rate multiplied by changes in volume).

|  | Three months ended June 30<br>2011 over 2010 |        |                 |          | Six months ended June 30<br>2011 over 2010 |        |                 |          |
|--|--|--------|-----------------|----------|--|--------|-----------------|----------|
|  | Increase (Decrease) Due to Changes in        |        | Rate/<br>Volume |          | Increase (Decrease) Due to Changes in      |        | Rate/<br>Volume |          |
|  | Volume                                       | Rate   | Volume          | Total    | Volume                                     | Rate   | Volume          | Total    |
|  | <i>(\$ in thousands)</i>                     |        |                 |          |  |        |                 |          |
| <b><u>Interest earning assets</u></b>            |  |        |                 |          |  |        |                 |          |
| Loans  | \$ (598)                                     | \$ 32  | \$ (9)          | \$ (575) | \$ (1,234)                                 | \$ 289 | \$ (34)         | \$ (979) |
| Investment securities                            | 291  | (47)   | (37)            | 207      | 744  | (132)  | (139)           | 473      |
| FHLB stock                                       |  |        |                 |          |  |        |                 |          |
| Fed funds sold/interest bearing deposits         | (2)  | (1)    |                 | (3)      | (7)  |        |                 | (7)      |
| Total interest earning assets                    | (309)  | (16)   | (46)            | (371)    | (497)                                      | 157    | (173)           | (513)    |
| <b><u>Interest bearing liabilities</u></b>       |  |        |                 |          |  |        |                 |          |
| NOW accounts                                     | 35   | 33     | 6               | 74       | 110  | 116    | 39              | 265      |
| Money market accounts                            | 29   | (33)   | (12)            | (16)     | 70   | (57)   | (27)            | (14)     |
| Savings accounts                                 | 19   | (19)   | (4)             | (4)      | 30   | (75)   | (10)            | (55)     |
| Time certificates of deposit                     | (258)  | (344)  | 81              | (521)    | (563)                                      | (745)  | 177             | (1,131)  |
| Securities sold under repurchase agreements      |  |        |                 |          |  |        |                 |          |
| Borrowed funds                                   | (42)   |        |                 | (42)     | (127)                                      | 24     | (14)            | (117)    |
| Junior subordinated debentures                   |  | (50)   |                 | (50)     |  | (101)  |                 | (101)    |
| Total interest bearing liabilities               | (217)  | (413)  | 71              | (559)    | (480)                                      | (838)  | 165             | (1,153)  |
| Total increase (decrease) in net interest income | \$ (92)                                      | \$ 397 | \$ (117)        | \$ 188   | \$ (17)                                    | \$ 995 | \$ (338)        | \$ 640   |

The year over year decreases in interest income were primarily attributable to decreases in yield on investments and changes in the mix of interest earning assets with loan volume down and investment volume up, partially offset by increases in yield on loans. The decreases in interest income were more than offset by reductions in rates paid on time certificates of deposit and decreases in time certificates of deposit balances.

*Interest Rate Risk.* The Bank seeks to reduce fluctuations in its net interest margin and to optimize net interest income with acceptable levels of risk through periods of changing interest rates. Accordingly, the Bank's interest rate sensitivity is monitored by its Asset and Liability Committee (ALCO) on an ongoing basis. The ALCO establishes risk measures, limits and policy guidelines for managing the amount of interest rate risk and its effect on net interest income and capital. An interest rate simulation model is used as a quantitative tool to monitor the impact of changing interest rates on net interest income and the economic value of equity. To evaluate changes in net interest income, the model uses various assumptions and considers the maturity and re-pricing characteristics of interest bearing assets and liabilities, as well as the relative sensitivities of these balance sheet components over a range of interest rate scenarios. The simulation model captures the impact of interest rate changes on the net value of future cash flows, which is the economic value of equity (EVE). Net interest income simulation measures exposure over a relatively short time period of 12 months and the EVE simulation measures exposure over the estimated remaining life of all balance sheet positions. Notwithstanding the Bank's interest rate risk management activities, the potential for changing interest rates is an uncertainty that can have an adverse effect on net income.

Presented below are the results of the simulation performed on the Bank's financial information as of June 30, 2011 and 2010. Immediate rate increases of 100, 200 and 300 basis points were modeled, while a rate decrease of just 25 basis points was modeled since the Fed Funds Target Discount Rate is 0.25% and cannot go lower than 0%. These rate changes assume an instantaneous and uniform change in market interest rates at the earliest re-pricing opportunity.

| Projected<br>Interest<br>Rate<br>Scenario | % Change in<br>Net Interest Income |        | % Change in<br>Economic Value of Equity |        |
|---|------------------------------------|--------|---|--------|
|   | 2011                               | 2010   | 2011                                    | 2010   |
| +300                                      | -13.4%                             | -17.9% | -31.8%                                  | -38.2% |
| +200                                      | -9.2%                              | -12.1% | -20.1%                                  | -26.0% |
| +100                                      | -4.5%                              | -5.6%  | -8.3%                                   | -13.3% |
| -25                                       | 1.1%                               | 0.6%   | 2.2%                                    | 4.2%   |

As noted above, computation of the prospective effect of hypothetical interest rate changes is based on a number of assumptions and results could vary significantly if different assumptions were used. The assumptions relied upon in making these calculations include the level of market interest rates, the shape of the yield curve, the degree to which certain assets and liabilities with similar maturities or periods to re-pricing react to changes in market interest rates, the degree to which non-maturity deposits (i.e. demand deposits) react to changes in market rates, expected prepayment rates, the degree to which early withdrawals occur on certificates of deposit and the volume of other deposit flows. In addition, the analysis does not reflect future actions that the Bank's ALCO might take in responding to or anticipating changes in interest rates. Accordingly, although the above table provides an indication of the Bank's sensitivity to interest rate changes at a point in time, these estimates are not intended to, and do not provide, a precise forecast of the effect of changes in market interest rates on the Bank's net interest income or economic value of equity.

### *Provision for Loan Losses*

The provision for loan losses represents an expense against income that allows the Bank to establish an appropriate allowance for loan losses. Charges to the provision for loan losses result from management's ongoing analysis of probable losses in the loan portfolio. Management's methodology for analyzing probable loan losses is consistent with the methods used as of December 31, 2010, except that the calculation was adjusted for changes in leading indicators such as unemployment and real estate market trends, as well as changes in the weighted average risk rating of loans in the portfolio.

The provision for loan losses during the six months ended June 30, 2011 was \$2.4 million, which is an increase of \$912 thousand, or 62.9%, over the \$1.5 million added to the provision for the same period in 2010. The provision for loan losses was \$1.5 million during the second quarter of 2011, compared to \$1.0 million added to the provision for the same period in 2010. As an annualized percentage of average outstanding loans, the provision for loan losses recorded for the six months ended June 30, 2011, was 1.68% as compared to 0.90% for the same period in 2010.

The increase in the provision for loan losses during the six months ended June 30, 2011, compared to the same period in 2010, is attributable to increases in net charge-offs during the period as well as increases in past due loans.

Net charge-offs for the first six months of 2011 were \$2.0 million compared to net charge-offs of \$1.3 million for the first six months of 2010. Annualized net charge-offs were 1.44% and 0.80% of average gross loans for the six months ended June 30, 2011 and 2010, respectively. The majority of net charge-offs during the first six months of 2011 and 2010 were due to losses on real estate secured loans, which accounted for 88.9% and 80.0% of total net charge-offs, respectively, and reflected the ongoing effects of the recent recession on the Bank's depressed real estate market and customer base.

See the *Loans* and *Allowance for Loan Losses* sections below for additional discussion on the Bank's loan portfolio and the adequacy of the allowance for loan losses.

### *Noninterest Income*

Noninterest income for the three months ended June 30, 2011, was \$904 thousand, a decrease of \$140 thousand, or 13.4%, from the same period in 2010. Noninterest income for the six months ended June 30, 2011, was \$1.7 million, a decrease of \$246 thousand, or 12.6%, from the same period in 2010. The primary reason for the current year decline in noninterest income was the decrease of \$285 thousand in the net gain on investment securities. The decrease in net gain on investment securities was partially offset by increases in service charges on deposits primarily related to increased overdraft and nonsufficient funds charges.

### *Noninterest Expense*

Noninterest expense for the three months ended June 30, 2011, was \$3.6 million, an increase of \$286 thousand, or 8.7%, from the same period in 2010. Noninterest expense for the six months ended June 30, 2011, was \$6.9 million, a decrease of \$349 thousand, or 5.4%, from the same period in 2010. The largest categories of increases in noninterest expenses were salaries and employee benefits and other noninterest expenses; these increases were partially offset by reductions in net losses on foreclosed real estate and FDIC assessments.

Year over year, salaries and employee benefits increased \$231 thousand, or 7.5%. The increase is primarily attributable to adding employees to our Special Assets and Audit departments, the addition of two new loan officers and one business development officer, as well as small increases in staffing at several branch offices. Full-time employee equivalents ( FTEs ) climbed from 106 FTEs as of June 30, 2010, to 114 FTEs as of June 30, 2011.

Net loss on foreclosed real estate was \$112 thousand for the three months ended June 30, 2011, compared to a net loss of \$124 thousand for the same period in 2010. Net loss on foreclosed real estate and other property owned was \$83 thousand for the six months ended June 30, 2011, compared to a net loss of \$203 thousand for the same period in 2010. During 2011, the net loss on foreclosed real estate included net gains from sales of property of \$113 thousand, offset by valuation allowance provisions of \$196 thousand. For the same period in 2010, the net loss on foreclosed real estate and other property owned included net gains from sales of property of \$97 thousand, offset by valuation allowance provisions of \$100 thousand on foreclosed real estate and \$200 thousand on other property owned.

FDIC assessments decreased \$94 thousand, or 22.6%, year over year. Beginning in April 2011, the FDIC changed its assessment method from a deposit-based assessment to an asset-based assessment, which caused a reduction in total assessments of approximately \$60 thousand during the second quarter of 2011. In addition, the FDIC discontinued its Transaction Account Guarantee Program premium in January 2011, which reduced total assessments by approximately \$30 thousand through June 30, 2011.

Other noninterest expenses for the three months ended June 30, 2011, were \$965 thousand, an increase of \$237 thousand from the same period in 2010. Other noninterest expenses for the six months ended June 30, 2011, were \$1.7 million, an increase of \$252 thousand from the same period in 2010. Year-over-year cost increases in other noninterest expenses included: costs related to maintaining or selling foreclosed real estate or for properties securing nonperforming loans, which increased \$84 thousand; costs associated with debit and credit card processing, which increased \$86 thousand; appraisal and other loan costs, which increased \$29 thousand; fees and costs related to the Bank's Reward Checking and Savings accounts, which increased \$27 thousand; and fees paid to the Bank's overdraft program provider, which increased \$16 thousand.

In addition to the foregoing, the Company experienced nominal year over year increases in the following other noninterest expense categories: occupancy and equipment increased \$35 thousand, depreciation and amortization increased \$33 thousand, and advertising and promotion increased \$12 thousand.

#### *Income Taxes*

The Company's consolidated effective tax rate as a percentage of pre-tax income for the six months ended June 30, 2011, was -9.7% as compared to 28.0% for the six months ended June 30, 2010. The effective tax rate differs from statutory rates principally because of non-taxable income arising from tax-exempt investment securities and bank owned life insurance.

#### **Financial Condition**

##### *Securities*

As of June 30, 2011, the Bank had \$64.6 million of investment securities, which is a decrease of \$5.1 million, or 7.3%, from December 31, 2010. Activity in the securities portfolio during the six months ended June 30, 2011, included \$6.2 million in purchases, \$10.5 million in called securities, \$2.5 million in securities sold, paydowns of \$228 thousand, and amortization of net purchase price premiums of \$179 thousand. As of June 30, 2011, the securities portfolio included a net unrealized gain of \$954 thousand, an increase of \$2.1 million from December 31, 2010. With the exception of corporate bonds with a fair value of \$11.2 million, all securities at June 30, 2011, are obligations of either the Treasury Department, U.S. government agencies or government-sponsored enterprises, or state or municipal governments.

##### *Loans*

At June 30, 2011, the Bank reported \$275 million in gross loans, a decrease of \$6.9 million, or 2.4%, compared to December 31, 2010. Construction and land development loans decreased \$9.4 million, while commercial real estate increased \$4.5 million. In response to the continuing weak economy, the Bank has implemented more stringent lending practices, has reduced purchasing participation loans from other banks, and is limiting new loans for land development, speculative construction and non-owner occupied commercial real estate.



The Bank has experienced weak loan demand in 2010 and 2011 despite efforts to pursue lending relationships with creditworthy customers in our market place. Loan demand has been adversely influenced by macroeconomic forces that have disrupted local and national economies. Specifically, real estate and related activities have slowed significantly, local unemployment rates have increased substantially, and real estate and other asset prices have declined appreciably.

There is continued competitive pressure on pricing in the Bank's primary market areas, especially for the most desirable loans. The Bank, like many other banks, is setting floors on variable rate lines of credit, and overall, this has helped the Bank's interest income, but it has negatively impacted interest rate risk, because interest income on these loans will not increase immediately when interest rates begin to rise. Many customers are requesting longer term fixed rates in anticipation of future rate increases. However, the Bank also believes that rates are likely to rise over the next one to five years and is attempting to minimize interest rate risk by keeping rates adjustable and by structuring loans to mature in five years or less. Variable interest rate loans comprised 63.4% and 65.2% of the loan portfolio as of June 30, 2011 and December 31, 2010.

Nonperforming assets decreased \$2.1 million, or 12.7%, from \$16.7 million at December 31, 2010 to \$14.6 million at June 30, 2011. Nonperforming assets as a percentage of total assets were 3.8% as of June 30, 2011, and 4.2% as of December 31, 2010. The following table shows a summary of nonperforming assets for the periods covered in this report:

|  | June 30,<br>2011         | December 31,<br>2010 |
|--|--------------------------|----------------------|
|  | <i>(\$ in thousands)</i> |                      |
| <b>Nonaccrual loans:</b>                             |                          |                      |
| Commercial real estate                               | \$ 7,086                 | \$ 8,661             |
| Construction and land development                    | 1,146                    | 2,613                |
| Residential real estate                              | 1,109                    | 1,362                |
| Commercial and industrial                            | 1,813                    | 21                   |
| Consumer   | 77                       | 56                   |
| Loans past due 90 days or more and accruing interest |                          |                      |
| <i>Total nonperforming loans</i>                     | 11,231                   | 12,713               |
| Foreclosed real estate                               | 3,329                    | 3,963                |
| <i>Total nonperforming assets</i>                    | \$ 14,560                | \$ 16,676            |

Loans are generally placed on nonaccrual status when either principal or interest payments on the loan are 90 days or more past due. When loans are placed on nonaccrual status, future interest accruals are discontinued and all unpaid accrued interest is reversed against interest income. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

At June 30, 2011, the Bank had twenty-three nonaccrual loans totaling \$11.2 million compared to twenty-five nonaccrual loans totaling \$12.7 million at December 31, 2010, representing a decrease of \$1.5 million, or 11.7%. This decrease was comprised of \$1.6 million in commercial real estate loans and \$1.5 million in construction and land development loans, and was partially offset by a \$1.8 million increase in commercial and industrial loans.

All of the Bank's nonaccrual loans are in the process of collection or under some form of a negotiated agreement for repayment of the debt and are supported by liens on collateral that mitigates the risk of loss. Whenever management determines that a collateral position is weak or insufficient to reasonably protect the Bank from loss, the loan balance is written down with a partial charge-off to a level where collateral protection is deemed adequate. If the customer has identifiable sources of repayment and is working on a repayment plan, a partial charge-off may be deferred and the amount of the exposure set aside in a specific reserve.

Five of the Bank's nonaccrual loans, representing 56% of total nonaccrual balances, are involved in legal action to foreclose liens, place receivers in control or to seek relief from the automatic stay of bankruptcy. Negotiations are underway with one other large nonaccrual borrower for an agreement to liquidate the collateral on an orderly basis over the next three months. Management is pursuing resolution of these loans, as appropriate.

Two nonaccrual loans representing 14% of the nonaccrual balances are related to participation loans purchased from other banks. In both cases, there is adequate collateral support and the lead banks are pursuing appropriate legal action to recover the collateral or collect the loans.

Foreclosed real estate was \$3.3 million at June 30, 2011, representing a decrease of \$634 thousand, or 16.0%, from the amount reported at December 31, 2010. The three largest foreclosed real estate properties consist of a business park, developed residential lots and undeveloped land located in Clark, Spokane and Shoshone counties. The remaining foreclosed properties consist of eight properties that are primarily residential. Five of these properties are under contract for sales that are expected to close during the third quarter of 2011. Most of the properties are listed for sale with marketing plans intended to liquidate the properties in a responsible and timely manner.

A troubled debt restructuring occurs when, due to a borrower's financial difficulties, the Bank grants a concession in loan terms or conditions that it would not otherwise consider. Restructured loans are included in impaired loans until such time as the restructured loan bears a market rate of interest, and performs according to the new terms for an acceptable duration, typically one year or longer depending on the circumstances specific to each credit. Restructured loans performing in accordance with their new terms are not included in nonaccrual loans unless there is uncertainty as to the ultimate collection of principal or interest. The following table presents a summary of restructured loans:

|                                   | June 30, 2011                     |   | December 31, 2010                 |   |
|-----------------------------------|-----------------------------------|---|-----------------------------------|---|
|                                   | Accruing<br>Restructured<br>Loans | Restructured<br>Loans Included<br>in<br>Nonaccrual<br>Loans<br><i>(\$ in thousands)</i> | Accruing<br>Restructured<br>Loans | Restructured<br>Loans Included<br>in<br>Nonaccrual<br>Loans |
| Real estate:                      |                                   |   |                                   |   |
| Commercial                        | \$ 10,162                         | \$ 814  | \$                                | \$ 3,972  |
| Construction and land development |                                   |   |                                   |   |
| Residential                       |                                   | 920   |                                   | 705   |
| Commercial and industrial         | 570                               |   | 397                               |   |
| Consumer                          |                                   |   |                                   |   |
|                                   | \$ 10,732                         | \$ 1,734  | \$ 397                            | \$ 4,677  |

Restructured loans increased significantly from \$5.1 million at December 31, 2010, to \$11.7 million at June 30, 2011. This net increase reflected an increase of \$8.1 million in new restructured loans, offset by \$1.5 million in payoffs and charge-offs. Included in the new restructured loans are six loans totaling \$7.1 million that have been granted interest rate concessions or are temporarily on an interest-only basis but are otherwise paying as agreed. An additional loan for about \$1.0 million is under a self-directed liquidation plan. Three loans totaling \$3.6 million have been classified as restructured for over six months; these loans are performing satisfactorily according to their renegotiated terms.

When consideration is requested by a borrower and changes are negotiated in a workout agreement, the changes are documented with forbearance or other agreements specifying the terms of those plans. Many of these agreements grant a period of interest-only payments without imposing other significant consequences. The intention of workout agreements is always to improve or protect the Bank's opportunity for successful liquidation of the asset. Significant progress has been made in working with borrowers to develop viable and mutually acceptable plans for repayment. Management believes the renegotiated terms for these loans create a realistic opportunity for the Bank to be paid in full. All restructured loans, both those accruing interest and those on nonaccrual, were contractually current as of June 30, 2011.

#### *Allowance for Loan Losses*

The allowance for loan losses is a valuation allowance for probable losses inherent in the loan portfolio. Management evaluates the need to establish allowances against losses on loans on a monthly basis. A provision for loan losses is charged to earnings when additional allowances are deemed necessary. When estimating the allowance for loan losses, management considers a number of factors, including: review of specific impaired loans; historical loan loss experience; quality, mix and size of loan portfolio; type and value of collateral; current and anticipated economic conditions; and other relevant factors. When there is clear evidence of an economic downturn, higher levels of reserves may be warranted.

As of June 30, 2011, the allowance for loan losses was \$7.3 million, an increase of \$339 thousand, or 4.9%, from the \$6.9 million balance as of December 31, 2010. These allowance balances represented 2.6% and 2.5% of gross loans outstanding as of June 30, 2011 and December 31, 2010, respectively.

The increase in the allowance for loan losses is principally attributable to the provision for loan losses exceeding net charge-offs for the six months ended June 30, 2011. See the *Provision for Loan Losses* section above for additional discussion of the Bank's charge-offs and provision for loans losses.

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The following table provides a summary of activity in the allowance for loan losses during the second quarter of 2011 and 2010, respectively:

|                                   | Balance,<br>Beginning<br>of<br>Period | Quarter ended June 30, 2011     |                                  |            | Balance,<br>End of<br>Period |
|-----------------------------------|---------------------------------------|---------------------------------|----------------------------------|------------|------------------------------|
|                                   |                                       | Provision<br>for Loan<br>Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                              |
| Real estate:                      |                                       |                                 |                                  |            |                              |
| Commercial                        | \$ 1,949                              | \$ 1,391                        | \$                               | \$         | \$ 3,340                     |
| Construction and land development | 1,066                                 | 73                              | (215)                            |            | 924                          |
| Residential                       | 1,366                                 | 52                              | (55)                             |            | 1,363                        |
| Commercial and industrial         | 1,239                                 | (222)                           | (129)                            |            | 888                          |
| Consumer                          | 280                                   | (7)                             | (47)                             | 1          | 227                          |
| Unallocated                       | 271                                   | 244                             |                                  |            | 515                          |
|                                   | \$ 6,171                              | \$ 1,531                        | \$ (446)                         | \$ 1       | \$ 7,257                     |

|                                   | Balance,<br>Beginning<br>of<br>Period | Quarter ended June 30, 2010     |                                  |            | Balance,<br>End of<br>Period |
|-----------------------------------|---------------------------------------|---------------------------------|----------------------------------|------------|------------------------------|
|                                   |                                       | Provision<br>for Loan<br>Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                              |
| Real estate:                      |                                       |                                 |                                  |            |                              |
| Commercial                        | \$ 1,893                              | \$ 515                          | \$ (40)                          | \$         | \$ 2,368                     |
| Construction and land development | 1,668                                 | (54)                            | (540)                            | 25         | 1,099                        |
| Residential                       | 966                                   | 481                             | (231)                            | 2          | 1,218                        |
| Commercial and industrial         | 2,456                                 | (344)                           | (20)                             | 10         | 2,102                        |
| Consumer                          | 169                                   | 63                              | (81)                             | 1          | 152                          |
| Unallocated                       | 23                                    | 289                             |                                  |            | 312                          |
|                                   | \$ 7,175                              | \$ 950                          | \$ (912)                         | \$ 38      | \$ 7,251                     |

The following table provides a summary of activity in the allowance for loan losses during the six months ended June 30, 2011 and 2010, respectively:

|                                   | Balance,<br>Beginning<br>of<br>Period | Six months ended June 30, 2011  |                                  |            | Balance,<br>End of<br>Period |
|-----------------------------------|---------------------------------------|---------------------------------|----------------------------------|------------|------------------------------|
|                                   |                                       | Provision<br>for Loan<br>Losses | Charge-offs<br>(\$ in thousands) | Recoveries |                              |
| Real estate:                      |                                       |                                 |                                  |            |                              |
| Commercial                        | \$ 2,779                              | \$ 1,889                        | \$ (1,328)                       | \$         | \$ 3,340                     |
| Construction and land development | 1,341                                 | (90)                            | (327)                            |            | 924                          |
| Residential                       | 1,081                                 | 426                             | (160)                            | 16         | 1,363                        |
| Commercial and industrial         | 1,162                                 | (104)                           | (171)                            | 1          | 888                          |
| Consumer                          | 347                                   | (66)                            | (55)                             | 1          | 227                          |
| Unallocated                       | 208                                   | 307                             |                                  |            | 515                          |
|                                   | \$ 6,918                              | \$ 2,362                        | \$ (2,041)                       | \$ 18      | \$ 7,257                     |

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|                                   | Six months ended June 30, 2010        |                                 |   |            | Balance,<br>End of<br>Period |
|-----------------------------------|---------------------------------------|---------------------------------|---|------------|------------------------------|
|                                   | Balance,<br>Beginning<br>of<br>Period | Provision<br>for Loan<br>Losses | Charge-offs<br><i>(\$ in thousands)</i> | Recoveries |                              |
| Real estate:                      |                                       |                                 |   |            |                              |
| Commercial                        | \$ 1,269                              | \$ 1,219                        | \$ (120)                                | \$         | \$ 2,368                     |
| Construction and land development | 1,801                                 | (24)                            | (705)                                   | 27         | 1,099                        |
| Residential                       | 604                                   | 840                             | (231)                                   | 5          | 1,218                        |
| Commercial and industrial         | 2,660                                 | (408)                           | (160)                                   | 10         | 2,102                        |
| Consumer                          | 134                                   | 125                             | (109)                                   | 2          | 152                          |
| Unallocated                       | 614                                   | (302)                           |   |            | 312                          |
|                                   | \$ 7,082                              | \$ 1,450                        | \$ (1,325)                              | \$ 44      | \$ 7,251                     |

A majority of the net loan charge-offs during 2011 were from real estate loans and were primarily attributable to the depressed real estate market and general economy.

The table below sets forth the allowance for loan losses by category of loan and summarizes the percentage of loans in each category to total loans as of June 30, 2011 and December 31, 2010:

|  | June 30, 2011            |                  | December 31, 2010 |                  |
|--|--------------------------|------------------|-------------------|------------------|
|  | Amount                   | Percent of Loans | Amount            | Percent of Loans |
|  | <i>(\$ in thousands)</i> |                  |                   |                  |
| <b>Real estate:</b>                          |                          |                  |                   |                  |
| Commercial                                   | \$ 3,340                 | 56.29%           | \$ 2,779          | 53.33%           |
| Construction and land development            | 924                      | 11.18%           | 1,341             | 14.24%           |
| Residential                                  | 1,363                    | 12.44%           | 1,081             | 12.44%           |
| Commercial and industrial loans              | 888                      | 17.05%           | 1,162             | 16.79%           |
| Consumer and other                           | 227                      | 3.04%            | 347               | 3.20%            |
| Supplementary allowance/non-specific factors | 515                      | n/a              | 208               | n/a              |
|  | \$ 7,257                 | 100.00%          | \$ 6,918          | 100.00%          |

*Deferred Tax Asset*

At June 30, 2011, the Company had recorded a net deferred tax asset of \$241 thousand, which compared to a net deferred tax asset of \$871 thousand at December 31, 2010. The net deferred tax asset decreased during the first six months of 2011 primarily as a result of an improvement in the fair value of available for sale securities. During 2009, the Company recorded a valuation allowance of \$742 thousand against a portion of its deferred tax assets due to uncertainty about the Company's ability to generate future taxable income sufficient to realize the benefits of temporary deductible differences that could not have been realized through carry-backs to prior years or through the reversal of future temporary taxable differences. Due to the ongoing weakness in the economy and its affect on credit quality, uncertainty remains about the extent to which a pattern of future taxable income will be established. Accordingly, the Company continued to maintain a valuation allowance of \$742 thousand as of June 30, 2011.

### *Deposits*

As of June 30, 2011, the Bank reported \$327.1 million in deposits, which represents a decrease of \$19.2 million, or 5.5%, from the \$346.2 million in deposits reported as of December 31, 2010. Time deposits declined \$17.3 million, other interest bearing deposits increased \$4.7 million, and noninterest bearing demand deposits decreased \$6.5 million. Time deposits have declined, in part, because some customers have moved time deposits into other interest bearing deposit accounts with higher yields as the rates paid by the Bank for time deposits have decreased in line with market rates.

Core deposits, which exclude time deposits, provide a relatively stable funding source. Core deposits decreased \$1.8 million, or 0.9%, during the first six months of 2011 and represented 64.7% and 61.6% of total deposits as of June 30, 2011 and December 31, 2010, respectively.

The Company is a member of the Certificate of Deposit Account Registry Service ( CDARS ) program. Through CDARS, it is possible to provide FDIC deposit insurance to deposit balances in excess of current deposit insurance limits. CDARS uses a deposit-matching program to exchange Bank deposits in excess of the current deposit insurance limits for excess balances at other participating banks, on a dollar-for-dollar basis, that would be fully insured at the Bank. This product is designed to enhance our ability to attract and retain customers and increase deposits, by providing additional FDIC coverage to customers. CDARS deposits can be reciprocal or one-way, and as of June 30, 2011, all of the Bank's CDARS deposits were reciprocal. At June 30, 2011 and December 31, 2010, the Bank's CDARS balances totaled \$6.9 million and \$6.5 million, respectively.

### *Borrowed Funds*

Included in borrowed funds are FHLB advances, junior subordinated debentures, and a capital lease obligation. Borrowed funds were \$14.1 million and \$9.5 million as of June 30, 2011 and December 31, 2010, respectively. The \$4.6 million increase in borrowed funds is primarily the result of an increase in FHLB advances net of payments.

### *Capital Resources*

Capital reflects the value of the shareholders' investment in the Company. Capital can be increased through the retention of earnings and the sale of new stock, including the exercise of stock options, and can be decreased as a result of the payment of dividends, the repurchase of outstanding shares and operating losses. Stock dividends do not affect capital. Capital formation allows the Company to grow assets and provides flexibility in times of adversity.

Shareholders' equity was \$37.2 million at June 30, 2011, compared with \$35.7 million at December 31, 2010. The \$1.5 million increase in shareholders' equity is attributable to \$351 thousand in net income and a \$1.4 million improvement in the net unrealized loss on investment securities, offset by \$286 thousand in accrued preferred stock dividends.

Banking regulations require the Bank to maintain minimum levels of capital. The Bank manages its capital to maintain a well-capitalized designation (the FDIC's highest rating). A well-capitalized rating from the FDIC requires that the Bank maintain or exceed capital levels of 10% of total risk-based assets. At June 30, 2011, the Bank's total capital to risk weighted assets was 14.2% compared to 13.6% reported as of December 31, 2010. The improved capital ratio reflects the Bank's net income during 2011 combined with a reduction in total risk weighted assets.

In April 2010, the Bank agreed with the FDIC and the Washington State Department of Financial Institutions (the DFI) that the Bank would, among other things, achieve and maintain a minimum leverage ratio of 10%. As of June 30, 2011, the Bank's leverage ratio was 10.4%. The Bank also agreed that it would obtain written approval from the FDIC prior to paying dividends or any other form of payment or distribution representing a reduction of Bank capital.

The Company also agreed with the Federal Reserve Bank that the Company would, among other things, support the Bank's compliance with the Bank's obligations to the FDIC and DFI by not receiving dividends or any other form of payment or distribution representing a reduction of capital from the Bank without the prior written approval of the Federal Reserve Bank. The Company further agreed that it would obtain written approval from the Federal Reserve Bank prior to the Company: (a) declaring or paying dividends, (b) making payments on trust preferred securities, or (c) making any other capital distributions.

In February 2009, the Company received \$10.5 million in proceeds from the issuance and sale of 10,500 shares of Series A preferred stock and 525 shares of Series B preferred stock to the Treasury under the Capital Purchase Program. From these proceeds, the Company invested \$7 million in the Bank, paid off a \$2.9 million note payable, and retained the remainder for operating cash.

The Company received no cash dividends from the Bank during the three-month and six-month periods ended June 30, 2011 and 2010. Generally, dividends contribute to the Company's ability to meet its operating needs, including interest costs related to loans, junior subordinated debt, and preferred stock dividends. The Company's ability to service borrowings is also generally dependent upon the availability of dividends from the Bank. The Bank's ability to pay dividends is limited by its earnings, financial condition, capital requirements, and capital distribution regulations.

The Company has the potential to secure additional capital through the capital markets. The availability and cost of such capital is partially dependent on the Company's financial performance, as well as on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside our control. There can be no assurance the Company will be able to raise additional capital if needed or on terms acceptable to us.

Historically, the Board of Directors has scheduled its dividend considerations so that annual cash dividends on its common stock, when and if declared by the Company, would be paid in mid-June of each year. The Company paid its first common stock cash dividend in 2003, in the amount of \$0.10 per share. In each of the subsequent five years, the Board of Directors increased the amount of the cash dividend paid per common share by \$0.02. The Company declared no dividends in 2010 or 2009, and the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its common stock will be subject to various restrictions as a result of its participation in the Capital Purchase Program. These restrictions include a requirement to receive prior consent from Treasury for any increase, during the three year period from February 13, 2009, in the payment of dividends by the Company that would exceed the last annual cash dividend of \$0.20 per share. Prior consent of Treasury will also be required from February 13, 2012 until February 13, 2019 for any annual increase of 3% or more in aggregate common dividends per share. From and after February 13, 2019, the Company will be prohibited from paying any common dividends or repurchasing any equity securities or trust preferred securities until all of the preferred stock held by Treasury has been redeemed in whole or Treasury has transferred all of the preferred stock to third parties. The Board of Directors intends to continue evaluating whether to resume the payment of dividends to common shareholders as growth and earnings permit.

#### *Off-Balance Sheet Arrangements and Commitments*

In the normal course of operations, the Bank engages in a variety of financial transactions that, in accordance with accounting principles generally accepted in the United States of America, are not recorded in our consolidated financial statements. These transactions are used primarily to manage customers' requests for funding and take the form of commitments to extend credit and standby letters of credit. The Bank uses the same credit policies in making commitments to lend funds and conditional obligations as it does for other credit products. In the event of nonperformance by the customer, the Bank's exposure to credit loss is represented by the contractual amount of the instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established by the contract. Since some commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As of June 30, 2011, commitments to extend credit totaled \$70.6 million and letters of credit totaled \$1.6 million.



### *Liquidity*

Liquidity is the term used to refer to the Bank's ability to meet its cash requirements. The Bank maintains sufficient liquidity to ensure that funds are available for both lending needs and the withdrawal of deposit funds. The Bank derives liquidity primarily through deposit growth, including core deposits, the maturity of investment securities, cash from operations and loan payments received. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. Additional liquidity is provided through sales of loans, sales of securities, and access to alternative funding sources. National time deposits, including brokered deposits, public deposits, and deposits available through various national listing programs are traditionally considered to be more volatile than core deposits; however, more recently, the volatility has been caused more by pricing than availability. Federal Home Loan Bank borrowings, and unsecured overnight federal funds borrowings are referred to as alternative funding sources.

The primary ongoing funding needs of the Company, separate from the Bank, include debt service on junior subordinated debentures and dividends on preferred stock. Liquidity needs of the Company have historically been met through dividends received from the Bank. The Bank has historically relied upon the generation of local deposits to fund its investment in loans, securities and other assets. On occasion, the Bank generates funds by advertising its certificate of deposit rates on a national listing service. Public funds are another source of deposits and are typically received from the states of either Washington or Idaho. Public funds are stable and are generally deposited with the Bank for as long as the Bank is willing to pay the required rate of interest on such funds and pledge securities equal to 100% of the uninsured balance for Washington public funds.

Concerns over deposit fluctuations with respect to the overall banking industry were addressed by the FDIC in September and October 2008. The FDIC temporarily increased the individual account deposit insurance from \$100,000 per depositor to \$250,000 per depositor. This increase in deposit insurance was made permanent by the Dodd-Frank Act in July 2010. The FDIC also implemented the Transaction Account Guarantee Program, which temporarily provides full FDIC insurance coverage for noninterest bearing transaction accounts; this program is set to expire on December 31, 2012.

When the level of liquid assets (our primary liquidity) does not meet our liquidity needs, other available sources of liquid assets (our secondary liquidity) include: the purchase of federal funds, sales of securities under agreements to repurchase, purchase of brokered certificates of deposit, liquidation of unpledged securities, and sales of loans. Our lines of credit with the FHLB and other correspondent banks are also available to meet current and anticipated liquidity needs. At June 30, 2011, the Company had approximately \$55 million of funds available on its FHLB line and \$15 million of funds available on its federal funds lines with correspondent banks.

The Bank also has access to additional brokered deposits. However, if the Bank were to become less than well capitalized under the capital adequacy guidelines, regulatory approval would have to be obtained in order to continue purchasing brokered deposits. Additionally, as a member of the CDARS program, the Bank is eligible to purchase certificates of deposit through the program. These sources provide significant secondary liquidity to the Bank to fulfill its customers' needs.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to accommodate deposit withdrawals, to support loan growth, to satisfy financial commitments and to take advantage of investment opportunities. Management estimates that the Bank has sufficient primary and secondary liquidity sources in place to meet the anticipated needs of both the Bank and the Company.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Not applicable because the Company is a smaller reporting company.

**Item 4. Controls and Procedures.**

*Evaluation of Disclosure Controls and Procedures*

The Company's Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of disclosure controls and procedures (as defined in Exchange Act Rules 240.13a-15(e)) as of June 30, 2011, the date of this quarterly report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's current disclosure controls and procedures are effective and timely, providing them with material information relating to the Company required to be disclosed in the reports that are filed or submitted under the Exchange Act.

*Changes in Internal Controls*

There have been no changes in internal controls or procedures during the last quarter that have materially affected, or are reasonably likely to materially affect the Company's control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

There are no material pending legal proceedings to which the Company is a party, or to which any of its property is subject, other than ordinary routine litigation incidental to the business of banking. No material loss is expected from any such pending claims or lawsuits.

**Item 1A. Risk Factors.**

An investment in our common stock is subject to risks inherent to our business. Before making an investment decision, you should carefully consider the risks and uncertainties described both in this report and in our annual report on Form 10-K for the fiscal year ended December 31, 2010, as updated by our filings with the SEC. These are not the only risks and uncertainties we face. Additional risks and uncertainties that management is not currently aware of or that management currently deems immaterial may also impair our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially affected.

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

Not applicable.

**Item 3. Defaults Upon Senior Securities.**

Not applicable.

**Item 4. (Removed and Reserved)**

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

The exhibits filed as part of this report and the exhibits incorporated herein by reference are listed in the Exhibits Index to this report, which follows the signature page.

**SIGNATURES**

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

NORTHWEST BANCORPORATION, INC.  
(Registrant)

Dated: August 12, 2011

/s/ Randall L. Fewel  
Randall L. Fewel  
President & Chief Executive Officer

(Principal Executive Officer)

Dated: August 12, 2011

/s/ Holly A. Poquette  
Holly A. Poquette  
Chief Financial Officer

(Principal Financial Officer)

Dated: August 12, 2011

/s/ Lisa A. Sanborn  
Lisa A. Sanborn  
Controller, Secretary/Treasurer

(Principal Accounting Officer)

**Exhibit Index**

- Exhibit 3.1 Restated Articles of Incorporation of the Company. Filed as Exhibit 3.1 to the Company's annual report on Form 10-K, filed with the SEC on March 27, 2009 and incorporated by reference herein.
- Exhibit 3.2 Amended and restated bylaws of the Company. Filed as Exhibit 3.1 to the Company's current report on form 8-K, filed with the SEC on January 25, 2010 and incorporated by reference herein.
- Exhibit 4.1 Reference is made to Exhibits 3.1 and 3.2 as well as Exhibits 4.2, 4.3 and 4.4 below.
- Exhibit 4.2 Form of Certificate for Series A Preferred Stock. Filed as Exhibit 4.1 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 4.3 Form of Certificate for Series B Preferred Stock. Filed as Exhibit 4.2 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 4.4 Warrant to purchase shares of the Company's Series B Preferred Stock, dated February 13, 2009 and issued to the United States Department of the Treasury. Filed as Exhibit 4.3 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 31.1 Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. Filed herewith.
- Exhibit 31.2 Certification of Holly A. Poquette, Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. Filed herewith.
- Exhibit 32.1 Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to 18 U.S.C. 1350. Furnished herewith.
- Exhibit 32.2 Certification of Holly A. Poquette, Chief Financial Officer, pursuant to 18 U.S.C. 1350. Furnished herewith.
- Exhibit 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, are formatted in Extensible Business Reporting Language (XBRL) and furnished herewith: (i) the Consolidated Statements of Financial Condition, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (Loss), (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements.<sup>(1)</sup>

<sup>(1)</sup> As provided in Rule 406T of Regulation S-T, these interactive data files are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.