BANNER CORP
Form 10-K
March 14, 2013

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

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2012

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM __________to __________

Commission File Number 0-26584
BANNER CORPORATION
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-1691604 (I.R.S. Employer Identification Number)

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

Registrant's telephone number, including area code: (509) 527-3636
Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value $.01 per share (Title of Each Class)	The NASDAQ Stock Market LLC (Name of Each Exchange on Which Registered)

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes __No X

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 X No ____

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes ____No X
The aggregate market value of the voting and nonvoting common equity held by nonaffiliates of the registrant based on the closing sales price
of the registrant's common stock quoted on The NASDAQ Stock Market on June 30, 2012, was:
Common Stock - $402,237,057
(The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the Registrant
that such person is an affiliate of the Registrant.)
The number of shares outstanding of the registrant's classes of common stock as of February 28, 2013:
Common Stock, $.01 par value – 19,455,023 shares

Documents Incorporated by Reference
Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 23, 2013 are incorporated by reference into Part III.

BANNER CORPORATION AND SUBSIDIARIES

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Forward-Looking Statements

Certain matters in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, liquidity, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” or similar expressions o conditional verbs such as “may,” “will,” “should,” “would” and “could.” Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance and projections of financial items. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated or implied by our forward-looking statements, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates and the relative differences between short and long-term interest rates, loan and deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute a formal or informal enforcement action against us or any of the Banks which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds, or maintain or increase deposits, or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the implementing regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets and liabilities, which estimates may prove to be incorrect and result in significant changes in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; the failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common stock and interest or principal payments on our junior subordinated debentures; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities

and Exchange Commission, including this report on Form 10-K. Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to update any forward-looking statements included in this report or the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. These risks could cause our actual results to differ materially from those expressed in any forward-looking statements by, or on behalf of, us. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur, and you should not put undue reliance on any forward-looking statements.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Banner Corporation and its consolidated subsidiaries, unless the context otherwise requires. All references to "Banner" refer to Banner Corporation and those to "the Banks" refer to its wholly-owned subsidiaries, Banner Bank and Islanders Bank, collectively.

PART 1

Item 1 – Business General

Banner Corporation (the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly-owned subsidiaries, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2012, its 85 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks (the DFI) and the Federal Deposit Insurance Corporation (the FDIC). As of December 31, 2012, we had total consolidated assets of $4.3 billion, net loans of $3.2 billion, total deposits of $3.6 billion and total stockholders' equity of $507 million.

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

Since becoming a public company in 1995, we have invested significantly in expanding our branch and distribution systems with a primary emphasis on strengthening our market presence in our five primary markets in the Northwest. Those markets include the four largest metropolitan areas in the Northwest: the Puget Sound region of Washington and the greater Boise, Idaho, Portland, Oregon, and Spokane, Washington markets, as well as our historical base in the vibrant agricultural communities in the Columbia Basin region of Washington and Oregon. Our aggressive franchise expansion during this period included the acquisition and consolidation of eight commercial banks, as well as the opening of 28 new branches and relocating ten others. Over the past ten years, we also invested heavily in advertising campaigns designed to significantly increase the brand awareness for Banner Bank. These investments, which have been significant elements in our strategies to grow loans, deposits and customer relationships, have increased our presence within desirable marketplaces and allow us to better serve existing and future customers. This emphasis on growth and development resulted in an elevated level of operating expenses during much of this period; however, we believe that the expanded branch network and heightened brand awareness have created a franchise that we believe is well positioned to allow us to successfully execute on our super community bank model. That strategy is focused on delivering customers, including middle market and small businesses, business owners, their families and employees, a compelling value proposition by providing the financial sophistication and breadth of products of a regional bank while retaining the appeal and superior service level of a community bank.

Despite weak economic conditions and ongoing strains in the financial and housing markets, Banner Corporation's successful execution of its strategic turnaround plan and operating initiatives ,which resulted in our return to profitability in 2011, continued in 2012 and delivered noteworthy results as evidenced by our solid profitability for the

year ended December 31, 2012. We achieved substantial progress on our goal to position the Company with a moderate risk profile and to maintain that profile and earnings momentum going forward. Highlights for the year included further improvement in our asset quality, additional customer account growth, significantly increased non-interest-bearing deposit balances and strong revenues from mortgage banking operations. As a result, substantially reduced credit costs, significant improvement in our net interest margin and strong non-interest revenues all contributed to meaningfully increased profitability in 2012. Also notable during the year was the repurchase and retirement of all of our Series A Preferred Stock. We realized gains of $2.5 million on these repurchase transactions. For the year ended December 31, 2012, we had net income of $64.9 million which, after providing for the preferred stock dividend, related discount accretion and gains on repurchases of preferred stock, resulted in a net income available to common shareholders of $59.1 million, or $3.16 per diluted share, compared to a net income of $5.5 million which, after providing for the preferred stock dividend and related discount accretion, resulted in a net loss to common shareholders of $2.4 million, or ($0.15) per diluted share for the year ended December 31, 2011.

Our return to consistent profitability was punctuated in 2012 by management's decision to reverse the valuation allowance against our deferred tax assets. For the year ended December 31, 2012, the elimination of the deferred tax asset valuation allowance, combined with the Company's pre-tax income, resulted in a net tax benefit of $24.8 million which significantly added to our net income for the year. The decision to reverse the valuation allowance reflects our confidence in the sustainability of our future profitability. Further, as a result of our return to profitability, including the recovery of our deferred tax asset, our improved asset quality and operating trends, strong capital position and our expectation for sustainable profitability for the foreseeable future, we also significantly reduced the credit portion of the discount rate utilized to estimate the fair value of the junior subordinated debentures issued by the Company. As a result, the estimated fair value of our junior subordinated debentures increased by $23.1 million during the year, accounting for most of the $16.5 million net charge before taxes for fair value adjustments for the year ended December 31, 2012. Changes in these two significant accounting estimates, while substantial, represent non-cash valuation adjustments that have no effect on our liquidity or our ability to fund our operations.

Although economic conditions have improved from the depths of the recession resulting in a material decrease in credit costs in recent periods, the pace of recovery has been modest and uneven and ongoing stress in the economy, reflected in high unemployment, tepid consumer spending, modest loan demand and very low interest rates, will likely continue to create a challenging operating environment going forward. Nonetheless, over the past two years we have significantly improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in lower credit costs and stronger revenues, and which we believe will lead to further improved operating results in future periods.

Our provision for loan losses was $13.0 million for the year ended December 31, 2012, compared to $35.0 million in 2011 and $70 million in 2010. The decrease from a year earlier reflects significant progress in reducing the levels of delinquencies, non-performing loans and net charge-offs, particularly for loans for the construction of one- to four-family homes and for acquisition and development of land for residential properties. From 2008 through 2011, higher than historical provision for loan losses was the most significant factor adversely affecting our operating results; however, the substantial decrease in non-performing assets resulted in much lower provisioning in 2012 and the expectation of more normal levels going forward. (See Note 6, Loans Receivable and the Allowance for Loan Losses, as well as “Asset Quality” below in this Form 10-K.)

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits and borrowings. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. Our net interest income before provision for loan losses increased to $167.6 million for the year ended December 31, 2012, compared to $164.6 million for the same prior year, primarily as a result of expansion of our net interest spread and net interest margin due to a lower cost of funds and a reduction in the adverse impact of non-performing assets. The continuing trend to lower funding costs primarily reflects a further decline in interest expense on deposits driven by significant changes in our deposit mix and pricing. This decrease in deposit costs coupled with the reduction in the adverse impact of non-performing assets represent important improvements in our core operating fundamentals. The increase in net interest income occurred despite a modest decline in average earning assets compared to a year ago, as we continued to focus on reducing our non-performing loans and make changes in our mix of assets and liabilities designed to reduce our risk profile and produce more sustainable earnings.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 22 of the Notes to the Consolidated Financial Statements.) For the year ended December 31, 2012, we recorded a net loss of $16.5 million in fair value adjustments and $409,000 of OTTI charges. In comparison, we recorded a net fair value loss of $624,000 for the year ended December 31, 2011, which was more than offset by a $3.0 million OTTI recovery. The current year fair value loss was primarily related to the increased valuation of our junior subordinated debentures, which was partially offset by similar adjustments to the fair value estimates for certain investment securities also carried at fair value.

Reflecting the large adverse fair value adjustment, our other operating income for the year ended December 31, 2012 decreased to $26.9 million, compared to $34.0 million for the year ended December 31, 2011. As a result, our total revenues (net interest income before the provision for loan losses plus other operating income) for 2012 decreased $4.0 million, to $194.6 million, compared to $198.6 million for 2011. However, as a result of exceptionally strong mortgage banking revenues and growth in core deposits, our revenues, excluding fair value and OTTI adjustments,

which we believe are more indicative of our core operations, increased by $15.2 million, or 8%, to $211.4 million for the year ended December 31, 2012, compared to $196.2 million for the year ended December 31, 2011.

Our other operating expenses decreased to $141.5 million for the year ended December 31, 2012, compared to $158.1 million for the year ended December 31, 2011, largely as a result of decreased costs related to real estate owned, FDIC deposit insurance costs and professional services, which were partially offset by increased compensation expenses. While significantly lower in 2012 than in 2011, both years' expenses reflect significant costs associated with problem loan collection activities including professional services and valuation charges related to real estate owned, which should decline in future periods as a result of the continuing reduction in non-performing assets.

Other operating income, revenues and other earnings information excluding fair value adjustments and OTTI losses are financial measures not made in conformity with U.S. generally acceptable accounting principles (GAAP). Management has presented these and other non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. Where applicable, we have also presented comparable earnings information using GAAP financial measures.

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

Recent Developments and Significant Events

Regulatory Actions: On March 19, 2012, the Memorandum of Understanding (MOU) by and between Banner Bank and the FDIC and Washington DFI (originally effective March 29, 2010) was terminated. On April 10, 2012, the MOU by and between the Company and the Federal Reserve Bank of San Francisco (originally effective March 23, 2010) was also terminated.

Income Tax Reporting and Accounting:

Amended Federal Income Tax Returns: On October 25, 2011, the Company filed amended federal income tax returns for tax years 2005, 2006, 2008 and 2009. The amended tax returns, which are under review by the Internal Revenue Service (IRS), significantly affect the timing for recognition of credit losses within previously filed income tax returns and, if approved, would result in the refund of up to $13.6 million of previously paid taxes from the utilization of net operating loss carryback claims into prior tax years. The outcome of the anticipated IRS review is inherently uncertain and since there can be no assurance of approval of some or all of the tax carryback claims, no asset has been recognized to reflect the possible results of these amendments as of December 31, 2012. Accordingly, the Company does not anticipate recognizing any tax benefit until the results of the IRS review have been determined. We expect this review to be completed and the issue resolved during 2013.

Deferred Tax Asset Valuation Allowance: The Company and the Banks file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company’s income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that all or a portion of our deferred tax assets will not be realized. While realization of the deferred tax asset is ultimately dependent on sustained profitability, the guidance reflected in the accounting standard is significantly influenced by consideration of recent historical operating results. During 2010, the Company evaluated its net deferred tax asset and determined it was prudent to establish a valuation allowance against the entire asset. As a result, we recorded an $18.0 million income tax expense for the year ended December 31, 2010. No tax benefit or expense was recognized during 2011. During the year ended December 31, 2012, management analyzed the Company's performance and trends, focusing on trends in asset quality, loan loss provisioning, capital position, net interest margin, core operating income and net income and the likelihood of continued profitability. Based on this analysis, management determined that a full valuation allowance was no longer appropriate and reversed all of the valuation allowance during the year ended December 31, 2012. See Note 13 of the Notes to the Consolidated Financial Statements for more information.

Stockholder Equity Transactions:

Preferred Stock: On March 29, 2012, the Company's $124 million of Series A Preferred Stock with a liquidation value of $1,000 per share, originally issued to the U.S. Treasury (Treasury) as part of its Capital Purchase Program, was sold by the Treasury as part of its efforts to manage and recover its investments under the Troubled Asset Relief Program (TARP). While the sale of these preferred shares to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients. The Treasury retained its related warrants to purchase up to $18.6 million in Banner common stock. Subsequently, during 2012, the Company repurchased or redeemed its Series A Preferred Stock, realizing gains aggregating $2.5 million, which partially offset the accelerated amortization of a portion of the initial discount recorded at the issuance of the Series A Preferred Stock. In addition, dividends paid in 2012 on the Series A Preferred Stock were reduced by the retirement of the repurchased shares.

Lending Activities

General: All of our lending activities are conducted through Banner Bank, its subsidiary, Community Financial Corporation, and Islanders Bank. We offer a wide range of loan products to meet the demands of our customers and our loan portfolio is very diversified by product type, borrower and geographic location within our market area. We originate loans for our own loan portfolio and for sale in the secondary market. Management’s strategy has been to

maintain a well diversified portfolio with a significant percentage of assets in the loan portfolio having more frequent interest rate repricing terms or shorter maturities than traditional long-term fixed-rate mortgage loans. As part of this effort, we have developed a variety of floating or adjustable interest rate products that correlate more closely with our cost of funds, particularly loans for commercial business and real estate, agricultural business, and construction and development purposes. However, in response to customer demand, we continue to originate fixed-rate loans, including fixed interest rate mortgage loans with terms of up to 30 years. The relative amount of fixed-rate loans and adjustable-rate loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

Historically, our lending activities have been primarily directed toward the origination of real estate and commercial loans. Prior to 2008, real estate lending activities were significantly focused on residential construction and land development and first mortgages on owner-occupied, one- to four-family residential properties; however, over the subsequent four years our origination of construction and land development loans declined materially and the proportion of the portfolio invested in these types of loans has declined substantially. During 2011 and particularly in 2012, we experienced more demand for one- to four-family construction loans and outstanding balances have increased modestly. Our residential mortgage loan originations also decreased during the earlier years of this cycle, although less significantly than the decline in construction and land development lending as exceptionally low interest rates supported demand for loans to refinance existing debt as well as loans to finance home purchases. Refinancing activity was particularly significant during 2012, which resulted in a meaningful increase in residential mortgage originations compared to the same period a year earlier. Despite the recent increase in these loan originations, our outstanding balances for residential mortgages have continued to decline, as most of the new originations have been sold in the secondary market while existing residential loans have been repaying at an accelerated pace. Our real estate lending activities also include the origination of multifamily and commercial real estate loans. While reduced from periods prior to the economic slowdown, our level of activity and investment in these types of loans has been relatively stable in recent periods. Our commercial business lending is directed toward meeting the credit and related deposit needs of various small to medium-sized business and agribusiness borrowers operating in our primary market areas. Reflecting the weak economy, in recent periods demand for these types of commercial business loans has been modest and, aside from seasonal variations, total outstanding balances have not significantly increased or decreased. Our consumer lending activity is primarily directed at meeting demand from

our existing deposit customers and, while we have increased our emphasis on consumer lending in recent years, demand for consumer loans also has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt. At December 31, 2012, our net loan portfolio totaled $3.158 billion compared to $3.213 billion at December 31, 2011.

For additional information concerning our loan portfolio, see Item 7, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Loans and Lending” including Tables 7 and 8, which sets forth the composition and geographic concentration of our loan portfolio, and Tables 9 and 10, which contain information regarding the loans maturing in our portfolio.

One- to Four-Family Residential Real Estate Lending: At both Banner Bank and Islanders Bank, we originate loans secured by first mortgages on one- to four-family residences in the Northwest communities where we have offices. While we offer a wide range of products, we have not engaged in any sub-prime lending programs, which we define as loans to borrowers with poor credit histories or undocumented repayment capabilities and with excessive reliance on the collateral as the source of repayment. However, in recent years we have experienced a modest increase in delinquencies on our residential loans in response to the weakened housing market conditions. At December 31, 2012, $582 million, or 18% of our loan portfolio, consisted of permanent loans on one- to four-family residences.

We offer fixed- and adjustable-rate mortgages (ARMs) at rates and terms competitive with market conditions, primarily with the intent of selling these loans into the secondary market. Fixed-rate loans generally are offered on a fully amortizing basis for terms ranging from 10 to 30 years at interest rates and fees that reflect current secondary market pricing. Most ARM products offered adjust annually after an initial period ranging from one to five years, subject to a limitation on the annual change of 1.0% to 2.0% and a lifetime limitation of 5.0% to 6.0%. For a small portion of the portfolio, where the initial period exceeds one year, the first rate change may exceed the annual limitation on subsequent rate changes. Our ARM products most frequently adjust based upon the average yield on Treasury securities adjusted to a constant maturity of one year or certain London Interbank Offered Rate (LIBOR) indices plus a margin or spread above the index. ARM loans held in our portfolio may allow for interest-only payments for an initial period up to five years but do not provide for negative amortization of principal and carry no prepayment restrictions. The retention of ARM loans in our loan portfolio can help reduce our exposure to changes in interest rates. However, borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. In recent years, borrower demand for ARM loans has been limited and we have chosen not to aggressively pursue ARM loans by offering minimally profitable, deeply discounted teaser rates or option-payment ARM products. As a result, ARM loans have represented only a small portion of our loans originated during this period and of our portfolio.

Our residential loans are generally underwritten and documented in accordance with the guidelines established by the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) and the Federal National Mortgage Association (Fannie Mae or FNMA). Government insured loans are underwritten and documented in accordance with the guidelines established by the Department of Housing and Urban Development (HUD) and the Veterans Administration (VA). In the loan approval process, we assess the borrower’s ability to repay the loan, the adequacy of the proposed security, the employment stability of the borrower and the creditworthiness of the borrower. For ARM loans, our standard practice provides for underwriting based upon fully indexed interest rates and payments. Generally, we will lend up to 95% of the lesser of the appraised value or purchase price of the property on conventional loans, although higher loan-to-value ratios are available on certain government insured programs. We require private mortgage insurance on conventional residential loans with a loan-to-value ratio at origination exceeding 80%. For the past four years, particularly in 2009 and 2010, a number of exceptions to these general underwriting guidelines were granted in connection with the sale or refinance of properties, particularly new

construction, for which we were already providing financing. These exceptions most commonly relate to loan-to-value and mortgage insurance requirements and not to credit underwriting or loan documentation standards. Such exceptions, while less frequent in recent periods, will likely continue in the near term to facilitate troubled loan resolution and may result in loans having performance characteristics different from the rest of our one-to-four-family loan portfolio.

Through our mortgage banking activities, we sell residential loans on either a servicing-retained or servicing-released basis. During the past three years, we have sold a significant portion of our conventional residential mortgage originations and nearly all of our government insured loans in the secondary market.

Construction and Land Lending: Historically, we have invested a significant portion of our loan portfolio in residential construction and land loans to professional home builders and developers; however, as housing markets weakened the amount of this investment was substantially reduced in recent years. In years prior to 2008, residential construction and land development lending was an area of major emphasis at Banner Bank and the primary focus of its subsidiary, CFC. To a lesser extent, we also originate construction loans for commercial and multifamily real estate. More recently, in response to improvement in certain sub-markets, our construction and development lending increased in 2011 and 2012 and made a meaningful contribution to increased revenues and profitability in those years. Although well diversified with respect to sub-markets, price ranges and borrowers, our construction and land loans are significantly concentrated in the greater Puget Sound region of Washington State and the Portland, Oregon market area. At December 31, 2012, construction and land loans totaled $305 million, or 9% of total loans of the Company, consisting of $161 million of one- to four-family construction loans, $77 million of residential land or land development loans, $53 million of commercial and multifamily real estate construction loans and $14 million of commercial land or land development loans.

Construction and land lending affords us the opportunity to achieve higher interest rates and fees with shorter terms to maturity than are usually available on other types of lending. Construction and land lending, however, involves a higher degree of risk than other lending opportunities because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity

of the loan with a project the value of which is insufficient to assure full repayment. Disagreements between borrowers and builders and the failure of builders to pay subcontractors may also jeopardize projects. Loans to builders to construct homes for which no purchaser has been identified carry additional risk because the payoff for the loan is dependent on the builder's ability to sell the property before the construction loan is due. We attempt to address these risks by adhering to strict underwriting policies, disbursement procedures and monitoring practices.

Construction loans made by us include those with a sales contract or permanent loan in place for the finished homes and those for which purchasers for the finished homes may be identified either during or following the construction period. We actively monitor the number of unsold homes in our construction loan portfolio and local housing markets to attempt to maintain an appropriate balance between home sales and new loan originations. The maximum number of speculative loans (loans that are not pre-sold) approved for each builder is based on a combination of factors, including the financial capacity of the builder, the market demand for the finished product and the ratio of sold to unsold inventory the builder maintains. We have attempted to diversify the risk associated with speculative construction lending by doing business with a large number of small and mid-sized builders spread over a relatively large geographic region with numerous sub-markets within our three-state service area.

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

Historically, we have also made land loans to developers, builders and individuals to finance the acquisition and/or development of improved lots or unimproved land, although over the past five years we generally have not originated this type of loan. In making land loans, we follow underwriting policies and disbursement and monitoring procedures similar to those for construction loans. The initial term on land loans is typically one to three years with interest only payments, payable monthly, and provisions for principal reduction as lots are sold and released from the lien of the mortgage.

We regularly monitor the construction and land loan portfolios and the economic conditions and housing inventory in each of our markets and increase or decrease this type of lending as we observe market conditions change. Housing markets in most areas of the Pacific Northwest significantly deteriorated beginning in 2008 and our origination of new construction loans declined sharply as a result; however, our level of construction lending has increased in the past two years as certain sub-markets have improved. We believe that the underwriting policies and internal monitoring systems we have in place have helped to mitigate some of the risks inherent in construction and land lending; however, weak housing market conditions nonetheless resulted in material delinquencies and charge-offs in our construction and land loan portfolios in recent years. While construction and land loans, including residential, commercial and multifamily, have been meaningfully reduced, they still represent 9% of our portfolio. Reducing the amount of non-performing construction and land development loans and related real estate acquired through foreclosure was the most critical issue that we needed to resolve to return to acceptable levels of profitability and we have made substantial progress during the past three years in this regard, as reflected in the decline in non-performing construction and land loans to 12% of non-performing loans at December 31, 2012 from 52% of non-performing loans at December 31, 2010. The most significant risk in this portfolio relates to the land development loans in a few areas where demand for building lots remains weak. (See "Asset Quality" below and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Asset Quality.")

Commercial and Multifamily Real Estate Lending: We originate loans secured by multifamily and commercial real estate including, as noted above, loans for construction of multifamily and commercial real estate

projects. Commercial real estate loans are made for both owner-occupied and investor properties. At December 31, 2012, our loan portfolio included $138 million in multifamily and $1.073 billion in commercial real estate loans, including $489 million in owner-occupied commercial real estate loans and $584 million in non-owner-occupied commercial real estate loans, which in aggregate comprised 37% of our total loans. Multifamily and commercial real estate lending affords us an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multifamily and commercial properties are generally greater in amount, more difficult to evaluate and monitor and, therefore, potentially riskier than one- to four-family residential mortgage loans. Because payments on loans secured by multifamily and commercial properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. In originating multifamily and commercial real estate loans, we consider the location, marketability and overall attractiveness of the properties. Our underwriting guidelines for multifamily and commercial real estate loans require an appraisal from a qualified independent appraiser and an economic analysis of each property with regard to the annual revenue and expenses, debt service coverage and fair value to determine the maximum loan amount. In the approval process we assess the borrowers' willingness and ability to manage the property and repay the loan and the adequacy of the collateral in relation to the loan amount.

Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Most of our multifamily and commercial real estate loans are linked to various Federal Home Loan Bank (FHLB) advance rates, certain prime rates or other market rate indices. Rates on these adjustable-rate loans generally adjust with a frequency of one to five years after an initial fixed-rate period ranging from one to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no large concentrations by property type, location or borrower. At December 31, 2012, the average size of our commercial real estate loans was $659,000 and the largest commercial real estate loan in our portfolio was approximately $15 million.

Commercial Business Lending: We are active in small- to medium-sized business lending and are engaged to a lesser extent in agricultural lending primarily by providing crop production loans. Our commercial bankers are focused on local markets and devote a great deal of effort to developing customer relationships and the ability to serve these types of borrowers with a full array of products and services delivered in a thorough and responsive manner. While also strengthening our commitment to small business lending, in recent years we have added experienced officers and staff focused on corporate lending opportunities for borrowers with credit needs generally in a $3 million to $15 million range. In addition to providing earning assets, this type of lending has helped us increase our deposit base. Expanding commercial lending and related commercial banking services is currently an area of significant focus, including recent reorganization and additions to staffing in the areas of business development, credit administration, Small Business Administration (SBA) lending, and loan and deposit operations.

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

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

Our commercial business loans may be structured as term loans or as lines of credit. Commercial business term loans are generally made to finance the purchase of fixed assets and have maturities of five years or less. Commercial business lines of credit are typically made for the purpose of providing working capital and are usually approved with a term of one year. Adjustable- or floating-rate loans are primarily tied to various prime rate or LIBOR indices. At December 31, 2012, commercial business loans totaled $618 million, or 19% of our total loans.

Agricultural Lending: Agriculture is a major industry in many parts of our service areas. While agricultural loans are not a large part of our portfolio, we intend to continue to make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operations of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile. At December 31, 2012, agricultural business loans, including collateral secured loans to purchase farm land and equipment, totaled $230 million, or 7% of our loan portfolio.

Agricultural operating loans generally are made as a percentage of the borrower’s anticipated income to support budgeted operating expenses. These loans are secured by a blanket lien on all crops, livestock, equipment, accounts and products and proceeds thereof. In the case of crops, consideration is given to projected yields and prices from each commodity. The interest rate is normally floating based on the prime rate or a LIBOR index plus a negotiated margin. Because these loans are made to finance a farm or ranch’s annual operations, they are usually written on a

one-year review and renewable basis. The renewal is dependent upon the prior year's performance and the forthcoming year's projections as well as the overall financial strength of the borrower. We carefully monitor these loans and related variance reports on income and expenses compared to budget estimates. To meet the seasonal operating needs of a farm, borrowers may qualify for single payment notes, revolving lines of credit and/or non-revolving lines of credit.

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

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

Among the more common risks to agricultural lending can be weather conditions and disease. These risks may be mitigated through multi-peril crop insurance. Commodity prices also present a risk, which may be reduced by the use of set price contracts. Normally, required beginning

and projected operating margins provide for reasonable reserves to offset unexpected yield and price deficiencies. In addition to these risks, we also consider management succession, life insurance and business continuation plans when evaluating agricultural loans.

Consumer and Other Lending: We originate a variety of consumer loans, including home equity lines of credit, automobile, boat and recreational vehicle loans and loans secured by deposit accounts. While consumer lending has traditionally been a small part of our business, with loans made primarily to accommodate our existing customer base, it has received consistent emphasis in recent years. Part of this emphasis has been the reintroduction of a Banner Bank-funded credit card program which we began marketing in 2005. Similar to other consumer loan programs, we focus this credit card program on our existing customer base to add to the depth of our customer relationships. In addition to earning balances, credit card accounts produce non-interest revenues through interchange fees and other activity-based revenues. Our underwriting of consumer loans is focused on the borrower's credit history and ability to repay the debt as evidenced by documented sources of income. At December 31, 2012, we had $291 million, or 9% of our loans receivable, in consumer related loans, including $170 million, or 5% of our loans receivable, in consumer loans secured by one- to four-family residences.

Similar to commercial business loans, our other consumer loans often entail greater risk than residential mortgage loans. Home equity lines of credit generally entail greater risk than do one- to four-family residential mortgage loans where we are in the first lien position. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. In the case of consumer loans which are unsecured or secured by rapidly depreciating assets such as automobiles, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. These loans may also give rise to claims and defenses by a consumer loan borrower against an assignee of such loans such as us, and a borrower may be able to assert against the assignee claims and defenses that it has against the seller of the underlying collateral.

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

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

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

Loan Originations, Sales and Purchases

While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. For the years ended December 31, 2012, 2011 and 2010, we originated loans, net of repayments, of $460 million, $270 million, and $114 million, respectively. The increase in net originations for 2012 reflects a significant increase in production of one- to four-family residential loans, as well as increased new commercial business and agricultural business loans and commercial real estate loans, and a reduction in charge-offs on problem loans. The lower level of originations, net of repayments and charge-offs, during 2010 was significantly impacted by reduced demand from creditworthy borrowers due to weak economic conditions, a substantial amount of loan repayments, and significant charge-offs.

We sell many of our newly originated one- to four-family residential mortgage loans to secondary market purchasers as part of our interest rate risk management strategy. Originations of one- to four-family residential loans for sale increased to $504 million for the year ended December 31, 2012 from $279 million during 2011. Proceeds from sales of loans for the years ended December 31, 2012, 2011 and 2010, totaled $505 million, $282 million, and $351 million, respectively. Sales of loans generally are beneficial to us because these sales may generate income at the time of sale, provide funds for additional lending and other investments, increase liquidity or reduce interest rate risk. We sell loans on both a servicing-retained and a servicing-released basis. All loans are sold without recourse. The decision to hold or sell loans is based on asset liability management goals, strategies and policies and on market conditions. See “Loan Servicing.” At December 31, 2012, we had $12 million in loans held for sale.

We periodically purchase whole loans and loan participation interests primarily during periods of reduced loan demand in our primary market area and at times to support our Community Reinvestment Act lending activities. Any such purchases are made generally consistent with our underwriting standards; however, the loans may be located outside of our normal lending area. During the years ended December 31, 2012, 2011 and 2010, we purchased $18 million, $5 million and $341,000, respectively, of loans and loan participation interests.

Loan Servicing

We receive fees from a variety of institutional owners in return for performing the traditional services of collecting individual payments and managing portfolios of sold loans. At December 31, 2012, we were servicing $1.031 billion of loans for others. Loan servicing includes processing payments, accounting for loan funds and collecting and paying real estate taxes, hazard insurance and other loan-related items such as private mortgage insurance. In addition to earning fee income, we retain certain amounts in escrow for the benefit of the lender for which we incur no interest expense but are able to invest the funds into earning assets. At December 31, 2012, we held $5.0 million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2012 was composed of $687 million of Freddie Mac residential mortgage loans, $212 million of Fannie Mae residential mortgage loans and $132 million of both residential and non-residential mortgage loans serviced for a variety of private investors. The portfolio included loans secured by property located primarily in the states of Washington, Oregon and Idaho. For the year ended December 31, 2012, we recognized a $872,000 gain from loan servicing in our results of operations, which was net of $2.6 million of servicing rights amortization and a $400,000 impairment charge for a valuation adjustment to mortgage servicing rights.

Mortgage Servicing Rights: We record mortgage servicing rights (MSRs) with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. For the years ended December 31, 2012, 2011 and 2010, we capitalized $3.7 million, $1.9 million, and $1.7 million, respectively, of MSRs relating to loans sold with servicing retained. No MSRs were purchased in those periods. Amortization of MSRs for the years ended December 31, 2012, 2011 and 2010, was $2.6 million, $1.8 million, and $2.0 million, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. These carrying values are adjusted when the valuation indicates the carrying value is impaired. During 2012, we recorded a $400,000 impairment charge to reduce the carrying value of our MSRs. MSRs generally are adversely affected by higher levels of current or anticipated prepayments resulting from decreasing interest rates. At December 31, 2012, our MSRs were carried at a value of $6.2 million, net of amortization.

Asset Quality

Classified Assets: State and federal regulations require that the Banks review and classify their problem assets on a regular basis. In addition, in connection with examinations of insured institutions, state and federal examiners have authority to identify problem assets and, if appropriate, require them to be classified. Historically, we have not had any meaningful differences of opinion with the examiners with respect to asset classification. Banner Bank's Credit Policy Division reviews detailed information with respect to the composition and performance of the loan portfolios, including information on risk concentrations, delinquencies and classified assets for both Banner Bank and Islanders Bank. The Credit Policy Division approves all recommendations for new classified loans or, in the case of smaller-balance homogeneous loans including residential real estate and consumer loans, it has approved policies governing such classifications, or changes in classifications, and develops and monitors action plans to resolve the problems associated with the assets. The Credit Policy Division also approves recommendations for establishing the appropriate level of the allowance for loan losses. Significant problem loans are transferred to Banner Bank's Special Assets Department for resolution or collection activities. The Banks' and Banner Corporation's Boards of Directors are given a detailed report on classified assets and asset quality at least quarterly. For additional information regarding asset quality and non-performing loans, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Asset Quality," and Tables 15, 16 and 17 contained therein.

Allowance for Loan Losses: In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the

term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. As a result, we maintain an allowance for loan losses consistent with GAAP guidelines. We increase our allowance for loan losses by charging provisions for possible loan losses against our income. The allowance for losses on loans is maintained at a level which, in management's judgment, is sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon continuing analysis of the factors underlying the quality of the loan portfolio. At December 31, 2012, we had an allowance for loan losses of $77 million, which represented 2.39% of loans and 225% of non-performing loans compared to 2.52% and 110%, respectively, at December 31, 2011. For additional information concerning our allowance for loan losses, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011—Provision and Allowance for Loan Losses," and Tables 21 and 22 contained therein.

Real Estate Owned: Real estate owned (REO) is property acquired by foreclosure or receiving a deed in lieu of foreclosure, and is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying amount of the defaulted loan. Development and improvement costs relating to the property are capitalized to the extent they add value to the property. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are credited or charged to operations in the period in which they are realized. The amounts we will ultimately recover from REO may differ substantially from the carrying value of the assets because of market factors beyond our control or because of changes in our strategies for recovering the investment. If the book value of the REO is determined to be in excess of the fair market value, a valuation allowance is recognized against earnings. At December 31, 2012, we had REO of $16 million, compared to $43 million at December 31, 2011. Valuation allowances recognized during 2012 were $5.2 million and for both 2011 and 2010 valuation charges were $15.1 million. For additional information on REO, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Asset Quality" and Table 18 contained therein and Note 7 of the Notes to the Consolidated Financial Statements.

Investment Activities

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

At December 31, 2012, our consolidated investment portfolio totaled $631 million and consisted principally of U.S. Government agency obligations, mortgage-backed securities, municipal bonds, corporate debt obligations, and asset-backed securities secured by student loans issued or guaranteed by the Student Loan Marketing Association. From time to time, investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in loan originations, deposits and other activities. During the year ended December 31, 2012, holdings of mortgage-backed securities increased $176 million to $306 million, while Treasury and agency obligations decreased $243 million to $99 million, corporate securities including equities increased $6 million to $49 million, municipal bonds increased $28 million to $135 million, and new investments in asset-backed securities were $43 million.

For detailed information on our investment securities, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Investments," and Tables 1 to 6 contained therein.

Off-Balance-Sheet Derivatives: Derivatives include "off-balance-sheet" financial products, the value of which is dependent on the value of underlying financial assets, such as stock, bonds, foreign currency, or a reference rate or index. Such derivatives include "forwards," "futures," "options" or "swaps." As a result of the 2007 acquisition of F&M Bank, we became a party to approximately $23 million ($16 million as of December 31, 2012) in notional amounts of interest rate swaps. These swaps serve as hedges to an equal amount of fixed-rate loans which include market value prepayment penalties that mirror the provision of the specifically matched interest rate swaps. In addition, in 2011 we began actively marketing interest rate swaps to certain loan customers in connection with longer-term floating rate loans, allowing them to effectively fix their loan interest rates. These customer swaps are matched with third party swaps with qualified broker/dealers or banks to offset the risk. As of December 31, 2012, we had $95 million in notional amounts of these customer interest rate swaps outstanding, with an equal amount of offsetting third party swaps also in place. The fair value adjustments for these swaps and the related loans are reflected in other assets or other liabilities as appropriate, and in the carrying value of the hedged loans. Also, as a part of mortgage banking

activities, we issue “rate lock” commitments to borrowers and obtain offsetting “best efforts” delivery commitments from purchasers of loans. While not providing any trading or net settlement mechanisms, these off-balance-sheet commitments do have many of the prescribed characteristics of derivatives and as a result are accounted for as such. Accordingly, on December 31, 2012, we recorded an asset of $74,000 and a liability of $74,000, representing the estimated market value of those commitments. Further, in 2012 we began using forward contracts for the sale of mortgage-backed securities and mandatory delivery commitments for the sale of loans to partially hedge "rate lock" commitments and closed loans to borrowers in our mortgage banking activities. On December 31, 2012, we recorded an asset of $436,000 and a liability of $121,000, representing the estimated market value of those commitments. These forward contracts and mandatory delivery commitments, as well as the related "rate lock" commitments and loans, are accounted for in the Consolidated Financial Statements at fair value with changes in fair value recognized in earnings. On December 31, 2012, we had no other investment related off-balance-sheet derivatives.

Deposit Activities and Other Sources of Funds

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

We compete with other financial institutions and financial intermediaries in attracting deposits. There is strong competition for transaction balances and savings deposits from commercial banks, credit unions and non-bank corporations, such as securities brokerage companies, mutual funds and other diversified companies, some of which have nationwide networks of offices. Much of the focus of our branch expansion, relocations and renovation and advertising and marketing campaigns has been directed toward attracting additional deposit customer relationships and balances. In addition, our electronic banking activities including debit card and automated teller machine (ATM) programs, on-line Internet banking services and, most recently, customer remote deposit and mobile banking capabilities are all directed at providing products and services

that enhance customer relationships and result in growing deposit balances. Growing core deposits (transaction and savings accounts) is a fundamental element of our business strategy.

Deposit Accounts: We generally attract deposits from within our primary market areas by offering a broad selection of deposit instruments, including demand checking accounts, interest-bearing checking accounts, money market deposit accounts, regular savings accounts, certificates of deposit, cash management services and retirement savings plans. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of deposit accounts, we consider current market interest rates, profitability to us, matching deposit and loan products and customer preferences and concerns. At December 31, 2012, we had $3.558 billion of deposits, including $2.529 billion of transaction and savings accounts and $1.029 billion in time deposits. For additional information concerning our deposit accounts, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Deposit Accounts." See also Table 11 contained therein, which sets forth the balances of deposits in the various types of accounts, and Table 12, which sets forth the amount of our certificates of deposit greater than $100,000 by time remaining until maturity as of December 31, 2012. In addition, see Note 9 of the Notes to the Consolidated Financial Statements.

Borrowings: While deposits are the primary source of funds for our lending and investment activities and for general business purposes, we also use borrowings to supplement our supply of lendable funds, to meet deposit withdrawal requirements and to more efficiently leverage our capital position. The FHLB-Seattle serves as our primary borrowing source, although in recent years we have significantly reduced our use of FHLB advances. The FHLB-Seattle provides credit for member financial institutions such as Banner Bank and Islanders Bank. As members, the Banks are required to own capital stock in the FHLB-Seattle and are authorized to apply for advances on the security of that stock and certain of their mortgage loans and securities provided certain credit worthiness standards have been met. Limitations on the amount of advances are based on the financial condition of the member institution, the adequacy of collateral pledged to secure the credit, and FHLB stock ownership requirements. At December 31, 2012, we had $10 million of borrowings from the FHLB-Seattle. At that date, Banner Bank had been authorized by the FHLB-Seattle to borrow up to $889 million under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to $26 million under a similar agreement. The Federal Reserve Bank also serves as an important source of borrowing capacity. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB-Seattle. At December 31, 2012, based upon our available unencumbered collateral, Banner Bank was eligible to borrow $595 million from the Federal Reserve Bank, although at that date we had no funds borrowed under this arrangement. Although eligible to participate, Islanders Bank has not applied for approval to borrow from the Federal Reserve Bank. For additional information concerning our borrowings, see Item 7, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2012 and 2011—Borrowings," Table 14 contained therein, and Notes 10 and 11 of the Notes to the Consolidated Financial Statements.

We issue retail repurchase agreements, generally due within 90 days, as an additional source of funds, primarily in connection with cash management services provided to our larger deposit customers. At December 31, 2012, we had issued retail repurchase agreements totaling $77 million, which were secured by a pledge of certain U.S. Government and agency notes and mortgage-backed securities with a market value of $109 million. We also may borrow funds through the use of secured wholesale repurchase agreements with securities brokers; however, during the three years ended December 31, 2012, we did not have any wholesale repurchase borrowings.

On March 31, 2009, Banner Bank completed an offering of $50 million of qualifying senior bank notes that were guaranteed by the FDIC under the Temporary Liquidity Guarantee Program (TLGP). This debt, which was issued to strengthen our overall liquidity position as we adjusted to a lower level of public funds deposits, matured and was repaid on March 31, 2012.

We have also issued $120 million of junior subordinated debentures in connection with the sale of trust preferred securities (TPS). The TPS were issued from 2002 through 2007 by special purpose business trusts formed by Banner Corporation and were sold in private offerings to pooled investment vehicles. The junior subordinated debentures associated with the TPS have been recorded as liabilities and are reported at fair value on our Consolidated Statements of Financial Condition. All of the debentures issued to the Trusts, measured at their fair value, less the common stock of the Trusts, qualified as Tier I capital as of December 31, 2012, under guidance issued by the Board of Governors of the Federal Reserve System. We have invested substantially all of the proceeds from the issuance of the TPS as additional paid in capital at Banner Bank. For additional information about deposits and other sources of funds, see Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources," and Notes 9, 10, 11 and 12 of the Notes to the Consolidated Financial Statements.

Personnel

As of December 31, 2012, we had 1,074 full-time and 99 part-time employees. Banner Corporation has no employees except for those who are also employees of Banner Bank, its subsidiaries, and Islanders Bank. The employees are not represented by a collective bargaining unit. We believe our relationship with our employees is good.

Taxation
Federal Taxation

General: For tax reporting purposes, we report our income on a calendar year basis using the accrual method of accounting on a consolidated basis. We are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the reserve for bad debts. Reference is made to Note 13 of the Notes to the Consolidated Financial Statements for additional information concerning the income taxes payable by us.

State Taxation

Washington Taxation: We are subject to a Business and Occupation (B&O) tax which is imposed under Washington law at the rate of 1.80% of gross receipts. For many years, this rate had been 1.50%. However, on April 12, 2010, the Washington State Legislature passed a law that temporarily increased this rate to 1.80%. This new higher rate will be in effect for the period May 1, 2010 through June 30, 2013. Interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities is not subject to this tax. Our B&O tax expense was $2.3 million, $2.2 million, and $2.3 million for the years ended December 31, 2012, 2011 and 2010, respectively.

Oregon and Idaho Taxation: Corporations with nexus in the states of Oregon and Idaho are subject to a corporate level income tax. Our operations in those states resulted in corporate income taxes of approximately $540,000, $30,000, and $60,000 for the years ended December 31, 2012, 2011 and 2010, respectively. As our operations in these states increase, the state income tax provision will have an increasing effect on our effective tax rate and results of operations.

Competition

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

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

Regulation
Banner Bank and Islanders Bank

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

Federal and state banking laws and regulations govern all areas of the operation of the Banks, including reserves, loans, investments, deposits, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state bank regulatory agencies also have the general authority to limit the dividends paid by insured banks and bank holding companies if such payments should be deemed to constitute an unsafe and unsound practice. The respective primary federal regulators of Banner Corporation, Banner Bank and Islanders Bank have authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks

from engaging in unsafe or unsound practices.

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

Deposit Insurance: The Deposit Insurance Fund (“DIF”) of the FDIC insures deposit accounts of the Banks up to $250,000 per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. Banner Bank's and Islanders Bank's deposit insurance premiums expense for the year ended December 31, 2012, were $3.5 million and $195,000, respectively.

As a result of a decline in the reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) and concerns about expected failure costs and available liquid assets in the DIF, the FDIC adopted a rule requiring each insured institution to prepay on December 30, 2009 the estimated amount of its quarterly assessments for the fourth quarter of 2009 and all quarters through the end of 2012 (in addition to the regular quarterly assessment for the third quarter which was due on December 30, 2009). The prepaid amount is recorded as an asset with a zero risk weight and the institution will continue to record quarterly expenses for deposit insurance. For purposes of calculating the prepaid amount, assessments were measured at the institution's assessment rate as of September 30, 2009, with a uniform increase of three basis points effective January 1, 2011, and were based on the institution's assessment base for the third quarter of 2009, with growth assumed quarterly at annual rate of 5%. If events cause actual assessments during the prepayment period to vary from the prepaid amount, institutions will pay excess

assessments in cash or receive a rebate of prepaid amounts not exhausted after collection of assessments due on June 30, 2013, as applicable. Collection of the prepayment does not preclude the FDIC from changing assessment rates or revising the risk-based assessment system in the future. The balance of our prepaid assessment was $12.4 million at December 31, 2012.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules, effective as of the second quarter of 2011, which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.
The FDIC conducts examinations of and requires reporting by state non-member banks, such as the Banks. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the deposit insurance fund.

The FDIC may terminate the deposit insurance of any insured depository institution if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is not aware of any existing circumstances which would result in termination of the deposit insurance of either Banner Bank or Islanders Bank.

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

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by either Banner Bank and Islanders Bank to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment

of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At December 31, 2012, both Banner Bank and Islanders Bank were categorized as “well capitalized” under the prompt corrective action regulations of the FDIC. For additional information, see Note 18 of the Notes to Consolidated Financial Statements.

Standards for Safety and Soundness: The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to internal controls, information systems and internal audit systems; loan documentation; credit underwriting; interest rate risk exposure; asset growth; asset quality; earnings; and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Capital Requirements: Federally insured financial institutions, such as Banner Bank and Islanders Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common stockholders' equity, qualifying restricted core capital elements (other than cumulative perpetual preferred

stock), less deductions for disallowed intangibles and disallowed deferred tax assets. Tier 2 capital, which recognizes up to 100% of Tier 1 capital for risk-based capital purposes includes such items as qualifying general loan loss reserves (up to 1.25% of risk-weighted assets), qualified subordinated debt, redeemable preferred stock, other restricted core capital elements, cumulative perpetual preferred stock, and net unrealized holding gains on equity securities (subject to certain limitations); provided, however, the amount of term subordinated debt and intermediate term preferred stock that may be included in Tier 2 capital for risk-based capital purposes is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 3% to 4% of total assets. At December 31, 2012, Banner Bank and Islanders Bank had Tier 1 leverage capital ratios of 12.29% and 13.02%, respectively. The FDIC retains the right to require an institution to maintain a higher capital level based on an institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of the category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect the bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At December 31, 2012, Banner Bank and Islanders Bank had Tier 1 risk-based capital ratios of 15.12% and 16.28%, respectively, and total risk-based capital ratios of 16.38% and 17.53%, respectively.

FDIC capital requirements are designated as the minimum acceptable standards for banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The FDIC capital regulations state that, where the FDIC determines that the financial history or condition, including off-balance-sheet risk, managerial resources and/or the future earnings prospects of a bank are not adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of capital for the bank is greater than the minimum standards established in the regulation.

We believe that, under the current regulations, Banner Bank and Islanders Bank exceed their minimum capital requirements. However, events beyond the control of the Banks, such as weak or depressed economic conditions in areas where they have most of their loans, could adversely affect future earnings and, consequently, the ability of the Banks to meet their capital requirements. For additional information concerning Banner Bank's and Islanders Bank's capital, see Note 18 of the Notes to the Consolidated Financial Statements.

New Proposed Capital Rules. In June 2012, the Federal Reserve, FDIC and the Office of the Comptroller of the Currency (OCC) approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules implement the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act. “Basel III” refers to various documents released by the Basel Committee on Banking Supervision. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to Banner Corporation and the Banks under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Banks, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as "well capitalized": (i) a new common equity Tier 1 risk-based capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a total risk-based capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

The proposed rules set forth certain changes for the calculation of risk-weighted assets and utilize an increased number of credit risk and other exposure categories and risk weights. In addition, the proposed rules also address: (i) a proposed alternative standard of creditworthiness

consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; and (iv) revised capital treatment for derivatives and repurchase-style transactions.

In particular, the proposed rules would expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures. Higher risk weights would apply to a variety of exposure categories. Specifics include, among others:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

- For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a “category 1” or “category 2” residential mortgage exposure (based on eight criteria that include, among others, the term, seniority of the lien, use of negative amortization, balloon payments and certain rate increases).

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

- Providing for a 100% risk weight for claims on securities firms.

- Eliminating the current 50% cap on the risk weight for OTC derivatives.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. The following discussion summarizes significant aspects of the Dodd-Frank Act that may affect the Banks and Banner Corporation. For certain of these changes, implementing regulations have not been promulgated, so we cannot determine the full impact of the Dodd-Frank Act on our business and operations at this time.

The following aspects of the Dodd-Frank Act are related to the operations of the Banks:

- The Consumer Financial Protection Bureau (“CFPB”), an independent consumer compliance regulatory agency within the Federal Reserve has been established. The CFPB is empowered to exercise broad regulatory, supervisory and enforcement authority over financial institutions with total assets of over $10 billion with respect to both new and existing consumer financial protection laws. Financial institutions with assets of less than $10 billion, like the Banks, will continue to be subject to supervision and enforcement by their primary federal banking regulator with respect to federal consumer financial protection laws. The CFPB also has authority to promulgate new consumer financial protection regulations and amend existing consumer financial protection regulations;
- The Federal Deposit Insurance Act was amended to direct federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries;
- The prohibition on payment of interest on demand deposits was repealed, effective July 21, 2011;
- Deposit insurance is permanently increased to $250,000;
- The deposit insurance assessment base for FDIC insurance is the depository institution's average consolidated total assets less the average tangible equity during the assessment period; and
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The minimum reserve ratio of the FDIC's DIF increased to 1.35 percent of estimated annual insured deposits or the comparable percentage of the assessment base; however, the FDIC is directed to "offset the effect" of the increased reserve ratio for insured depository institutions with total consolidated assets of less than $10 billion. Pursuant to the Dodd-Frank Act, the FDIC recently issued a rule setting a designated reserve ratio at 2.0% of insured deposits.

The following aspects of the Dodd-Frank Act are related to the operations of Banner Corporation:

- Tier 1 capital treatment for "hybrid" capital items like trust preferred securities is eliminated subject to various grandfathering and transition rules. The federal banking agencies must promulgate new rules on regulatory capital within 18 months from July 21, 2010, for both depository institutions and their holding companies, to include leverage capital and risk-based capital measures at least as stringent as those now applicable to the Banks under the prompt corrective action regulations;
- Public companies are required to provide their shareholders with a non-binding vote: (i) at least once every three years on the compensation paid to executive officers, and (ii) at least once every six years on whether they should have a "say on pay" vote every one, two or three years;

- A separate, non-binding shareholder vote is required regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments;
- Securities exchanges are required to prohibit brokers from using their own discretion to vote shares not beneficially owned by them for certain "significant" matters, which include votes on the election of directors, executive compensation matters, and any other matter determined to be significant;
- Stock exchanges are prohibited from listing the securities of any issuer that does not have a policy providing for (i) disclosure of its policy on incentive compensation payable on the basis of financial information reportable under the securities laws, and (ii) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid erroneously during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information;
- Disclosure in annual proxy materials is required concerning the relationship between the executive compensation paid and the financial performance of the issuer;
- Item 402 of Regulation S-K is amended to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees; and
- Smaller reporting companies are exempt from complying with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act.

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

- Total reported loans for construction, land development and other land represent 100% or more of the bank's capital; or

- Total commercial real estate loans (as defined in the guidance) represent 300% or more of the bank's total capital or the outstanding balance of the bank's commercial real estate loan portfolio has increased 50% or more during the prior 36 months.

The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory guidance on evaluation of capital adequacy. As of December 31, 2012, Banner Bank's and Islanders Bank's aggregate loans for construction, land development and land loans were 92% and 51% of total capital, respectively. In addition, at December 31, 2012 Banner Bank's and Islanders Bank's loans on commercial real estate were 227% and 213% of total capital, respectively.

Activities and Investments of Insured State-Chartered Financial Institutions: Federal law generally limits the activities and equity investments of FDIC insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (1) acquiring or retaining a majority interest in a subsidiary, (2) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such

limited partnership investments may not exceed 2% of the bank's total assets, (3) acquiring up to 10% of the voting stock of a company that solely provides or re-insures directors', trustees' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (4) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

Washington State has enacted a law regarding financial institution parity. Primarily, the law affords Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of the Washington Department of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered commercial banks may exercise any of the powers that the Federal Reserve has determined to be closely related to the business of banking and the powers of national banks, subject to the approval of the Director in certain situations. The law also provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

Environmental Issues Associated With Real Estate Lending: The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) is a federal statute that generally imposes strict liability on all prior and present “owners and operators” of sites containing hazardous waste. However, Congress asked to protect secured creditors by providing that the term “owner and operator” excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this “secured creditor exemption” has been the

subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including Banner Bank and Islanders Bank, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System: The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Interest-bearing checking accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits at a bank. At December 31, 2012, the Banks' deposits with the Federal Reserve Bank and vault cash exceeded their reserve requirements.

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

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

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

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

Anti-Money Laundering and Customer Identification: In response to the terrorist events of September 11, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act

of 2001 (USA Patriot Act) was signed into law on October 26, 2001. The USA Patriot Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications. Banner Bank's and Islanders Bank's policies and procedures comply with the requirements of the USA Patriot Act.

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

Banner Corporation

General: Banner Corporation, as sole shareholder of Banner Bank and Islanders Bank, is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended, or the BHCA, and the regulations of the Federal Reserve. We are required to file quarterly reports with the Federal Reserve

and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and charge us for the cost of the examination. The Federal Reserve also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. Banner Corporation is also required to file certain reports with, and otherwise comply with the rules and regulations of the Securities and Exchange Commission.

The Bank Holding Company Act: Under the BHCA, we are supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd-Frank Act and earlier Federal Reserve policy provide that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial distress to the banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. The Dodd-Frank Act requires new regulations to be promulgated concerning the source of strength. Banner Corporation and any subsidiaries that it may control are considered “affiliates” within the meaning of the Federal Reserve Act, and transactions between Banner Bank and affiliates are subject to numerous restrictions. With some exceptions, Banner Corporation, and its subsidiaries, are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by Banner Corporation, or by its affiliates.

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

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

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

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and corporate governance rules and requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC and the Comptroller General. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Interstate Banking and Branching: The Federal Reserve must approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the statutory law of the host state. Nor may the Federal Reserve approve an application if the applicant (and its depository institution affiliates) controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state which may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

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

Dividends: The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses its view that although there are no specific regulations restricting dividend payments by bank holding companies other than state corporate laws, a bank holding company must maintain an adequate capital position and generally should not pay cash dividends unless the company's net

income for the past year is sufficient to fully fund the cash dividends and that the prospective rate of earnings appears consistent with the company's capital needs, asset quality, and overall financial condition. The Federal Reserve policy statement also indicates that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends.

Capital Requirements: The Federal Reserve has established capital adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Banks, although the Federal Reserve regulations provide for the inclusion of certain trust preferred securities for up to 25% of Tier 1 capital in determining compliance with the guidelines. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with $500 million or more in total consolidated assets. The guidelines require that a company's total risk-based capital must equal 8% of risk-weighted assets and one half of the 8% (4%) must consist of Tier 1 (core) capital. As of December 31, 2012, Banner Corporation's total risk-based capital was 16.96% of risk-weighted assets and its Tier 1 (core) capital was 15.70% of risk-weighted assets. The Dodd-Frank Act required new capital regulations to be adopted in final form 18 months after the July 21, 2010 enactment date of the Dodd-Frank Act. In June 2012, the Federal Reserve, FDIC and the OCC approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Stock Repurchases: A bank holding company, except for certain “well-capitalized” and highly rated bank holding companies, is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding twelve months, is equal to 10% or more of its consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order or any condition imposed by, or written agreement with, the Federal Reserve. We did not repurchase any shares of common stock during the 2012 fiscal year.

Management Personnel
Executive Officers

The following table sets forth information with respect to the executive officers of Banner Corporation and Banner Bank as of December 31, 2012:

Name	Age	Position with Banner Corporation	Position with Banner Bank
Mark J. Grescovich	48	President, Chief Executive Officer, Director	President, Chief Executive Officer, Director
Lloyd W. Baker	64	Executive Vice President, Chief Financial Officer	Executive Vice President, Chief Financial Officer
Cynthia D. Purcell	55		Executive Vice President, Retail Banking and Administration
Richard B. Barton	69		Executive Vice President, Chief Lending Officer
Steven W. Rust	65		Executive Vice President, Chief Information Officer
Douglas M. Bennett	60		Executive Vice President, Real Estate Lending Operations
Tyrone J. Bliss	55		Executive Vice President, Risk Management and Compliance Officer

Gary W. Wagers	52	Executive Vice President, Retail Products and Services
John T. Wagner	62	Executive Vice President, Corporate Administration
James T. Reed, Jr.	50	Senior Vice President, Commercial Banking
M. Kirk Quillin	50	Senior Vice President, Commercial Banking

Biographical Information

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

Mark J. Grescovich is President and Chief Executive Officer, and a director, of Banner Corporation and Banner Bank. Mr. Grescovich joined the Bank in April 2010 and became Chief Executive Officer in August 2010 following an extensive banking career specializing in finance, credit administration and risk management. Prior to joining the Bank, Mr. Grescovich was the Executive Vice President and Chief Corporate Banking Officer for Akron, Ohio-based FirstMerit Corporation and FirstMerit Bank N.A., a commercial bank with $14.5 billion in assets and over 200 branch offices in three states. He assumed the role and responsibility for FirstMerit's commercial and regional line of business in 2007, having served since 1994 in various commercial and corporate banking positions, including that of Chief Credit Officer. Prior to joining FirstMerit, Mr. Grescovich was a Managing Partner in corporate finance with Sequoia Financial Group, Inc. of Akron, Ohio and a commercial and corporate lending officer and credit analyst with Society National Bank of Cleveland, Ohio.

Lloyd W. Baker joined First Savings Bank of Washington (now Banner Bank) in 1995 as Asset/Liability Manager, has been a member of the executive management committee since 1998 and has served as the Chief Financial Officer of Banner Corporation and Banner Bank since 2000. His banking career began in 1972.

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

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

Steven W. Rust joined Banner Bank in October 2005. Mr. Rust has over 34 years of relevant industry experience prior to joining Banner Bank and was founder and President of InfoSoft Technology, through which he worked for nine years as a technology consultant and interim Chief Information Officer for banks and insurance companies. He worked 19 years with US Bank/West One Bancorp as Senior Vice President & Manager of Information Systems.

Douglas M. Bennett, who joined First Federal Savings and Loan (now Banner Bank) in 1974, has over 36 years of experience in real estate lending. He has served as a member of Banner Bank's executive management committee since 2004.

Tyrone J. Bliss joined Banner Bank in 2002. Mr. Bliss is a Certified Regulatory Compliance Manager with more than 33 years of commercial banking experience. Prior to joining Banner Bank, his career included senior risk management and compliance positions with Bank of America's Consumer Finance Group, Barnett Banks, Inc., and Florida-based community banks.

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

John T. Wagner began his banking career in 1972 with Norwest Bank. He worked for Seafirst Bank and Bank of America from 1977 to 2003, concluding his career there as Market President for Eastern Washington and Idaho. He joined F&M Bank in October, 2003 as President and Chief Operating Officer. Currently, Mr. Wagner serves as Executive Vice President at Banner Bank. He is a graduate of the University of Montana with a bachelor's degree in

Finance. He is a 1986 graduate of the Pacific Coast Banking School and has completed the Executive Management Program at Duke University.

James T. Reed, Jr. joined Towne Bank (now Banner Bank) as a Vice President and Commercial Branch Manager in July 1995 and was named to his current position as the West Region Commercial Banking Executive in July 2012. He is responsible for Commercial Banking in Western Washington and Western Oregon as well as Specialty Banking. Mr. Reed began his banking career with Rainier Bank which later became Security Pacific Bank and later still West One Bank. He earned a Bachelor of Arts in Interdisciplinary Arts and Sciences from the University of Washington, and earned certificates from Pacific Coast Banking School, Northwest Intermediate Banking School and Northwest Intermediate Commercial Lending School. Currently, Mr. Reed sits on the University of Washington Bothell Advisory Board and the University of Washington Foundation Board.

M. Kirk Quillin joined Banner Bank's commercial banking group in 2002 as a Senior Vice President and commercial loan manager and was named to his current position as the East Region Commercial Banking Executive in July 2012. He is responsible for commercial and specialty banking for all locations in Eastern Washington, Eastern Oregon and Idaho. Mr. Quillin began his career in the banking industry in 1984 with Idaho First National Bank, which is now U.S. Bank. His career also included management positions in commercial lending with Washington Mutual. He earned a B.S. in Finance and Economics from Boise State University and was certified by the Pacific Coast Banking School and Northwest Intermediate Commercial Lending School.

Corporate Information

Our principal executive offices are located at 10 South First Avenue, Walla Walla, Washington 99362. Our telephone number is (509) 527-3636. We maintain a website with the address www.bannerbank.com. The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor’s own Internet access charges, we make available

free of charge through our website our Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to, the Securities and Exchange Commission.

Item 1A – Risk Factors

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

Risks Factors Related to Our Business

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

Our operations are significantly affected by national and regional economic conditions. Weakness in the national economy or the economies of the markets in which we operate could have a material adverse effect on our financial condition, results of operations and prospects. Substantially all of our loans are to businesses and individuals in the states of Washington, Oregon and Idaho. All of our branches and most of our deposit customers are also located in these three states. Beginning in 2008, Washington, Oregon and Idaho have experienced significant home price declines, increased foreclosures and high unemployment rates, and each state continues to face fiscal challenges, which may have adverse long term effects on economic conditions in those states. As a result of the high concentration of our customer base in the Puget Sound area of Washington State, the deterioration of businesses in the Puget Sound area, or one or more businesses with a large employee base in that area, could have a material adverse effect on our business, financial condition, liquidity, results of operations and prospects. In addition, weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade.

A further deterioration in economic conditions or a prolonged delay in economic recovery in the market areas we serve, in particular the Puget Sound area of Washington State, the Portland, Oregon metropolitan area, Spokane, Washington, Boise, Idaho and the agricultural regions of the Columbia Basin, could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, liquidity and results of operations:

- demand for our products and services may decline;
- loan delinquencies, problem assets and foreclosures may increase;
- collateral for loans, especially real estate, may decline further in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans; and
- the amount of our low-cost or non-interest-bearing deposits may decrease.

A return of recessionary conditions could result in increases in our level of non-performing loans and/or reduce demand for our products and services, which could have adverse effect on our results of operations.

The ongoing debate in Congress regarding the national debt ceiling and federal budget deficit and concerns over the United States' credit rating (which was downgraded by Standard & Poor's), the European sovereign debt crisis, the overall weakness in the economy and continued high unemployment in the United States, among other economic indicators, have contributed to increased volatility in the capital markets and diminished expectations for the

economy.

A return of recessionary conditions and/or continued negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. Further declines in real estate values and sales volumes and continued high unemployment levels may result in higher than expected loan delinquencies and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect our capital, liquidity, and financial condition.
Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. If the Federal Reserve increases the federal funds rate, overall interest rates will likely rise, which may negatively impact the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

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

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

sell their homes, such borrowers may be unable to repay their loans in full from the sale proceeds. As a result, these loans may experience higher rates of delinquencies, defaults and losses.

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

We originate construction and land loans, commercial and multifamily mortgage loans, commercial business loans, consumer loans, agricultural mortgage loans and agricultural loans primarily within our market areas. We had $2.42 billion outstanding in these types of higher risk loans at December 31, 2012 compared to $2.65 billion at December 31, 2011. These loans typically present different risks to us for a number of reasons, including those discussed below:

- Construction and Land Loans. At December 31, 2012, construction and land loans were $305 million or 9% of our total loan portfolio. This type of lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Loans on land under development or held for future construction also pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand conditions. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to independently repay principal and interest. While our origination of these types of loans has decreased significantly in the last five years, we continue to have significant levels of construction and land loan balances. At December 31, 2012, construction and land loans that were non-performing were $4 million, or 11% of our total non-performing loans.

- Commercial and Multifamily Real Estate Loans. At December 31, 2012, commercial and multifamily real estate loans were $1.211 billion, or 37% of our total loan portfolio. These loans typically involve higher principal amounts than other types of loans. Repayment is dependent upon income being generated from the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. This risk is exacerbated in the current economic environment. At December 31, 2012, commercial and multifamily real estate loans that were non-performing were $7 million, or 19% of our total non-performing loans.

- Commercial Business Loans. At December 31, 2012, commercial business loans were $618 million, or 19% of our total loan portfolio. Our commercial loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise, may be illiquid and may fluctuate in value based on the success of the business. At December 31, 2012, commercial business loans that were non-performing were $5 million, or 14% of our total non-performing loans.

- Agricultural Loans. At December 31, 2012, agricultural loans were $230 million, or 7% of our total loan portfolio. Repayment is dependent upon the successful operation of the business, which is greatly dependent on many things outside the control of either us or the borrowers. These factors include weather, commodity prices, and interest rates among others. Collateral securing these loans may be difficult to evaluate, manage or liquidate and may not provide an adequate source of repayment. At December 31, 2012, there were no agricultural loans that were non-performing .

- Consumer Loans. At December 31, 2012, consumer loans were $291 million, or 9% of our total loan portfolio. Consumer loans (such as personal lines of credit) are collateralized, if at all, with assets that may not provide an adequate source of payment of the loan due to depreciation, damage, or loss. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. At December 31, 2012, consumer loans that were non-performing were $4 million, or 10% of our total non-performing loans.

If our allowance for loan losses is not adequate, we may be required to make further increases in our provisions for loan losses and to charge off additional loans in the future, which could adversely affect our financial condition, liquidity and results of operations.

For the year ended December 31, 2012, we recorded a provision for loan losses of $13.0 million, compared to $35.0 million for the year ended December 31, 2011. We also recorded net loan charge-offs of $18.4 million for the year ended December 31, 2012, compared to $49.5 million for the year ended December 31, 2011. Despite the decrease from the prior year, we are still experiencing elevated levels of loan delinquencies and credit losses by historical standards. At December 31, 2012, our total non-performing loans had decreased to $34.4 million compared to $75.3 million at December 31, 2011. If current weak conditions in the housing and real estate markets continue, we expect that we will continue

to experience higher than normal delinquencies and credit losses. Moreover, if weak economic conditions in our market areas persist, we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could materially adversely affect our financial condition and results of operations.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio which would cause our results of operations, liquidity and financial condition to be adversely affected.

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

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

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

- our general reserve, based on our historical default and loss experience, certain macroeconomic factors, and management's expectations of future events;
- our specific reserve, based on our evaluation of non-performing loans and their underlying collateral; and
- an unallocated reserve to provide for other credit losses inherent in our portfolio that may not have been contemplated in the other loss factors.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and loss and delinquency experience, and evaluate economic conditions and make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for additions to our allowance through an increase in the provision for loan losses. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. Our allowance for loan losses was 2.39% of total loans outstanding and 225% of non-performing loans at December 31, 2012. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and capital.

If our non-performing assets increase, our earnings will be adversely affected.

At December 31, 2012 and 2011, our non-performing assets (which consist of nonaccruing loans, accruing loans 90 days or more past due, non-performing investment securities, and real estate owned (REO)) were $50.2 million and $118.9 million, respectively, or 1.18% and 2.79% of total assets, respectively. Our non-performing assets adversely affect our net income in various ways:

- We do not record interest income on nonaccrual loans, non-performing investment securities, or REO.
- We must provide for probable loan losses through a current period charge to the provision for loan losses.
- Non-interest expense increases when we must write down the value of properties in our REO portfolio to reflect changing market values or recognize other-than-temporary impairment on non-performing investment securities.
- There are legal fees associated with the resolution of problem assets, as well as carrying costs, such as taxes, insurance, and maintenance fees related to our REO.
- The resolution of non-performing assets requires the active involvement of management, which can distract them from more profitable activity.

If additional borrowers become delinquent and do not pay their loans and we are unable to successfully manage our non-performing assets, our losses and troubled assets could increase significantly, which could have a material adverse effect on our financial condition, liquidity and results of operations.

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

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. We may at some point, however, need to raise additional capital to support continued growth or be required by our regulators to increase our capital resources. Our ability to

raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. Accordingly, we cannot make assurances that we will be able to raise additional capital if needed on terms that are acceptable to us, or at all. If we cannot raise additional capital when needed, our ability to further expand our operations could be materially impaired and our financial condition and liquidity could be materially and adversely affected. In addition, if we are unable to raise additional capital when required by our bank regulators, we may be subject to adverse regulatory action.

We may have significant variation in our annual and quarterly results.

We reported net income of $59.1 million available to common shareholders during the year ended December 31, 2012 compared to a net loss of $2.4 million during the year ended December 31, 2011. Our operating results in recent periods have been significantly influenced by the relatively high, although declining, levels of delinquencies, non-performing loans, and related provision for loan losses, net loan charge-offs and charges related to REO. In addition, several other factors affecting our business can cause significant variations in our quarterly results of operations. In particular, variations in the volume of our loan originations and sales, the differences between our cost of funds and the average interest rate earned on investments, special FDIC insurance charges, significant changes in real estate valuations and the fair valuation of our junior subordinated debentures or our investment securities portfolio could have a material adverse effect on our results of operations, financial condition and liquidity.

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

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

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

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

The market for some of the investment securities held in our portfolio has been generally disrupted, uncertain and inefficient in recent years. These market conditions have affected and may further detrimentally affect the value of these securities, such as through reduced valuations because of the perception of heightened credit and liquidity risks. There can be no assurance that the declines in market value associated with this disruption and lack of activity will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

An increase in interest rates, change in the programs offered by secondary market purchasers or our ability to qualify for their programs may reduce our mortgage banking revenues, which would negatively impact our non-interest income.

Our mortgage banking operations provide a significant portion of our non-interest income. We generate mortgage revenues primarily from gains on the sale of single-family mortgage loans pursuant to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae and non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. Any future changes in these programs, our eligibility to participate in such programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities could, in turn, materially adversely affect our results of operations. Mortgage banking is generally considered a volatile source of income because it depends largely on the level of loan volume which, in turn, depends largely on prevailing market interest rates. In a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations. In addition, although we sell loans into the secondary market without recourse, we are required to give customary representations and warranties about the loans to the buyers. If we breach those representations and warranties, the buyers may require us to repurchase the loans and we may incur a loss on the repurchase.

Our results of operations, liquidity and cash flows are subject to interest rate risk.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also

be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. In addition, a substantial amount of our loans have adjustable interest rates. As a result, these loans may experience a higher rate of default in a rising interest rate environment. Further, a significant portion of our adjustable rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately 64% of our loan portfolio was comprised of adjustable or floating-rate loans at December 31, 2012, and approximately $1.5 billion, or 72%, of those loans contained interest rate floors, below which the loans' contractual interest rate may not adjust. At December 31, 2012, the weighted average floor interest rate of these loans was 5.08%. At that date, approximately $1.3 billion, or 86%, of these loans were at their floor interest rate. The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates, although this result is subject to the risks that borrowers may refinance these loans during periods of declining interest rates. Also, when loans are at their floors, there is a further risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates which could have a material adverse effect on our results of operations.

Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition, liquidity and results of operations. Further, a prolonged period of exceptionally low market interest rates, such as we are currently experiencing, could have an adverse effect on our results of operations as a result of substantially reduced asset yields. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results.

Historically low interest rates may adversely affect our net interest income and profitability.
During the last four years, it has been the policy of the Board of Governors of the Federal Reserve System (the "Federal Reserve") to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. As a result, yields on securities we have purchased, and market rates on the loans we have originated, have been at levels lower than were available prior to 2008. Consequently, the average yield on our interest-earning assets has decreased during the recent low interest rate environment. As a general matter, our interest-bearing liabilities re-price or mature more quickly than our interest-earning assets, which has contributed to increases in net interest income in the short term. However, our ability to lower our interest expense is limited at these interest rate levels, while the average yield on our interest-earning assets may continue to decrease. The Federal Reserve has indicated its intention to maintain low interest rates in the near future. Accordingly, our net interest income may decrease, which may have an adverse affect on our profitability. For information with respect to changes in interest rates, see "Risk Factors- Our results of operations, liquidity and cash flows are subject to interest rate risk."

If our investment in the Federal Home Loan Bank of Seattle becomes impaired, our earnings and shareholders' equity could decrease.

At December 31, 2012, the Company had recorded $36.7 million in FHLB stock, compared to $37.4 million at December 31, 2011. The Banks' investments in FHLB stock are generally viewed as a long-term investment and are carried at par value ($100 per share), which reasonably approximates its fair value. It does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions and can only be purchased and redeemed at par. As members of the FHLB system, the Banks are required to maintain a minimum level of investment in FHLB stock based on specific percentages of their outstanding FHLB advances. For the years ended December 31, 2012, 2011 and 2010, the Banks did not receive any dividend income on FHLB stock.

Management periodically evaluates FHLB stock for impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is

influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

The Seattle FHLB announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the FHFA), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. The FHLB of Seattle announced September 7, 2012 that the FHFA now considers the FHLB of Seattle to be adequately capitalized. Dividends on, or repurchases of, the FHLB of Seattle stock continue to require consent of the FHFA. The FHFA subsequently approved the repurchase of portions of FHLB of Seattle stock, and as of December 31, 2012, the FHLB had repurchased $665,900 of the Banks' stock. The Company will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of Banner's investment. Based on the above, the Company has determined there is not any impairment on the FHLB stock investment as of December 31, 2012.

The Dodd-Frank Wall Street Reform and Consumer Protection Act has, among other things, tightened capital standards, created a new Consumer Financial Protection Bureau and will result in new laws and regulations that are expected to increase our costs of operations.
The Banks are subject to extensive examination, supervision and comprehensive regulation by the FDIC and the Washington DFI, and Banner Corporation is subject to examination and supervision by the Federal Reserve. The FDIC, Washington DFI and the Federal Reserve govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution's

operations, reclassify assets, determine the adequacy of an institution's allowance for loan losses and determine the level of deposit insurance premiums assessed.
Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has significantly changed the bank regulatory structure and has affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.
Certain provisions of the Dodd-Frank Act are expected to have a near term impact on us. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.
The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor.
The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.
The Dodd-Frank Act created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Financial institutions such as the Banks with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.
It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Any additional changes in our regulation and oversight, whether in the form of new laws, rules or regulations, could make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

In June 2012, the Federal Reserve, FDIC and the OCC proposed rules that would substantially amend the regulatory risk-based capital rules applicable to Banner Corporation and the Banks. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Various provisions of the Dodd-Frank Act increase the capital requirements of bank holding companies, such as Banner Corporation. The leverage and risk-based capital ratios of these entities may not be lower than the leverage and risk-based capital ratios for insured depository institutions. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to Banner Corporation and the Banks under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a

"capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios, and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to Banner Corporation and the Banks.

In addition, in the current economic and regulatory environment, regulators of banks and bank holding companies have become more likely to impose capital requirements on bank holding companies and banks that are more stringent than those required by applicable existing regulations.

The application of more stringent capital requirements for Banner Corporation and the Banks could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

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

The Dodd-Frank Act established 1.35% of total insured deposits as the minimum reserve ratio. The FDIC has adopted a plan under which it will meet this ratio by the statutory deadline of September 30, 2020. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $10 billion of the increase in the minimum reserve ratio to 1.35% from the former minimum of 1.15%. The FDIC has not announced how it will implement this offset. In addition to the statutory minimum ratio, the FDIC must set a designated reserve ratio or DRR, which may exceed the statutory minimum. The FDIC has set 2.0% as the DRR.

As required by the Dodd-Frank Act, the FDIC has adopted final regulations under which insurance premiums are based on an institution's total assets minus its tangible equity instead of its deposits. While our FDIC insurance premiums initially have been reduced by these regulations, it is possible that our future insurance premiums will increase under the final regulations.

Failure to manage our growth may adversely affect our performance.

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

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

Liquidity is essential to our business and the inability to obtain adequate funding may negatively affect growth and, consequently, our earnings capability and capital levels. An inability to raise funds through deposits, borrowings, the sale of loans or investment securities and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the Washington, Oregon or Idaho markets in which our loans are concentrated, negative operating results or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued uncertainty in credit markets. In particular, our liquidity position could be significantly constrained if we are unable to access funds from the Federal Home Loan Bank of Seattle, the Federal Reserve Bank of San Francisco or other wholesale funding sources or if adequate financing is not available at acceptable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources, our revenues may not increase proportionately to cover our costs. In this case, our results of operations and financial condition would be negatively affected. In addition, changes in recent years in the collateralization requirements and other provisions of the Washington and Oregon public funds deposit programs have changed the economic benefit associated with accepting public funds deposits, which may affect our need to utilize alternative sources of liquidity.

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

We may have opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions, including transactions in the states of Washington, Oregon and Idaho. Although these FDIC-assisted transactions typically provide for FDIC assistance to an acquirer to mitigate certain risks, such as sharing exposure to loan losses and providing indemnification against certain liabilities of the failed institution, we are (and would be in future transactions) subject to many of the same risks we would face in acquiring another bank in a negotiated transaction,

including risks associated with maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the time frames we expect. In addition, because these acquisitions are structured in a manner that would not allow us the time and access to information normally associated with preparing for and evaluating a negotiated acquisition, we may face additional risks in FDIC-assisted transactions, including additional strain on management resources, management of problem loans, problems related to integration of personnel and operating systems and impact to our capital resources requiring us to raise additional capital. We cannot provide assurance that we would be successful in overcoming these risks or any other problems encountered in connection with FDIC-assisted transactions. Our inability to overcome these risks could have a material adverse effect on our business, financial condition and results of operations.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit our shareholders. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution's allowance for loan losses. The significant federal and state banking regulations that affect us are described in this report under the heading “Item 1. Business-Regulation.” These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and

products, among other things. For example, regulatory changes to the rules for overdraft fees for debit transactions and interchange fees have the potential to reduce our fee income which would result in a reduction of our non-interest income. Further, legislative proposals limiting our rights as a creditor could result in credit losses or increased expense in pursuing our remedies as a creditor. If proposals such as these, or other proposals limiting our rights as a creditor, were to be implemented, we could experience increased credit losses on our loans, or increased expense in pursuing our remedies as a creditor. Our failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, which could have a material adverse effect on our business, financial condition, liquidity and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

Our litigation-related costs might continue to increase.

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

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

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

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

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

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

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

We operate in a highly competitive industry and market areas.

The Banks face substantial competition in all phases of their operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. To date, the Banks have been competitive by focusing on their business lines in their market areas and emphasizing the high level of service and responsiveness desired by their customers. We compete for loans, deposits and other financial services with other commercial banks, thrifts, credit unions, brokerage houses, mutual funds, insurance companies and specialized finance companies. Many of our competitors offer products and services which we do not offer, and many have substantially greater resources and lending limits, name recognition and market presence that benefit them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than the Banks do, and newer competitors may also be more aggressive in terms of pricing loan and deposit products than we are in order to obtain a share of the market. Some of the financial institutions and financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies, federally insured state-chartered banks and national banks and federal savings banks. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services.

Our ability to compete successfully depends on a number of factors including the following:

- the ability to develop, maintain and build upon long-term customer relationships based on top-quality service, high ethical standards and safe, sound assets;

- the ability to expand our market position;
- the scope, relevance and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition, liquidity and results of operations.

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

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

Item 1B – Unresolved Staff Comments

None.

Item 2 – Properties

Banner Corporation maintains its administrative offices and main branch office, which is owned by us, in Walla Walla, Washington. In total, as of December 31, 2012, we have 88 branch offices located in Washington, Oregon and Idaho. Three of those 88 are Islanders Bank branches and 85 are Banner Bank branches. Sixty-four branches are located in Washington, fifteen in Oregon and nine in Idaho. Of those offices, approximately half are owned and the other half are leased facilities. We also have seven leased locations for loan production offices spread throughout the same three-state area. The lease terms for our branch and loan production offices are not individually material. Lease expirations range from one to 25 years. Administrative support offices are primarily in Washington, where we have eight facilities, of which we own four and lease four. Additionally, we have one leased administrative support office in Idaho and own one located in Oregon. In the opinion of management, all properties are adequately covered by insurance, are in a good state of repair and are appropriately designed for their present and future use.

Item 3 – Legal Proceedings

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

Item 4 – Mine Safety Disclosures

Not applicable.

PART II

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

Price Range of Common Stock and Dividend Information

Our common stock is traded on the NASDAQ Global Select Market under the symbol "BANR." Shareholders of record as of December 31, 2012 totaled 1,604 based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or "street" name through various brokerage firms. The following tables show the reported high and low sale prices of our common stock for the periods presented, adjusted for the one-for-seven reverse stock split of June 2011, as well as the cash dividends declared per share of common stock for each of those periods.

Year Ended December 31, 2012	High	Low	Cash Dividend Declared
First quarter	$22.97	$17.13	$0.01
Second quarter	22.80	18.05	0.01
Third quarter	27.41	20.04	0.01
Fourth quarter	31.32	26.49	0.01

Year Ended December 31, 2011	High	Low	Cash Dividend Declared
First quarter	$18.48	$14.00	$0.07
Second quarter	20.23	15.56	0.01
Third quarter	19.25	12.37	0.01
Fourth quarter	18.45	11.67	0.01

The timing and amount of cash dividends paid on our common stock depends on our earnings, capital requirements, financial condition and other relevant factors and is subject to the discretion of our board of directors. After consideration of these factors, beginning in the third quarter of 2008, we reduced our dividend payout to preserve our capital and further reduced our dividend in the first quarter of 2009. Our aggregate dividend payments were also reduced by our one-for-seven reverse stock split effective June 1, 2011. There can be no assurance that we will pay dividends on our common stock in the future.

Our ability to pay dividends on our common stock depends primarily on dividends we receive from Banner Bank and Islanders Bank. Under federal regulations, the dollar amount of dividends the Banks may pay depends upon their capital position and recent net income. Generally, if a bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. In addition, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the conversion. Banner Bank, our primary subsidiary, converted to a stock form of ownership and is therefore subject to the limitation described in the preceding sentence. The Washington DFI has the power to require any bank to suspend the payment of any and all dividends. In addition, under Washington law, no bank may declare or pay any dividend in an amount greater than its retained earnings without the prior approval of the Washington DFI.

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

of payment to the capital stock on which the applicable distribution is to be made, exceed our total assets.

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

Payments of the distributions on our trust preferred securities from the special purpose subsidiary trusts we sponsored are fully and unconditionally guaranteed by us. The junior subordinated debentures that we have issued to our subsidiary trusts are ranked senior to our shares of common stock. We must make required payments on the junior subordinated debentures before any dividends can be paid on our TPS and our common stock and, in the event of our bankruptcy, dissolution or liquidation, the interest and principal obligations under the junior subordinated debentures must be satisfied before any distributions can be made on our common stock. We may defer the payment of interest on each of the junior subordinated debentures for a period not to exceed 20 consecutive quarters, provided that the deferral period does not extend beyond the stated maturity. During such deferral period, distributions on the corresponding trust preferred securities will also be deferred and we may not pay cash dividends to the holders of shares of our common stock. At December 31, 2012, we are current on all interest payments.

Issuer Purchases of Equity Securities

We did not repurchase any of our common stock during 2012.

Equity Compensation Plan Information

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

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

	Period Ended					
Index	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
Banner Corporation	100.00	34.08	9.80	8.61	9.19	16.49
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
SNL Bank $1B-$5B	100.00	82.94	59.45	67.39	61.46	75.78
SNL Bank NASDAQ	100.00	72.62	58.91	69.51	61.67	73.51

*Assumes $100 invested in Banner Corporation common stock and each index at the close of business on December 31, 2007 and that all dividends were reinvested. Information for the graph was provided by SNL Financial L.C. © 2013.

Item 6 – Selected Financial Data

The following condensed consolidated statements of financial condition and operations and selected performance ratios as of December 31, 2012, 2011, 2010, 2009, and 2008 and for the years then ended have been derived from our audited consolidated financial statements. Certain information for prior years has been restated in accordance with the U.S. Securities and Exchange Commission Staff Accounting Bulletin No. 108 which addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements.

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

FINANCIAL CONDITION DATA:

	December 31				
(In thousands)	2012	2011	2010	2009	2008
Total assets	$4,265,564	$4,257,312	$4,406,082	$4,722,221	$4,584,368
Loans receivable, net	3,158,223	3,213,426	3,305,716	3,694,852	3,886,211
Cash and securities [(1)]	811,902	754,396	729,345	640,657	419,718
Deposits	3,557,804	3,475,654	3,591,198	3,865,550	3,778,850
Borrowings	160,000	212,649	267,761	414,315	318,421
Common stockholders' equity	506,919	411,748	392,472	287,721	317,433
Total stockholders' equity	506,919	532,450	511,472	405,128	433,348
Shares outstanding	19,455	17,553	16,165	3,077	2,450
Shares outstanding excluding unearned, restricted shares held in ESOP	19,421	17,519	16,130	3,042	2,416

OPERATING DATA:

	For the Year Ended December 31				
(In thousands)	2012	2011	2010	2009	2008
Interest income	$187,162	$197,563	$218,082	$237,370	$273,158
Interest expense	19,514	32,992	60,312	92,797	125,345
Net interest income before provision for loan losses	167,648	164,571	157,770	144,573	147,813
Provision for loan losses	13,000	35,000	70,000	109,000	62,500
Net interest income	154,648	129,571	87,770	35,573	85,313
Deposit fees and other service charges	25,266	22,962	22,009	21,394	21,540
Mortgage banking operations revenue	12,940	5,068	6,370	8,893	6,045
Other-than-temporary impairment recoveries (losses)	(409)	3,000	(4,231)	(1,511)	—
Net change in valuation of financial instruments carried at fair value	(16,515)	(624)	1,747	12,529	9,156
All other operating income	5,620	3,584	3,253	2,385	2,888
Total other operating income	26,902	33,990	29,148	43,690	39,629
Goodwill write-off	—	—	—	—	121,121
REO operations	3,354	22,262	26,025	7,147	2,283
All other operating expenses	138,099	135,842	134,776	134,933	136,616
Total other operating expense	141,453	158,104	160,801	142,080	260,020
	40,097	5,457	(43,883)	(62,817)	(135,078)

Income (loss) before provision for income tax expense (benefit)					
Provision for income tax expense (benefit)	(24,785)	—	18,013	(27,053)	(7,085)
Net income (loss)	$64,882	$5,457	$(61,896)	$(35,764)	$(127,993)

(footnotes follow)

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PER COMMON SHARE DATA:

	At or For the Years Ended December 31				
	2012	2011	2010	2009	2008
Net income (loss):					
Basic	$3.17	$(0.15)	$(7.21)	$(16.31)	$(55.58)
Diluted	3.16	(0.15)	(7.21)	(16.31)	(55.58)
Common stockholders' equity per share [(2)(9)]	26.10	23.50	24.33	94.58	131.39
Common stockholders' tangible equity per share [(2)(9)]	25.88	23.14	23.80	90.94	125.71
Cash dividends	0.04	0.10	0.28	0.28	3.50
Dividend payout ratio (basic)	1.26%	(66.67)%	(3.88)%	(1.72)%	(6.30)%
Dividend payout ratio (diluted)	1.27%	(66.67)%	(3.88)%	(1.72)%	(6.30)%

OTHER DATA:

	As of December 31				
	2012	2011	2010	2009	2008
Full time equivalent employees	1,074	1,078	1,060	1,060	1,095
Number of branches	88	89	89	89	86

KEY FINANCIAL RATIOS:

	At or For the Years Ended December 31				
	2012	2011	2010	2009	2008
Performance Ratios:					
Return on average assets [(3)]	1.54%	0.13%	(1.36)%	(0.78)%	(2.78)%
Return on average common equity [(4)]	14.03	1.37	(17.19)	(11.69)	(30.90)
Average common equity to average assets	10.96	9.31	7.90	6.71	8.99
Interest rate spread [(5)]	4.13	3.99	3.61	3.23	3.36
Net interest margin [(6)]	4.17	4.05	3.67	3.33	3.45
Non-interest income to average assets	0.64	0.79	0.64	0.96	0.86
Non-interest expense to average assets	3.35	3.69	3.53	3.12	5.65
Efficiency ratio [(7)]	72.71	79.62	86.03	75.47	138.72
Average interest-earning assets to interest-bearing liabilities	109.1	106.90	104.32	104.55	103.21
Selected Financial Ratios:					
Allowance for loan losses as a percent of total loans at end of period	2.39	2.52	2.86	2.51	1.90
Net charge-offs as a percent of average outstanding loans during the period	0.57	1.50	1.88	2.28	0.84
Non-performing assets as a percent of total assets	1.18	2.79	5.77	6.27	4.56
Allowance for loan losses as a percent of non-performing loans [(8)]	225.33	110.09	64.30	44.55	40.14
Common stockholders' tangible equity to tangible assets [(9)]	11.80	9.54	8.73	5.87	6.64
Consolidated Capital Ratios:					
Total capital to risk-weighted assets	16.96	18.07	16.92	12.73	13.11
Tier 1 capital to risk-weighted assets	15.70	16.80	15.65	11.47	11.86
Tier 1 leverage capital to average assets	12.74	13.44	12.24	9.62	10.32

(1) Includes securities available-for-sale and held-to-maturity.
(2) Calculated using shares outstanding excluding unearned restricted shares held in ESOP and adjusted for 1-for-7 reverse stock split.
(3) Net income divided by average assets.
(4) Net income divided by average common equity.

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

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

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

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

(9) Common stockholders’ tangible equity per share and the ratio of tangible common stockholders’ equity to tangible assets are non-GAAP financial measures. We calculate tangible common equity by excluding the balance of goodwill, other intangible assets and preferred equity from stockholders’ equity. We calculate tangible assets by excluding the balance of goodwill and other intangible assets from total assets. We believe that this is consistent with the treatment by our bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. In addition, excluding preferred equity, the level of which may vary from company to company, allows investors to more easily compare our capital adequacy to other companies in the industry that also use this measure. Management believes that these non-GAAP financial measures provide information to investors that is useful in understanding the basis of our capital position. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Because not all companies use the same calculation of tangible common equity and tangible assets, this presentation may not be comparable to other similarly titled measures as calculated by other companies. For a reconciliation of these non-GAAP measures, see Item 7, "Management's Discussion and Analysis of Financial Condition-Executive Overview."

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

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

Executive Overview

We are a bank holding company incorporated in the State of Washington and own two subsidiary banks, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2012, its 85 branch offices and seven loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank and conducts its business from three locations in San Juan County, Washington. As of December 31, 2012, we had total consolidated assets of $4.3 billion, net loans of $3.2 billion, total deposits of $3.6 billion and total stockholders' equity of $507 million.

Banner Bank is a regional bank which offers a wide variety of commercial banking services and financial products to individuals, businesses and public sector entities in its primary market areas. Islanders Bank is a community bank which offers similar banking services to individuals, businesses and public entities located in the San Juan Islands. The Banks' primary business is that of traditional banking institutions, accepting deposits and originating loans in locations surrounding their offices in portions of Washington, Oregon and Idaho. Banner Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans.

Banner Corporation experienced marked improvement in asset quality and operating results 2011, which continued and accelerated throughout 2012. Highlights for the year included further improvement in our asset quality metrics, additional customer account growth, significantly increased non-interest-bearing deposit balances, exceptional mortgage banking activity and record revenues from core operations. As a result, substantially reduced credit costs, significant improvement in our net interest margin and strong non-interest revenues all contributed to meaningfully increased profitability in 2012. For the year ended December 31, 2012, we had net income of $64.9 million which, after providing for the preferred stock dividend, related discount accretion and gains on repurchases of preferred stock, resulted in a net income available to common shareholders of $59.1 million, or $3.16 per diluted share. This compares to a net income of $5.5 million, but a net loss to common shareholders of $2.4 million, or ($0.15) per diluted share, for the year ended December 31, 2011. Also notable during 2012 was the repurchase and retirement of all of our Series A Preferred Stock. As a result of these repurchase transactions, we realized gains of $2.5 million.

Although there continue to be indications that economic conditions are improving from the recent recessionary downturn, the pace of recovery has been modest and uneven and ongoing stress in the economy will likely continue to be challenging going forward. As a result, our future operating results and financial performance will be significantly affected by the course of recovery. However, over the past four years we have significantly improved our risk profile by aggressively managing and reducing our problem assets which contributed substantially to our return to profitability in 2012 and 2011 and which we believe provide the foundation for sustainable improvement to our operating results in future periods.

Our provision for loan losses was $13.0 million for the year ended December 31, 2012, compared to $35.0 million in 2011 and $70 million in 2010. The decrease from a year earlier reflects significant progress in reducing the levels of delinquencies, non-performing loans and net charge-offs, particularly for loans for the construction of one- to four-family homes and for acquisition and development of land for residential properties. From 2008 through 2011,

higher than historical provision for loan losses was the most significant factor adversely affecting our operating results. Looking forward, we anticipate that our continuing efforts to decrease non-performing loans should result in a return to more normal levels of loan loss provisioning in future periods. (See Note 6 of the Notes to the Consolidated Financial Statements, as well as "Asset Quality" below.)

Aside from the level of loan loss provision, our operating results depend primarily on our net interest income. As more fully explained below, our net interest income before provision for loan losses increased $3.1 million , or 2%, for the year ended December 31, 2012 to $167.6 million, which followed an increase of $6.8 million for the prior year, primarily as a result of an expansion of our net interest spread and net interest margin due to a lower cost of funds and a reduction in the adverse impact of non-performing assets. The trend to lower funding costs and the resulting increase in the net interest margin was driven by rapidly declining interest expense on deposits and represents an important improvement in our core operating fundamentals. The increase in net interest income occurred despite a modest decline in average earning assets in 2012, as we continued to make changes in our mix of assets and liabilities designed to reduce our risk profile and produce more sustainable earnings.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 22 of the Notes to the Consolidated Financial Statements.) For the year ended December 31, 2012, we recorded a net charge of $16.5 million in fair value adjustments compared to a net charge of $624,000 for the year ended December 31, 2011. Also, for the year ended December 31, 2012, our net income included a $409,000 net OTTI charge. By comparison, for the year ended December 31, 2011, we had a net OTTI recovery of $3.0 million as a result of the full cash repayment on a security that had been written off as an OTTI charge in 2010.

Our other operating income for the year ended December 31, 2012 was $26.9 million, compared to $34.0 million for the year ended December 31, 2011. However, other operating income, excluding fair value and OTTI adjustments, was $43.8 million for the year ended December 31, 2012, an increase of $12.2 million compared to a year earlier. Our total revenues (net interest income before the provision for loan losses plus other

operating income) for 2012 were $194.6 million compared to $198.6 million for 2011. Our revenues excluding fair value and OTTI adjustments, which we believe is more indicative of our core operations, increased $15.2 million, or 8%, to $211.4 million for the year ended December 31, 2012, compared to $196.2 million for the year ended December 31, 2011. This growth in core revenues was the result of the meaningful increases in our net interest income, and deposit fees and service charges, as well as a substantial increase in revenues from mortgage banking activities.

Our other operating expenses decreased to $141.5 million for the year ended December 31, 2012, compared to $158.1 million for the year ended December 31, 2011, largely as a result of decreased costs related to REO operations, FDIC deposit insurance and professional services, which were partially offset by increased compensation expenses. While much lower in 2012 than in 2011, both years' expenses reflect significant costs associated with problem loan collection activities, including professional services and valuation charges related to REO, which we believe will decline further in future periods provided reductions in non-performing assets continue.

In addition, reflecting our return to profitability and expectation of sustainable profitability in future periods, during 2012, we reversed all of the valuation allowance against our net deferred tax assets and significantly adjusted the fair value estimate for our junior subordinated debentures. The substantial changes to both of these significant accounting estimates were directly linked to our improved performance and profitability. For the year ended December 31, 2012, the elimination of the deferred tax asset valuation allowance, combined with the Company's pre-tax income, resulted in a net tax benefit of $24.8 million, which substantially added to our net income for the year.

As noted above, for the years ended December 31, 2012 and 2011, our net income included significant adjustments related to the valuation of selected financial assets and liabilities we record at fair value, as well as OTTI losses in 2012 and an OTTI recovery in 2011. However, for comparison purposes we often present information excluding these fair value and OTTI adjustments. Revenues and other earnings information excluding the change in valuation of financial instruments carried at fair value and OTTI recoveries or losses represent non-GAAP financial measures. Management has presented these non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP measures, see the tables below, as well as the discussion related to tangible common stockholders' equity per share and the ratio of common stockholders' tangible equity to tangible assets in footnote number 9 to the Key Financial Ratios tables. These non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Because not all companies use the same calculations, our presentation may not be comparable to other similarly titled measures as calculated by other companies. See "Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011" for more detailed information about our financial performance.

The following tables set forth reconciliations of non-GAAP financial measures discussed in this report (dollars in thousands):

	For the Years Ended December 31		
	2012	2011	2010
Total other operating income	$26,902	$33,990	$29,148
Exclude other-than-temporary impairment losses (recoveries)	409	(3,000)	4,231
Exclude change in valuation of financial instruments carried at fair value	16,515	624	(1,747)
Total other operating income, excluding fair value adjustments and OTTI	$43,826	$31,614	$31,632
Net interest income before provision for loan losses	$167,648	$164,571	$157,770
Total other operating income	26,902	33,990	29,148
Total revenue	194,550	198,561	186,918

Exclude other-than-temporary impairment losses (recoveries)	409	(3,000)	4,231
Exclude change in valuation of financial instruments carried at fair value	16,515	624	(1,747)
Total revenue, excluding fair value adjustments and OTTI	$211,474	$196,185	$189,402
Net income (loss)	$64,882	$5,457	$(61,896)
Exclude other-than-temporary impairment losses (recoveries)	409	(3,000)	4,231
Exclude change in valuation of financial instruments carried at fair value	16,515	624	(1,747)
Exclude related tax expense	(5,923)	855	(869)
Total earnings (loss), excluding fair value adjustments and OTTI, net of related tax effects	$75,883	$3,936	$(60,281)

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	December 31		
	2012	2011	2010
Stockholders’ equity	$506,919	$532,450	$511,472
Other intangible assets, net	4,230	6,331	8,609
Tangible equity	502,689	526,119	502,863
Preferred equity	—	120,702	119,000
Tangible common stockholders’ equity	$502,689	$405,417	$383,863
Total assets	$4,265,564	$4,257,312	$4,406,082
Other intangible assets, net	4,230	6,331	8,609
Tangible assets	$4,261,334	$4,250,981	$4,397,473
Tangible common stockholders’ equity to tangible assets	11.80 %	9.54 %	8.73 %
Common stockholders' equity per share-GAAP	$26.10	$23.50	$24.33
Adjustment for other intangibles, net, per share	0.22	0.36	0.47
Common stockholders' tangible equity per share	$25.88	$23.14	$23.80

We offer a wide range of loan products to meet the demands of our customers. Our lending activities are primarily directed toward the origination of real estate and commercial loans. Until recent periods, real estate lending activities were significantly focused on residential construction and first mortgages on owner-occupied, one- to four-family residential properties; however, over the previous four years our origination of construction and land development loans declined materially and the proportion of the portfolio invested in these types of loans has declined substantially. More recently, we have experienced increased demand for one- to four-family construction loans and outstanding balances have increased modestly. Our residential mortgage loan originations also decreased during the earlier years of this cycle, although less significantly than the decline in construction and land development lending as exceptionally low interest rates supported demand for loans to refinance existing debt as well as loans to finance home purchases. Refinancing activity was particularly significant in 2012, leading to a meaningful increase in residential mortgage originations compared to the same period a year earlier. Despite the recent increase in these loan originations, our outstanding balances for residential mortgages have continued to decline, as most of the new originations have been sold in the secondary market while existing residential loans have been repaying at an accelerated pace. Our real estate lending activities also include the origination of multifamily and commercial real estate loans. While reduced from periods prior to the economic slowdown, our level of activity and investment in these types of loans has been relatively stable in recent periods. Our commercial business lending is directed toward meeting the credit and related deposit needs of various small to medium-sized business and agribusiness borrowers operating in our primary market areas. Reflecting the weak economy, in recent periods demand for these types of commercial business loans has been modest and, aside from seasonal variations, total outstanding balances have remained relatively unchanged. Our consumer loan activity is primarily directed at meeting demand from our existing deposit customers and, while we have increased our emphasis on consumer lending in recent years, demand for consumer loans also has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt. At December 31, 2012, our net loan portfolio totaled $3.158 billion compared to $3.213 billion at December 31, 2011.

Deposits, customer retail repurchase agreements and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits and we generally attract deposits within our primary market areas. Much of the focus of our earlier branch expansion and current marketing efforts have been directed toward attracting additional deposit customer relationships and balances . The long-term success of our deposit gathering activities is reflected not only in the growth of deposit balances, but also in increases in the level of deposit fees, service charges and other payment processing revenues compared to periods prior to that expansion. For the two years ended December 31, 2012, we have had a meaningful increase of transaction and savings accounts (checking, savings and money market accounts) and related fees and payment processing revenues, as we have remained focused on growing these core deposits. Total deposits at

December 31, 2012 increased $82 million to $3.558 billion, compared to $3.476 billion a year earlier. However, the mix of our deposits significantly changed as certificates of deposit decreased $221 million, while core deposits increased $303 million, with particularly strong growth in non-interest-bearing checking accounts, which increased $203 million for the year.

Critical Accounting Policies

In the opinion of management, the accompanying Consolidated Statements of Financial Condition and related Consolidated Statements of Operations, Comprehensive Income, Changes in Stockholders' Equity and Cash Flows reflect all adjustments (which include reclassification and normal recurring adjustments) that are necessary for a fair presentation in conformity with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements.

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including OTTI losses, (iv) the valuation of intangibles, such as core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale and (vi) the valuation of or recognition of deferred tax assets and liabilities. These policies and judgments, estimates and assumptions are described in greater detail below. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and our financial condition and operating results in future periods. There have been no significant changes in our application of accounting policies since December 31, 2011. For additional information concerning critical accounting policies, see Notes 1, 6, 13, 21 and 22 of the Notes to the Consolidated Financial Statements and the following:

Interest Income: (Notes 1 and 6) Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the amounts owed, principal or interest, may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.

Provision and Allowance for Loan Losses: (Notes 1 and 6) The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. We maintain an allowance for loan losses consistent in all material respects with the GAAP guidelines outlined in ASC 450, Contingencies. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and value impaired loans consistent with the accounting guidelines outlined in ASC 310, Receivables.

The allowance for losses on loans is maintained at a level sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon our continuing analysis of the factors underlying the quality of the loan portfolio. These factors include, among others, changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loans. Realized losses related to specific assets are applied as a reduction of the carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by us at the time financial statements are prepared. Although we use the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond our control. The adequacy of general and specific reserves is based on our continuing evaluation of the pertinent factors underlying the quality of the loan portfolio as well as individual review of certain large balance

loans. Loans are considered impaired when, based on current information and events, we determine that it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment.

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

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition

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

Fair Value Accounting and Measurement: (Notes 1 and 22) We use fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. We include in the Notes to the Consolidated Financial Statements information about the extent to which fair value is used to measure financial assets and liabilities, the valuation methodologies used and the impact on our results of operations and financial condition. Additionally, for financial instruments not recorded at fair value we disclose, where appropriate, our estimate of their fair value. For more information regarding fair value accounting, please refer to Note 22 in the Notes to the Consolidated Financial Statements.

Other Intangible Assets: (Notes 1 and 21) Other intangible assets consists primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

Mortgage Servicing Rights: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of the servicing right is estimated and capitalized. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized servicing rights are reported in other assets and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Real Estate Held for Sale: (Notes 1 and 7) Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Development and improvement costs relating to the property may be capitalized, while other holding costs are expensed. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts the Banks will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of market factors beyond the Banks' control or because of changes in the Banks' strategies for recovering the investment.

Income Taxes and Deferred Taxes: (Note 13) The Company and its wholly-owned subsidiaries file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP (ASC 740), a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of our deferred tax assets will not be realized.

Accounting Standards Recently Adopted or Issued

Accounting Standards Recently Adopted

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. This guidance is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance has been applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The amendments remove the transferor’s ability criterion from the consideration of effective control for repurchase and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. The adoption of this ASU has not had a material effect on the Company’s Consolidated Financial Statements.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurement - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the first interim or annual period beginning on or after December 15, 2011 and did not have a significant impact on the Company's Consolidated Financial Statements.

In June 2011, FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The amendments in this ASU is required to be applied retrospectively. The amendments are effective for fiscal years and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The FASB decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendments require that all non-owner changes in stockholders’ equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, the amendments require the consecutive presentation of the statement of net income and other comprehensive income and require the presentation of reclassification

adjustments on the face of the financial statements from other comprehensive income to net income. See also ASU No. 2011-12. The adoption of this ASU has not had a material effect on the Company's Consolidated Financial Statements.

In December 2011, FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. This update was made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. The amendments in this Update are effective at the same time as the amendments in Update 2011-05 so that entities were not required to comply with the presentation requirements in Update 2011-05 until this ASU becomes effective. The adoption of this ASU has not had a material effect on the Company's Consolidated Financial Statements.

Comparison of Financial Condition at December 31, 2012 and 2011

General. Total assets in aggregate were nearly unchanged at $4.266 billion at December 31, 2012, compared to $4.257 billion at December 31, 2011. However, net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) decreased $55 million, or 2%, to $3.158 billion at December 31, 2012, from $3.213 billion at December 31, 2011. The contraction in net loans primarily reflects decreases in residential and non-owner occupied commercial real estate loans, as continued refinancing activity resulted in significant levels of loan prepayments. One- to four-family residential real estate loans decreased $61 million during 2012, while non-owner occupied commercial real estate loans decreased $38 million. In addition, residential and commercial land and land development loans, in aggregate, decreased $22 million during 2012 and commercial construction loans decreased $12 million. These decreases were partially offset by increases in commercial loans, including owner-occupied commercial real estate, and commercial and agricultural business loans. During 2012, owner-occupied commercial real estate loans increased $20 million, while commercial business loans increased $17 million and agricultural business loans increased by $12 million. The net decrease in loans was partially offset by a reduction of $5 million in the allowance for loan losses, as net charge-offs modestly exceeded the provision for loan losses during the year ended December 31, 2012. The decrease in aggregate loan balances for the year in part also reflects our efforts to reduce our exposure to certain weaker credits as we continued to aggressively manage problem assets. While demand for consumer loans remained weak and utilization of existing credit lines for consumer and commercial borrowers was low, our production of new commercial real estate and commercial and agricultural business loans was again encouraging. Importantly, the change in total assets also reflects a $27 million decrease in REO which was more than offset by a $35 million increase in deferred tax assets primarily as the result of the elimination of the valuation allowance for those assets.

Securities increased to $631 million at December 31, 2012, from $622 million at December 31, 2011, and the aggregate total of securities and interest-bearing deposits increased $54 million, or 8%, to $746 million at December 31, 2012, compared to $692 million a year earlier. Securities acquired during the year generally have expected maturities ranging from six months to six years and were purchased to generate a modest increase in yield compared to interest-bearing cash balances. With the exception of certain trust preferred securities, aggregate fair value adjustments to the securities portfolio were modest during the first nine months of 2012. At December 31, 2012, the fair value of our trading securities was $19 million less than their amortized cost. The reduction reflected in the fair value of these securities compared to their amortized cost primarily was centered in single-issuer trust preferred securities and collateralized debt obligations secured by pools of trust preferred securities issued by bank holding companies and insurance companies, partially offset by modest gains in all other trading securities. (See Note 4 of the Notes to the Consolidated Financial Statements.) Our available-for-sale portfolio grew during the year, as purchases of primarily U.S. Government and agency mortgage-related and asset-backed securities exceeded net repayments, sales and maturities of other securities by $7 million. Periodically, we also acquire securities (primarily municipal

bonds) which are generally designated as held-to-maturity and this portfolio increased by $11 million from the prior year-end balances.

REO decreased $27 million, to $16 million at December 31, 2012 compared to $43 million at December 31, 2011, continuing the improving trend with respect to these non-earning assets. The December 31, 2012 total included $10 million in land or land development projects, $1 million in commercial real estate and $5 million in single-family homes and related residential construction. During the year ended December 31, 2012, we transferred $14 million of loans into REO, capitalized additional investments of $300,000 in acquired properties, disposed of approximately $41 million of properties and recognized $452,000 of charges against current earnings for valuation adjustments for REO properties net of gains related to properties sold. (See “Asset Quality” discussion below.)

Deposits increased $82 million, or 2%, to $3.558 billion at December 31, 2012, from $3.476 billion at December 31, 2011. Non-interest-bearing deposits increased by $203 million, or 26%, to $981 million from $778 million, and interest-bearing transaction and savings accounts increased by $99 million, or 7%, to $1.547 billion at December 31, 2012 from $1.448 billion at December 31, 2011. Offsetting these increases, certificates of deposit decreased $221 million, or 18%, to $1.029 billion at December 31, 2012 from $1.250 billion at December 31, 2011. The growth in non-interest-bearing deposits and other transaction and savings accounts was particularly notable and significantly contributed to our improved net interest margin and deposit fee revenues. A portion of the decrease in certificates of deposit was in brokered certificates which decreased $33 million from the prior year-end balance; however, much of the decrease reflects management’s pricing decisions designed to allow maturing higher priced retail certificates to migrate off the balance sheet or into core deposits.

FHLB advances decreased $229,000, to $10.3 million at December 31, 2012 from $10.5 million at December 31, 2011, while other borrowings decreased $75 million to $77 million at December 31, 2012. The modest decrease in FHLB advances reflects a limited amount of maturities and no additional borrowing as a part of our short-term cash management activities. Other borrowings at December 31, 2012 were comprised of $77 million of retail repurchase agreements that are primarily related to customer cash management accounts as compared to $102 million at December 31, 2011. Retail repurchase agreement balances decreased during the year as many customers elected to keep more of their funds in the related non-interest-bearing transaction accounts to receive earnings credit to offset the service fees associated with those accounts or utilized funds for alternative purposes including paying down credit lines. Included in other borrowings at December 31, 2011 was $50 million

of qualifying senior bank notes covered by the FDIC Temporary Liquidity Guarantee Program (TLGP) with a fixed interest rate of 2.625%. This debt, which was issued in March 2009 to strengthen our overall liquidity position as we adjusted to a lower level of public funds deposits, was repaid on March 31, 2012. No additional junior subordinated debentures were issued or matured during the year; however, the estimated fair value of these instruments increased to $73 million from $50 million a year ago as a result of a significant change in the discount rate used to estimate fair value of these financial instruments. For more information, see Notes 10, 11 and 12 of the Notes to the Consolidated Financial Statements.

Total stockholders' equity decreased $25 million to $507 million at December 31, 2012 compared to $532 million at December 31, 2011, primarily due to the redemption of the $124 million of Series A Preferred Stock, which was partially offset by capital raised through our Dividend Reinvestment and Stock Purchase and Sale Plan (DRIP) and retained earnings from operations. During the year ended December 31, 2012, we issued 1,901,493 additional shares of common stock for $37 million at an average net per share price of $19.33 through our DRIP. The increase in paid in capital from stock issuances, as well as additions to retained earnings as a result of net income from operations and changes in accumulated other comprehensive income, were reduced by the accrual and payment of preferred and common stock dividends and the redemption of the Series A Preferred Stock, resulting in the net $25 million decrease in total stockholders' equity. Tangible common stockholders' equity, which excludes the Series A Preferred Stock and intangible assets, increased $97 million to $503 million, or 11.80% of tangible assets at December 31, 2012. During the year ended December 31, 2012, we did not repurchase any shares of Banner Corporation common stock.

Investments: At December 31, 2012, our consolidated investment portfolio totaled $631 million and consisted principally of U.S. Government and agency obligations, mortgage-backed and mortgage-related securities, municipal bonds, corporate debt obligations, and asset-backed securities. From time to time, our investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in our loan origination, deposit and other activities. During the year ended December 31, 2012, our aggregate investment in securities increased $9 million. Holdings of mortgage-backed securities increased $176 million, municipal bonds increased $28 million, and corporate bonds increased $6 million while asset-backed securities, which were all purchased during the year, increased $43 million. Partially offsetting these increases was a net decrease in U.S. Government and agency obligations of $243 million.

U.S. Government and Agency Obligations: Our portfolio of U.S. Government and agency obligations had a carrying value of $99 million ($98 million at amortized cost, with a fair value adjustment of $1 million) at December 31, 2012, a weighted average contractual maturity of 4.1 years and a weighted average coupon rate of 1.22%. Most of the U.S. Government and agency obligations we own include call features which allow the issuing agency the right to call the securities at various dates prior to the final maturity. Certain agency obligations also include step-up provisions which provide for periodic increases in the coupon rate if the call options are not exercised.

Mortgage-Backed Obligations: At December 31, 2012, our mortgage-backed and mortgage-related securities had a carrying value of $306 million ($301 million at amortized cost, with a fair value adjustment of $5 million). The weighted average coupon rate of these securities was 3.23% and the weighted average contractual maturity was 11.7 years, although we receive principal payments on these securities each period resulting in a much shorter expected average life. As of December 31, 2012, 97% of the mortgage-backed and mortgage-related securities pay interest at a fixed rate and 3% pay at an adjustable-interest rate. We do not believe that any of our mortgage-backed obligations had a meaningful exposure to sub-prime mortgages.

Municipal Bonds: The carrying value of our tax-exempt bonds at December 31, 2012 was $104 million (also with an amortized cost of $104 million), and was comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by revenues from the specific project being financed) issued by cities and counties and various housing authorities, and hospital, school, water and sanitation districts located in the states of

Washington, Oregon and Idaho, our primary service area. We also had taxable bonds in our municipal bond portfolio, which at December 31, 2012 had a carrying value of $31 million (also $31 million at amortized cost). Many of our qualifying municipal bonds are not rated by a nationally recognized credit rating agency due to the smaller size of the total issuance and a portion of these bonds have been acquired through direct private placement by the issuers. We have not experienced any defaults or payment deferrals on our municipal bonds. At December 31, 2012, our municipal bond portfolio, including taxable and tax-exempt, had a weighted average maturity of approximately 8.8 years and a weighted average coupon rate of 3.86%.

Corporate Bonds: Our corporate bond portfolio, which had a carrying value of $49 million ($70 million at amortized cost) at December 31, 2012, was comprised principally of long-term adjustable-rate capital securities issued by financial institutions, including single issuers, trust preferred securities and collateralized debt obligations secured by pools of trust preferred securities issued by bank holding companies and insurance companies. The market for these capital securities deteriorated significantly in 2008 and 2009 and in our opinion is still not currently functioning in a meaningful manner. As a result, the fair value estimates for many of these securities are more subjective than in periods before 2008 when they were acquired. Nonetheless, it is apparent that the values have declined appreciably since purchase, which is reflected in our financial statements and results of operations. In addition to the disruption in the market for these securities, the decline in value also reflects deterioration in the financial condition of some of the issuing financial institutions and payment deferrals and defaults by certain institutions. (See “Critical Accounting Policies” above and Note 22 of the Notes to the Consolidated Financial Statements.) At December 31, 2012, the portfolio had a weighted average maturity of 19.4 years and a weighted average coupon rate of 2.40%.

Asset-Backed Securities: At December 31, 2012, our asset-backed securities portfolio had a carrying value of $43 million ($42 million at amortized cost), and was comprised primarily of securitized pools of student loans issued or guaranteed by the Student Loan Marketing Association (SLMA). The weighted average coupon rate of these adjustable-rate securities was 1.40%, the adjustments are tied to changes in three-month LIBOR and the weighted average contractual maturity was 9.5 years.

The following tables set forth certain information regarding carrying values and percentage of total carrying values of our portfolio of securities—trading and securities—available-for-sale, both carried at estimated fair market value, and securities—held-to-maturity, carried at amortized cost as of December 31, 2012, 2011 and 2010 (dollars in thousands):

Table 1: Securities—Trading

	As of December 31,					
	2012		2011		2010	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
U.S. Government and agency obligations	$1,637	2.3 %	$2,635	3.3 %	$4,379	4.6 %
Municipal bonds:						
Taxable	—	—	420	0.5	693	0.7
Tax exempt	5,684	8.0	5,542	6.9	5,705	6.0
Total municipal bonds	5,684	8.0	5,962	7.4	6,398	6.7
Corporate bonds	35,741	50.2	35,055	43.4	34,724	36.4
Mortgage-backed or related securities:						
1-4 residential agency guaranteed	28,107	39.4	36,673	45.4	49,688	52.1
Total mortgage-backed or related securities	28,107	39.4	36,673	45.4	49,688	52.1
Equity securities	63	0.1	402	0.5	190	0.2
Total securities—trading	$71,232	100.0 %	$80,727	100.0 %	$95,379	100.0 %

Table 2: Securities—Available-for-Sale

	As of December 31,					
	2012		2011		2010	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
U.S. Government and agency obligations	$96,980	20.5 %	$338,971	72.8 %	$135,428	67.6 %
Municipal bonds:						
Taxable	21,153	4.5	10,581	2.3	775	0.4
Tax exempt	23,785	5.0	16,729	3.6	4,621	2.3
Total municipal bonds	44,938	9.5	27,310	5.9	5,396	2.7
Corporate bonds	10,729	2.3	6,260	1.3	22,522	11.2
Mortgage-backed or related securities:						
1-4 residential agency guaranteed	87,859	18.6	70,500	15.1	33,337	16.7
1-4 residential other	1,299	0.3	1,835	0.4	3,544	1.8
Multifamily agency guaranteed	177,940	37.6	20,919	4.5	—	—
Multifamily other	10,659	2.2	—	—	—	—
Total mortgage-backed or related securities	277,757	58.7	93,254	20.0	36,881	18.5
Asset-backed securities:	42,516	9.0	—	—	—	—
Total securities—available-for-sale	$472,920	100.0 %	$465,795	100.0 %	$200,227	100.0 %

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Table 3: Securities—Held-to-Maturity

	As of December 31,					
	2012		2011		2010	
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total
Municipal bonds:						
Taxable	$10,326	11.9 %	$7,496	9.9 %	$5,654	7.8 %
Tax exempt	74,076	85.7	66,692	88.4	65,183	90.4
Total municipal bonds	84,402	97.6	74,188	98.3	70,837	98.2
Corporate bonds	2,050	2.4	1,250	1.7	1,250	1.8
Total securities—held-to-maturity	$86,452	100.0 %	$75,438	100.0 %	$72,087	100.0 %
Estimated market value	$92,458		$80,107		$73,916	

The following table shows the maturity or period to repricing of our consolidated portfolio of securities—trading at fair value as of December 31, 2012 (dollars in thousands):

Table 4: Securities–Trading Maturity/Repricing and Rates

	Securities—Trading at December 31, 2012											
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield [1]
U.S. Government and agency obligations:												
Fixed-rate	$—	— %	$—	— %	$180	6.00%	$1,457	5.19%	$—	— %	$1,637	5.30%
	—	—	—	—	180	6.00	1,457	5.19	—	—	1,637	5.30
Municipal bonds:												
Fixed-rate tax exempt	—	—	1,767	3.91	3,569	5.60	—	—	348	2.63	5,684	4.91
	—	—	1,767	3.91	3,569	5.60	—	—	348	2.63	5,684	4.91
Corporate bonds:												
Adjustable-rate	30,909	2.28	4,832	2.41	—	—	—	—	—	—	35,741	2.29
	30,909	2.28	4,832	2.41	—	—	—	—	—	—	35,741	2.29
Mortgage-backed or related securities:												
Fixed-rate	—	—	3,100	5.33	11,786	4.48	4,854	5.36	3,091	4.73	22,831	4.82
Adjustable-rate	5,276	4.04	—	—	—	—	—	—	—	—	5,276	4.04
	5,276	4.04	3,100	5.33	11,786	4.48	4,854	5.36	3,091	4.73	28,107	4.67
Equity securities	63	—	—	—	—	—	—	—	—	—	63	—
Total securities—trading—carrying value	$36,248	2.43	$9,699	3.43	$15,535	4.78	$6,311	5.32	$3,439	4.51	$71,232	3.17
Total securities—trading—amortized cost	$56,771		$10,496		$14,251		$5,629		$3,192		$90,339	

[1] Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

The following table shows the maturity or period to repricing of our consolidated portfolio of securities—available-for-sale at fair value as of December 31, 2012 (dollars in thousands):

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

	Securities—Available-for-Sale at December 31, 2012										
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		To
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Ca Va
U.S. Government and agency obligations:											
Fixed-rate	$10,005	0.80%	$61,182	0.93%	$23,508	0.59%	$576	1.47%	$—	— %	$9
Adjustable-rate	1,709	0.63	—	—	—	—	—	—	—	—	1,7
	11,714	0.78	61,182	0.93	23,508	0.59	576	1.47	—	—	96
Municipal bonds:											
Fixed rate taxable	590	0.39	18,579	1.46	1,497	0.77	487	2.20	—	—	21
Fixed rate tax exempt	3,777	1.09	17,110	1.35	2,898	1.66	—	—	—	—	23
	4,367	0.99	35,689	1.41	4,395	1.36	487	2.20	—	—	44
Corporate bonds:											
Fixed-rate	2,021	1.11	8,708	0.98	—	—	—	—	—	—	10
	2,021	1.11	8,708	0.98	—	—	—	—	—	—	10
Mortgage-backed or related securities:											
Fixed-rate	—	—	101,568	1.06	78,389	1.19	21,861	2.12	72,559	2.55	27
Adjustable-rate	3,380	2.86	—	—	—	—	—	—	—	—	3,3
	3,380	2.86	101,568	1.06	78,389	1.19	21,861	2.12	72,559	2.55	27
Asset-backed securities:											
Fixed-rate	—	—	—	—	10,042	1.65	—	—	—	—	10
Adjustable-rate	32,474	1.04	—	—	—	—	—	—	—	—	32
	32,474	1.04	—	—	10,042	1.65	—	—	—	—	42
Total securities—available-for-sale—carrying value	$53,956	1.09	$207,147	1.08	$116,334	1.12	$22,924	2.10	$72,559	2.55	$4
Total securities—available-for sale amortized cost	$53,753		$205,913		$115,289		$23,084		$71,611		$4

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

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The following table shows the maturity or period to repricing of our consolidated portfolio of securities held-to-maturity as of December 31, 2012 (dollars in thousands):

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

	Securities—Held-to-Maturity at December 31, 2012											
	One Year or Less		Over One to Five Years		Over Five to Ten Years		Over Ten to Twenty Years		Over Twenty Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weight Averag Yield [1]
Municipal bonds:												
Fixed rate taxable	$100	6.25%	$4,098	4.07%	$3,330	4.30%	$2,768	4.59%	$30	5.78%	$10,326	4.31%
Fixed rate tax exempt	2,973	3.46	8,543	3.63	9,165	2.80	50,263	4.34	3,132	4.08	74,076	4.02
	3,073	3.55	12,641	3.78	12,495	3.20	53,031	4.36	3,162	4.10	84,402	4.06
Corporate bonds:												
Fixed-rate	250	2.00	1,000	3.00	800	4.00	—	—	—	—	2,050	3.27
	250	2.00	1,000	3.00	800	4.00	—	—	—	—	2,050	3.27
Total securities held-to-maturity—carrying value	$3,323	3.44	$13,641	3.72	$13,295	3.25	$53,031	4.36	$3,162	4.10	$86,452	4.04
Total securities held-to-maturity—estimated market value	$3,410		$14,335		$13,452		$57,868		$3,393		$92,458	

[1] Yields on tax-exempt municipal bonds are not calculated as tax equivalent.

Loans and Lending. Our loan portfolio decreased $61 million, or 2%, during the year ended December 31, 2012, compared to a decrease of $107 million, or 3%, during the year ended December 31, 2011. While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. Reflecting the recession in 2008 and 2009 and subsequent modest pace of recovery, loan demand, other than for lower rate refinancing of real estate loans, has been weak for most of the past five years as consumers and businesses have been cautious in their use of credit. However, we have implemented strategies designed to capture more market share and achieve increases in targeted loans and our loan originations increased meaningfully in 2011 and 2012. Nonetheless, looking forward, new loan originations and portfolio balances will continue to be significantly affected by the course of the recovery from the current sluggish economic environment. For the years ended December 31, 2012, 2011 and 2010, we originated loans, net of repayments and charge-offs, of $460 million, $270 million and $114 million, respectively. The level of net originations during all three years was significantly impacted by a substantial amount of loan repayments and charge-offs. We generally sell a significant portion of our newly originated one- to four-family residential mortgage loans to secondary market purchasers. Proceeds from sales of loans for the years ended December 31, 2012, 2011 and 2010 totaled $505 million, $282 million and $351 million, respectively. See "Loan Servicing Portfolio" below. Loans held for sale increased to $12.0 million at December 31, 2012, compared to $3 million at December 31, 2011.

At various times, we also purchase whole loans and participation interests in loans. During the years ended December 31, 2012, 2011and 2010, we purchased $15 million, $5 million and $341,000, respectively, of loans and loan participation interests.

One- to Four-Family Residential Real Estate Lending: At December 31, 2012, $582 million, or 18%, of our loan portfolio, consisted of permanent loans on one- to four-family residences. We are active originators of one- to four-family residential loans in communities where we have established offices in Washington, Oregon and Idaho. Our originations of one- to four-family residential loans were particularly strong in 2012; however, since most of these new loans were sold in the secondary market and principal repayments on existing loans were substantial, we had a $61 million decrease in the balance of loans on one- to four-family residences compared to the prior year. Our one- to four-family loan originations totaled $538 million for the year ended December 31, 2012, compared to $358 million and $468 million for the years ended December 31, 2011 and 2010, respectively.

Construction and Land Lending: Historically, we invested a significant proportion of our loan portfolio in residential construction loans, as well as land loans and loans for the construction of commercial and multifamily real estate. However, as housing markets weakened in 2008, we significantly reduced our origination of new construction and land development loans. The slower pace of originations coupled with repayments as a result of home sales and restructuring opportunities as well as charge-off and foreclosure actions caused our portfolio of one- to four-family construction loans to decrease substantially through 2011. Reversing this trend during the year ended December 31, 2012, one- to four-family construction loans increased by $17 million to $161 million. Land development loans (both residential and commercial) decreased by $22 million to $91 million at December 31, 2012. Although significantly below our production levels prior to the beginning of the housing downturn, our construction loan originations have increased for each of the past three years as builders have adjusted to new price levels and certain sub-markets have become more active. Our construction and land development loan originations totaled $492 million for the year ended December 31, 2012, compared to $376 million for the year ended December 31, 2011, and $295 million in 2010. At December 31, 2012, construction and land loans totaled $305 million (including $161 million of one- to four-family construction loans, $77 million of residential land or land development loans, $53 million of commercial and multifamily real estate construction loans and $14 million of commercial land or land development loans), or 9% of total loans, compared to $319 million, or 10%, at December 31, 2011. The geographic distribution of our construction and land development loans is approximately 36% in the greater Puget Sound market and 42% in the greater Portland, Oregon market, with the remaining 22% in the various eastern Washington, eastern Oregon and western Idaho markets we serve. While delinquencies and defaults in residential construction and land development loans had a

material adverse effect on our results of operations for much of the recent economic cycle, at December 31, 2012, only $4 million were classified as non-performing loans. For the year ended December 31, 2012, performing construction loans made an important contribution to our net interest income and profitability.

Commercial and Multifamily Real Estate Lending: We also originate loans secured by multifamily and commercial real estate. Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no significant concentrations by property type, borrowers or locations. We experienced reasonable demand for both multifamily and commercial real estate loans in 2012, though total balances in these categories decreased $20 million or 2% from the prior year end. At December 31, 2012, our loan portfolio included $1.073 billion of commercial real estate loans, or 33% of the total loan portfolio. Our portfolio of multifamily loans was much smaller, at $138 million, or 4% of total loans.

Commercial Business Lending: We are active in small- to medium-sized business lending. In addition to providing earning assets, this type of lending has helped increase our deposit base. Reflecting the relatively weak economic environment, demand for new loans remained modest and line utilizations continued to be low in 2012; however, our production levels for targeted loans were encouraging and resulted in a $17 million, or 3%, increase in commercial business loan balances for the year. This growth occurred despite our successful efforts to reduce our exposure to certain weak or non-performing borrowers. At December 31, 2012, commercial business loans totaled $618 million, or 19% of total loans, compared to $601 million, or 18%, at December 31, 2011.

Agricultural Lending: Agriculture is a major industry in many Washington, Oregon and Idaho locations in our service area. While agricultural loans are not a large part of our portfolio, we routinely make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operation of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile at times. Generally, in recent years, weather conditions, production levels and market prices have been good for most of our agricultural borrowers. Our 2012 production levels for agricultural loans

were consistent with recent years and at December 31, 2012, agricultural loans totaled $230 million, or 7% of the loan portfolio, compared to $218 million, or 7%, at December 31, 2011.

Consumer and Other Lending: We originate a variety of consumer loans, including home equity lines of credit, automobile, recreational vehicle and boat loans, credit cards and loans secured by deposit accounts. Consumer lending has traditionally been a modest part of our business with loans made primarily to accommodate our existing customer base. In recent years, including 2012, demand for consumer loans has been restrained and outstanding balances have decreased modestly. During the fourth quarter of 2012, we purchased approximately $13 million of consumer loans originated by another northwest financial institution that are secured by recreational boats. At December 31, 2012, we had $291 million, or 9% of our loan portfolio, in consumer loans, compared to $284 million, or 9%, at December 31, 2011. As of December 31, 2012, 59% of our consumer loans were secured by one- to four-family real estate, including home equity lines of credit. Credit card balances totaled $21 million at December 31, 2012 compared to $20 million a year earlier.

Loan Servicing Portfolio: At December 31, 2012, we were servicing $1.031 billion of loans for others and held $5.0 million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2012 was composed of $687 million of Freddie Mac residential mortgage loans, $212 million of Fannie Mae residential mortgage loans and $132 million of both residential and non-residential mortgage loans serviced for a variety of private investors. The portfolio included loans secured by property located primarily in the states of Washington, Oregon and Idaho. For the year ended December 31, 2012, we recognized $872,000 of loan servicing fees in our results of operations, which were net of $2.6 million of amortization for mortgage servicing rights (MSRs) and a $400,000 impairment charge for a valuation adjustment to MSRs.

Mortgage Servicing Rights: We record MSRs with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. For the years ended December 31, 2012, 2011 and 2010, we capitalized $3.7 million, $1.9 million, and $1.7 million, respectively, of MSRs relating to loans sold with servicing retained. No MSRs were purchased in those periods. Amortization of MSRs for the years ended December 31, 2012, 2011 and 2010 was $2.6 million, $1.8 million, and $2.0 million, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. These carrying values are adjusted when the valuation indicates the carrying value is impaired. At December 31, 2012, our MSRs were carried at a value of $6.2 million, net of amortization, compared to $5.6 million at December 31, 2011.

Table 7: Loan Portfolio Analysis

The following table sets forth the composition of the Company’s loan portfolio, including loans held for sale, by type of loan as of the dates indicated (dollars in thousands):

	December 31									
	2012		2011		2010		2009		2008	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percen of Tot
Commercial real estate										
Owner-occupied	$489,581	15.1 %	$469,806	14.2 %	$515,093	15.1 %	$509,464	13.4 %	$459,446	11.6
Investment properties	583,641	18.0	621,622	18.9	550,610	16.2	573,495	15.1	554,263	14.0
Multifamily real estate	137,504	4.3	139,710	4.2	134,634	4.0	153,497	4.1	151,274	3.8
Commercial construction	30,229	0.9	42,391	1.3	62,707	1.8	80,236	2.1	104,495	2.6
Multifamily construction	22,581	0.7	19,436	0.6	27,394	0.8	57,422	1.5	33,661	0.8
One- to four-family construction	160,815	5.0	144,177	4.4	153,383	4.5	239,135	6.3	420,673	10.6
Land and land development										
Residential	77,010	2.4	97,491	3.0	167,764	4.9	284,331	7.5	401,129	10.1
Commercial	13,982	0.4	15,197	0.5	32,386	1.0	43,743	1.2	62,128	1.6
Commercial business	618,049	19.1	601,440	18.2	585,457	17.2	637,823	16.8	679,867	17.2
Agricultural business, including secured by farmland	230,031	7.1	218,171	6.6	204,968	6.0	205,307	5.4	204,142	5.2
One- to four-family real estate	581,670	18.0	642,501	19.5	682,924	20.1	703,277	18.6	599,169	15.1
Consumer secured by one- to four-family real estate	170,123	5.3	181,049	5.5	186,036	5.5	191,454	5.1	175,646	4.5
Consumer—other	120,498	3.7	103,347	3.1	99,761	2.9	110,937	2.9	115,515	2.9
Total loans outstanding	3,235,714	100.0%	3,296,338	100.0%	3,403,117	100.0%	3,790,121	100.0%	3,961,408	100.0
Less allowance for loan losses	(77,491)		(82,912)		(97,401)		(95,269)		(75,197)	
Net loans	$3,158,223		$3,213,426		$3,305,716		$3,694,852		$3,886,211	

Table 8: Loans by Geographic Concentration

The following table sets forth the Company's loans by geographic concentration at December 31, 2012 (dollars in thousands):

	Washington	Oregon	Idaho	Other	Total
Commercial real estate					
Owner-occupied	$366,422	$57,903	$61,379	$3,877	$489,581
Investment properties	450,142	85,416	42,774	5,309	583,641
Multifamily real estate	117,654	11,309	8,249	292	137,504
Commercial construction	20,839	6,107	934	2,349	30,229
Multifamily construction	12,383	10,198	—	—	22,581
One- to four-family construction	88,090	71,663	1,062	—	160,815
Land and land development					
Residential	41,680	33,478	1,852	—	77,010
Commercial	8,979	3,092	1,911	—	13,982
Commercial business	396,935	72,594	58,416	90,104	618,049
Agricultural business, including secured by farmland	108,671	51,286	70,074	—	230,031
One-to four-family real estate	360,625	195,364	23,596	2,085	581,670
Consumer secured by one- to four-family real estate	114,405	42,395	12,644	679	170,123
Consumer—other	80,209	34,668	5,621	—	120,498
Total loans outstanding	$2,167,034	$675,473	$288,512	$104,695	$3,235,714
Percent of total loans	67.0 %	20.9 %	8.9 %	3.2 %	100.0 %

The following table sets forth certain information at December 31, 2012 regarding the dollar amount of loans maturing in our portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances are net of unamortized premiums and discounts, include loans held for sale and exclude the allowance for loan losses (in thousands):

Table 9: Loans by Maturity

	Maturing Within One Year	Maturing After One to Three Years	Maturing After Three to Five Years	Maturing After Five to Ten Years	Maturing After Ten Years	Total
Commercial real estate						
Owner-occupied	$28,135	$34,120	$56,595	$263,008	$107,723	$489,581
Investment properties	70,302	75,891	94,839	288,431	54,178	583,641
Multifamily real estate	13,042	16,911	8,400	56,985	42,166	137,504
Commercial construction	14,121	7,347	—	6,477	2,284	30,229
Multifamily construction	10,671	10,198	718	994	—	22,581
One- to four-family construction	92,270	52,508	929	170	14,938	160,815
Land and land development						
Residential	28,617	47,529	560	53	251	77,010
Commercial	7,291	1,191	3,777	1,155	568	13,982
Commercial business	241,193	126,924	113,069	103,793	33,070	618,049
Agricultural business, including secured by farmland	90,844	51,263	25,341	52,114	10,469	230,031

One- to four-family real estate	22,258	20,589	13,384	26,288	499,151	581,670
Consumer secured by one- to four-family real estate	1,323	3,785	1,361	11,349	152,305	170,123
Consumer—other	14,662	10,649	15,202	21,309	58,676	120,498
Total loans	$634,729	$458,905	$334,175	$832,126	$975,779	$3,235,714

Contractual maturities of loans do not necessarily reflect the actual life of such assets. The average life of loans typically is substantially less than their contractual maturities because of principal repayments and prepayments. In addition, due-on-sale clauses on certain mortgage loans generally give us the right to declare loans immediately due and payable in the event that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase; however, when current mortgage loan market rates

are substantially higher than rates on existing mortgage loans and, conversely, decreases when rates on existing mortgage loans are substantially higher than current mortgage loan market rates.

The following table sets forth the dollar amount of all loans maturing after December 31, 2012 which have fixed interest rates and floating or adjustable interest rates (in thousands):

Table 10: Loans Maturing after One Year

	Fixed Rates	Floating or Adjustable Rates	Total
Commercial real estate			
Owner-occupied	$57,424	$404,023	$461,447
Investment properties	121,659	391,679	513,338
Multifamily real estate	44,649	79,813	124,462
Commercial construction	7,945	8,163	16,108
Multifamily construction	994	10,916	11,910
One- to four-family construction	17,690	50,856	68,546
Land and land development			
Residential	13,317	35,077	48,394
Commercial	478	6,212	6,690
Commercial business	168,208	208,649	376,857
Agricultural business, including secured by farmland	37,698	101,489	139,187
One- to four-family real estate	431,615	127,796	559,411
Consumer secured by one- to four-family real estate	12,005	156,794	168,799
Consumer—other	91,718	14,118	105,836
Total loans maturing after one year	$1,005,400	$1,595,585	$2,600,985

Deposits: We made further progress in 2012 implementing our strategies to strengthen our franchise by remixing our deposits away from high cost certificates of deposit and emphasizing core deposit activity in non-interest-bearing and other transaction and savings accounts. Increasing core deposits (transaction and savings accounts) is a fundamental element of our business strategy. This strategy continues to improve our cost of funds and increase the opportunity for deposit fee revenues, while stabilizing our funding base. Total deposits increased $82 million, to $3.558 billion at December 31, 2012 from $3.476 billion at December 31, 2011, non-interest-bearing deposits increased by $203 million, or 26%, to $981 million at year end from $778 million at December 31, 2011, and interest-bearing transaction and savings accounts increased by $100 million, or 7%, to $1.547 billion at December 31, 2012 compared to $1.448 billion a year earlier. This core deposit growth augmented similarly strong results in 2011 and coupled with significantly better pricing was primarily responsible for the much improved net interest margin we experienced in 2012. Offsetting these increases, certificates of deposit decreased $221 million, or 18%, to $1.029 billion at December 31, 2012 from $1.250 billion at December 31, 2011. A portion of the decrease in certificates of deposit was in brokered certificates, which decreased $33 million from the prior year-end balances; however, much of the decrease reflects a reduction in retail certificates as a result of management's pricing decisions designed to allow maturing higher priced certificates to migrate off the balance sheet or into core deposit accounts.

The following table sets forth the balances of deposits in the various types of accounts offered by the Banks at the dates indicated (dollars in thousands):

Table 11: Deposits

	December 31							
	2012			2011			2010	
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total
Non-interest-bearing checking	$981,240	27.6 %	$203,677	$777,563	22.4 %	$177,106	$600,457	16.7 %
Interest-bearing checking	410,316	11.5	47,774	362,542	10.4	4,840	357,702	10.0
Regular savings	727,957	20.5	58,361	669,596	19.3	53,084	616,512	17.2
Money market	408,998	11.5	(6,458)	415,456	11.9	(43,578)	459,034	12.8
Total transaction and savings accounts	2,528,511	71.1	303,354	2,225,157	64.0	191,452	2,033,705	56.7
Certificates which mature:								
Within 1 year	759,626	21.3	(212,689)	972,315	28.0	(213,090)	1,185,405	33.0
After 1 year, but within 2 years	153,371	4.3	(15,982)	169,353	4.9	(94,335)	263,688	7.3
After 2 years, but within 5 years	112,772	3.2	7,169	105,603	3.0	499	105,104	2.9
After 5 years	3,524	0.1	298	3,226	0.1	(70)	3,296	0.1
Total certificate accounts	1,029,293	28.9	(221,204)	1,250,497	36.0	(306,996)	1,557,493	43.3
Total Deposits	$3,557,804	100.0 %	$82,150	$3,475,654	100.0 %	$(115,544)	$3,591,198	100.0 %
Included in Total Deposits:								
Public transaction accounts	$79,955	2.2 %	$7,891	$72,064	2.1 %	$7,582	$64,482	1.8 %
Public interest-bearing certificates	60,518	1.7	(6,594)	67,112	1.9	(14,697)	81,809	2.3
Total public deposits	$140,473	3.9 %	$1,297	$139,176	4.0 %	$(7,115)	$146,291	4.1 %
Total brokered deposits	$15,702	0.4 %	$(33,492)	$49,194	1.4 %	$(53,790)	$102,984	2.9 %

The following table indicates the amount of the Banks' certificates of deposit with balances equal to or greater than $100,000 by time remaining until maturity as of December 31, 2012 (in thousands):

Table 12: Maturity Period—$100,000 or greater CDs

	Certificates of Deposit $100,000 or Greater
Due in three months or less	$157,149
Due after three months through six months	86,898
Due after six months through twelve months	167,525
Due after twelve months	159,516
Total	$571,088

Table 13: Geographic Concentration of Deposits

The following table provides additional detail on geographic concentrations of our deposits at December 31, 2012 (in thousands):

	Washington	Oregon	Idaho	Total
Deposits by State	$2,718,396	$600,179	$239,229	$3,557,804

Borrowings: The FHLB-Seattle serves as our primary borrowing source. To access funds, we are required to own a sufficient level of capital stock in the FHLB-Seattle and may apply for advances on the security of such stock and certain of our mortgage loans and securities provided that certain creditworthiness standards have been met. At December 31, 2012, we had $10 million of borrowings from the FHLB-Seattle (at fair value) at a weighted average rate of 2.45%, a decrease of $229,000 compared to a year earlier. Also at December 31, 2012, we had an investment of $37 million in FHLB-Seattle capital stock. At that date, Banner Bank was authorized by the FHLB-Seattle to borrow up to $889 million under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to $26 million under a similar agreement.

Table 14: FHLB Advances Outstanding

The following table provides additional detail on our FHLB advances as of December 31, 2012 and 2011 (dollars in thousands):

	December 31 2012		2011	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate
Due in one year or less	$10,000	2.38 %	$—	— %
Due after one year through three years	—	—	10,000	2.38
Due after three years through five years	—	—	—	—
Due after five years	210	5.94	217	5.94
Total FHLB advances, at par	10,210	2.45	10,217	2.45
Fair value adjustment	94		316	
Total FHLB advances, carried at fair value	$10,304		$10,533	

At certain times the Federal Reserve Bank has also served as an important source of borrowings. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB-Seattle. At December 31, 2012, based upon our available unencumbered collateral, Banner Bank was eligible to borrow $595 million from the Federal Reserve Bank; however, at that date we had no funds borrowed

under this arrangement.

We also issue retail repurchase agreements to customers that are primarily related to customer cash management accounts and in the past have borrowed funds through the use of secured wholesale repurchase agreements with securities brokers. In each case, the repurchase agreements are generally due within 90 days. At December 31, 2012, retail repurchase agreements totaling $77 million, with a weighted average rate of 0.30%, were secured by a pledge of certain mortgage-backed securities and agency securities with a market value of $109 million. Retail repurchase agreement balances, which are primarily associated with sweep account arrangements, decreased $25 million, or 25%, from the 2011 year-end balance. We had no outstanding borrowings under wholesale repurchase agreements at December 31, 2012 or 2011.

We have issued an aggregate of $120 million, net of repayments, of trust preferred securities (TPS) since 2002. The junior subordinated debentures associated with the TPS have been recorded as liabilities on our Consolidated Statements of Financial Condition, although portions of the TPS qualify as Tier 1 or Tier II capital for regulatory capital purposes. The junior subordinated debentures are carried at fair value on our Consolidated Statements of Financial Condition and have an estimated fair value of $73 million at December 31, 2012. At December 31, 2012, the TPS had a weighted average rate of 2.42%. See Notes 1 and 12 of the Notes to the Consolidated Financial Statements for additional information with respect to the TPS.

Asset Quality: While non-performing assets declined substantially in 2012 and 2011, beginning in the third quarter of 2008 and continuing throughout 2009 and 2010, housing markets deteriorated in many of our primary service areas and we experienced significantly higher levels of delinquencies and non-performing assets, primarily in our construction and land development loan portfolios. During this period, home and lot sales activity was exceptionally slow, causing stress on builders' and developers' cash flows and their ability to service debt, which was reflected in our increased non-performing asset totals. Further, property values generally declined, reducing the value of the collateral securing loans. In addition, other non-housing-related segments of the loan portfolio developed signs of stress and increasing levels of non-performing loans as the effects of the recessionary economy became more evident and the pace of the recovery remained slow. As a result, our provision for loan losses was significantly higher than historical levels and our normal expectations. This higher than normal level of delinquencies and non-accruals also had a material adverse effect on operating income as a result of foregone interest revenues, increased loan collection costs and carrying costs and valuation adjustments for real estate acquired through foreclosure. While our non-performing assets have been significantly reduced, resulting in materially reduced credit costs in 2012, and we are actively engaged with our borrowers in resolving remaining problem assets, our future results will continue to be meaningfully influenced by the course of recovery from the economic recession. However, our reserve levels are substantial and, as a result of our impairment analysis and charge-off actions, reflect current appraisals and valuation estimates as well as recent regulatory examination results.

Non-performing assets decreased to $50 million, or 1.18% of total assets, at December 31, 2012, from $119 million, or 2.79% of total assets, at December 31, 2011, and $254 million, or 5.77% of total assets, at December 31, 2010. Construction and land development loans, including related REO, represented approximately 27% of our non-performing assets at December 31, 2012. Reflecting lingering weakness in the economy and property values which now have generally stabilized but are lower than when many of the related loans were originated, we continued to provide for loan losses at a relatively high level during 2012 and maintained a substantial allowance for loan losses at year end even though non-performing loans and total loans outstanding declined. At December 31, 2012, our allowance for loan losses was $77 million, or 2.39% of total loans and 225% of non-performing loans, compared to $83 million, or 2.52% of total loans and 110% of non-performing loans at December 31, 2011. Included in our allowance at December 31, 2012 was an unallocated portion of $12 million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. We continue to believe our level of non-performing loans and assets, which declined significantly during the past two years, is manageable and we believe that we have sufficient capital and human resources to manage the collection of our non-performing assets in an orderly fashion.

The primary components of the $50 million in non-performing assets are $31 million in nonaccrual loans and $16 million in REO and other repossessed assets. The geographic distribution of non-performing assets included approximately $18 million, or 35%, in the Puget Sound region, $17 million, or 33%, in the greater Portland market area, $2 million, or 5%, in the greater Boise market area, and $14 million, or 27%, in other areas of Washington, Oregon and Idaho.

Loans are reported as restructured when we grant concessions to a borrower experiencing financial difficulties that we would not otherwise consider. As a result of these concessions, restructured loans are impaired as the Banks will not

collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. If any restructured loan becomes delinquent or other matters call into question the borrower's ability to repay full interest and principal in accordance with the restructured terms, the restructured loan(s) would be reclassified as nonaccrual. At December 31, 2012, we had $57 million of restructured loans currently performing under their restructured terms.

The following table sets forth information with respect to our non-performing assets and restructured loans, at the dates indicated (dollars in thousands):

Table 15: Non-Performing Assets

	December 31				
	2012	2011	2010	2009	2008
Nonaccrual loans: [1]					
Secured by real estate:					
Commercial	$6,579	$9,226	$24,727	$7,300	$12,879
Multifamily	—	362	1,889	383	—
Construction/land	3,672	27,731	75,734	159,264	154,823
One- to four-family	12,964	17,408	16,869	14,614	8,649
Commercial business	4,750	13,460	21,100	21,640	8,617
Agricultural business, including secured by farmland	—	1,896	5,853	6,277	1,880
Consumer	3,396	2,905	2,332	3,923	130
	31,361	72,988	148,504	213,401	186,978
Loans more than 90 days delinquent, still on accrual:					
Secured by real estate:					
One- to four-family	2,877	2,147	2,955	358	124
Commercial business	—	4	—	—	—
Consumer	152	173	30	91	243
	3,029	2,324	2,985	449	367
Total non-performing loans	34,390	75,312	151,489	213,850	187,345
Securities on nonaccrual	—	500	1,896	4,232	—
REO assets held for sale, net [2]	15,778	42,965	100,872	77,743	21,782
Other repossessed assets held for sale, net	75	74	73	59	104
Total non-performing assets	$50,243	$118,851	$254,330	$295,884	$209,231
Total non-performing loans to net loans before allowance for loan losses	1.06 %	2.28 %	4.45 %	5.64 %	4.73 %
Total non-performing loans to total assets	0.81 %	1.77 %	3.44 %	4.53 %	4.09 %
Total non-performing assets to total assets	1.18 %	2.79 %	5.77 %	6.27 %	4.56 %
Restructured loans [3]	$57,462	$54,533	$60,115	$43,683	$23,635
Loans 30-89 days past due and on accrual	$11,685	$9,962	$28,847	$34,156	$61,124

(1) Includes $8.0 million of non-accrual restructured loans. For the year ended December 31, 2012, $3.2 million in interest income would have been recorded had nonaccrual loans been current, and no interest income on these loans was included in net income for this period.

(2) Real estate acquired by us as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate held for sale until it is sold. When property is acquired, it is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Subsequent to foreclosure, the property is carried at the lower of the foreclosed amount or net realizable value. Upon receipt of a new appraisal and market analysis, the carrying value is written down through the establishment of a specific reserve to the anticipated sales price, less selling and holding costs.

(3) These loans are performing under their restructured terms.

In addition to the non-performing loans noted in Table 15, as of December 31, 2012, we had classified loans with an aggregate outstanding balance of $100 million that are not on nonaccrual status, with respect to which known

information concerning possible credit problems with the borrowers or the cash flows of the properties securing the respective loans has caused management to be concerned about the ability of the borrowers to comply with present loan repayment terms. This may result in the future inclusion of such loans in the nonaccrual loan category.

The following table provides additional detail and geographic concentration of non-performing assets at December 31, 2012 (dollars in thousands):

Table 16: Non-Performing Assets by Geographic Concentration

	Washington	Oregon	Idaho	Total
Secured by real estate:				
Commercial	$5,814	$—	$765	$6,579
Construction and land				
One- to four-family construction	1,565	—	—	1,565
Residential land acquisition & development	—	1,422	—	1,422
Residential land improved lots	119	276	—	395
Residential land unimproved	245	—	—	245
Commercial land improved	46	—	—	46
Total construction and land	1,975	1,698	—	3,673
One- to four-family	11,932	2,487	1,422	15,841
Commercial business	4,676	74	—	4,750
Consumer	2,623	423	501	3,547
Total non-performing loans	27,020	4,682	2,688	34,390
REO and repossessed assets	5,850	9,557	446	15,853
Total non-performing assets at end of the period	$32,870	$14,239	$3,134	$50,243
Percent of non-performing assets	65.5 %	28.3 %	6.2 %	100.0 %

Table 17: Non-Performing Loan Summary

Within our non-performing loans, we have a total of six nonaccrual lending relationships, each with aggregate loan exposures in excess of $1 million that collectively comprise $8 million, or 24% of our total non-performing loans as of December 31, 2012, and the single largest relationship totaled $1.8 million at that date. The most significant of our non-performing loan exposures at December 31, 2012 are included in the following table (dollars in thousands):

Amount	Percent of Total Non-Performing Loans	Collateral Securing the Indebtedness	Geographic Location
$1,819	5.3 %	Accounts receivable and inventory	Greater Seattle-Puget Sound area
1,432	4.2	Commercial building	Central Washington
1,405	4.1	Business assets, accounts receivable, and vehicles	Greater Spokane, WA area
1,306	3.8	Seven single family residences	Greater Portland, OR area
1,190	3.5	Seven single family residences	Greater Seattle-Puget Sound area
1,086	3.1	Four commercial lots and one commercial acreage lot	Greater Portland, OR area
26,152	76.0	Relationships under $1 million; various collateral	Sum of 164 loans spread throughout the franchise
$34,390	100.0 %	Total non-performing loans	

Table 18: Real Estate Owned Summary

At December 31, 2012, we had $15.8 million of REO, the most significant component of which is a subdivision in the greater Portland, Oregon area consisting of 13 residential buildable lots and 33.2 acres of undeveloped land with a book value of $2.1 million. The second largest REO holding is 5.9 acres of undeveloped land in the greater Portland, Oregon area with a book value $1.7 million. The third largest holding is 20.5 acres of undeveloped residential land in the greater Portland, Oregon area with a book value of $1.1 million. All other REO holdings have individual book values of less than $586,000. The table below summarizes our REO by geographic location and property type (dollars in thousands):

Amount	Percent of Total REO		REO Description	Geographic Location
$10,594	67.2	%	13 single family residences 18 residential lots 83 acres undeveloped buildable residential land	Greater Portland, OR area
1,658	10.5		Five single family residences One residential lot Three parcels of undeveloped residential land One acre of buildable residential land	Greater Seattle-Puget Sound area
819	5.2		One single family residences 21 residential lots One parcel of residential land Three commercial office buildings 63 acres of forest land One parcel of undeveloped waterfront land	Greater Spokane, WA area
445	2.8		One single family residence 53 residential lots Three commercial lots One commercial office building	Greater Boise, ID area
2,194	13.9		Three single family residences 21 residential lots One single family residence under construction 13 acres of undeveloped land One residence with 31 acres of agricultural land One parcel of bare land One 79 acre farm	Other Washington locations
68	0.4		One single family residence	Other Oregon locations
$15,778	100.0	%		

Comparison of Results of Operations for the Years Ended December 31, 2012 and 2011

Following three difficult years and despite a still challenging economy, Banner Corporation returned to profitability in 2011 and achieved significantly increased profitability in 2012. While this return to profitability largely resulted from a material decrease in credit costs, particularly our provision for loan losses, it also reflected strong revenue generation

from our core operations. The decrease in credit costs reflects a substantially reduced level of non-performing assets while the increase in revenues was driven by improvement in our net interest income and deposit fees and other service charges fueled by growth in core deposits and, in 2012, significantly increased revenues from mortgage banking operations and a substantial net benefit from income taxes. For the year ended December 31, 2012, we had net income of $64.9 million, which, after providing for the preferred stock dividend of $4.9 million, the related discount accretion of $3.3 million, and including a $2.5 million gain on repurchase and retirement of preferred stock, resulted in net income to common shareholders of $59.1 million, or $3.16 per diluted share. This compares to net income of $5.5 million, which, after providing for the preferred stock dividend of $6.2 million and related discount accretion of $1.7 million, resulted in a net loss to common shareholders of $2.4 million, or ($0.15) per diluted share, for the year ended December 31, 2011. Our provision for loan losses was $13.0 million for the year ended December 31, 2012, compared to $35.0 million for the prior year. For the year ending December 31, 2012, our results also include a net tax benefit of $24.8 million, primarily the result of a reversal of a full valuation allowance for our net deferred tax assets.

Aside from credit costs, our operating results depend largely on our net interest income which, as explained below, increased by $3.1 million to $167.7 million, primarily because of a significant reduction in deposit costs and a reduction in the adverse effect of non-performing assets. Our operating results for the year ended December 31, 2012 also reflected a decrease in other operating income, which was particularly influenced by a net charge of $16.5 million as a result of changes in the valuation of financial instruments carried at fair value that was only partially offset by increases in deposit fees and service charges, revenues from mortgage banking operations and miscellaneous other operating income. By comparison, for the year ended December 31, 2011, we recorded a $3 million recovery of a previous OTTI charge, which was partially offset by $624,000 in net fair value losses. Excluding these fair value and OTTI adjustments, our other operating income increased by $12.2 million

to $43.8 million for the year ended December 31, 2012 compared to $31.6 million the preceding year, due primarily to a $7.9 million increase in mortgage banking revenue, a $2.3 million increase in deposit fees and service charges and a $2.2 million increase in miscellaneous other operating income. Other operating expenses decreased to $141.5 million for the year ended December 31, 2012, a decrease of 11% from the prior year, largely as a result of decreased costs related to REO and FDIC deposit insurance.

Net Interest Income. Net interest income before provision for loan losses increased by $3.1 million, or 2%, to $167.7 million for the year ended December 31, 2012, compared to $164.6 million one year earlier, primarily as a result of an increase in the net interest margin and despite a modest decrease in average interest-earning assets. The net interest margin of 4.17% for the year ended December 31, 2012 increased 12 basis points from the prior year, largely as a result of the effect of a much lower cost of deposits which more than offset a further decrease in asset yields. While less severe than in the preceding year as a result of the significant reduction in problem assets, our net interest margin continued to be adversely affected by the level of nonaccrual loans and other non-performing assets. However, nonaccruing loans reduced the margin by just eight basis points during the year ended December 31, 2012, a meaningful improvement compared to a 22 basis point reduction for the prior year. In addition, the mix of earning assets changed to include fewer loans and more securities and interest-bearing deposits as our on-balance-sheet liquidity remained high. This continued shift in the mix during the still very low interest rate environment had a further adverse effect on earning asset yields. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on earning assets for the year ended December 31, 2012 decreased by 20 basis points compared to the prior year. Importantly, however, funding costs were also significantly lower, especially deposit costs which decreased 31 basis points to 0.44% from 0.75% a year earlier, more than offsetting the decline in asset yields. As a result, the net interest spread expanded to 4.13% for the year ended December 31, 2012 compared to 3.99% for the prior year and was only partially offset by the 1% decline in average interest-earning assets.

Interest Income. Interest income for the year ended December 31, 2012 was $187.2 million, compared to $197.6 million for the prior year, a decrease of $10.4 million, or 5%. The decrease in interest income occurred as a result of a $46 million decrease in the average balance of interest-earning assets, as well as a 20 basis point decrease in the average yield on those assets. The yield on average interest-earning assets decreased to 4.66% for the year ended December 31, 2012, compared to 4.86% one year earlier, largely as a result of changes in the mix of assets and the impact of lower market rates on the loan and securities portfolios. The Federal Reserve continued monetary policy actions during the year designed to maintain short-term market interest rates at the extremely low levels of the past four years and initiated further actions to move intermediate- and longer-term rates even lower in 2012. Despite the pressure from lower market interest rates, our loan yields were only modestly lower at 5.41% for the year ended December 31, 2012 compared to 5.59% in the preceding year largely because of a decrease in the amount of non-performing loans. Looking forward, loan yields will likely continue to decline in the current interest rate environment as refinance activity will be reflective of market rates that are below the average portfolio yield and opportunities to further reduce the impact of non-performing loans have diminished. Average loans receivable for the year ended December 31, 2012 decreased $74 million, or 2%, to $3.224 billion, compared to $3.298 billion for the prior year. Interest income on loans decreased by $10.1 million, or 5%, to $174.3 million for the year from $184.4 million for the year ended December 31, 2011, reflecting the decreased average balance and the lower average yield on loans.

The combined average balance of mortgage-backed securities, investment securities, daily interest-bearing deposits and FHLB stock increased by $28 million (excluding the effect of fair value adjustments) for the year ended December 31, 2012; however the interest and dividend income from those investments decreased by $366,000 compared to the prior year. The effect of the increased average balance was offset as the average yield on the securities portfolio and cash equivalents decreased to1.61% for the year ended December 31, 2012, from 1.72% one year earlier. The adverse impact of lower market rates on the combined yield on these investments was partially offset by changes in the mix to include lower balances of daily interest-bearing deposits and more investment securities;

however, yields on this portfolio should continue to decline in future periods given continuation of the currently low interest rate environment.

Interest Expense. Interest expense for the year ended December 31, 2012 was $19.5 million, compared to $33.0 million for the prior year, a decrease of $13.5 million, or 41%. The sharp decline in interest expense occurred as a result of a 34 basis point decrease in the average cost of all interest-bearing liabilities to 0.53% for the year ended December 31, 2012, from 0.87% one year earlier, and a $119 million, or 3%, decrease in average interest-bearing liabilities. The decrease in average interest-bearing balances reflects a substantial decrease in the average balance of certificates of deposit, as well as decreases in FHLB advances and other borrowings, which were only partially offset by increases in transaction and savings accounts. The growth in non-interest-bearing deposits and other transaction and savings accounts during the past two years has significantly contributed to our improved net interest margin in 2012.

Deposit interest expense decreased $11.1 million, or 42%, to $15.1 million for the year ended December 31, 2012 compared to $26.2 million for the prior year as a result of a 31 basis point decrease in the cost of deposits and a $62 million decrease in the average balance of deposits. Average deposit balances decreased to $3.448 billion for the year ended December 31, 2012, from $3.510 billion for the year ended December 31, 2011, while the average rate paid on deposit balances decreased to 0.44% in the current year from 0.75% for the prior year. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits frequently tend to lag changes in market interest rates as evidenced by the continuing decline in our deposit costs despite relatively stable short-term market interest rates over the past twelve months.

While we do not anticipate further reductions in market interest rates, we do expect additional modest declines in deposits costs over the near term as maturities of certificates of deposit will present further repricing opportunities and competitive pricing should remain restrained in response to modest loan demand in the current economic environment. Further, continuing changes in our deposit mix, especially growth in lower cost transaction and savings accounts, in particular non-interest-bearing deposits, have meaningfully contributed to the decrease in our funding costs compared to earlier periods, and should also result in lower deposit costs going forward.

Average FHLB advances (excluding the effect of fair value adjustments) decreased to $10 million for the year ended December 31, 2012, compared to $15 million for the prior year. The decline in outstanding FHLB advances was almost entirely responsible for the $116,000 decrease in the related interest expense as the average rate paid on FHLB advances remained nearly unchanged for the years ended December 31, 2012 and 2011 at 2.49% and 2.52%, respectively.

Other borrowings consist of retail repurchase agreements with customers secured by certain investment securities and, prior to March 31, 2012, the $50 million of senior bank notes issued under the TLGP. The senior bank notes had a fixed rate of 2.625%, plus a 1.00% guarantee fee, and matured on March 31, 2012. Repaying these notes resulted in a significant reduction in the cost of borrowings for 2012. Primarily as a result of repaying the senior bank notes, the average balance for other borrowings decreased $52 million to $102 million at December 31, 2012 compared to $154 million a year earlier. The rate on these other borrowings likewise decreased to 0.74% from 1.47% a year earlier and the related interest expense for other borrowings decreased by $1.5 million to $758,000 for the year ended December 31, 2012, from $2.3 million one year earlier.

Junior subordinated debentures which were issued in connection with our trust preferred securities had an average balance (excluding the effect of fair value adjustments) of $124 million for both the years ended December 31, 2012 and 2011. These junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index. During 2012, the average rate decreased to 2.72% compared to 3.39% for 2011. The lower average cost of the junior subordinated debentures in the current year was primarily the result of the expiration on February 29, 2012 of a five-year fixed-rate period on one debenture and its repricing from a fixed rate of 6.56% to an adjustable rate of LIBOR plus 1.62%, or 1.99% at December 31, 2012.

Table 19, Analysis of Net Interest Spread, presents, for the periods indicated, our condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets and interest expense and rates paid on average interest-bearing liabilities. Average balances are computed using daily average balances. (See the footnotes to the tables for more information on average balances.)

The following table provides an analysis of our net interest spread for the last three years (dollars in thousands):

Table 19: Analysis of Net Interest Spread

	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010		
	Average Balance	Interest and Dividends	Yield/ Cost [4]	Average Balance	Interest and Dividends	Yield/ Cost [4]	Average Balance	Interest and Dividends	Yield/ Cost [4]
Interest-earning assets:									
Mortgage loans	$2,380,308	$131,523	5.53 %	$2,464,462	$139,102	5.64 %	$2,735,285	$152,270	5.57 %
Commercial/agricultural loans	751,486	36,836	4.90	744,439	39,127	5.26	780,662	47,052	6.03
Consumer and other loans	91,983	5,963	6.48	88,749	6,128	6.90	91,204	6,462	7.09
Total loans [1]	3,223,777	174,322	5.41	3,297,650	184,357	5.59	3,607,151	205,784	5.70
Mortgage-backed securities	188,806	4,176	2.21	87,463	3,455	3.95	89,310	4,045	4.53
Other securities	431,580	8,328	1.93	423,612	9,245	2.18	271,616	7,546	2.78
Interest-bearing deposits with banks	138,179	336	0.24	219,025	506	0.23	291,968	707	0.24
FHLB stock	37,263	—	—	37,371	—	—	37,371	—	—
Total investment securities	795,828	12,840	1.61	767,471	13,206	1.72	690,265	12,298	1.78
Total interest-earning assets	4,019,605	187,162	4.66	4,065,121	197,563	4.86	4,297,416	218,082	5.07
Non-interest-earning assets	199,561			215,646					