

BANNER CORP  
Form 10-Q  
May 09, 2014

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

FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014.

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

Commission File Number 0-26584

BANNER CORPORATION  
(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of incorporation or  
organization)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

|   |                      |
|---|----------------------|
| Title of class:                         | As of April 30, 2014 |
| Common Stock, \$.01 par value per share | 19,575,904 shares *  |

BANNER CORPORATION AND SUBSIDIARIES

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## Special Note Regarding Forward-Looking Statements

Certain matters in this report on Form 10-Q contain certain 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 or future or 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 non-performing assets, 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 an informal or formal enforcement action against us or any of our bank subsidiaries 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 changes related to 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; the requisite regulatory approvals for the Banner Bank-Idaho Banking Company merger might not be obtained; whether Banner will be successful in the sale process that is being conducted pursuant to Chapter 363 of the Bankruptcy Code; 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. 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.

BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited) (In thousands, except shares)

March 31, 2014 and December 31, 2013

|  | March 31<br>2014 | December 31<br>2013 |
|--|------------------|---------------------|
| <b>ASSETS</b>  |                  |                     |
| Cash and due from banks  | \$ 144,775       | \$ 137,349          |
| Securities—trading, amortized cost \$71,110 and \$75,150, respectively   | 58,387           | 62,472              |
| Securities—available-for-sale, amortized cost \$466,866 and \$474,960, respectively  | 464,657          | 470,280             |
| Securities—held-to-maturity, fair value \$112,409 and \$103,610, respectively  | 109,567          | 102,513             |
| Federal Home Loan Bank (FHLB) stock  | 33,288           | 35,390              |
| Loans receivable:  |                  |                     |
| Held for sale  | 3,239            | 2,734               |
| Held for portfolio   | 3,519,673        | 3,415,711           |
| Allowance for loan losses  | (74,371)         | (74,258)            |
|  | 3,448,541        | 3,344,187           |
| Accrued interest receivable  | 15,202           | 13,996              |
| Real estate owned (REO), held for sale, net  | 3,236            | 4,044               |
| Property and equipment, net  | 89,440           | 90,267              |
| Intangible assets, net   | 1,970            | 2,449               |
| Bank-owned life insurance (BOLI)   | 62,377           | 61,945              |
| Deferred tax assets, net   | 26,341           | 27,479              |
| Income tax receivable  | 1,163            | 9,728               |
| Other assets   | 29,352           | 26,799              |
|  | \$4,488,296      | \$4,388,898         |
| <b>LIABILITIES</b>   |                  |                     |
| Deposits:  |                  |                     |
| Non-interest-bearing   | \$ 1,095,665     | \$ 1,115,346        |
| Interest-bearing transaction and savings accounts  | 1,681,854        | 1,629,885           |
| Interest-bearing certificates  | 905,016          | 872,695             |
|  | 3,682,535        | 3,617,926           |
| Advances from FHLB at fair value   | 48,351           | 27,250              |
| Other borrowings   | 89,921           | 83,056              |
| Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)  | 74,135           | 73,928              |
| Accrued expenses and other liabilities   | 29,189           | 31,324              |
| Deferred compensation  | 16,641           | 16,442              |
|  | 3,940,772        | 3,849,926           |
| <b>COMMITMENTS AND CONTINGENCIES (Note 15)</b>   |                  |                     |
| <b>STOCKHOLDERS' EQUITY</b>  |                  |                     |
| Common stock and paid in capital - \$0.01 par value per share, 50,000,000 shares authorized, 19,576,535 shares issued and outstanding at March 31, 2014; 19,543,769 shares issued and 19,509,429 shares outstanding at December 31, 2013 | 566,964          | 569,028             |
| Accumulated deficit  | (18,026)         | (25,073)            |
| Accumulated other comprehensive (loss) income  | (1,414)          | (2,996)             |
| Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost: no shares outstanding at March 31, 2014 and 34,340 shares outstanding at December 31, 2013   | —                | (1,987)             |
|  | 547,524          | 538,972             |
|  | \$4,488,296      | \$4,388,898         |

See Selected Notes to the Consolidated Financial Statements

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited) (In thousands except for per share amounts)  
For the Three Months Ended March 31, 2014 and 2013

|  | Three Months Ended<br>March 31 |          |
|--|--------------------------------|----------|
|  | 2014                           | 2013     |
| <b>INTEREST INCOME:</b>  |                                |          |
| Loans receivable   | \$41,743                       | \$41,489 |
| Mortgage-backed securities   | 1,471                          | 1,172    |
| Securities and cash equivalents  | 1,892                          | 1,847    |
|  | 45,106                         | 44,508   |
| <b>INTEREST EXPENSE:</b>   |                                |          |
| Deposits   | 1,964                          | 2,719    |
| FHLB advances  | 38                             | 24       |
| Other borrowings   | 44                             | 56       |
| Junior subordinated debentures   | 721                            | 741      |
|  | 2,767                          | 3,540    |
| Net interest income before provision for loan losses                   | 42,339                         | 40,968   |
| <b>PROVISION FOR LOAN LOSSES</b>                                       | —                              | —        |
| Net interest income  | 42,339                         | 40,968   |
| <b>OTHER OPERATING INCOME:</b>   |                                |          |
| Deposit fees and other service charges                                 | 6,602                          | 6,301    |
| Mortgage banking operations  | 1,840                          | 2,838    |
| Miscellaneous  | 636                            | 790      |
|  | 9,078                          | 9,929    |
| Gain on sale of securities   | 35                             | 1,006    |
| Other-than-temporary impairment recovery                               | —                              | 409      |
| Net change in valuation of financial instruments carried at fair value | (255                           | ) (1,347 |
| Total other operating income   | 8,858                          | 9,997    |
| <b>OTHER OPERATING EXPENSES:</b>                                       |                                |          |
| Salary and employee benefits   | 21,156                         | 20,729   |
| Less capitalized loan origination costs                                | (2,195                         | ) (2,871 |
| Occupancy and equipment  | 5,696                          | 5,329    |
| Information/computer data services                                     | 1,935                          | 1,720    |
| Payment and card processing expenses                                   | 2,515                          | 2,305    |
| Professional services  | 1,038                          | 905      |
| Advertising and marketing  | 1,057                          | 1,499    |
| Deposit insurance  | 576                            | 645      |
| State/municipal business and use taxes                                 | 159                            | 464      |
| REO operations   | 39                             | (251     |
| Amortization of core deposit intangibles                               | 479                            | 505      |
| Miscellaneous  | 3,126                          | 3,120    |
| Total other operating expenses   | 35,581                         | 34,099   |
| Income before provision for income taxes                               | 15,616                         | 16,866   |
| <b>PROVISION FOR INCOME TAXES</b>                                      | 5,046                          | 5,284    |
| <b>NET INCOME</b>  | \$10,570                       | \$11,582 |
| Earnings per common share:   |                                |          |
| Basic  | \$0.55                         | \$0.60   |

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|   |        |        |
|---|--------|--------|
| Diluted   | \$0.54 | \$0.60 |
| Cumulative dividends declared per common share              | \$0.18 | \$0.12 |
| See Selected Notes to the Consolidated Financial Statements |        |        |

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BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited) (In thousands)  
For the Three Months Ended March 31, 2014 and 2013

|  | Three Months Ended<br>March 31 |          |
|--|--------------------------------|----------|
|  | 2014                           | 2013     |
| NET INCOME   | \$10,570                       | \$11,582 |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:                              |                                |          |
| Unrealized holding gain (loss) on AFS securities arising during the period           | 2,437                          | (378 )   |
| Income tax benefit (expense) related to AFS unrealized holding gains (losses)        | (877 )                         | 136      |
| Reclassification for net (gains) losses on AFS securities realized in earnings       | 34                             | (117 )   |
| Income tax benefit (expense) related to AFS realized gains (losses)                  | (12 )                          | 42       |
| Amortization of unrealized gain on tax exempt securities transferred from AFS to HTM | —                              | —        |
| Other comprehensive income (loss)  | 1,582                          | (317 )   |
| COMPREHENSIVE INCOME   | \$12,152                       | \$11,265 |

See Selected Notes to the Consolidated Financial Statements

BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Unaudited) (In thousands, except for shares)  
For the Three Months Ended March 31, 2014

|   | Common Stock<br>and Paid in Capital |           | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Unearned<br>Restricted<br>ESOP<br>Shares | Stockholders'<br>Equity |
|---|-------------------------------------|-----------|------------------------|---|--|-------------------------|
|   | Shares                              | Amount    |                        |   |  |                         |
| Balance, January 1, 2014  | 19,509,429                          | \$569,028 | \$ (25,073 )           | \$ (2,996 )   | \$(1,987 )                               | \$ 538,972              |
| Net income  |                                     |           | 10,570                 |   |  | 10,570                  |
| Change in valuation of<br>securities—available-for-sale, net of<br>income tax     |                                     |           |                        | 1,582   |  | 1,582                   |
| Accrual of dividends on common stock<br>(\$0.18/share cumulative)                 |                                     |           | (3,523 )               |   |  | (3,523 )                |
| Redemption of unallocated shares upon<br>termination of ESOP                      |                                     | (1,987 )  |                        |   | 1,987                                    | —                       |
| Repurchase of shares upon termination<br>of ESOP                                  | (13,550 )                           | (556 )    |                        |   |  | (556 )                  |
| Proceeds from issuance of common<br>stock for stockholder reinvestment<br>program | 612                                 | 27        |                        |   |  | 27                      |
| Issuance of restricted stock and<br>amortization of related compensation          | 80,044                              | 452       |                        |   |  | 452                     |
| BALANCE, March 31, 2014   | 19,576,535                          | \$566,964 | \$ (18,026 )           | \$ (1,414 )   | \$—                                      | \$ 547,524              |

See Selected Notes to the Consolidated Financial Statements

BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Unaudited) (In thousands, except for shares)  
For the Year Ended December 31, 2013

|  | Common Stock<br>and Paid in Capital |           | Accumulated  | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Unearned<br>Restricted<br>ESOP<br>Shares | Stockholders'<br>Equity |
|--|-------------------------------------|-----------|--------------|---|--|-------------------------|
|  | Shares                              | Amount    | Deficit      |   |  |                         |
| Balance, January 1, 2013   | 19,420,625                          | \$567,907 | \$ (61,102 ) | \$ 2,101  | \$(1,987 )                               | \$ 506,919              |
| Net income   |                                     |           | 46,555       |   |  | 46,555                  |
| Change in valuation of<br>securities—available-for-sale, net of<br>income tax  |                                     |           |              | (5,097 )  |  | (5,097 )                |
| Accrual of dividends on common stock<br>(\$0.54/share cumulative)              |                                     |           | (10,526 )    |   |  | (10,526 )               |
| Proceeds from issuance of common stock<br>for stockholder reinvestment program | 2,098                               | 72        |              |   |  | 72                      |
| Issuance of restricted stock and<br>amortization of related compensation       | 86,706                              | 1,049     |              |   |  | 1,049                   |
| BALANCE, December 31, 2013   | 19,509,429                          | \$569,028 | \$ (25,073 ) | \$ (2,996 )   | \$(1,987 )                               | \$ 538,972              |

See Selected Notes to the Consolidated Financial Statements

BANNER CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

For the Three Months Ended March 31, 2014 and 2013

|   | Three Months Ended<br>March 31 |            |
|---|--------------------------------|------------|
|   | 2014                           | 2013       |
| <b>OPERATING ACTIVITIES:</b>  |                                |            |
| Net income  | \$ 10,570                      | \$ 11,582  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                |            |
| Depreciation  | 2,059                          | 1,852      |
| Deferred income and expense, net of amortization                                  | 1,127                          | 1,516      |
| Amortization of core deposit intangibles  | 479                            | 505        |
| Gain on sale of securities  | (35                            | ) (1,006   |
| Other-than-temporary impairment recovery  | —                              | (409       |
| Net change in valuation of financial instruments carried at fair value            | 255                            | 1,347      |
| Purchases of securities—trading   | (2,387                         | ) (4,190   |
| Proceeds from sales of securities—trading   | 2,387                          | 6,070      |
| Principal repayments and maturities of securities—trading                         | 4,055                          | 1,948      |
| Decrease in deferred taxes  | 1,138                          | 6,212      |
| Increase (decrease) in current taxes payable                                      | 8,566                          | (6,537     |
| Equity-based compensation   | 452                            | 207        |
| Increase in cash surrender value of BOLI  | (425                           | ) (528     |
| Gain on sale of loans, net of capitalized servicing rights                        | (981                           | ) (2,130   |
| Gain on disposal of real estate held for sale and property and equipment          | (159                           | ) (816     |
| Provision for losses on real estate held for sale                                 | 37                             | 73         |
| Origination of loans held for sale  | (68,388                        | ) (127,214 |
| Proceeds from sales of loans held for sale  | 68,864                         | 135,880    |
| Net change in:  |                                |            |
| Other assets  | (4,366                         | ) 3,707    |
| Other liabilities and equity  | (3,099                         | ) (2,885   |
| Net cash provided from operating activities                                       | 20,149                         | 25,184     |
| <b>INVESTING ACTIVITIES:</b>  |                                |            |
| Purchases of securities—available-for-sale  | (28,846                        | ) (52,673  |
| Principal repayments and maturities of securities—available-for-sale              | 7,868                          | 33,055     |
| Proceeds from sales of securities—available-for-sale                              | 28,207                         | 13,900     |
| Purchases of securities—held-to-maturity  | (7,269                         | ) (2,083   |
| Principal repayments and maturities of securities—held-to-maturity                | 45                             | 54         |
| Loan originations, net of principal repayments                                    | (52,247                        | ) (13,980  |
| Purchases of loans and participating interest in loans                            | (53,978                        | ) (91      |
| Proceeds from sales of other loans  | 1,319                          | 995        |
| Purchases of property and equipment   | (1,231                         | ) (1,133   |
| Proceeds from sale of real estate held for sale, net                              | 1,641                          | 6,480      |
| Proceeds from FHLB stock repurchase program                                       | 2,102                          | 333        |
| Other   | (5                             | ) (23      |
| Net cash used by investing activities   | (102,394                       | ) (15,166  |
| <b>FINANCING ACTIVITIES:</b>  |                                |            |
| Increase (decrease) in deposits, net  | 64,609                         | (37,220    |
| Advances, net of (repayments) of FHLB borrowings                                  | 21,098                         | (10,002    |
| Increase in other borrowings, net   | 6,864                          | 11,813     |

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|  |            |            |   |
|--|------------|------------|---|
| Cash dividends paid  | (2,927     | ) (195     | ) |
| Cash proceeds from issuance of stock for stockholder reinvestment plan | 27         | 2          |   |
| Net cash provided from (used by) financing activities                  | 89,671     | (35,602    | ) |
| NET INCREASE(DECREASE) IN CASH AND DUE FROM BANKS                      | 7,426      | (25,584    | ) |
| CASH AND DUE FROM BANKS, BEGINNING OF PERIOD                           | 137,349    | 181,298    |   |
| CASH AND DUE FROM BANKS, END OF PERIOD                                 | \$ 144,775 | \$ 155,714 |   |

(Continued on next page)

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BANNER CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
 (Unaudited) (In thousands)  
 For the Three Months Ended March 31, 2014 and 2013

|   | Three Months Ended<br>March 31 |         |
|---|--------------------------------|---------|
|   | 2014                           | 2013    |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>   |                                |         |
| Interest paid in cash   | \$2,821                        | \$3,710 |
| Taxes paid (refunds received) in cash   | (3,785)                        | ) 5,431 |
| <b>NON-CASH INVESTING AND FINANCING TRANSACTIONS:</b>   |                                |         |
| Loans, net of discounts, specific loss allowances and unearned income,<br>transferred to real estate owned and other repossessed assets | 870                            | 1,341   |

See Selected Notes to the Consolidated Financial Statements



BANNER CORPORATION AND SUBSIDIARIES  
SELECTED NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1: BASIS OF PRESENTATION AND CRITICAL ACCOUNTING POLICIES

The accompanying unaudited consolidated interim financial statements include the accounts of Banner Corporation (the Company or Banner), a bank holding company incorporated in the State of Washington and its wholly-owned subsidiaries, Banner Bank and Islanders Bank (the Banks).

These unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (SEC). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. Certain reclassifications have been made to the 2013 Consolidated Financial Statements and/or schedules to conform to the 2014 presentation. These reclassifications may have affected certain ratios for the prior periods. The effect of these reclassifications is considered immaterial. All significant intercompany transactions and balances have been eliminated.

The 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 the Company's 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 Banner's financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including other-than-temporary impairment (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 in subsequent notes to the Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations (Critical Accounting Policies) in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC. 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 the Company's results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and the Company's financial condition and operating results in future periods.

The information included in this Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the SEC (2013 Form 10-K). Interim results are not necessarily indicative of results for a full year.

Note 2: RECENT DEVELOPMENTS AND SIGNIFICANT EVENTS

Proposed Acquisition of Idaho Banking Company

On April 24, 2014, the Company announced that it had entered into an agreement with Idaho Bancorp, the holding company for Idaho Banking Company, pursuant to which Banner Corporation will purchase all of the stock and equity

interests in Idaho Banking Company and merge it with and into Banner Bank. The transaction is subject to regulatory approval and other customary conditions of closing and is anticipated to be completed in the third quarter of 2014. The purchase agreement contemplates that Idaho Bancorp (the holding company) will file a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code and that the sale will be conducted under Section 363 of the Bankruptcy Code.

#### Proposed Acquisition of Six Sterling Savings Bank Branches

On February 19, 2014, the Company announced that Banner Bank had entered into an agreement for the acquisition of six branches in Oregon from Sterling Savings Bank, now Umpqua Holdings Corporation, after the consummation of the merger between those two institutions. On April 23, 2014, we received regulatory approval for the transaction. The purchase of the branches is still subject to the satisfaction of customary closing conditions and is expected to be completed in the second quarter of 2014.

#### Stockholder Equity Transactions:

**Omnibus Incentive Plan:** On January 8, 2014, the Company's board of directors unanimously adopted, and on April 22, 2014 the Company's shareholders approved, the Banner Corporation 2014 Omnibus Incentive Plan. The purpose of the Plan is to promote the success and enhance the value of Banner by linking the personal interests of employees and directors with those of Banner's shareholders. The Plan is further intended to provide flexibility to Banner in its ability to motivate, attract, and retain the services of employees and directors upon whose judgment, interest and special effort Banner depends. The Plan also allows performance-based compensation to be provided in a manner that exempts such compensation from the deduction limits imposed by Section 162(m) of the Internal Revenue Code.

Note 3: ACCOUNTING STANDARDS RECENTLY ADOPTED

Unrecognized Tax Benefits

In July 2013, FASB issued Accounting Standards Update (ASU) No. 2013-11, Presentation of an Unrecognized Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This ASU requires an unrecognized tax benefit to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. An exception exists to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax of the applicable jurisdiction does not require the entity to use, and entity does not intend to use, the deferred tax asset for such a purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU No. 2013-11 is effective for fiscal years and interim periods beginning after December 15, 2013. The Company adopted the provisions of ASU No. 2013-11 effective January 1, 2014. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

Investing in Qualified Affordable Housing Projects

In January 2014, FASB issued ASU No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. The objective of this ASU is to provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in this ASU modify the conditions that a reporting entity must meet to be eligible to use a method other than the equity or cost methods to account for qualified affordable housing project investments. If the modified conditions are met, the amendments permit an entity to amortize the initial cost of the investment in proportion to the amount of tax credits and other tax benefits received and recognize the net investment performance in the income statement as a component of income tax expense (benefit). Additionally, the amendments introduce new recurring disclosures about all investments in qualified affordable housing projects irrespective of the method used to account for the investments. The amendments in this ASU should be applied retrospectively to all periods presented. ASU No. 2014-01 is effective beginning after December 15, 2014 and is not expected to have a material impact on the Company's consolidated financial statements.

Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure

In January 2014, FASB issued ASU No. 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this ASU clarify that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU No. 2014-04 is effective for fiscal years and interim periods beginning after December 15, 2014 and is not expected to have a material impact on the Company's consolidated financial statements.

Note 4: BUSINESS SEGMENTS

The Company is managed by legal entity and not by lines of business. Each of the Banks is a community oriented commercial bank chartered in the State of Washington. Each of the Banks' primary business is that of traditional banking institutions, gathering deposits and originating loans for portfolios in their respective markets. The Banks offer a wide variety of deposit products to their consumer and commercial customers. Lending activities include the origination of real estate, commercial/agriculture business and consumer loans. Banner Bank is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, the Banks receive other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Banks is reviewed by the Company's executive management and Board of Directors on a monthly basis. All of the executive officers of the Company are members of Banner Bank's management team.

Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements and require reporting of selected information about operating segments in interim reports to stockholders. The Company has determined that its current business and operations consist of a single business segment.

## —Note 5: INTEREST-BEARING DEPOSITS AND SECURITIES

The following table sets forth additional detail regarding our interest-bearing deposits and securities at the dates indicated (includes securities—trading, available-for-sale and held-to-maturity, all at carrying value) (in thousands):

|   | March 31<br>2014 | December 31<br>2013 | March 31<br>2013 |
|---|------------------|---------------------|------------------|
| Interest-bearing deposits included in cash and due from banks | \$71,459         | \$67,638            | \$96,300         |
| U.S. Government and agency obligations                        | 61,438           | 61,327              | 79,959           |
| Municipal bonds:  |                  |                     |                  |
| Taxable   | 30,372           | 34,216              | 43,921           |
| Tax exempt  | 124,692          | 119,588             | 110,062          |
| Total municipal bonds   | 155,064          | 153,804             | 153,983          |
| Corporate bonds   | 42,097           | 44,154              | 47,233           |
| Mortgage-backed or related securities:                        |                  |                     |                  |
| One- to four-family residential agency guaranteed             | 57,263           | 58,117              | 89,036           |
| One- to four-family residential other                         | 1,003            | 1,051               | 1,282            |
| Multifamily agency guaranteed                                 | 279,912          | 281,319             | 200,012          |
| Multifamily other   | 10,415           | 10,234              | 10,787           |
| Total mortgage-backed or related securities                   | 348,593          | 350,721             | 301,117          |
| Asset-backed securities:                                      |                  |                     |                  |
| Student Loan Marketing Association (SLMA)                     | 15,749           | 15,681              | 32,239           |
| Other asset-backed securities                                 | 9,608            | 9,510               | 18,261           |
| Total asset-backed securities                                 | 25,357           | 25,191              | 50,500           |
| Equity securities (excludes FHLB stock)                       | 62               | 68                  | 60               |
| Total securities  | 632,611          | 635,265             | 632,852          |
| FHLB stock (see Note 6)                                       | 33,288           | 35,390              | 36,373           |
|   | \$737,358        | \$738,293           | \$765,525        |

Securities—Trading: The amortized cost and estimated fair value of securities—trading at March 31, 2014 and December 31, 2013 are summarized as follows (dollars in thousands):

|  | March 31, 2014    |            |                     | December 31, 2013 |            |                     |   |
|--|-------------------|------------|---------------------|-------------------|------------|---------------------|---|
|  | Amortized<br>Cost | Fair Value | Percent of<br>Total | Amortized<br>Cost | Fair Value | Percent of<br>Total |   |
| U.S. Government and agency obligations               | \$1,370           | \$1,511    | 2.6                 | % \$1,370         | \$1,481    | 2.4                 | % |
| Municipal bonds:                                     |                   |            |                     |                   |            |                     |   |
| Tax exempt   | 1,666             | 1,719      | 2.9                 | 4,969             | 5,023      | 8.0                 |   |
| Corporate bonds                                      | 49,464            | 35,062     | 60.1                | 49,498            | 35,140     | 56.2                |   |
| Mortgage-backed or related securities:               |                   |            |                     |                   |            |                     |   |
| One- to four-family residential agency<br>guaranteed | 9,822             | 10,545     | 18.1                | 10,483            | 11,230     | 18.0                |   |
| Multifamily agency guaranteed                        | 8,774             | 9,488      | 16.2                | 8,816             | 9,530      | 15.3                |   |
| Total mortgage-backed or related securities          | 18,596            | 20,033     | 34.3                | 19,299            | 20,760     | 33.3                |   |
| Equity securities                                    | 14                | 62         | 0.1                 | 14                | 68         | 0.1                 |   |
|  | \$71,110          | \$58,387   | 100.0               | % \$75,150        | \$62,472   | 100.0               | % |

There were three sales of securities—trading totaling \$2.4 million with a resulting net gain of \$1,000 during the three months ended March 31, 2014. There were 21 sales of securities—trading totaling \$6.1 million with a resulting net gain of \$1.1 million during the three months ended March 31, 2013, including \$1.0 million which represented recoveries on certain collateralized debt obligations that had previously been written



off. In addition to the \$1.1 million net gain, the Company also recognized a \$409,000 OTTI recovery on sales of securities—trading during the three months ended March 31, 2013, which was related to the sale of certain equity securities issued by government-sponsored entities. The Company recognized no OTTI charges or recoveries on securities—trading during the three months ended March 31, 2014. There were no securities—trading on nonaccrual status at March 31, 2014 and 2013.

The amortized cost and estimated fair value of securities—trading at March 31, 2014 and December 31, 2013, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

|   | March 31, 2014 |            | December 31, 2013 |            |
|---|----------------|------------|-------------------|------------|
|   | Amortized Cost | Fair Value | Amortized Cost    | Fair Value |
| Maturing in one year or less                  | \$260          | \$261      | \$260             | \$263      |
| Maturing after one year through five years    | 5,803          | 6,147      | 7,056             | 7,298      |
| Maturing after five years through ten years   | 10,181         | 11,063     | 12,602            | 13,572     |
| Maturing after ten years through twenty years | 33,005         | 26,608     | 33,335            | 27,472     |
| Maturing after twenty years                   | 21,847         | 14,246     | 21,883            | 13,799     |
|   | 71,096         | 58,325     | 75,136            | 62,404     |
| Equity securities                             | 14             | 62         | 14                | 68         |
|   | \$71,110       | \$58,387   | \$75,150          | \$62,472   |

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Securities—Available-for-Sale: The amortized cost and estimated fair value of securities—available-for-sale at March 31, 2014 and December 31, 2013 are summarized as follows (dollars in thousands):

|  | March 31, 2014    |                              |                               |             |                     |   |
|--|-------------------|------------------------------|-------------------------------|-------------|---------------------|---|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value  | Percent of<br>Total |   |
| U.S. Government and agency obligations               | \$59,139          | \$83                         | \$(471)                       | ) \$58,751  | 12.6                | % |
| Municipal bonds:                                     |                   |                              |                               |             |                     |   |
| Taxable  | 19,774            | 125                          | (78)                          | ) 19,821    | 4.2                 |   |
| Tax exempt   | 30,505            | 173                          | (165)                         | ) 30,513    | 6.6                 |   |
| Total municipal bonds                                | 50,279            | 298                          | (243)                         | ) 50,334    | 10.8                |   |
| Corporate bonds                                      | 5,000             | —                            | (15)                          | ) 4,985     | 1.1                 |   |
| Mortgage-backed or related securities:               |                   |                              |                               |             |                     |   |
| One- to four-family residential agency<br>guaranteed | 46,234            | 971                          | (487)                         | ) 46,718    | 10.1                |   |
| One- to four-family residential other                | 945               | 58                           | —                             | ) 1,003     | 0.2                 |   |
| Multifamily agency guaranteed                        | 269,103           | 457                          | (2,466)                       | ) 267,094   | 57.5                |   |
| Multifamily other                                    | 10,580            | —                            | (165)                         | ) 10,415    | 2.2                 |   |
| Total mortgage-backed or related securities          | 326,862           | 1,486                        | (3,118)                       | ) 325,230   | 70.0                |   |
| Asset-backed securities:                             |                   |                              |                               |             |                     |   |
| SLMA   | 15,528            | 221                          | —                             | ) 15,749    | 3.4                 |   |
| Other asset-backed securities                        | 10,058            | —                            | (450)                         | ) 9,608     | 2.1                 |   |
| Total asset-backed securities                        | 25,586            | 221                          | (450)                         | ) 25,357    | 5.5                 |   |
|  | \$466,866         | \$2,088                      | \$(4,297)                     | ) \$464,657 | 100.0               | % |
|  | December 31, 2013 |                              |                               |             |                     |   |
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value  | Percent of<br>Total |   |
| U.S. Government and agency obligations               | \$59,178          | \$117                        | \$(635)                       | ) \$58,660  | 12.5                | % |
| Municipal bonds:                                     |                   |                              |                               |             |                     |   |
| Taxable  | 23,842            | 100                          | (278)                         | ) 23,664    | 5.0                 |   |
| Tax exempt   | 29,229            | 170                          | (208)                         | ) 29,191    | 6.2                 |   |
| Total municipal bonds                                | 53,071            | 270                          | (486)                         | ) 52,855    | 11.2                |   |
| Corporate bonds                                      | 7,001             | 2                            | (39)                          | ) 6,964     | 1.5                 |   |
| Mortgage-backed or related securities:               |                   |                              |                               |             |                     |   |
| One- to four-family residential agency<br>guaranteed | 47,077            | 648                          | (838)                         | ) 46,887    | 10.0                |   |
| One- to four-family residential other                | 988               | 63                           | —                             | ) 1,051     | 0.2                 |   |
| Multifamily agency guaranteed                        | 271,428           | 402                          | (3,392)                       | ) 268,438   | 57.1                |   |
| Multifamily other                                    | 10,604            | —                            | (370)                         | ) 10,234    | 2.2                 |   |
| Total mortgage-backed or related securities          | 330,097           | 1,113                        | (4,600)                       | ) 326,610   | 69.5                |   |
| Asset-backed securities:                             |                   |                              |                               |             |                     |   |
| SLMA   | 15,553            | 128                          | —                             | ) 15,681    | 3.3                 |   |
| Other asset-backed securities                        | 10,060            | —                            | (550)                         | ) 9,510     | 2.0                 |   |
| Total asset-backed securities                        | 25,613            | 128                          | (550)                         | ) 25,191    | 5.3                 |   |
|  | \$474,960         | \$1,630                      | \$(6,310)                     | ) \$470,280 | 100.0               | % |





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At March 31, 2014 and December 31, 2013, an aging of unrealized losses and fair value of related securities—available-for-sale was as follows (in thousands):

|  | March 31, 2014                    |                      |                                 |                      |                     |                      |
|--|-----------------------------------|----------------------|---------------------------------|----------------------|---------------------|----------------------|
|  | Less Than 12 Months<br>Fair Value | Unrealized<br>Losses | 12 Months or More<br>Fair Value | Unrealized<br>Losses | Total<br>Fair Value | Unrealized<br>Losses |
| U.S. Government and agency obligations               | \$29,777                          | \$(471)              | \$—                             | \$—                  | \$29,777            | \$(471)              |
| Municipal bonds:                                     |                                   |                      |                                 |                      |                     |                      |
| Taxable  | 7,413                             | (73)                 | 425                             | (5)                  | 7,838               | (78)                 |
| Tax exempt   | 8,863                             | (58)                 | 1,626                           | (107)                | 10,489              | (165)                |
| Total municipal bonds                                | 16,276                            | (131)                | 2,051                           | (112)                | 18,327              | (243)                |
| Corporate bonds                                      | 4,986                             | (15)                 | —                               | —                    | 4,986               | (15)                 |
| Mortgage-backed or related securities:               |                                   |                      |                                 |                      |                     |                      |
| One- to four-family residential agency<br>guaranteed | 3,514                             | (44)                 | 12,297                          | (443)                | 15,811              | (487)                |
| Multifamily agency guaranteed                        | 170,998                           | (2,143)              | 23,891                          | (323)                | 194,889             | (2,466)              |
| Multifamily other                                    | 10,415                            | (165)                | —                               | —                    | 10,415              | (165)                |
| Total mortgage-backed or related securities          | 184,927                           | (2,352)              | 36,188                          | (766)                | 221,115             | (3,118)              |
| Asset-backed securities:                             |                                   |                      |                                 |                      |                     |                      |
| Other asset-backed securities                        | —                                 | —                    | 9,608                           | (450)                | 9,608               | (450)                |
|  | \$235,966                         | \$(2,969)            | \$47,847                        | \$(1,328)            | \$283,813           | \$(4,297)            |
|  | December 31, 2013                 |                      |                                 |                      |                     |                      |
|  | Less Than 12 Months<br>Fair Value | Unrealized<br>Losses | 12 Months or More<br>Fair Value | Unrealized<br>Losses | Total<br>Fair Value | Unrealized<br>Losses |
| U.S. Government and agency obligations               | \$39,621                          | \$(633)              | \$998                           | \$(2)                | \$40,619            | \$(635)              |
| Municipal bonds:                                     |                                   |                      |                                 |                      |                     |                      |
| Taxable  | 15,580                            | (261)                | 413                             | (17)                 | 15,993              | (278)                |
| Tax exempt   | 8,217                             | (205)                | 487                             | (3)                  | 8,704               | (208)                |
| Total municipal bonds                                | 23,797                            | (466)                | 900                             | (20)                 | 24,697              | (486)                |
| Corporate bonds                                      | 4,961                             | (39)                 | —                               | —                    | 4,961               | (39)                 |
| Mortgage-backed or related securities:               |                                   |                      |                                 |                      |                     |                      |
| One- to four-family residential agency<br>guaranteed | 14,972                            | (133)                | 22,560                          | (705)                | 37,532              | (838)                |
| Multifamily agency guaranteed                        | 199,407                           | (3,162)              | 10,096                          | (230)                | 209,503             | (3,392)              |
| Multifamily other                                    | 10,234                            | (370)                | —                               | —                    | 10,234              | (370)                |
| Total mortgage-backed or related securities          | 224,613                           | (3,665)              | 32,656                          | (935)                | 257,269             | (4,600)              |
| Asset-backed securities:                             |                                   |                      |                                 |                      |                     |                      |
| Other asset-backed securities                        | —                                 | —                    | 9,510                           | (550)                | 9,510               | (550)                |
|  | \$292,992                         | \$(4,803)            | \$44,064                        | \$(1,507)            | \$337,056           | \$(6,310)            |

There were six sales of securities—available-for-sale totaling \$28.2 million with a resulting net gain of \$34,000 during the three months ended March 31, 2014. There were four sales of securities—available-for-sale totaling \$13.9 million with a resulting net loss of \$117,000 during the three months ended March 31, 2013. At March 31, 2014, there were 94 securities—available for sale with unrealized losses, compared to 114 securities at December 31, 2013. Management does not believe that any individual unrealized loss as of March 31, 2014 represents OTTI. The decline in fair market values of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. There were no securities—available-for-sale on nonaccrual status at March 31, 2014 and 2013.



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The amortized cost and estimated fair value of securities—available-for-sale at March 31, 2014 and December 31, 2013, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

|   | March 31, 2014 |            | December 31, 2013 |            |
|---|----------------|------------|-------------------|------------|
|   | Amortized Cost | Fair Value | Amortized Cost    | Fair Value |
| Maturing in one year or less                  | \$22,596       | \$22,669   | \$25,136          | \$25,256   |
| Maturing after one year through five years    | 320,498        | 318,483    | 322,493           | 319,489    |
| Maturing after five years through ten years   | 56,619         | 56,325     | 58,468            | 57,782     |
| Maturing after ten years through twenty years | 5,220          | 5,045      | 15,535            | 15,135     |
| Maturing after twenty years                   | 61,933         | 62,135     | 53,328            | 52,618     |
|   | \$466,866      | \$464,657  | \$474,960         | \$470,280  |

Securities—Held-to-Maturity: The amortized cost and estimated fair value of securities—held-to-maturity at March 31, 2014 and December 31, 2013 are summarized as follows (dollars in thousands):

|  | March 31, 2014 |                        |                         |            |                                 | Percent of Total Amortized Cost |  |
|--|----------------|------------------------|-------------------------|------------|---------------------------------|---------------------------------|--|
|  | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |                                 |                                 |  |
| U.S. Government and agency obligations | \$1,176        | \$—                    | \$(59)                  | \$1,117    | 1.1                             | %                               |  |
| Municipal bonds:                       |                |                        |                         |            |                                 |                                 |  |
| Taxable                                | 10,551         | 208                    | (80)                    | 10,679     | 9.6                             |                                 |  |
| Tax exempt                             | 92,460         | 3,523                  | (723)                   | 95,260     | 84.4                            |                                 |  |
| Total municipal bonds                  | 103,011        | 3,731                  | (803)                   | 105,939    | 94.0                            |                                 |  |
| Corporate bonds                        | 2,050          | —                      | —                       | 2,050      | 1.9                             |                                 |  |
| Mortgage-backed or related securities: |                |                        |                         |            |                                 |                                 |  |
| Multifamily agency guaranteed          | 3,330          | 3                      | (30)                    | 3,303      | 3.0                             |                                 |  |
|  | \$109,567      | \$3,734                | \$(892)                 | \$112,409  | 100.0                           | %                               |  |
| December 31, 2013                      |                |                        |                         |            |                                 |                                 |  |
|  | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Percent of Total Amortized Cost |                                 |  |
| U.S. Government and agency obligations | \$1,186        | \$—                    | \$(80)                  | \$1,106    | 1.2                             | %                               |  |
| Municipal bonds:                       |                |                        |                         |            |                                 |                                 |  |
| Taxable                                | 10,552         | 193                    | (204)                   | 10,541     | 10.3                            |                                 |  |
| Tax exempt                             | 85,374         | 2,545                  | (1,299)                 | 86,620     | 83.3                            |                                 |  |
| Total municipal bonds                  | 95,926         | 2,738                  | (1,503)                 | 97,161     | 93.6                            |                                 |  |
| Corporate bonds                        | 2,050          | —                      | —                       | 2,050      | 2.0                             |                                 |  |
| Mortgage-backed or related securities: |                |                        |                         |            |                                 |                                 |  |
| Multifamily agency guaranteed          | 3,351          | —                      | (58)                    | 3,293      | 3.2                             |                                 |  |
|  | \$102,513      | \$2,738                | \$(1,641)               | \$103,610  | 100.0                           | %                               |  |

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At March 31, 2014 and December 31, 2013, an age analysis of unrealized losses and fair value of related securities—held-to-maturity was as follows (in thousands):

|  | March 31, 2014      |                   |                   |                   |            |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government and agency obligations | \$1,117             | \$(59 )           | \$—               | \$—               | \$1,117    | \$(59 )           |
| Municipal bonds:                       |                     |                   |                   |                   |            |                   |
| Taxable                                | 1,593               | (25 )             | 3,002             | (55 )             | 4,595      | (80 )             |
| Tax exempt                             | 22,129              | (708 )            | 306               | (15 )             | 22,435     | (723 )            |
| Total municipal bonds                  | 23,722              | (733 )            | 3,308             | (70 )             | 27,030     | (803 )            |
| Mortgage-backed or related securities: |                     |                   |                   |                   |            |                   |
| Multifamily agency guaranteed          | 2,231               | (30 )             | —                 | —                 | 2,231      | (30 )             |
|  | \$27,070            | \$(822 )          | \$3,308           | \$(70 )           | \$30,378   | \$(892 )          |
|  |                     |                   |                   |                   |            |                   |
|  | December 31, 2013   |                   |                   |                   |            |                   |
|  | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government and agency obligations | \$1,106             | \$(80 )           | \$—               | \$—               | \$1,106    | \$(80 )           |
| Municipal bonds:                       |                     |                   |                   |                   |            |                   |
| Taxable                                | 3,344               | (110 )            | 2,964             | (94 )             | 6,308      | (204 )            |
| Tax exempt                             | 31,234              | (1,282 )          | 303               | (17 )             | 31,537     | (1,299 )          |
| Total municipal bonds                  | 34,578              | (1,392 )          | 3,267             | (111 )            | 37,845     | (1,503 )          |
| Mortgage-backed or related securities: |                     |                   |                   |                   |            |                   |
| Multifamily agency guaranteed          | 3,293               | (58 )             | —                 | —                 | 3,293      | (58 )             |
|  | \$38,977            | \$(1,530 )        | \$3,267           | \$(111 )          | \$42,244   | \$(1,641 )        |

There were no sales of securities—held-to-maturity during the three months ended March 31, 2014 and 2013. At March 31, 2014, there were 31 securities—held-to-maturity with unrealized losses, compared to 36 securities at December 31, 2013. Management does not believe that any individual unrealized loss as of March 31, 2014 represents OTTI. The decline in fair market value of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. There were no securities—held-to-maturity on nonaccrual status at March 31, 2014 and 2013.

The amortized cost and estimated fair value of securities—held-to-maturity at March 31, 2014 and December 31, 2013, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

|   | March 31, 2014 |            | December 31, 2013 |            |
|---|----------------|------------|-------------------|------------|
|   | Amortized Cost | Fair Value | Amortized Cost    | Fair Value |
| Maturing in one year or less                  | \$1,270        | \$1,277    | \$1,270           | \$1,281    |
| Maturing after one year through five years    | 10,824         | 11,170     | 10,834            | 11,206     |
| Maturing after five years through ten years   | 21,001         | 21,059     | 17,948            | 17,908     |
| Maturing after ten years through twenty years | 60,268         | 62,598     | 59,643            | 60,791     |
| Maturing after twenty years                   | 16,204         | 16,305     | 12,818            | 12,424     |
|   | \$109,567      | \$112,409  | \$102,513         | \$103,610  |



Pledged Securities: The following table presents, as of March 31, 2014, investment securities which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law (in thousands):

|   | Carrying Value | Amortized Cost | Fair Value |
|---|----------------|----------------|------------|
| Purpose or beneficiary:                     |                |                |            |
| State and local governments public deposits | \$ 128,207     | \$ 127,997     | \$ 130,975 |
| Interest rate swap counterparties           | 8,850          | 8,527          | 8,850      |
| Retail repurchase agreements                | 103,394        | 103,120        | 103,394    |
| Total pledged securities                    | \$ 240,451     | \$ 239,644     | \$ 243,219 |

#### Note 6: FHLB STOCK

The Banks' investments in Federal Home Loan Bank of Seattle stock are carried at par value (\$100 per share), which reasonably approximates its fair value. 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. At March 31, 2014 and December 31, 2013, respectively, the Company had recorded \$33.3 million and \$35.4 million in investments in FHLB stock. This stock is generally viewed as a long-term investment and 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. For the three months ended March 31, 2014, the Banks received dividend income of \$9,000 on FHLB stock. For the three months ended March 31, 2013, 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.

Previously, the Federal Housing Finance Agency (the FHFA), the FHLB of Seattle's primary regulator, determined that the FHLB of Seattle had a risk-based capital deficiency as of December 31, 2008, and required the FHLB to suspend future dividends and the repurchase and redemption of outstanding common stock. Subsequent improvement in the FHLB's operating performance and financial condition, however, led to a September 7, 2012 announcement by the FHLB 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 the consent of the FHFA. However, the FHFA has subsequently approved the repurchase of portions of FHLB of Seattle stock in each quarter since the third quarter of 2012, and has approved the payment of cash dividends by the FHLB of Seattle in each quarter since the third quarter of 2013. The FHLB repurchased \$2.1 million of the Banks' stock during the quarter ending March 31, 2014. The FHLB of Seattle announced on February 20, 2014 that, based on fourth quarter 2013 financial results, its Board of Directors had declared a \$0.025 per share cash dividend. It is the third dividend in a number of years and represents a significant milestone in FHLB of Seattle's return to normal operations. 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 no impairment on the FHLB stock investment as of March 31, 2014.

#### Note 7: LOANS RECEIVABLE AND THE ALLOWANCE FOR LOAN LOSSES

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

Interest is accrued as earned unless management doubts the collectability of the loan or the unpaid interest. Interest accruals are generally discontinued when loans become 90 days past due for scheduled interest payments. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is included in interest income based upon an assessment of the likelihood that the loans will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the loan may be uncollectable. Such interest is then recognized as income only if it is ultimately collected.



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Loans receivable, including loans held for sale, at March 31, 2014, December 31, 2013 and March 31, 2013 are summarized as follows (dollars in thousands):

|  | March 31, 2014 |                  | December 31, 2013 |                  | March 31, 2013 |                  |   |
|--|----------------|------------------|-------------------|------------------|----------------|------------------|---|
|  | Amount         | Percent of Total | Amount            | Percent of Total | Amount         | Percent of Total |   |
| Commercial real estate:                              |                |                  |                   |                  |                |                  |   |
| Owner-occupied                                       | \$504,429      | 14.3             | % \$502,601       | 14.7             | % \$497,442    | 15.3             | % |
| Investment properties                                | 746,670        | 21.2             | 692,457           | 20.3             | 602,761        | 18.6             |   |
| Multifamily real estate                              | 153,003        | 4.3              | 137,153           | 4.0              | 134,290        | 4.1              |   |
| Commercial construction                              | 11,146         | 0.3              | 12,168            | 0.4              | 34,762         | 1.1              |   |
| Multifamily construction                             | 63,862         | 1.8              | 52,081            | 1.5              | 34,147         | 1.1              |   |
| One- to four-family construction                     | 219,169        | 6.2              | 200,864           | 5.8              | 171,876        | 5.3              |   |
| Land and land development:                           |                |                  |                   |                  |                |                  |   |
| Residential  | 73,733         | 2.1              | 75,695            | 2.2              | 78,446         | 2.4              |   |
| Commercial   | 10,864         | 0.3              | 10,450            | 0.3              | 12,477         | 0.4              |   |
| Commercial business                                  | 716,546        | 20.4             | 682,169           | 20.0             | 619,478        | 19.1             |   |
| Agricultural business, including secured by farmland | 208,817        | 5.9              | 228,291           | 6.7              | 210,225        | 6.5              |   |
| One- to four-family residential                      | 517,621        | 14.7             | 529,494           | 15.5             | 566,730        | 17.5             |   |
| Consumer:  |                |                  |                   |                  |                |                  |   |
| Consumer secured by one- to four-family              | 177,855        | 5.1              | 173,188           | 5.1              | 165,305        | 5.1              |   |
| Consumer-other                                       | 119,197        | 3.4              | 121,834           | 3.5              | 112,382        | 3.5              |   |
| Total loans outstanding                              | 3,522,912      | 100.0            | % 3,418,445       | 100.0            | % 3,240,321    | 100.0            | % |
| Less allowance for loan losses                       | (74,371 )      |                  | (74,258 )         |                  | (76,396 )      |                  |   |
| Net loans  | \$3,448,541    |                  | \$3,344,187       |                  | \$3,163,925    |                  |   |

Loan amounts are net of unearned loan fees in excess of unamortized costs of \$8.2 million as of March 31, 2014, \$8.3 million as of December 31, 2013 and \$9.0 million as of March 31, 2013.

The Company's total loans by geographic concentration at March 31, 2014 were as follows (dollars in thousands):

|  | Washington | Oregon   | Idaho    | Other    | Total     |
|--|------------|----------|----------|----------|-----------|
| Commercial real estate:                              |            |          |          |          |           |
| Owner-occupied                                       | \$375,100  | \$58,446 | \$58,503 | \$12,380 | \$504,429 |
| Investment properties                                | 512,057    | 105,742  | 58,988   | 69,883   | 746,670   |
| Multifamily real estate                              | 119,490    | 18,360   | 15,014   | 139      | 153,003   |
| Commercial construction                              | 10,663     | —        | 483      | —        | 11,146    |
| Multifamily construction                             | 46,652     | 17,210   | —        | —        | 63,862    |
| One- to four-family construction                     | 117,699    | 100,208  | 1,262    | —        | 219,169   |
| Land and land development:                           |            |          |          |          |           |
| Residential  | 41,348     | 31,143   | 1,242    | —        | 73,733    |
| Commercial   | 5,393      | 3,339    | 2,132    | —        | 10,864    |
| Commercial business                                  | 420,900    | 90,299   | 66,677   | 138,670  | 716,546   |
| Agricultural business, including secured by farmland | 115,341    | 49,250   | 44,226   | —        | 208,817   |
| One- to four-family residential                      | 327,889    | 166,592  | 20,994   | 2,146    | 517,621   |
| Consumer:  |            |          |          |          |           |
| Consumer secured by one- to four-family              | 115,758    | 47,961   | 13,494   | 642      | 177,855   |
| Consumer—other                                       | 80,993     | 32,089   | 5,747    | 368      | 119,197   |

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|                        |             |           |           |           |             |   |
|------------------------|-------------|-----------|-----------|-----------|-------------|---|
| Total loans            | \$2,289,283 | \$720,639 | \$288,762 | \$224,228 | \$3,522,912 |   |
| Percent of total loans | 65.0        | % 20.5    | % 8.2     | % 6.3     | % 100.0     | % |

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The geographic concentrations of the Company's land and land development loans by state at March 31, 2014 were as follows (dollars in thousands):

|  | Washington | Oregon   | Idaho   | Total    |   |
|--|------------|----------|---------|----------|---|
| Residential:                               |            |          |         |          |   |
| Acquisition and development                | \$17,523   | \$11,899 | \$1,018 | \$30,440 |   |
| Improved land and lots                     | 17,866     | 18,643   | 224     | 36,733   |   |
| Unimproved land                            | 5,959      | 601      | —       | 6,560    |   |
| Commercial:                                |            |          |         |          |   |
| Acquisition and development                | —          | —        | 351     | 351      |   |
| Improved land and lots                     | 2,739      | 513      | 625     | 3,877    |   |
| Unimproved land                            | 2,654      | 2,826    | 1,156   | 6,636    |   |
| Total land and land development loans      | \$46,741   | \$34,482 | \$3,374 | \$84,597 |   |
| Percent of land and land development loans | 55.2       | % 40.8   | % 4.0   | % 100.0  | % |

The Company originates both adjustable- and fixed-rate loans. The maturity and repricing composition of those loans, less undisbursed amounts and deferred fees and origination costs, at March 31, 2014, December 31, 2013 and March 31, 2013 were as follows (in thousands):

|  | March 31, 2014 | December 31, 2013 | March 31, 2013 |
|--|----------------|-------------------|----------------|
| Fixed-rate (term to maturity):                             |                |                   |                |
| Maturing in one year or less                               | \$138,143      | \$122,313         | \$152,586      |
| Maturing after one year through three years                | 129,715        | 143,322           | 176,372        |
| Maturing after three years through five years              | 186,169        | 187,279           | 187,021        |
| Maturing after five years through ten years                | 213,774        | 209,869           | 172,654        |
| Maturing after ten years                                   | 476,228        | 439,004           | 445,872        |
| Total fixed-rate loans                                     | 1,144,029      | 1,101,787         | 1,134,505      |
| Adjustable-rate (term to rate adjustment):                 |                |                   |                |
| Maturing or repricing in one year or less                  | 1,413,240      | 1,390,579         | 1,274,415      |
| Maturing or repricing after one year through three years   | 313,218        | 279,791           | 253,048        |
| Maturing or repricing after three years through five years | 546,291        | 541,529           | 515,861        |
| Maturing or repricing after five years through ten years   | 104,609        | 99,503            | 62,443         |
| Maturing or repricing after ten years                      | 1,525          | 5,256             | 49             |
| Total adjustable-rate loans                                | 2,378,883      | 2,316,658         | 2,105,816      |
| Total loans  | \$3,522,912    | \$3,418,445       | \$3,240,321    |

The adjustable-rate loans have interest rate adjustment limitations and are generally indexed to various prime or London Inter-bank Offering Rate (LIBOR) rates, One to Five Year Constant Maturity Treasury Indices or FHLB advance rates. Future market factors may affect the correlation of the interest rate adjustment with the rates the Banks pay on the short-term deposits that were primarily utilized to fund these loans.

Impaired Loans and the Allowance for Loan Losses. A loan is considered impaired when, based on current information and circumstances, the Company determines it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Impaired loans are comprised of loans on nonaccrual, troubled debt restructurings (TDRs) that are performing under their restructured terms, and loans that are 90 days or more past due, but are still on accrual.

Troubled Debt Restructures. Some of the Company's loans are reported as TDRs. Loans are reported as TDRs when the bank grants one or more concessions to a borrower experiencing financial difficulties that it would not otherwise consider. Examples of such concessions include forgiveness of principal or accrued interest, extending the maturity date(s) or providing a lower interest rate than would be normally available for a transaction of similar risk. Our TDRs

have generally not involved forgiveness of amounts due, but almost always include a modification of multiple factors; the most common combination includes interest rate, payment amount and maturity date. As a result of these concessions, restructured loans are impaired as the Bank will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. Loans identified as TDRs are accounted for in accordance with the Company's impaired loan accounting policies.

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The amount of impaired loans and the related allocated reserve for loan losses as of March 31, 2014 and December 31, 2013 were as follows (in thousands):

|  | March 31, 2014 |                    | December 31, 2013 |                    |
|--|----------------|--------------------|-------------------|--------------------|
|  | Loan Amount    | Allocated Reserves | Loan Amount       | Allocated Reserves |
| Impaired loans:                                      |                |                    |                   |                    |
| Nonaccrual loans                                     |                |                    |                   |                    |
| Commercial real estate:                              |                |                    |                   |                    |
| Owner-occupied                                       | \$2,509        | \$39               | \$2,466           | \$31               |
| Investment properties                                | 3,692          | 62                 | 3,821             | 89                 |
| One- to four-family construction                     | 269            | 70                 | 269               | —                  |
| Land and land development:                           |                |                    |                   |                    |
| Residential  | 1,866          | 234                | 924               | 6                  |
| Commercial business                                  | 977            | 80                 | 724               | 104                |
| One- to four-family residential                      | 10,587         | 63                 | 12,532            | 250                |
| Consumer:  |                |                    |                   |                    |
| Consumer secured by one- to four-family              | 1,178          | 33                 | 903               | 13                 |
| Consumer—other                                       | 221            | —                  | 269               | 1                  |
| Total nonaccrual loans                               | 21,299         | 581                | 21,908            | 494                |
| Loans past due and still accruing                    |                |                    |                   |                    |
| Agricultural business, including secured by farmland | 104            | 7                  | 105               | 8                  |
| One- to four-family residential                      | 1,465          | 9                  | 2,611             | 16                 |
| Consumer:  |                |                    |                   |                    |
| Consumer secured by one- to four-family              | —              | —                  | 13                | —                  |
| Consumer—other                                       | —              | —                  | 131               | 1                  |
| Total loans past due and still accruing              | 1,569          | 16                 | 2,860             | 25                 |
| Troubled debt restructuring on accrual status:       |                |                    |                   |                    |
| Commercial real estate:                              |                |                    |                   |                    |
| Owner-occupied                                       | 185            | 4                  | 186               | 4                  |
| Investment properties                                | 4,621          | 570                | 5,367             | 415                |
| Multifamily real estate                              | 5,726          | 1,060              | 5,744             | 1,139              |
| One- to four-family construction                     | 5,727          | 846                | 6,864             | 1,002              |
| Land and land development:                           |                |                    |                   |                    |
| Residential  | 2,271          | 371                | 4,061             | 754                |
| Commercial business                                  | 1,040          | 159                | 1,299             | 222                |
| One- to four-family residential                      | 19,998         | 1,250              | 23,302            | 1,355              |
| Consumer:  |                |                    |                   |                    |
| Consumer secured by one- to four-family              | 360            | 32                 | 360               | 33                 |
| Consumer—other                                       | 239            | 34                 | 245               | 34                 |
| Total troubled debt restructurings on accrual status | 40,167         | 4,326              | 47,428            | 4,958              |
| Total impaired loans                                 | \$63,035       | \$4,923            | \$72,196          | \$5,477            |

As of March 31, 2014 and December 31, 2013, the Company had commitments to advance funds up to an additional amount of \$913,000 and \$225,000, respectively, related to TDRs.



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The following tables provide additional information on impaired loans with and without specific allowance reserves at or for the three months ended March 31, 2014 and at or for the year ended December 31, 2013 (in thousands):

At or For the Three Months Ended March 31, 2014

|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| Without a specific allowance reserve <sup>(1)</sup> |                        |                                |                      |                                   |                                  |
| Commercial real estate:                             |                        |                                |                      |                                   |                                  |
| Owner-occupied                                      | \$608                  | \$658                          | \$39                 | \$615                             | \$—                              |
| Investment properties                               | 336                    | 882                            | 63                   | 351                               | —                                |
| Commercial business                                 | 977                    | 1,546                          | 80                   | 1,188                             | —                                |
| Agricultural business/farmland                      | 104                    | 104                            | 7                    | 104                               | —                                |
| One- to four-family residential                     | 7,091                  | 7,572                          | 30                   | 7,098                             | —                                |
| Consumer:   |                        |                                |                      |                                   |                                  |
| Consumer secured by one- to four-family             | 811                    | 954                            | 11                   | 815                               | —                                |
| Consumer—other                                      | 99                     | 119                            | —                    | 107                               | —                                |
|   | 10,026                 | 11,835                         | 230                  | 10,278                            | —                                |
| With a specific allowance reserve <sup>(2)</sup>    |                        |                                |                      |                                   |                                  |
| Commercial real estate:                             |                        |                                |                      |                                   |                                  |
| Owner-occupied                                      | 2,086                  | 2,086                          | 4                    | 2,101                             | 3                                |
| Investment properties                               | 7,977                  | 9,030                          | 569                  | 7,996                             | 56                               |
| Multifamily real estate                             | 5,726                  | 5,726                          | 1,060                | 5,731                             | 78                               |
| One- to-four family construction                    | 5,996                  | 6,076                          | 916                  | 5,962                             | 62                               |
| Land and land development:                          |                        |                                |                      |                                   |                                  |
| Residential   | 4,137                  | 5,292                          | 605                  | 4,218                             | 32                               |
| Commercial business                                 | 1,040                  | 1,040                          | 159                  | 1,044                             | 13                               |
| One- to four-family residential                     | 24,959                 | 25,969                         | 1,292                | 25,148                            | 256                              |
| Consumer:   |                        |                                |                      |                                   |                                  |
| Consumer secured by one- to four-family             | 727                    | 727                            | 54                   | 727                               | 5                                |
| Consumer—other                                      | 361                    | 378                            | 34                   | 364                               | 6                                |
|   | 53,009                 | 56,324                         | 4,693                | 53,291                            | 511                              |
| Total   |                        |                                |                      |                                   |                                  |
| Commercial real estate:                             |                        |                                |                      |                                   |                                  |
| Owner-occupied                                      | 2,694                  | 2,744                          | 43                   | 2,716                             | 3                                |
| Investment properties                               | 8,313                  | 9,912                          | 632                  | 8,347                             | 56                               |
| Multifamily real estate                             | 5,726                  | 5,726                          | 1,060                | 5,731                             | 78                               |
| One- to four-family construction                    | 5,996                  | 6,076                          | 916                  | 5,962                             | 62                               |
| Land and land development:                          |                        |                                |                      |                                   |                                  |
| Residential   | 4,137                  | 5,292                          | 605                  | 4,218                             | 32                               |
| Commercial business                                 | 2,017                  | 2,586                          | 239                  | 2,232                             | 13                               |
| Agricultural business/farmland                      | 104                    | 104                            | 7                    | 104                               | —                                |
| One- to four-family residential                     | 32,050                 | 33,541                         | 1,322                | 32,246                            | 256                              |
| Consumer:   |                        |                                |                      |                                   |                                  |
| Consumer secured by one- to four-family             | 1,538                  | 1,681                          | 65                   | 1,542                             | 5                                |
| Consumer—other                                      | 460                    | 497                            | 34                   | 471                               | 6                                |
|   | \$63,035               | \$68,159                       | \$4,923              | \$63,569                          | \$511                            |

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|   | At or For the Year Ended December 31, 2013 |                          |                   |                             |                            |
|---|--|--------------------------|-------------------|-----------------------------|----------------------------|
|   | Recorded Investment                        | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| Without a specific allowance reserve <sup>(1)</sup> |  |                          |                   |                             |                            |
| Commercial real estate:                             |  |                          |                   |                             |                            |
| Owner-occupied                                      | \$534                                      | \$584                    | \$31              | \$569                       | \$—                        |
| Investment properties                               | 429  | 974                      | 89                | 624                         | —                          |
| Commercial business                                 | 724  | 1,040                    | 104               | 896                         | —                          |
| Agricultural business/farmland                      | 105  | 105                      | 8                 | 110                         | 8                          |
| One- to four-family residential                     | 8,611                                      | 9,229                    | 42                | 8,889                       | 31                         |
| Consumer:   |  |                          |                   |                             |                            |
| Consumer secured by one- to four-family             | 870  | 1,013                    | 13                | 900                         | 1                          |
| Consumer—other                                      | 276  | 285                      | 2                 | 287                         | 8                          |
|   | 11,549                                     | 13,230                   | 289               | 12,275                      | 48                         |
| With a specific allowance reserve <sup>(2)</sup>    |  |                          |                   |                             |                            |
| Commercial real estate:                             |  |                          |                   |                             |                            |
| Owner-occupied                                      | 2,118                                      | 2,118                    | 4                 | 2,192                       | 12                         |
| Investment properties                               | 8,759                                      | 10,395                   | 415               | 8,353                       | 241                        |
| Multifamily real estate                             | 5,744                                      | 5,744                    | 1,139             | 5,705                       | 298                        |
| One- to four family construction                    | 7,133                                      | 7,213                    | 1,002             | 5,870                       | 239                        |
| Land and land development:                          |  |                          |                   |                             |                            |
| Residential   | 4,985                                      | 6,140                    | 760               | 6,053                       | 221                        |
| Commercial business                                 | 1,298                                      | 1,298                    | 222               | 1,340                       | 59                         |
| One- to four-family residential                     | 29,834                                     | 31,440                   | 1,579             | 31,668                      | 1,032                      |
| Consumer:   |  |                          |                   |                             |                            |
| Consumer secured by one- to four-family             | 406  | 407                      | 33                | 503                         | 24                         |
| Consumer—other                                      | 370  | 386                      | 34                | 390                         | 21                         |
|   | 60,647                                     | 65,141                   | 5,188             | 62,074                      | 2,147                      |
| Total   |  |                          |                   |                             |                            |
| Commercial real estate                              |  |                          |                   |                             |                            |
| Owner-occupied                                      | 2,652                                      | 2,702                    | 35                | 2,761                       | 12                         |
| Investment properties                               | 9,188                                      | 11,369                   | 504               | 8,977                       | 241                        |
| Multifamily real estate                             | 5,744                                      | 5,744                    | 1,139             | 5,705                       | 298                        |
| One- to four-family construction                    | 7,133                                      | 7,213                    | 1,002             | 5,870                       | 239                        |
| Land and land development                           |  |                          |                   |                             |                            |
| Residential   | 4,985                                      | 6,140                    | 760               | 6,053                       | 221                        |
| Commercial business                                 | 2,022                                      | 2,338                    | 326               | 2,236                       | 59                         |
| Agricultural business/farmland                      | 105  | 105                      | 8                 | 110                         | 8                          |
| One- to four-family residential                     | 38,445                                     | 40,669                   | 1,621             | 40,557                      | 1,063                      |
| Consumer  |  |                          |                   |                             |                            |
| Consumer secured by one- to four-family             | 1,276                                      | 1,420                    | 46                | 1,403                       | 25                         |
| Consumer—other                                      | 646  | 671                      | 36                | 677                         | 29                         |
|   | \$72,196                                   | \$78,371                 | \$5,477           | \$74,349                    | \$2,195                    |

(1) Loans without a specific allowance reserve have not been individually evaluated for impairment, but have been included in pools of homogeneous loans for evaluation of related allowance reserves.

(2) Loans with a specific allowance reserve have been individually evaluated for impairment using either a discounted cash flow analysis or, for collateral dependent loans, current appraisals to establish realizable value. These analyses may identify a specific impairment amount needed or may conclude that no reserve is needed. Any



specific impairment that is identified is included in the category's Related Allowance column.

The following tables present TDRs at March 31, 2014 and December 31, 2013 (in thousands):

|   | March 31, 2014    |                      |               |
|---|-------------------|----------------------|---------------|
|   | Accrual<br>Status | Nonaccrual<br>Status | Total<br>TDRs |
| Commercial real estate:                 |                   |                      |               |
| Owner-occupied                          | \$ 185            | \$ 700               | \$ 885        |
| Investment properties                   | 4,621             | 1,587                | 6,208         |
| Multifamily real estate                 | 5,726             | —                    | 5,726         |
| One- to four-family construction        | 5,727             | 269                  | 5,996         |
| Land and land development:              |                   |                      |               |
| Residential                             | 2,271             | 1,116                | 3,387         |
| Commercial business                     | 1,040             | 143                  | 1,183         |
| One- to four-family residential         | 19,998            | 2,751                | 22,749        |
| Consumer:                               |                   |                      |               |
| Consumer secured by one- to four-family | 360               | 249                  | 609           |
| Consumer—other                          | 239               | 122                  | 361           |
|   | \$40,167          | \$6,937              | \$47,104      |
|   |                   |                      |               |
|   | December 31, 2013 |                      |               |
|   | Accrual<br>Status | Nonaccrual<br>Status | Total<br>TDRs |
| Commercial real estate:                 |                   |                      |               |
| Owner-occupied                          | \$ 186            | \$ 613               | \$ 799        |
| Investment properties                   | 5,367             | 1,630                | 6,997         |
| Multifamily real estate                 | 5,744             | —                    | 5,744         |
| One- to four-family construction        | 6,864             | 269                  | 7,133         |
| Land and land development:              |                   |                      |               |
| Residential                             | 4,061             | 174                  | 4,235         |
| Commercial business                     | 1,299             | 164                  | 1,463         |
| One- to four-family residential         | 23,302            | 2,474                | 25,776        |
| Consumer:                               |                   |                      |               |
| Consumer secured by one- to four-family | 360               | 252                  | 612           |
| Consumer—other                          | 245               | 123                  | 368           |
|   | \$47,428          | \$5,699              | \$53,127      |

The following tables present new TDRs that occurred during the three months ended March 31, 2014 and 2013 (dollars in thousands):

|   | Three Months Ended March 31, 2014 |  |   |
|---|-----------------------------------|--|---|
|   | Number of Contracts               | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment |
| Recorded Investment <sup>(1)</sup> <sup>(2)</sup> |                                   |  |   |
| Commercial real estate                            |                                   |  |   |
| Owner occupied                                    | 1                                 | \$ 94  | \$ 94   |
| Commercial business                               | 1                                 | 100  | 100   |
|   | 2                                 | \$ 194   | \$ 194  |
|   |                                   |  |   |
|   | Three Months Ended March 31, 2013 |  |   |
|   | Number of Contracts               | Pre-modification Outstanding Recorded Investment | Post-modification Outstanding Recorded Investment |
| Recorded Investment <sup>(1)</sup> <sup>(2)</sup> |                                   |  |   |
| One- to four-family construction                  | 4                                 | \$ 427   | \$ 427  |
| One- to four-family residential                   | 10                                | 3,709  | 3,695   |
|   | 14                                | \$ 4,136   | \$ 4,122  |

- (1) Since most loans were already considered classified and/or on nonaccrual status prior to restructuring, the modifications did not have a material effect on the Company's determination of the allowance for loan losses. The majority of these modifications do not fit into one separate type, such as rate, term, amount, interest-only or payment, but instead are a combination of multiple types of modifications; therefore, they are disclosed in aggregate.
- (2) payment, but instead are a combination of multiple types of modifications; therefore, they are disclosed in aggregate.

The following table presents TDRs which incurred a payment default within twelve months of the restructure date during the three-month periods ended March 31, 2014 and 2013 (in thousands). A default on a TDR results in either a transfer to nonaccrual status or a partial charge-off:

|                     | Three Months Ended March 31 |       |
|---------------------|-----------------------------|-------|
|                     | 2014                        | 2013  |
| Commercial business | \$—                         | \$351 |
| Total               | \$—                         | \$351 |

**Credit Quality Indicators:** To appropriately and effectively manage the ongoing credit quality of the Company's loan portfolio, management has implemented a risk-rating or loan grading system for its loans. The system is a tool to evaluate portfolio asset quality throughout each applicable loan's life as an asset of the Company. Generally, loans and leases are risk rated on an aggregate borrower/relationship basis with individual loans sharing similar ratings. There are some instances when specific situations relating to individual loans will provide the basis for different risk ratings within the aggregate relationship. Loans are graded on a scale of 1 to 9. A description of the general characteristics of these categories is shown below:

**Overall Risk Rating Definitions:** Risk-ratings contain both qualitative and quantitative measurements and take into account the financial strength of a borrower and the structure of the loan or lease. Consequently, the definitions are to be applied in the context of each lending transaction and judgment must also be used to determine the appropriate risk rating, as it is not unusual for a loan or lease to exhibit characteristics of more than one risk-rating category. Consideration for the final rating is centered in the borrower's ability to repay, in a timely fashion, both principal and interest. There were no material changes in the risk-rating or loan grading system in the three months ended March 31, 2014.

**Risk Rating 1: Exceptional**

A credit supported by exceptional financial strength, stability, and liquidity. The risk rating of 1 is reserved for the Company's top quality loans, generally reserved for investment grade credits underwritten to the standards of institutional credit providers.

**Risk Rating 2: Excellent**

A credit supported by excellent financial strength, stability and liquidity. The risk rating of 2 is reserved for very strong and highly stable customers with ready access to alternative financing sources.

**Risk Rating 3: Strong**

A credit supported by good overall financial strength and stability. Collateral margins are strong; cash flow is stable although susceptible to cyclical market changes.

**Risk Rating 4: Acceptable**

A credit supported by the borrower's adequate financial strength and stability. Assets and cash flow are reasonably sound and provide for orderly debt reduction. Access to alternative financing sources will be more difficult to obtain.

**Risk Rating 5: Watch**

A credit with the characteristics of an acceptable credit which requires, however, more than the normal level of supervision and warrants formal quarterly management reporting. Credits in this category are not yet criticized or classified, but due to adverse events or aspects of underwriting require closer than normal supervision. Generally, credits should be watch credits in most cases for six months or less as the impact of stress factors are analyzed.

**Risk Rating 6: Special Mention**

A credit with potential weaknesses that deserves management's close attention is risk rated a 6. If left uncorrected, these potential weaknesses will result in deterioration in the capacity to repay debt. A key distinction between Special Mention and Substandard is that in a Special Mention credit, there are identified weaknesses that pose potential risk(s) to the repayment sources, versus well defined weaknesses that pose risk(s) to the repayment sources. Assets in this category are expected to be in this category no more than 9-12 months as the potential weaknesses in the credit are resolved.

**Risk Rating 7: Substandard**

A credit with well defined weaknesses that jeopardize the ability to repay in full is risk rated a 7. These credits are inadequately protected by either the sound net worth and payment capacity of the borrower or the value of pledged

collateral. These are credits with a distinct possibility of loss. Loans headed for foreclosure and/or legal action due to deterioration are rated 7 or worse.

**Risk Rating 8: Doubtful**

A credit with an extremely high probability of loss is risk rated 8. These credits have all the same critical weaknesses that are found in a substandard loan; however, the weaknesses are elevated to the point that based upon current information, collection or liquidation in full is improbable. While some loss on doubtful credits is expected, pending events may strengthen a credit making the amount and timing of any loss indeterminable. In these situations taking the loss is inappropriate until it is clear that the pending event has failed to strengthen the credit and improve the capacity to repay debt.

**Risk Rating 9: Loss**

A credit that is considered to be currently uncollectible or of such little value that it is no longer a viable Bank asset is risk rated 9. Losses should be taken in the accounting period in which the credit is determined to be uncollectible. Taking a loss does not mean that a credit has absolutely no recovery or salvage value but, rather, it is not practical or desirable to defer writing off the credit, even though partial recovery may occur in the future.

The following table shows the Company's portfolio of risk-rated loans and non-risk-rated loans by grade or other characteristics as of March 31, 2014 and December 31, 2013 (in thousands):

|  | March 31, 2014            |                               |                          |                        |                          |                        |            |              |
|--|---------------------------|-------------------------------|--------------------------|------------------------|--------------------------|------------------------|------------|--------------|
|  | Commercial<br>Real Estate | Multifamily<br>Real<br>Estate | Construction<br>and Land | Commercial<br>Business | Agricultural<br>Business | One- to<br>Four-Family | Consumer   | Total Loans  |
| Risk-rated loans:                      |                           |                               |                          |                        |                          |                        |            |              |
| Pass (Risk Ratings 1-5) <sup>(1)</sup> | \$ 1,216,193              | \$ 147,391                    | \$ 358,451               | \$ 693,520             | \$ 207,851               | \$ 502,701             | \$ 293,947 | \$ 3,420,054 |
| Special mention                        | 8,752                     | —                             | 350                      | 12,092                 | 606                      | —                      | 104        | 21,904       |
| Substandard                            | 25,610                    | 5,612                         | 19,973                   | 10,926                 | 360                      | 14,920                 | 3,001      | 80,402       |
| Doubtful                               | 544                       | —                             | —                        | 8                      | —                        | —                      | —          | 552          |
| Loss                                   | —                         | —                             | —                        | —                      | —                        | —                      | —          | —            |
| Total loans                            | \$ 1,251,099              | \$ 153,003                    | \$ 378,774               | \$ 716,546             | \$ 208,817               | \$ 517,621             | \$ 297,052 | \$ 3,522,912 |
| Performing loans                       | \$ 1,244,898              | \$ 153,003                    | \$ 376,639               | \$ 715,569             | \$ 208,713               | \$ 505,569             | \$ 295,653 | \$ 3,500,044 |
| Non-performing loans <sup>(2)</sup>    | 6,201                     | —                             | 2,135                    | 977                    | 104                      | 12,052                 | 1,399      | 22,868       |
| Total loans                            | \$ 1,251,099              | \$ 153,003                    | \$ 378,774               | \$ 716,546             | \$ 208,817               | \$ 517,621             | \$ 297,052 | \$ 3,522,912 |
| December 31, 2013                      |                           |                               |                          |                        |                          |                        |            |              |
|  | Commercial<br>Real Estate | Multifamily<br>Real<br>Estate | Construction<br>and Land | Commercial<br>Business | Agricultural<br>Business | One- to<br>Four-Family | Consumer   | Total Loans  |
| Risk-rated loans:                      |                           |                               |                          |                        |                          |                        |            |              |
| Pass (Risk Ratings 1-5) <sup>(1)</sup> | \$ 1,160,921              | \$ 131,523                    | \$ 332,150               | \$ 655,007             | \$ 225,329               | \$ 511,967             | \$ 291,992 | \$ 3,308,889 |
| Special mention                        | 6,614                     | —                             | 350                      | 10,484                 | 561                      | —                      | 106        | 18,115       |
| Substandard                            | 26,979                    | 5,630                         | 18,758                   | 16,669                 | 2,401                    | 17,527                 | 2,924      | 90,888       |
| Doubtful                               | 544                       | —                             | —                        | 9                      | —                        | —                      | —          | 553          |
| Loss                                   | —                         | —                             | —                        | —                      | —                        | —                      | —          | —            |
| Total loans                            | \$ 1,195,058              | \$ 137,153                    | \$ 351,258               | \$ 682,169             | \$ 228,291               | \$ 529,494             | \$ 295,022 | \$ 3,418,445 |
| Performing loans                       | \$ 1,188,771              | \$ 137,153                    | \$ 350,065               | \$ 681,445             | \$ 228,187               | \$ 514,351             | \$ 293,705 | \$ 3,393,677 |
| Non-performing loans <sup>(2)</sup>    | 6,287                     | —                             | 1,193                    | 724                    | 104                      | 15,143                 | 1,317      | 24,768       |
| Total loans                            | \$ 1,195,058              | \$ 137,153                    | \$ 351,258               | \$ 682,169             | \$ 228,291               | \$ 529,494             | \$ 295,022 | \$ 3,418,445 |

The Pass category includes some performing loans that are part of homogenous pools which are not individually risk-rated. This includes all consumer loans, all one- to four-family residential loans and, as of March 31, 2014

<sup>(1)</sup> and December 31, 2013, in the commercial business category, \$97 million and \$94 million, respectively, of credit-scored small business loans. As loans in these pools become non-performing, they are individually risk-rated.

<sup>(2)</sup> Non-performing loans include non-accrual loans and loans past due greater than 90 days and on accrual status.

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The following tables provide additional detail on the age analysis of the Company's past due loans as of March 31, 2014 and December 31, 2013 (in thousands):

|   | March 31, 2014            |                           |                                |                   |             |             |   |
|---|---------------------------|---------------------------|--------------------------------|-------------------|-------------|-------------|---|
|   | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Current     | Total Loans | Loans 90<br>Days or<br>More Past<br>Due and<br>Accruing |
| Commercial real estate:                                 |                           |                           |                                |                   |             |             |   |
| Owner-occupied  | \$3,312                   | \$—                       | \$544                          | \$3,856           | \$500,573   | \$504,429   | \$—   |
| Investment properties                                   | —                         | —                         | 1,820                          | 1,820             | 744,850     | 746,670     | —   |
| Multifamily real estate                                 | —                         | —                         | —                              | —                 | 153,003     | 153,003     | —   |
| Commercial construction                                 | —                         | —                         | —                              | —                 | 11,146      | 11,146      | —   |
| Multifamily construction                                | —                         | —                         | —                              | —                 | 63,862      | 63,862      | —   |
| One-to-four-family construction                         | 1,516                     | —                         | 269                            | 1,785             | 217,384     | 219,169     | —   |
| Land and land development:                              |                           |                           |                                |                   |             |             |   |
| Residential   | —                         | 560                       | 750                            | 1,310             | 72,423      | 73,733      | —   |
| Commercial  | —                         | —                         | —                              | —                 | 10,864      | 10,864      | —   |
| Commercial business                                     | 3,714                     | 822                       | 118                            | 4,654             | 711,892     | 716,546     | —   |
| Agricultural business, including<br>secured by farmland | 450                       | —                         | 105                            | 555               | 208,262     | 208,817     | 104   |
| One- to four-family residential                         | 843                       | 1,836                     | 5,796                          | 8,475             | 509,146     | 517,621     | 1,465   |
| Consumer:   |                           |                           |                                |                   |             |             |   |
| Consumer secured by one- to<br>four-family              | 232                       | 660                       | 459                            | 1,351             | 176,504     | 177,855     | —   |
| Consumer—other  | 451                       | 331                       | 15                             | 797               | 118,400     | 119,197     | —   |
| Total   | \$10,518                  | \$4,209                   | \$9,876                        | \$24,603          | \$3,498,309 | \$3,522,912 | \$1,569   |

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December 31, 2013

|   | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Current     | Total Loans | Loans 90<br>Days or<br>More Past<br>Due and<br>Accruing |
|---|---------------------------|---------------------------|--------------------------------|-------------------|-------------|-------------|---|
| Commercial real estate:                                 |                           |                           |                                |                   |             |             |   |
| Owner-occupied  | \$883                     | \$550                     | \$813                          | \$2,246           | \$500,355   | \$502,601   | \$—   |
| Investment properties                                   | —                         | —                         | —                              | —                 | 692,457     | 692,457     | —   |
| Multifamily real estate                                 | 1,845                     | 785                       | —                              | 2,630             | 134,523     | 137,153     | —   |
| Commercial construction                                 | —                         | —                         | —                              | —                 | 12,168      | 12,168      | —   |
| Multifamily construction                                | —                         | —                         | —                              | —                 | 52,081      | 52,081      | —   |
| One-to-four-family construction                         | 9                         | 7                         | 4                              | 20                | 200,844     | 200,864     | —   |
| Land and land development:                              |                           |                           |                                |                   |             |             |   |
| Residential   | —                         | —                         | 251                            | 251               | 75,444      | 75,695      | —   |
| Commercial  | —                         | —                         | —                              | —                 | 10,450      | 10,450      | —   |
| Commercial business                                     | 2,001                     | 2                         | 299                            | 2,302             | 679,867     | 682,169     | —   |
| Agricultural business, including<br>secured by farmland | —                         | —                         | —                              | —                 | 228,291     | 228,291     | 105   |
| One-to four-family residential                          | 521                       | 2,550                     | 9,142                          | 12,213            | 517,281     | 529,494     | 2,611   |
| Consumer:   |                           |                           |                                |                   |             |             |   |
| Consumer secured by one- to<br>four-family              | 723                       | 93                        | 918                            | 1,734             | 171,454     | 173,188     | 13  |
| Consumer—other  | 384                       | 99                        | 131                            | 614               | 121,220     | 121,834     | 131   |
| Total   | \$6,366                   | \$4,086                   | \$11,558                       | \$22,010          | \$3,396,435 | \$3,418,445 | \$2,860   |



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The following tables provide additional information on the allowance for loan losses and loan balances individually and collectively evaluated for impairment at or for the three months ended March 31, 2014 and 2013 (in thousands):

For the Three Months Ended March 31, 2014

|                               | Commercial<br>Real<br>Estate | Multifamily<br>Real<br>Estate | Construction<br>and Land | Commercial<br>Business | Agricultural<br>Business | One- to<br>Four-Family | Consumer | Unallocated | Total     |
|-------------------------------|------------------------------|-------------------------------|--------------------------|------------------------|--------------------------|------------------------|----------|-------------|-----------|
| Allowance for<br>loan losses: |                              |                               |                          |                        |                          |                        |          |             |           |
| Beginning<br>balance          | \$ 16,759                    | \$ 5,306                      | \$ 17,640                | \$ 11,773              | \$ 2,841                 | \$ 11,486              | \$ 1,335 | \$ 7,118    | \$ 74,258 |
| Provision for<br>loan losses  | 595                          | 346                           | 748                      | 35                     | (555 )                   | (382 )                 | (532 )   | (255 )      | —         |
| Recoveries                    | 296                          | —                             | 232                      | 293                    | 350                      | 188                    | 282      | —           | 1,641     |
| Charge-offs                   | (238 )                       | —                             | —                        | (738 )                 | —                        | (379 )                 | (173 )   | —           | (1,528 )  |
| Ending balance                | \$ 17,412                    | \$ 5,652                      | \$ 18,620                | \$ 11,363              | \$ 2,636                 | \$ 10,913              | \$ 912   | \$ 6,863    | \$ 74,371 |

At March 31, 2014

|  | Commercial<br>Real<br>Estate | Multifamily<br>Real<br>Estate | Construction<br>and Land | Commercial<br>Business | Agricultural<br>Business | One- to<br>Four-Family | Consumer | Unallocated | Total     |
|--|------------------------------|-------------------------------|--------------------------|------------------------|--------------------------|------------------------|----------|-------------|-----------|
| Allowance<br>individually<br>evaluated for<br>impairment | \$ 574                       | \$ 1,059                      | \$ 1,521                 | \$ 159                 | \$ —                     | \$ 1,292               | \$ 88    | \$ —        | \$ 4,693  |
| Allowance<br>collectively<br>evaluated for<br>impairment | 16,838                       | 4,593                         | 17,099                   | 11,204                 | 2,636                    | 9,621                  | 824      | 6,863       | 69,678    |
| Total allowance<br>for loan losses                       | \$ 17,412                    | \$ 5,652                      | \$ 18,620                | \$ 11,363              | \$ 2,636                 | \$ 10,913              | \$ 912   | \$ 6,863    | \$ 74,371 |

At March 31, 2014

|  | Commercial<br>Real Estate | Multifamily<br>Real<br>Estate | Construction<br>and Land | Commercial<br>Business | Agricultural<br>Business | One- to<br>Four-Family | Consumer   | Unallo | Total        |
|--|---------------------------|-------------------------------|--------------------------|------------------------|--------------------------|------------------------|------------|--------|--------------|
| Loan balances:                                       |                           |                               |                          |                        |                          |                        |            |        |              |
| Loans<br>individually<br>evaluated for<br>impairment | \$ 10,063                 | \$ 5,726                      | \$ 10,133                | \$ 1,040               | \$ —                     | \$ 24,959              | \$ 1,088   | \$ —   | \$ 53,009    |
| Loans<br>collectively<br>evaluated for<br>impairment | 1,241,036                 | 147,277                       | 368,641                  | 715,506                | 208,817                  | 492,662                | 295,964    | —      | 3,469,903    |
| Total loans  | \$ 1,251,099              | \$ 153,003                    | \$ 378,774               | \$ 716,546             | \$ 208,817               | \$ 517,621             | \$ 297,052 | \$ —   | \$ 3,522,912 |

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For the Three Months Ended March 31, 2013

|                            | Commercial Real Estate | Multifamily Real Estate | Construction and Land | Commercial Business | Agricultural Business | One- to Four-Family | Consumer | Unallocated | Total     |
|----------------------------|------------------------|-------------------------|-----------------------|---------------------|-----------------------|---------------------|----------|-------------|-----------|
| Allowance for loan losses: |                        |                         |                       |                     |                       |                     |          |             |           |
| Beginning balance          | \$ 15,322              | \$ 4,506                | \$ 14,991             | \$ 9,957            | \$ 2,295              | \$ 16,475           | \$ 1,348 | \$ 11,865   | \$ 76,759 |
| Provision for loan losses  | (1,784 )               | 569                     | 557                   | 597                 | (50 )                 | (10 )               | 116      | 5           | —         |
| Recoveries                 | 1,586                  | —                       | 101                   | 386                 | 37                    | 116                 | 102      | —           | 2,328     |
| Charge-offs                | (348 )                 | —                       | (435 )                | (929 )              | —                     | (651 )              | (328 )   | —           | (2,691 )  |
| Ending balance             | \$ 14,776              | \$ 5,075                | \$ 15,214             | \$ 10,011           | \$ 2,282              | \$ 15,930           | \$ 1,238 | \$ 11,870   | \$ 76,396 |

At March 31, 2013

|   | Commercial Real Estate | Multifamily Real Estate | Construction and Land | Commercial Business | Agricultural Business | One- to Four-Family | Consumer | Unallocated | Total     |
|---|------------------------|-------------------------|-----------------------|---------------------|-----------------------|---------------------|----------|-------------|-----------|
| Allowance individually evaluated for impairment | \$ 1,030               | \$ 1,775                | \$ 2,008              | \$ 285              | \$ —                  | \$ 2,225            | \$ 208   | \$ —        | \$ 7,531  |
| Allowance collectively evaluated for impairment | 13,746                 | 3,300                   | 13,206                | 9,726               | 2,282                 | 13,705              | 1,030    | 11,870      | 68,865    |
| Total allowance for loan losses                 | \$ 14,776              | \$ 5,075                | \$ 15,214             | \$ 10,011           | \$ 2,282              | \$ 15,930           | \$ 1,238 | \$ 11,870   | \$ 76,396 |

At March 31, 2013

|   | Commercial Real Estate | Multifamily Real Estate | Construction and Land | Commercial Business | Agricultural Business | One- to Four-Family | Consumer   | Unallocated Total | Total        |
|---|------------------------|-------------------------|-----------------------|---------------------|-----------------------|---------------------|------------|-------------------|--------------|
| Loan balances:                              |                        |                         |                       |                     |                       |                     |            |                   |              |
| Loans individually evaluated for impairment | \$ 12,632              | \$ 7,075                | \$ 13,139             | \$ 4,137            | \$ —                  | \$ 33,945           | \$ 1,704   | \$ —              | \$ 72,632    |
| Loans collectively evaluated for impairment | 1,087,571              | 127,215                 | 318,569               | 615,341             | 210,225               | 532,785             | 275,983    | —                 | 3,167,689    |
| Total loans                                 | \$ 1,100,203           | \$ 134,290              | \$ 331,708            | \$ 619,478          | \$ 210,225            | \$ 566,730          | \$ 277,687 | \$ —              | \$ 3,240,321 |

## Note 8: REAL ESTATE OWNED, NET

The following table presents the changes in REO, net of valuation adjustments, for the three months ended March 31, 2014 and 2013 (in thousands):

|                                     | Three Months Ended |          |
|-------------------------------------|--------------------|----------|
|                                     | March 31           |          |
|                                     | 2014               | 2013     |
| Balance, beginning of the period    | \$4,044            | \$15,778 |
| Additions from loan foreclosures    | 707                | 1,086    |
| Additions from capitalized costs    | 4                  | 46       |
| Dispositions of REO                 | (1,641             | ) (6,481 |
| Gain on sale of REO                 | 159                | 804      |
| Valuation adjustments in the period | (37                | ) (73    |
| Balance, end of the period          | \$3,236            | \$11,160 |

The following table shows REO by type and geographic location by state as of March 31, 2014 (in thousands):

|                                 | Washington | Oregon  | Idaho | Total   |
|---------------------------------|------------|---------|-------|---------|
| Commercial real estate          | \$—        | \$—     | \$175 | \$175   |
| Land development—residential    | 614        | 1,142   | 33    | 1,789   |
| One- to four-family real estate | 627        | 645     | —     | 1,272   |
| Balance, end of period          | \$1,241    | \$1,787 | \$208 | \$3,236 |

REO properties are recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan, establishing a new cost basis. Subsequently, REO properties are carried at the lower of the new cost basis or updated fair market values, based on updated appraisals of the underlying properties, as received. Valuation allowances on the carrying value of REO may be recognized based on updated appraisals or on management's authorization to reduce the selling price of a property.

## Note 9: INTANGIBLE ASSETS AND MORTGAGE SERVICING RIGHTS

Intangible Assets: At March 31, 2014, intangible assets consisted primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits.

The Company amortizes CDI over their estimated useful life and reviews them at least annually for events or circumstances that could impact their recoverability. The CDI assets shown in the table below represent the value ascribed to the long-term deposit relationships acquired in three separate bank acquisitions during 2007 and a single branch acquisition in the quarter ended September 30, 2013. These intangible assets are being amortized using an accelerated method over estimated useful lives of three to eight years. The CDI assets are not estimated to have a significant residual value.

The following table summarizes the changes in the Company's core deposit intangibles for the three months ended March 31, 2014 and the year ended December 31, 2013 (in thousands):

|                            |      |         |
|----------------------------|------|---------|
| Balance, December 31, 2013 | CDI  | \$2,449 |
| Amortization               | (479 | )       |
| Balance, March 31, 2014    | CDI  | \$1,970 |
| Balance, December 31, 2012 | CDI  | \$4,230 |

|                                |         |   |
|--------------------------------|---------|---|
| Additions through acquisitions | 160     |   |
| Amortization                   | (1,941  | ) |
| Balance, December 31, 2013     | \$2,449 |   |

The following table presents the future estimated annual amortization expense with respect to intangibles as of December 31, 2013 (in thousands):

| Year Ended        | CDI      |
|-------------------|----------|
| December 31, 2014 | \$ 1,800 |
| December 31, 2015 | 640      |
| December 31, 2016 | 9        |
|                   | \$2,449  |

**Mortgage Servicing Rights:** Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially recorded at fair value and are amortized in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Mortgage servicing rights are subsequently evaluated for impairment based upon the fair value of the rights compared to the amortized cost (remaining unamortized initial fair value). If the fair value is less than the amortized cost, a valuation allowance is created through an impairment charge to servicing fee income. However, if the fair value is greater than the amortized cost, the amount above the amortized cost is not recognized in the carrying value. During the three months ended March 31, 2014 and 2013, the Company did not record an impairment charge. Loans serviced for others totaled \$1.146 billion, \$1.116 billion and \$984 million at March 31, 2014, December 31, 2013 and March 31, 2013, respectively. Custodial accounts maintained in connection with this servicing totaled \$3.0 million, \$5.4 million and \$2.8 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively.

An analysis of our mortgage servicing rights, net of valuation allowances, for the three months ended March 31, 2014 and 2013 is presented below (in thousands):

|   | Three Months Ended |         |
|---|--------------------|---------|
|   | March 31           |         |
|   | 2014               | 2013    |
| Balance, beginning of the period          | \$8,086            | \$6,244 |
| Amounts capitalized                       | 575                | 776     |
| Amortization <sup>(1)</sup>               | (462)              | (685)   |
| Balance, end of the period <sup>(2)</sup> | \$8,199            | \$6,335 |

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

(2) There was no valuation allowance as of March 31, 2014 and a \$1.3 million valuation allowance as of March 31, 2013.

#### Note 10: DEPOSITS AND RETAIL REPURCHASE AGREEMENTS

Deposits consisted of the following at March 31, 2014, December 31, 2013 and March 31, 2013 (dollars in thousands):

|                                       | March 31, 2014 |                  | December 31, 2013 |                  | March 31, 2013 |                  |
|---------------------------------------|----------------|------------------|-------------------|------------------|----------------|------------------|
|                                       | Amount         | Percent of Total | Amount            | Percent of Total | Amount         | Percent of Total |
| Non-interest-bearing accounts         | \$1,095,665    | 29.8 %           | \$1,115,346       | 30.8 %           | \$962,156      | 27.3 %           |
| Interest-bearing checking             | 435,910        | 11.8             | 422,910           | 11.7             | 400,598        | 11.4             |
| Regular savings accounts              | 829,282        | 22.5             | 798,764           | 22.1             | 759,866        | 21.6             |
| Money market accounts                 | 416,662        | 11.3             | 408,211           | 11.3             | 415,061        | 11.8             |
| Total transaction and saving accounts | 2,777,519      | 75.4             | 2,745,231         | 75.9             | 2,537,681      | 72.1             |
| Certificates of deposit               | 905,016        | 24.6             | 872,695           | 24.1             | 982,903        | 27.9             |
| Total deposits                        | \$3,682,535    | 100.0 %          | \$3,617,926       | 100.0 %          | \$3,520,584    | 100.0 %          |
| Included in total deposits:           |                |                  |                   |                  |                |                  |

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|   |           |     |   |           |     |   |           |     |   |
|---|-----------|-----|---|-----------|-----|---|-----------|-----|---|
| Public fund transaction accounts          | \$84,840  | 2.3 | % | \$87,521  | 2.4 | % | \$73,273  | 2.1 | % |
| Public fund interest-bearing certificates | 57,202    | 1.6 |   | 51,465    | 1.4 |   | 53,552    | 1.5 |   |
| Total public deposits                     | \$142,042 | 3.9 | % | \$138,986 | 3.8 | % | \$126,825 | 3.6 | % |
| Total brokered deposits                   | \$59,304  | 1.6 | % | \$4,291   | 0.1 | % | \$15,709  | 0.4 | % |

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Certificate of deposit accounts by total balance at March 31, 2014, December 31, 2013 and March 31, 2013 were as follows (in thousands):

|   | March 31, 2014 | December 31, 2013 | March 31, 2013 |
|---|----------------|-------------------|----------------|
| Certificates of deposit less than \$100,000         | \$415,049      | \$386,745         | \$440,601      |
| Certificates of deposit \$100,000 through \$250,000 | 312,323        | 308,130           | 350,661        |
| Certificates of deposit more than \$250,000         | 177,644        | 177,820           | 191,641        |
| Total certificates of deposit                       | \$905,016      | \$872,695         | \$982,903      |

Scheduled maturities and repricing of certificate accounts at March 31, 2014, December 31, 2013 and March 31, 2013 were as follows (in thousands):

|                                       | March 31, 2014 | December 31, 2013 | March 31, 2013 |
|---------------------------------------|----------------|-------------------|----------------|
| Certificates which mature or reprice: |                |                   |                |
| Within one year or less               | \$704,498      | \$660,394         | \$705,933      |
| After one year through two years      | 112,776        | 117,789           | 160,279        |
| After two years through three years   | 43,066         | 47,362            | 60,336         |
| After three years through four years  | 25,324         | 26,443            | 27,160         |
| After four years through five years   | 16,112         | 17,075            | 25,353         |
| After five years                      | 3,240          | 3,632             | 3,842          |
| Total certificates of deposit         | \$905,016      | \$872,695         | \$982,903      |

The following table presents the geographic concentration of deposits at March 31, 2014 (dollars in thousands):

|                           | Washington  | Oregon    | Idaho     | Total       |  |   |
|---------------------------|-------------|-----------|-----------|-------------|--|---|
| Total deposits            | \$2,797,012 | \$646,485 | \$239,038 | \$3,682,535 |  |   |
| Percent of total deposits | 76.0        | % 17.5    | % 6.5     | % 100.0     |  | % |

In addition to deposits, we also offer retail repurchase agreements which are customer funds that are primarily associated with sweep account arrangements tied to transaction deposit accounts. While we include these collateralized borrowings in other borrowings reported in our Consolidated Statements of Financial Condition, these accounts primarily represent customer utilization of our cash management services and related deposit accounts.

The following table presents retail repurchase agreement balances as of March 31, 2014, December 31, 2013 and March 31, 2013 (in thousands):

|                              | March 31, 2014 | December 31, 2013 | March 31, 2013 |
|------------------------------|----------------|-------------------|----------------|
| Retail repurchase agreements | \$89,921       | \$83,056          | \$88,446       |

#### Note 11: FAIR VALUE ACCOUNTING AND MEASUREMENT

The Company measures and discloses certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (that is, not a forced liquidation or distressed sale). GAAP (ASC 820, Fair Value Measurements) establishes a consistent framework for measuring fair value and disclosure requirements about fair value measurements. Among other things, the accounting standard requires the reporting entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's estimates for market assumptions. These two types of inputs create the following fair value hierarchy:

-

Level 1 – Quoted prices in active markets for identical instruments. An active market is a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2 – Observable inputs other than Level 1 including quoted prices in active markets for similar instruments, quoted prices in less active markets for identical or similar instruments, or other observable inputs that can be corroborated by observable market data.

Level 3 – Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs from non-binding single dealer quotes not corroborated by observable market data.



The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for certain financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values. Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

#### Items Measured at Fair Value on a Recurring Basis:

Banner records trading account securities, securities available-for-sale, FHLB advances, junior subordinated debentures and certain derivative transactions at fair value on a recurring basis.

- The securities assets primarily consist of U.S. Government and agency obligations, municipal bonds, corporate bonds, single issue trust preferred securities (TPS), pooled trust preferred collateralized debt obligation securities (TRUP CDO), mortgage-backed securities, asset-backed securities, equity securities and certain other financial instruments.

From mid-2008 through the current quarter, the lack of active markets and market participants for certain securities resulted in an increase in Level 3 measurements. This has been particularly true for our TRUP CDO securities. As of March 31, 2014, Banner owned \$31 million in current par value of these securities. The market for TRUP CDO securities has been generally inactive during the period, This was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which TRUP CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market also has been inactive as almost no new TRUP CDOs have been issued since 2007. There are still very few market participants who are willing and/or able to transact for these securities. Thus, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issuer or of the fair value of the security.

Given these conditions in the debt markets and the absence of observable transactions in the secondary and new issue markets, management determined that for the TRUP CDOs at March 31, 2014 and December 31, 2013:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value,

An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs was equally or more representative of fair value than the market approach valuation technique, and

- The Company's TRUP CDOs should be classified exclusively within Level 3 of the fair value hierarchy because of the significant assumptions required to determine fair value at the measurement date.

The TRUP CDO valuations were derived using input from independent third parties who used proprietary cash flow models for analyzing collateralized debt obligations. Their approaches to determining fair value involve considering the credit quality of the collateral, assuming a level of defaults based on the probability of default of each underlying trust preferred security, creating expected cash flows for each TRUP CDO security and discounting that cash flow at an appropriate risk-adjusted rate plus a liquidity premium.

Where appropriate, management reviewed the valuation methodologies and assumptions used by the independent third party providers and determined that the fair value estimates were reasonable and utilized those estimates in the Company's reported financial statements. The result of this fair value analysis of these Level 3 measurements was a fair value loss of \$62,000 in the quarter ended March 31, 2014. The small loss in the current quarter was primarily the result of a modest adjustment to the discount rate which more than offset the impact of the passage of time on years to maturity in the discounted present value calculation used to estimate the fair value of these securities.

At March 31, 2014, Banner also owned approximately \$19 million in amortized cost of single issuer TPS securities for which no direct market data or independent valuation source is available. Similar to the TRUP CDOs above, there were too few, if any, issuances of new TPS securities or sales of existing TPS securities to provide Level 1 or even Level 2 fair value measurements for these securities. Management, therefore, utilized a discounted cash-flow model to calculate the present value of each security's expected future cash flows to determine their respective fair values. Management took into consideration the limited market data that was available regarding similar securities and assessed the performance of the three individual issuers of TPS securities owned by the Company. In the current quarter, the Company again sought input from independent third parties to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. Management concluded that market yields have been reasonably stable in recent periods and that the indicated spreads and implied yields for non-investment grade securities as well as the yields associated with individual issuers in the third party analyst reports continue to suggest that a 525 basis point spread over the three-month LIBOR index, the same spread as used in the quarters ended December 31, 2013 and March 31, 2013, was still a reasonable basis for determining an appropriate discount rate to estimate the fair value of these securities. These factors were then incorporated

into the model at March 31, 2014, where a discount rate equal to three-month LIBOR plus 525 basis points was used to calculate the respective fair values of these securities. The result of this Level 3 fair value measurement was a fair value gain of \$17,000 in the quarter ended March 31, 2014. The Company has and will continue to assess the appropriate fair value hierarchy for determination of these fair values on a quarterly basis.

For all other trading securities and securities available-for-sale we used matrix pricing models from investment reporting and valuation services. Management considers this to be a Level 2 input method.

Fair valuations for FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. Management considers this to be a Level 2 input method.

The fair valuations of junior subordinated debentures (TPS-related debt that the Company has issued) were also valued using discounted cash flows. These debentures carry interest rates that reset quarterly, using the three-month LIBOR index plus spreads of 1.38% to 3.35%. While the quarterly reset of the index on this debt would seemingly keep its fair value reasonably close to book value, the disparity in the fixed spreads above the index and the inability to determine realistic current market spreads, due to lack of new issuances and trades, resulted in having to rely more heavily on assumptions about what spread would be appropriate if market transactions were to take place. In periods prior to the third quarter of 2008, the discount rate used was based on recent issuances or quotes from brokers on the date of valuation for comparable bank holding companies and was considered to be a Level 2 input method. However, as noted above in the discussions of TPS and TRUP CDOs, due to the unprecedented disruption of certain financial markets, management concluded that there were insufficient transactions or other indicators to continue to reflect these measurements as Level 2 inputs. Due to this reliance on assumptions and not on directly observable transactions, management believes fair value for these instruments should follow a Level 3 input methodology. From March 2009 to March 2012, the Company used a discount rate of LIBOR plus 800 basis points to value its junior subordinated debentures. However, similar to the discussion above about the TPS securities, in June 2012, management assessed the performance of Banner and concluded that it had demonstrated sufficient improvement in asset quality, capital position and other performance measures to project sustainable profitability for the foreseeable future sufficient to warrant a reduction in the discount rate used in its fair value modeling. Since the discount rate used in the fair value modeling is the most sensitive unobservable estimate in the calculation, the Company again utilized input from the same independent third party noted above to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. In valuing the debentures at March 31, 2014, management evaluated the general market for credit spreads as noted above and for the discount rate used the period-ending three-month LIBOR plus 525 basis points. As noted above in the discussion about single-issuer TPS securities, since market spreads have been reasonably stable in recent periods we used the same spread as used in the quarters ended December 31, 2013 and March 31, 2013, resulting in a fair value loss on these instruments of \$207,000 for the quarter ended March 31, 2014, compared to a \$291,000 loss for the quarter ended December 31, 2013 and a \$157,000 loss in the quarter ended March 31, 2013. The fair value adjustment in the current period was primarily the result of the passage of time on the years to maturity in the discounted present value calculation used to estimate the fair value.

Derivative instruments include interest rate commitments related to one- to four-family loans and residential mortgage-backed securities and interest rate swaps. The fair value of interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical trends, where appropriate. The fair value of interest rate swaps is determined by using current market quotes on similar instruments provided by active broker/dealers in the swap market. Management considers these to be Level 2 input methods. The changes in the fair value of all of these derivative instruments are primarily attributable to changes in the level of market interest rates. The Company has elected to record the fair value of these derivative instruments on a net basis.



The following tables present financial assets and liabilities measured at fair value on a recurring basis and the level within the fair value hierarchy of the fair value measurements for those assets as of March 31, 2014 and December 31, 2013 (in thousands):

|   | March 31, 2014 |           |          | Total     |
|---|----------------|-----------|----------|-----------|
|   | Level 1        | Level 2   | Level 3  |           |
| <b>Assets:</b>  |                |           |          |           |
| <b>Securities—available-for-sale</b>  |                |           |          |           |
| U.S. Government and agency  | \$—            | \$58,751  | \$—      | \$58,751  |
| Municipal bonds   | —              | 50,334    | —        | 50,334    |
| Corporate bonds   | —              | 4,986     | —        | 4,986     |
| Mortgage-backed or related securities   | —              | 325,230   | —        | 325,230   |
| Asset-backed securities   | —              | 25,356    | —        | 25,356    |
|   | —              | 464,657   | —        | 464,657   |
| <b>Securities—trading</b>   |                |           |          |           |
| U.S. Government and agency  | —              | 1,511     | —        | 1,511     |
| Municipal bonds   | —              | 1,719     | —        | 1,719     |
| TPS and TRUP CDOs   | —              | —         | 35,062   | 35,062    |
| Mortgage-backed or related securities   | —              | 20,033    | —        | 20,033    |
| Equity securities and other   | —              | 62        | —        | 62        |
|   | —              | 23,325    | 35,062   | 58,387    |
| <b>Derivatives</b>  |                |           |          |           |
| Interest rate lock commitments  | —              | 160       | —        | 160       |
| Interest rate swaps   | —              | 5,072     | —        | 5,072     |
|   | \$—            | \$493,214 | \$35,062 | \$528,276 |
| <b>Liabilities:</b>   |                |           |          |           |
| Advances from FHLB at fair value  | \$—            | \$48,351  | \$—      | \$48,351  |
| Junior subordinated debentures net of unamortized deferred issuance costs at fair value | —              | —         | 74,135   | 74,135    |
| <b>Derivatives</b>  |                |           |          |           |
| Interest rate sales forward commitments, net  | —              | 69        | —        | 69        |
| Interest rate swaps   | —              | 5,072     | —        | 5,072     |
|   | \$—            | \$53,492  | \$74,135 | \$127,627 |

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|   | December 31, 2013 |           |          | Total     |
|---|-------------------|-----------|----------|-----------|
|   | Level 1           | Level 2   | Level 3  |           |
| <b>Assets:</b>  |                   |           |          |           |
| <b>Securities—available-for-sale</b>  |                   |           |          |           |
| U.S. Government and agency  | \$—               | \$58,660  | \$—      | \$58,660  |
| Municipal bonds   | —                 | 52,855    | —        | 52,855    |
| Corporate bonds   | —                 | 6,964     | —        | 6,964     |
| Mortgage-backed or related securities   | —                 | 326,610   | —        | 326,610   |
| Asset-backed securities   | —                 | 25,191    | —        | 25,191    |
|   | —                 | 470,280   | —        | 470,280   |
| <b>Securities—trading</b>   |                   |           |          |           |
| U.S. Government and agency  | —                 | 1,481     | —        | 1,481     |
| Municipal bonds   | —                 | 5,023     | —        | 5,023     |
| TPS and TRUP CDOs   | —                 | —         | 35,140   | 35,140    |
| Mortgage-backed or related securities   | —                 | 20,760    | —        | 20,760    |
| Equity securities and other   | —                 | 68        | —        | 68        |
|   | —                 | 27,332    | 35,140   | 62,472    |
| <b>Derivatives</b>  |                   |           |          |           |
| Interest rate lock commitments  | —                 | 130       | —        | 130       |
| Interest rate swaps   | —                 | 4,946     | —        | 4,946     |
|   | \$—               | \$502,688 | \$35,140 | \$537,828 |
| <b>Liabilities:</b>   |                   |           |          |           |
| Advances from FHLB at fair value  | \$—               | \$27,250  | \$—      | \$27,250  |
| Junior subordinated debentures net of unamortized deferred issuance costs at fair value | —                 | —         | 73,928   | 73,928    |
| <b>Derivatives</b>  |                   |           |          |           |
| Interest rate sales forward commitments, net  | —                 | 43        | —        | 43        |
| Interest rate swaps   | —                 | 4,946     | —        | 4,946     |
|   | \$—               | \$32,239  | \$73,928 | \$106,167 |

The following table provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three months ended March 31, 2014 and 2013 (in thousands):

|                                       | Three Months Ended<br>March 31, 2014 |   |
|---------------------------------------|--------------------------------------|---|
|                                       | Level 3 Fair Value Inputs            |   |
|                                       | TPS and TRUP<br>CDOs                 | Borrowings—Junior<br>Subordinated<br>Debentures |
| Beginning balance                     | \$35,140                             | \$ 73,928                                       |
| Total gains or losses recognized      |                                      |   |
| Assets gains (losses), including OTTI | (44                                  | ) —   |
| Liabilities (gains) losses            | —                                    | 207   |
| Purchases, issuances and settlements  | —                                    | —   |
| Paydowns and maturities               | (34                                  | ) —   |
| Transfers in and/or out of Level 3    | —                                    | —   |
| Ending balance at March 31, 2014      | \$35,062                             | \$ 74,135                                       |
|                                       |                                      |   |
|                                       | Three Months Ended<br>March 31, 2013 |   |
|                                       | Level 3 Fair Value Inputs            |   |
|                                       | TPS and TRUP<br>CDOs                 | Borrowings—Junior<br>Subordinated<br>Debentures |
| Beginning balance                     | \$35,741                             | \$ 73,063                                       |
| Total gains or losses recognized      |                                      |   |
| Assets gains (losses), including OTTI | (982                                 | ) —   |
| Liabilities (gains) losses            | —                                    | 157   |
| Purchases, issuances and settlements  | —                                    | —   |
| Paydowns and maturities               | (239                                 | ) —   |
| Transfers in and/or out of Level 3    | —                                    | —   |
| Ending balance at March 31, 2013      | \$34,520                             | \$ 73,220                                       |

The Company has elected to continue to recognize the interest income and dividends from the securities reclassified to fair value as a component of interest income as was done in prior years when they were classified as available-for-sale. Interest expense related to the FHLB advances and junior subordinated debentures continues to be measured based on contractual interest rates and reported in interest expense. The change in fair market value of these financial instruments has been recorded as a component of other operating income.

#### Items Measured at Fair Value on a Non-recurring Basis:

Carrying values of certain impaired loans are periodically evaluated to determine if valuation adjustments, or partial write-downs, should be recorded. These non-recurring fair value adjustments are recorded when observable market prices or current appraised values of collateral indicate a shortfall in collateral value or discounted cash flows indicate a shortfall compared to current carrying values of the related loan. If the Company determines that the value of the impaired loan is less than the carrying value of the loan, the Company either establishes an impairment reserve as a specific component of the allowance for loan and lease losses (ALLL) or charges off the impaired amount. The remaining impaired loans are evaluated for reserve needs in homogenous pools within the Company's ALLL methodology. As of March 31, 2014, the Company reviewed all of its adversely classified loans totaling \$81 million and identified \$63 million which were considered impaired. Of those \$63 million in impaired loans, \$53 million were

individually evaluated to determine if valuation adjustments, or partial write-downs, should be recorded, or if specific impairment reserves should be established. The \$53 million had original carrying values of \$56 million which have been reduced by partial write-downs totaling \$3 million. In addition to these write-downs, in order to bring the impaired loan balances to fair value, Banner has also established \$5 million in specific reserves on these impaired loans. Impaired loans that were collectively evaluated for reserve purposes within homogenous pools totaled \$10 million and were found to require allowances totaling \$230,000. The valuation inputs for impaired loans are considered to be Level 3 inputs.



The Company records REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at the lower of the estimated fair value of the properties, less expected selling costs, or the carrying amount of the defaulted loans. From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current appraised value of property. Banner considers any valuation inputs related to REO to be Level 3 inputs. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the three months ended March 31, 2014, the Company recognized \$37,000 of additional impairment charges related to REO assets, compared to \$73,000 for the same quarter one year earlier.

The following tables present financial assets measured at fair value on a non-recurring basis and the level within the fair value hierarchy of the fair value measurements for those assets as of March 31, 2014 and December 31, 2013 (in thousands):

|                | At or For the Three Months Ended March 31, 2014 |         |          |          | Net Gains/(Losses) Recognized During the Period |
|----------------|---|---------|----------|----------|---|
|                | Level 1   | Level 2 | Level 3  | Total    |   |
| Impaired loans | \$—   | \$—     | \$10,084 | \$10,084 | \$(4,326 )                                      |
| REO            | —   | —       | 3,236    | 3,236    | (70 )   |

  

|                | At or For the Year Ended December 31, 2013 |         |          |          | Net Gains/(Losses) Recognized During the Period |
|----------------|--|---------|----------|----------|---|
|                | Level 1                                    | Level 2 | Level 3  | Total    |   |
| Impaired loans | \$—  | \$—     | \$10,627 | \$10,627 | \$(4,890 )                                      |
| REO            | —  | —       | 4,044    | 4,044    | (853 )  |

The following table provides a description of the valuation technique, unobservable inputs, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring and nonrecurring basis at March 31, 2014 and December 31, 2013:

| Financial Instruments          | Valuation Techniques  | Unobservable Inputs | Weighted Average Rate |                   |
|--------------------------------|-----------------------|---------------------|-----------------------|-------------------|
|                                |                       |                     | March 31, 2014        | December 31, 2013 |
| TPS securities                 | Discounted cash flows | Discount rate       | 5.48                  | % 5.50 %          |
| TRUP CDOs                      | Discounted cash flows | Discount rate       | 3.99                  | 3.85              |
| Junior subordinated debentures | Discounted cash flows | Discount rate       | 5.48                  | 5.50              |
| Impaired loans                 | Discounted cash flows | Discount rate       | Various               | Various           |
| REO                            | Collateral Valuations | Market values       | n/a                   | n/a               |
|                                | Appraisals            | Market values       | n/a                   | n/a               |

TPS and TRUP CDOs: Management believes that the credit risk-adjusted spread used to develop the discount rate utilized in the fair value measurement of TPS and TRUP CDOs is indicative of the risk premium a willing market participant would require under current market conditions for instruments with similar contractual rates and terms and conditions and issuers with similar credit risk profiles and with similar expected probability of default. Management

attributes the change in fair value of these instruments during the first quarter of 2014 primarily to perceived general market adjustments to the risk premiums for these types of assets and to improved performance of the underlying issuers.

Junior subordinated debentures: Similar to the TPS and TRUP CDOs discussed above, management believes that the credit risk-adjusted spread utilized in the fair value measurement of the junior subordinated debentures is indicative of the risk premium a willing market participant would require under current market conditions for an issuer with Banner's credit risk profile. Management attributes the change in fair value of the junior subordinated debentures during the first quarter of 2014 primarily to perceived general market adjustments to the risk premiums for these types of liabilities and to changes to our entity-specific credit risk profile as a result of improved operating performance. Future contractions in the risk adjusted spread relative to the spread currently utilized to measure the Company's junior subordinated debentures at fair value as of March 31, 2014, or the passage of time, will result in negative fair value adjustments. At March 31, 2014 the discount rate utilized was based on a credit spread of 525 basis points and three-month LIBOR of 23 basis points.

Impaired loans: Loans are considered impaired when, based on current information and events; management determines that it is probable that the Banks 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.

REO: Fair value adjustments on REO are based on updated real estate appraisals which are based on current market conditions. In many of our markets real estate sales are still slow and prices are negatively affected by an over-supply of properties for sale. These market conditions decrease the amount of comparable sales data and increase the reliance on estimates and assumptions about current and future market conditions and could negatively affect our operating results.

#### Fair Values of Financial Instruments:

The following table presents estimated fair values of the Company's financial instruments as of March 31, 2014 and December 31, 2013, whether or not measured at fair value in the consolidated Statements of Financial Condition. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret market data in the development of the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The carrying value and estimated fair value of financial instruments are as follows (in thousands):

|   | March 31, 2014 |                      | December 31, 2013 |                      |
|---|----------------|----------------------|-------------------|----------------------|
|   | Carrying Value | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <b>Assets:</b>                                      |                |                      |                   |                      |
| Cash and due from banks                             | \$144,775      | \$144,775            | \$137,349         | \$137,349            |
| Securities—trading                                  | 58,387         | 58,387               | 62,472            | 62,472               |
| Securities—available-for-sale                       | 464,657        | 464,657              | 470,280           | 470,280              |
| Securities—held-to-maturity                         | 109,567        | 112,409              | 102,513           | 103,610              |
| Loans receivable held for sale                      | 3,239          | 3,258                | 2,734             | 2,751                |
| Loans receivable                                    | 3,519,673      | 3,402,304            | 3,415,711         | 3,297,936            |
| FHLB stock  | 33,288         | 33,288               | 35,390            | 35,390               |
| Bank-owned life insurance                           | 62,377         | 62,377               | 61,945            | 61,945               |
| Mortgage servicing rights                           | 8,199          | 11,835               | 8,086             | 11,529               |
| Derivatives   | 5,232          | 5,232                | 5,076             | 5,076                |
| <b>Liabilities:</b>                                 |                |                      |                   |                      |
| Demand, interest checking and money market accounts | 1,948,237      | 1,719,788            | 1,946,467         | 1,697,095            |
| Regular savings                                     | 829,282        | 728,481              | 798,764           | 695,863              |
| Certificates of deposit                             | 905,016        | 899,421              | 872,695           | 867,904              |
| FHLB advances at fair value                         | 48,351         | 48,351               | 27,250            | 27,250               |
| Junior subordinated debentures at fair value        | 74,135         | 74,135               | 73,928            | 73,928               |
| Other borrowings                                    | 89,921         | 89,921               | 83,056            | 83,056               |
| Derivatives   | 5,141          | 5,141                | 4,989             | 4,989                |

Fair value estimates, methods, assumptions and the level within the fair value hierarchy of the fair value measurements are set forth below for the Company's financial and off-balance-sheet instruments:

**Cash and Due from Banks:** The carrying amount of these items is a reasonable estimate of their fair value. These values are considered Level 1 measures.

**Securities:** The estimated fair values of investment securities and mortgaged-backed securities are priced using current active market quotes, if available, which are considered Level 1 measurements. For most of the portfolio, matrix pricing based on the securities' relationship to other benchmark quoted prices is used to establish the fair value. These measurements are considered Level 2. Due to the continued credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads for some of the Company's TPS and TRUP CDO securities (see earlier discussion above in determining the securities' fair market value), management has classified these securities as a Level 3 fair value measure.

**Loans Receivable:** Fair values are estimated first by stratifying the portfolios of loans with similar financial characteristics. Loans are segregated by type such as multifamily real estate, residential mortgage, nonresidential mortgage, commercial/agricultural, consumer and other. Each loan category is further segmented into fixed- and adjustable-rate interest terms and by performing and non-performing categories. A preliminary

estimate of fair value is then calculated based on discounted cash flows using as a discount rate the current rate offered on similar products, plus an adjustment for liquidity to reflect the non-homogeneous nature of the loans. The preliminary estimate is then further reduced by the amount of the allowance for loan losses to arrive at a final estimate of fair value. Fair value for significant non-performing loans is also based on recent appraisals or estimated cash flows discounted using rates commensurate with risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information. Management considers this to be a Level 2 measure.

**FHLB Stock:** The fair value is based upon the redemption value of the stock which equates to its carrying value. This fair value is considered a Level 3 measure.

**Mortgage Servicing Rights:** Fair values are estimated based on current pricing for sales of servicing for new loans adjusted up or down based on the serviced loan's interest rate versus current new loan rates. Management considers this to be a Level 3 measure.

**Deposit Liabilities:** The fair value of deposits with no stated maturity, such as savings and checking accounts, is estimated by applying decay rate assumptions to segregated portfolios of similar deposit types to generate cash flows which are then discounted using short-term market interest rates. The market value of certificates of deposit is based upon the discounted value of contractual cash flows. The discount rate is determined using the rates currently offered on comparable instruments. Fair value estimates for deposits are considered Level 3 measures.

**FHLB Advances and Other Borrowings:** Fair valuations for Banner's FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. This is considered to be a Level 2 input method. Other borrowings are priced using discounted cash flows to the date of maturity based on using current rates at which such borrowings can currently be obtained. This fair value is considered to be a Level 3 measure.

**Junior Subordinated Debentures:** Due to continued credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads (see earlier discussion above in determining the junior subordinated debentures' fair market value), junior subordinated debentures have been classified as a Level 3 fair value measure. Management believes that the credit risk adjusted spread and resulting discount rate utilized is indicative of those that would be used by market participants.

**Derivatives:** Derivatives include interest rate swap agreements, interest rate lock commitments to originate loans held for sale and forward sales contracts to sell loans and securities related to mortgage banking activities. Fair values for these instruments, which generally change as a result of changes in the level of market interest rates, are estimated based on dealer quotes and secondary market sources. Management considers these to be Level 2 inputs.

**Off-Balance Sheet Items:** Off-balance sheet financial instruments include unfunded commitments to extend credit, including standby letters of credit, and commitments to purchase investment securities. The fair value of these instruments is not considered practical to estimate without incurring excessive costs and management does not believe the fair value estimates would be material. Other commitments to fund loans totaled \$1.102 billion and \$1.097 billion at March 31, 2014 and December 31, 2013, respectively, and have no carrying value at both dates, representing the cost of such commitments. There were no commitments to purchase securities at March 31, 2014 or at December 31, 2013.

**Limitations:** The fair value estimates presented herein are based on pertinent information available to management as of March 31, 2014 and December 31, 2013. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for

purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not financial instruments include the deferred tax assets/liabilities; land, buildings and equipment; costs in excess of net assets acquired and real estate held for sale.

Note 12: INCOME TAXES AND DEFERRED TAXES

The Company files a consolidated income tax return including all of its wholly-owned subsidiaries on a calendar year basis. 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 will be in effect when the differences between the financial statement carrying amounts and tax bases 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 of change. A valuation allowance is recognized as a reduction to deferred tax assets when management determines it is more likely than not that deferred tax assets will not be available to offset future income tax liabilities.

Accounting standards for income taxes prescribe a recognition threshold and measurement process for financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a tax return, and also provide guidance on the de-recognition of previously recorded benefits and their classification, as well as the proper recording of interest and penalties, accounting in interim periods, disclosures and transition. The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

As of March 31, 2014, the Company had an insignificant amount of unrecognized tax benefits for uncertain tax positions, none of which would materially affect the effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will significantly increase or decrease in the next twelve months. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in the income tax expense. The Company files consolidated income tax returns in U.S. federal jurisdiction and in the Oregon and Idaho state jurisdictions. The tax years which remain subject to examination by the taxing authorities are the years ended December 31, 2013, 2012, 2011, and 2010. Tax years 2006 - 2009 are not open for assessment of additional tax, but remain open for adjustments to the amount of NOLs, credit, and other carryforwards utilized in open years or to be utilized in the future.

**Note 13: CALCULATION OF WEIGHTED AVERAGE SHARES OUTSTANDING FOR EARNINGS PER SHARE (EPS)**

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

|   | Three Months Ended |          |
|---|--------------------|----------|
|   | March 31           |          |
|   | 2014               | 2013     |
| Net income (loss)                         | \$10,570           | \$11,582 |
| Basic weighted average shares outstanding | 19,346             | 19,313   |
| Plus unvested restricted stock            | 64                 | 110      |
| Diluted weighted shares outstanding       | 19,410             | 19,423   |
| Earnings (loss) per common share          |                    |          |
| Basic                                     | \$0.55             | \$0.60   |
| Diluted                                   | \$0.54             | \$0.60   |

Options to purchase an additional 25,364 shares of common stock as of March 31, 2014 were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. Also, as of March 31, 2014, the warrants originally issued to the U.S. Treasury in the fourth quarter of 2008 to purchase up to \$18.6 million (243,998 shares, post reverse-split) of common stock were not included in the computation of diluted EPS for the quarter ended March 31, 2014 and the year ended December 31, 2013 because the exercise price of the warrants was greater than the average market price of common shares. In June 2013, the Treasury sold the warrants in a public auction. That sale did not change the Company's capital position and did not have any impact on the financial accounting and reporting for these securities.

**Note 14: STOCK-BASED COMPENSATION PLANS**

The Company operates the following stock-based compensation plans as approved by the shareholders: the 1998 Stock Option Plan and the 2001 Stock Option Plan (collectively, SOPs) and the Banner Corporation 2012 Restricted Stock and Incentive Bonus Plan. In addition, during 2006 the Board of Directors approved the Banner Corporation Long-Term Incentive Plan, an account-based benefit plan which for reporting purposes is considered a stock appreciation rights plan.

**Restricted Stock Grants.** Under the 2012 Restricted Stock Plan, which was approved on April 24, 2012, the Company is authorized to issue up to 300,000 shares of its common stock to provide a means for attracting and retaining highly skilled officers of Banner Corporation and its affiliates. Shares granted under the Plan have a minimum vesting period of three years. The Plan will continue in effect for a term of ten years, after which no further awards may be granted. Vesting requirements may include time-based conditions, performance-based conditions, or market-based conditions.

Concurrent with the approval of the 2012 Restricted Stock Plan was the approval of a grant of \$300,000 of restricted stock (14,535 restricted shares) that vests in one-third increments over a three-year period to Mark J. Grescovich, President and Chief Executive Officer of Banner Corporation and Banner Bank. Subsequent to that initial issuance was the issuance of 253,044 additional shares to certain other officers of the Company. The 2012 Restricted Stock Plan was amended on April 23, 2013 to provide for the ability to grant (1) cash-denominated incentive-based awards payable in cash or common stock, including those that are eligible to qualify as qualified performance-based compensation for the purposes of Section 162(m) of the Code and (2) restricted stock awards that qualify as qualified performance-based compensation for the purposes of Section 162(m) of the Code. As of March 31, 2014, the Company had granted 267,579 shares of restricted stock from the 2012 Restricted Stock Plan, of which 33,318 shares had vested and 234,261 shares remain unvested.

Additionally, the Company granted shares of restricted common stock to Mark J. Grescovich, President and Chief Executive Officer of Banner Bank and Banner Corporation on August 22, 2010 and on August 23, 2011. The restricted shares were granted to Mr. Grescovich in accordance with his employment agreement, which, as an inducement material to his joining the Company and the Bank, provided for the granting of restricted shares on the six-month and the 18-month anniversaries of the effective date of the agreement. The shares vest in one-third annual increments over the subsequent three-year periods following the grants. A total of 34,257 shares were granted. As of March 31, 2014, 28,359 shares had vested and 5,898 shares remain unvested.



The expense associated with all restricted stock grants was \$473,000 for the three-month period ended March 31, 2014 and was \$207,000 for the three-month period ended March 31, 2013. Unrecognized compensation expense for these awards as of March 31, 2014 was \$5.7 million and will be amortized over the next 36 months.

**Stock Options.** Under the SOPs, Banner reserved 2,284,186 shares for issuance pursuant to the exercise of stock options to be granted to directors and employees. Authority to grant additional options under the 1996 Stock Option Plan terminated on July 26, 2006. Authority to grant additional options under the 1998 Stock Option Plan terminated on July 24, 2008. Authority to grant additional options under the 2001 Stock Option Plan terminated on April 20, 2011. The exercise price of the stock options is set at 100% of the fair market value of the stock price on the date of grant. Options granted vest at a rate of 20% per year from the date of grant and any unexercised incentive stock options will expire ten years after date of grant or 90 days after employment or service ends.

During the three months ended March 31, 2014 and 2013, the Company did not grant any stock options. Additionally, there were no significant modifications made to any stock option grants during the period. The fair values of stock options granted are amortized as compensation expense on a straight-line basis over the vesting period of the grant.

There were no stock-based compensation costs related to the SOPs for the quarters ended March 31, 2014 or March 31, 2013. The SOPs' stock option grant compensation costs are generally based on the fair value calculated from the Black-Scholes option pricing on the date of the grant award. The Black-Scholes model assumes an expected stock price volatility based on the historical volatility at the date of the grant and an expected term based on the remaining contractual life of the vesting period. The Company bases the estimate of risk-free interest rate on the U.S. Treasury Constant Maturities Indices in effect at the time of the grant. The dividend yield is based on the current quarterly dividend in effect at the time of the grant.

During the three months ended March 31, 2014 and 2013, there were no exercises of stock options. Cash was not used to settle any equity instruments previously granted. The Company issues shares from authorized but unissued shares upon the exercise of stock options. The Company does not currently expect to repurchase shares from any source to satisfy such obligations under the SOPs.

**Banner Corporation Long-Term Incentive Plan:** In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is directly related to changes in the value of Company common stock, dividends declared on Company common stock and changes in Banner Bank's average earnings rate, and is considered a stock appreciation right (SAR). Each SAR entitles the holder to receive cash upon vesting, equal to the excess of the fair market value of a share of the Company's common stock on the date of maturity of the SAR over the fair market value of such share on the date granted plus, for some grants, the dividends declared on the stock from the date of grant to the date of vesting. The primary objective of the Plan is to create a retention incentive by allowing officers who remain with the Company or the Banks for a sufficient period of time to share in the increases in the value of Company stock. The Company re-measures the fair value of SARs each reporting period until the award is settled and recognizes changes in fair value and vesting in compensation expense. The Company recognized a credit to compensation expense of \$149,000 for the three months ended March 31, 2014 due to a decrease in market value of the underlying stock, compared to compensation expense of \$89,000 for the three months ended March 31, 2013. At March 31, 2014, the aggregate liability related to SARs was \$1.4 million and was included in deferred compensation.

#### Note 15: COMMITMENTS AND CONTINGENCIES

**Lease Commitments** — The Bank leases 63 sites under non-cancelable operating leases. The leases contain various provisions for increases in rental rates, based either on changes in the published Consumer Price Index or a predetermined escalation schedule. Substantially all of the leases provide the Company with the option to extend the lease term one or more times following expiration of the initial term.

Financial Instruments with Off-Balance-Sheet Risk—The Company has financial instruments with off-balance-sheet risk generated in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit, commitments related to standby letters of credit, commitments to originate loans, commitments to sell loans, commitments to buy and sell securities. These instruments involve, to varying degrees, elements of credit and interest rate risk similar to the risk involved in on-balance sheet items recognized in our Consolidated Statements of Financial Condition.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument from commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. We use the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments.

Outstanding commitments for which no asset or liability for the notional amount has been recorded consisted of the following at the dates indicated (in thousands):

|   | Contract or Notional Amount |                   |
|---|-----------------------------|-------------------|
|   | March 31, 2014              | December 31, 2013 |
| Commitments to extend credit  | \$1,075,777                 | \$1,073,897       |
| Standby letters of credit and financial guarantees                              | 7,576                       | 6,990             |
| Commitments to originate loans  | 18,874                      | 15,776            |
| Derivatives also included in Note 16:   |                             |                   |
| Commitments to originate loans held for sale                                    | 24,190                      | 21,434            |
| Commitments to sell loans secured by one- to four-family residential properties | 8,489                       | 9,378             |
| Commitments to sell securities related to mortgage banking activities           | 21,500                      | 15,200            |

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

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

Interest rates on residential one- to four-family mortgage loan applications are typically rate locked (committed) to customers during the application stage for periods ranging from 30 to 60 days, the most typical period being 45 days. Traditionally these loan applications with rate lock commitments had the pricing for the sale of these loans locked with various qualified investors under a best-efforts delivery program at or near the time the interest rate is locked with the customer. The Bank then attempts to deliver these loans before their rate locks expired. This arrangement generally required delivery of the loans prior to the expiration of the rate lock. Delays in funding the loans required a lock extension. The cost of a lock extension at times was borne by the customer and at times by the Bank. These lock extension costs have not had a material impact to our operations. In 2012, the Company also began entering into forward commitments at specific prices and settlement dates to deliver either: (1) residential mortgage loans for purchase by secondary market investors (i.e., Freddie Mac or Fannie Mae), or (2) mortgage-backed securities to broker/dealers. The purpose of these forward commitments is to offset the movement in interest rates between the execution of its residential mortgage rate lock commitments with borrowers and the sale of those loans to the secondary market investor. There were no counterparty default losses on forward contracts in the three months ended March 31, 2014 or March 31, 2013. Market risk with respect to forward contracts arises principally from changes in the value of contractual positions due to changes in interest rates. We limit our exposure to market risk by monitoring differences between commitments to customers and forward contracts with market investors and securities broker/dealers. In the event we have forward delivery contract commitments in excess of available mortgage loans, the transaction is completed by either paying or receiving a fee to or from the investor or broker/dealer equal to the increase or decrease in the market value of the forward contract.

**Legal Proceedings**—In the normal course of business, the Company and/or its subsidiaries 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. The 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 the Banks hold a security interest. Based on information known to management at this time, the Company and the Banks are not a party to any legal proceedings that management believes would have a material adverse effect on the results of operations or consolidated financial position at March 31, 2014.

**NOTE 16: DERIVATIVES AND HEDGING**

The Company, through its Banner Bank subsidiary, is party to various derivative instruments that are used for asset and liability management and customer financing needs. Derivative instruments are contracts between two or more parties that have a notional amount and an underlying variable, require no net investment and allow for the net settlement of positions. The notional amount serves as the basis for the payment provision of the contract and takes the form of units, such as shares or dollars. The underlying variable represents a specified interest rate, index, or other component. The interaction between the notional amount and the underlying variable determines the number of units to be exchanged between the parties and influences the market value of the derivative contract. The Company obtains dealer quotations to value its derivative contracts.

The Company's predominant derivative and hedging activities involve interest rate swaps related to certain term loans and forward sales contracts associated with mortgage banking activities. Generally, these instruments help the Company manage exposure to market risk and meet customer financing needs. Market risk represents the possibility that economic value or net interest income will be adversely affected by fluctuations in external factors such as market-driven interest rates and prices or other economic factors.

## Derivatives Designated in Hedge Relationships

The Company's fixed rate loans result in exposure to losses in value or net interest income as interest rates change. The risk management objective for hedging fixed rate loans is to effectively convert the fixed rate received to a floating rate. The Company has hedged exposure to changes in the fair value of certain fixed rate loans through the use of interest rate swaps. For a qualifying fair value hedge, changes in the value of the derivatives are recognized in current period earnings along with the corresponding changes in the fair value of the designated hedged item attributable to the risk being hedged.

In a program brought to Banner Bank through its merger with F&M Bank in 2007, customers received fixed interest rate commercial loans and the Bank subsequently hedged that fixed rate loan by entering into an interest rate swap with a dealer counterparty. The Bank receives fixed rate payments from the customers on the loans and makes similar fixed rate payments to the dealer counterparty on the swaps in exchange for variable rate payments based on the one-month LIBOR index. Some of these interest rate swaps are designated as fair value hedges. Through application of the "short cut method of accounting," there is an assumption that the hedges are effective. The Bank discontinued originating interest rate swaps under this program in 2008.

As of March 31, 2014 and December 31, 2013, the notional values or contractual amounts and fair values of the Company's derivatives designated in hedge relationships were as follows (in thousands):

|                     | Asset Derivatives               |                              |                                 |                              | Liability Derivatives           |                              |                                 |                              |
|---------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|
|                     | March 31, 2014                  |                              | December 31, 2013               |                              | March 31, 2014                  |                              | December 31, 2013               |                              |
|                     | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(1)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(1)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(2)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(2)</sup> |
| Interest rate swaps | \$7,338                         | \$1,259                      | \$7,420                         | \$1,295                      | \$7,338                         | \$1,259                      | \$7,420                         | \$1,295                      |

<sup>(1)</sup> Included in Loans Receivable on the Consolidated Statements of Financial Condition.

<sup>(2)</sup> Included in Other Liabilities on the Consolidated Statements of Financial Condition.

## Derivatives Not Designated in Hedge Relationships

Interest Rate Swaps. The Company's subsidiary, Banner Bank, has been using an interest rate swap program for commercial loan customers, termed the Back-to-Back Program, since 2010. In the Back-to-Back Program, the Bank provides the client with a variable rate loan and enters into an interest rate swap in which the client receives a variable rate payment in exchange for a fixed rate payment. The Bank offsets its risk exposure by entering into an offsetting interest rate swap with a dealer counterparty for the same notional amount and length of term as the client interest rate swap providing the dealer counterparty with a fixed rate payment in exchange for a variable rate payment. There are also a few interest rate swaps from prior to 2009 that were not designated in hedge relationships that are included in these totals. These swaps do not qualify as designated hedges; therefore, each swap is accounted for as a free standing derivative.

Mortgage Banking. In the normal course of business, the Company sells originated mortgage loans into the secondary mortgage loan markets. During the period of loan origination and prior to the sale of the loans in the secondary market, the Company has exposure to movements in interest rates associated with written rate lock commitments with potential borrowers to originate loans that are intended to be sold and for closed loans that are awaiting sale and delivery into the secondary market.

Written loan commitments that relate to the origination of mortgage loans that will be held for resale are considered free-standing derivatives and do not qualify for hedge accounting. Written loan commitments generally have a term of

up to 60 days before the closing of the loan. The loan commitment does not bind the potential borrower to enter into the loan, nor does it guarantee that the Company will approve the potential borrower for the loan. Therefore, when determining fair value, the Company makes estimates of expected "fallout" (loan commitments not expected to close), using models which consider cumulative historical fallout rates, current market interest rates and other factors.

Written loan commitments in which the borrower has locked in an interest rate results in market risk to the Company to the extent market interest rates change from the rate quoted to the borrower. The Company economically hedges the risk of changing interest rates associated with its interest rate lock commitments by entering into forward sales contracts.

Mortgage loans which are held for sale are subject to changes in fair value due to fluctuations in interest rates from the loan's closing date through the date of sale of the loans into the secondary market. Typically, the fair value of these loans declines when interest rates increase and rises when interest rates decrease. To mitigate this risk, the Company enters into forward sales contracts on a significant portion of these loans to provide an economic hedge against those changes in fair value. Mortgage loans held for sale and the forward sales contracts are recorded at fair value with ineffective changes in value recorded in current earnings as loan sales and servicing income.

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As of March 31, 2014 and December 31, 2013, the notional values or contractual amounts and fair values of the Company's derivatives not designated in hedge relationships were as follows (in thousands):

|                           | Asset Derivatives               |                              |                                 |                              | Liability Derivatives           |                              |                                 |                              |
|---------------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|------------------------------|
|                           | March 31, 2014                  |                              | December 31, 2013               |                              | March 31, 2014                  |                              | December 31, 2013               |                              |
|                           | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(1)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(1)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(2)</sup> | Notional/<br>Contract<br>Amount | Fair<br>Value <sup>(2)</sup> |
| Interest rate swaps       | \$139,002                       | \$3,813                      | \$135,122                       | \$3,651                      | \$139,002                       | \$3,813                      | \$135,122                       | \$3,651                      |
| Mortgage loan commitments | 15,701                          | 128                          | 14,107                          | 57                           | 8,489                           | 32                           | 7,326                           | 43                           |
| Forward sales contracts   | 8,489                           | 32                           | 22,526                          | 73                           | 21,500                          | 37                           | —                               | —                            |
|                           | \$163,192                       | \$3,973                      | \$171,755                       | \$3,781                      | \$168,991                       | \$3,882                      | \$142,448                       | \$3,694                      |

(1) Included in Other Assets on the Consolidated Statement of Financial Condition, with the exception of those interest rate swaps from prior to 2009 that were not designated in hedge relationships (with a fair value of \$726,000 at March 31, 2014 and \$791,000 at December 31, 2013), which are included in Loans Receivable.

(2) Included in Other Liabilities on the Consolidated Statement of Financial Condition.

Gains (losses) recognized in income on non-designated hedging instruments for the three months ended March 31, 2014 and 2013 were as follows (in thousands):

|                           | Location on Income Statement | Three Months Ended<br>March 31 |       |
|---------------------------|------------------------------|--------------------------------|-------|
|                           |                              | 2014                           | 2013  |
| Mortgage loan commitments | Mortgage banking operations  | \$70                           | \$62  |
| Forward sales contracts   | Mortgage banking operations  | (66                            | ) (56 |
|                           |                              | \$4                            | \$6   |

The Company is exposed to credit-related losses in the event of nonperformance by the counterparty to these agreements. Credit risk of the financial contract is controlled through the credit approval, limits, and monitoring procedures and management does not expect the counterparties to fail their obligations.

In connection with the interest rate swaps between Banner Bank and the dealer counterparties, the agreements contain a provision where if Banner Bank fails to maintain its status as a well/adequately capitalized institution, then the counterparty could terminate the derivative positions and Banner Bank would be required to settle its obligations. Similarly, Banner Bank could be required to settle its obligations under certain of its agreements if specific regulatory events occur, such as a publicly issued prompt corrective action directive, cease and desist order, or a capital maintenance agreement that required Banner Bank to maintain a specific capital level. If Banner Bank had breached any of these provisions at March 31, 2014 or December 31, 2013, it could have been required to settle its obligations under the agreements at the termination value. As of March 31, 2014 and December 31, 2013, the termination value of derivatives in a net liability position related to these agreements was \$3.7 million and \$2.7 million, respectively. The Company generally posts collateral against derivative liabilities in the form of government agency-issued bonds, mortgage-backed securities, or commercial mortgage-backed securities. Collateral posted against derivative liabilities was \$8.9 million and \$8.9 million as of March 31, 2014 and December 31, 2013, respectively.

Derivative assets and liabilities are recorded at fair value on the balance sheet and do not take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis and to offset net derivative positions with related collateral where applicable.





The following table illustrates the potential effect of the Company's derivative master netting arrangements, by type of financial instrument, on the Company's Statement of Financial Condition as of March 31, 2014 and December 31, 2013 (in thousands):

| March 31, 2014         |                          |  |   |   |   |  |            |
|------------------------|--------------------------|--|---|---|---|--|------------|
|                        | Gross Amounts Recognized | Amounts offset in the Statement of Financial Condition | Net Amounts in the Statement of Financial Condition | Netting Adjustment Per Applicable Master Netting Agreements | Gross Amounts of Financial Instruments Not Offset in the Statement of Financial Condition | Fair Value of Financial Collateral in the Statement of Financial Condition | Net Amount |
| Derivative assets      |                          |  |   |   |   |  |            |
| Interest rate swaps    | \$5,072                  | \$—  | \$5,072   | \$(696)   | ) \$—   |  | \$4,376    |
|                        | \$5,072                  | \$—  | \$5,072   | \$(696)   | ) \$—   |  | \$4,376    |
| Derivative liabilities |                          |  |   |   |   |  |            |
| Interest rate swaps    | \$5,072                  | \$—  | \$5,072   | \$(696)   | ) \$(3,680)   |  | \$696      |
|                        | \$5,072                  | \$—  | \$5,072   | \$(696)   | ) \$(3,680)   |  | \$696      |
| December 31, 2013      |                          |  |   |   |   |  |            |
|                        | Gross Amounts Recognized | Amounts offset in the Statement of Financial Condition | Net Amounts in the Statement of Financial Condition | Netting Adjustment Per Applicable Master Netting Agreements | Gross Amounts of Financial Instruments Not Offset in the Statement of Financial Condition | Fair Value of Financial Collateral in the Statement of Financial Condition | Net Amount |
| Derivative assets      |                          |  |   |   |   |  |            |
| Interest rate swaps    | \$4,946                  | \$—  | \$4,946   | \$(554)   | ) \$—   |  | \$4,392    |
|                        | \$4,946                  | \$—  | \$4,946   | \$(554)   | ) \$—   |  | \$4,392    |
| Derivative liabilities |                          |  |   |   |   |  |            |
| Interest rate swaps    | \$4,946                  | \$—  | \$4,946   | \$(554)   | ) \$(2,657)   |  | \$1,735    |
|                        | \$4,946                  | \$—  | \$4,946   | \$(554)   | ) \$(2,657)   |  | \$1,735    |

## ITEM 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations

### 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 March 31, 2014, its 85 branch offices and nine 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. 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 and the Federal Deposit Insurance Corporation (the FDIC). As of March 31, 2014, we had total consolidated assets of \$4.5 billion, total loans of \$3.5 billion, total deposits of \$3.7 billion and total stockholders’ equity of \$548 million.

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

Banner Corporation's successful execution of its strategic plan and operating initiatives continued in the first quarter of 2014, as evidenced by our solid operating results and profitability. Highlights for the quarter included significant loan and core deposit growth, additional client acquisition, further improvement in our asset quality and solid revenues from core operations.

In spite of persistently weak economic conditions and exceptionally low interest rates which have created an unusually challenging banking environment for an extended period, the Company experienced marked improvement and consistent profitability in 2012 and 2013 which continued in the first quarter of 2014. For the quarter ended March 31, 2014, our net income available to common shareholders was \$10.6 million, or \$0.54 per diluted share, compared to a net income to common shareholders of \$11.6 million, or \$0.60 per diluted share, for each of the quarters ended December 31, 2013 and March 31, 2013. Although there continue to be indications that economic conditions are improving, the pace of expansion has been modest and uneven and ongoing softness 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 economic activity. However, over the past three years we have significantly added to our client relationships and account base, as well as substantially improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in stronger revenues and lower credit costs, and which we believe has positioned the Company well to meet this challenging environment with continued success.

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 \$1.4 million, or 3%, to \$42.3 million for

the quarter ended March 31, 2014, compared to \$41.0 million for the same quarter one year earlier. During the same period, our interest rate spread decreased to 4.04% from 4.13%. This increase in net interest income reflects the significant growth in earning assets and occurred despite the decrease in interest rate spread as a result of declining yields on earning assets, which were only partially offset by continuing reductions in deposit and other funding costs.

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 credit costs and our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the valuation of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. (See Note 11 of the Selected Notes to the Consolidated Financial Statements.)

As a result of substantial reserves already in place representing 2.11% of total loans outstanding at March 31, 2014 as well as recording net recoveries in the first quarter of 2014, we did not record a provision for loan losses in the three months ended March 31, 2014. Our reserves at December 31, 2013 and March 31, 2013 were 2.17% and 2.36%, respectively, of total loans outstanding and, similar to the current quarter, no provisions for loan losses were recorded in either of those periods. The allowance for loan losses at March 31, 2014 was \$74.4 million, representing 325% of non-performing loans. Non-performing loans decreased by 8% to \$22.9 million at March 31, 2014, compared to \$24.8 million three months earlier, and decreased 32% when compared to \$33.4 million a year earlier. (See Note 7, Loans Receivable and the Allowance for Loan Losses, as well as "Asset Quality" below in this Form 10-Q.)

Our total other operating income, which includes the gain on sale of securities and changes in the value of financial instruments carried at fair value, was \$8.9 million for the quarter ended March 31, 2014, compared to \$10.0 million for the quarter ended March 31, 2013. For the quarter ended March 31, 2014, we recorded a net fair value loss of \$255,000 in fair value adjustments, which was partially offset by \$35,000 in gains on sale of securities. In comparison, for the quarter ended March 31, 2013, we recorded a net fair value loss of \$1.3 million, offset by \$1.0 million in gains on sale of securities and \$409,000 in OTTI recoveries. However, other operating income excluding the gain on sale of securities,

OTTI adjustments and changes in the value of financial instruments, which we believe is more indicative of our core operations, decreased 9% to \$9.1 million for the quarter ended March 31, 2014, compared to \$9.9 million for the same quarter a year earlier, as a result of substantially decreased revenues from our mortgage banking operations and despite meaningfully increased deposit fees and service charges fueled by growth in non-interest-bearing deposit accounts.

Our total revenues (net interest income before the provision for loan losses plus total other operating income) for the first quarter of 2014 increased \$232,000 to \$51.2 million, compared to \$51.0 million for the same period a year earlier, as a result of increased net interest income, deposit fees and service charges, and changes in fair value adjustments, which were only partially offset by decreased mortgage banking revenues, gain on sale of securities and OTTI recoveries. Our total revenues, excluding fair value and OTTI adjustments and gain on sale of securities, which we believe are more indicative of our core operations, also remained strong at \$51.4 million for the quarter ended March 31, 2014, a \$520,000, or 1% increase, compared to \$50.9 million for the same period a year earlier.

Our other operating expenses increased in the first quarter of 2014 compared to a year earlier largely as a result of increased compensation and occupancy and equipment expenses, as well as reductions in the credit for capitalized loan origination costs and in gains on the sale of real estate owned, which were partially offset by a net decrease in all other operating expenses. Other operating expenses were \$35.6 million for the quarter ended March 31, 2014, compared to \$34.1 million for the same quarter a year earlier.

Other operating income, revenues and other earnings information excluding fair value adjustments, OTTI losses or recoveries, and gains or losses on sale of securities are non-GAAP financial measures. 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. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP financial measures, see the tables below. 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 Three Months Ended March 31, 2014 and 2013” for more detailed information about our financial performance.

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

|   | For the Three Months<br>Ended<br>March 31 |          |
|---|---|----------|
|   | 2014                                      | 2013     |
| Total other operating income  | \$8,858                                   | \$9,997  |
| Exclude gain on sale of securities  | (35                                       | ) (1,006 |
| Exclude other-than-temporary impairment (recovery) loss   | —   | (409     |
| Exclude change in valuation of financial instruments carried at fair value  | 255                                       | 1,347    |
| Total other operating income, excluding fair value adjustments, OTTI and gain on sale of securities               | \$9,078                                   | \$9,929  |
| Net interest income before provision for loan losses  | \$42,339                                  | \$40,968 |
| Total other operating income  | 8,858                                     | 9,997    |
| Total revenue   | 51,197                                    | 50,965   |
| Exclude gain on sale of securities  | (35                                       | ) (1,006 |
| Exclude other-than-temporary impairment (recovery) loss   | —   | (409     |
| Exclude change in valuation of financial instruments carried at fair value  | 255                                       | 1,347    |
| Total revenue, excluding fair value adjustments, OTTI and gain on sale of securities                              | \$51,417                                  | \$50,897 |
| Income before provision for taxes   | \$15,616                                  | \$16,866 |
| Exclude gain on sale of securities  | (35                                       | ) (1,006 |
| Exclude other-than-temporary impairment (recovery) loss   | —   | (409     |
| Exclude change in valuation of financial instruments carried at fair value  | 255                                       | 1,347    |
| Income before provision for taxes, excluding fair value adjustments, OTTI and gain on sale of securities          | \$15,836                                  | \$16,798 |
| Net income  | \$10,570                                  | \$11,582 |
| Exclude gain on sale of securities  | (35                                       | ) (1,006 |
| Exclude other-than-temporary impairment (recovery) loss   | —   | (409     |
| Exclude change in valuation of financial instruments carried at fair value  | 255                                       | 1,347    |
| Exclude related tax expense (benefit)   | (79                                       | ) 24     |
| Total earnings, excluding fair value adjustments, OTTI and gain on sale of securities, net of related tax effects | \$10,711                                  | \$11,538 |

The ratio of tangible common stockholders' equity to tangible assets is also a non-GAAP financial measure. We calculate tangible common equity by excluding other intangible assets from stockholders' equity. We calculate tangible assets by excluding the balance of 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. Management believes that this non-GAAP financial measure provides information to investors that is useful in understanding the basis of our capital position (dollars in thousands).

|   | March 31, 2014 | December 31,<br>2013 | March 31, 2013 |   |
|---|----------------|----------------------|----------------|---|
| Stockholders' equity                                    | \$547,524      | \$538,972            | \$516,062      |   |
| Other intangible assets, net                            | 1,970          | 2,449                | 3,724          |   |
| Tangible common stockholders' equity                    | \$545,554      | \$536,523            | \$512,338      |   |
| Total assets  | \$4,488,296    | \$4,388,898          | \$4,238,358    |   |
| Other intangible assets, net                            | 1,970          | 2,449                | 3,724          |   |
| Tangible assets   | \$4,486,326    | \$4,386,449          | \$4,234,634    |   |
| Tangible common stockholders' equity to tangible assets | 12.16          | % 12.23              | % 12.10        | % |

Loans are our most significant and generally highest yielding earning assets. As a result, while adhering to sound underwriting practices and appropriate diversification guidelines, we attempt to maintain a portfolio of loans in a range of 90% to 95% of total deposits. We had solid loan growth in the current quarter and at March 31, 2014 our net loan portfolio totaled \$3.449 billion compared to \$3.344 billion at December 31, 2013 and \$3.164 billion at March 31, 2013.

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. Commercial real estate loans for both owner-occupied and investment properties, including construction and development loans for these types of properties, totaled \$1.273 billion, or approximately 36% of our loan portfolio at March 31, 2014. In addition, multifamily residential real estate loans, including construction and development loans, totaled \$217 million and comprise approximately 6% of our loan portfolio. While our level of activity and investment in commercial and multifamily real estate loans has been relatively stable for many years, we have experienced an increase in new originations in recent periods resulting in growth in these loan balances. Commercial real estate loans increased by \$56 million in the first quarter of 2014 and multifamily loans increased by \$16 million. We also originate residential construction and development loans and, although our portfolio balances are well below the peak levels before the financial crisis, beginning in 2011 and continuing since then we have experienced increased demand for one- to four-family construction loans. Outstanding residential construction and development balances increased \$18 million, or 9%, to \$219 million at March 31, 2014 compared to \$201 million at December 31, 2013 and increased \$47 million, or 28%, compared to \$172 million at March 31, 2013. Still, residential construction and development loans represent only approximately 8% of our total loan portfolio at March 31, 2014. 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 slowly recovering economy, demand for these types of commercial business loans has been modest although our production levels have increased in recent periods. In recent years, our commercial business lending has also included participation in certain national syndicated loans, including shared national credits. Commercial and agricultural business loans increased \$15 million, or 2%, to \$925 million at March 31, 2014, compared to \$910 million at December 31, 2013, and have increased \$96 million, or 12%, compared to \$830 million at March 31, 2013. Commercial and agricultural business loans represented approximately 26% of our portfolio at March 31, 2014.

Our residential mortgage loan originations have been relatively strong in recent years, as exceptionally low interest rates have supported demand for loans to refinance existing debt as well as loans to finance home purchases. Refinancing activity was particularly significant in 2012 and in the first six months of 2013, leading to meaningful increases in residential mortgage originations during those periods; however, the rise in mortgage interest rates that began in the second quarter of 2013 has slowed origination activity and has resulted in much lower refinancing activity in the current period. Despite significant 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. Still, residential real estate loans totaling \$518 million represent nearly 15% of our loan portfolio at March 31, 2014. 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 has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt. Consumer loans, including those secured by one-to-four family residential properties, were approximately 8% of our portfolio at March 31, 2014.

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. This effort has been particularly focused on increasing transaction and savings accounts and for the past three years we have been very successful in increasing these core deposit 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. While not reflected in the current or prior quarters' balances or operating results, we were pleased to announce in the current quarter an agreement to purchase six additional branches in southwestern Oregon. That acquisition transaction, which is expected to close in June 2014, will include approximately \$226 million in deposits and \$96 million in loans.

Total deposits were \$3.683 billion at March 31, 2014, compared to \$3.618 billion three months earlier and \$3.521 billion a year ago. While non-interest-bearing account balances decreased 2% to \$1.096 billion at March 31, 2014, compared to \$1.115 billion at December 31, 2013, largely as a result of seasonal factors, our successful client acquisition strategies, resulted in a 14% increase in these non-interest-bearing deposits compared to \$962 million a year ago. Interest-bearing transaction and savings accounts increased 3% to \$1.682 billion at March 31, 2014, compared to \$1.630 billion at December 31, 2013 and \$1.576 billion a year ago, while certificates of deposit increased 4% to \$905 million at March 31, 2014, compared to \$873 million at December 31, 2013 but decreased 8% compared to \$983 million a year earlier. Non-certificate core deposits represented 75% of total deposits at the end of the first quarter, compared to 72% of total deposits a year earlier.

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 Selected Notes to the Consolidated Financial Statements contained in Item 1 of this Form 10-Q.

#### Summary of Critical Accounting Policies

Our significant accounting policies are described in Note 1 of the Notes to the Consolidated Financial Statements for the year ended December 31, 2013 included in the 2013 Form 10-K. 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 during the first three months of 2014.

**Interest Income:** (Note 1) 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:** (Note 7) 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 on an individual loan basis. The level of general loan loss 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: (Note 11) 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 11 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

**Other Intangible Assets:** (Note 9) 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:** (Note 9) 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:** (Note 8) 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 12) 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.

#### Comparison of Financial Condition at March 31, 2014 and December 31, 2013

**General.** Total assets increased \$99 million, or 2.3%, to \$4.488 billion at March 31, 2014, from \$4.389 billion at December 31, 2013. Net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) increased \$104 million, or 3.1%, to \$3.449 billion at March 31, 2014, from \$3.344 billion at December 31, 2013.

The increase in net loans included increases of \$56 million in commercial real estate loans, \$34 million in commercial business loans, \$18 million in one- to four-family construction loans, \$16 million in multifamily loans, \$12 million in multifamily construction loans, and \$2 million in consumer loans, partially offset by decreases of \$19 million in agricultural business loans, \$12 million in one- to four-family real estate loans, \$2 million in land and land development loans, and \$1 million in commercial construction loans. The increase in commercial real estate loans included \$54 million for investment properties and \$2 million for owner-occupied properties. The increase in commercial business loans is an encouraging sign of improving economic activity. The increase in one- to four-family

and in multifamily construction loans was particularly helpful to the net interest margin as interest rates, loan fees and the velocity of turnover in this lending activity are generally higher than for most other categories of loans. The decrease in agricultural business loans represents a normal seasonal reduction in the first quarter. The decrease in one-to four-family real estate was largely the result of continued prepayments in the current low interest rate environment.

The aggregate balance of interest-earning deposits and securities increased \$1 million from December 31, 2013 to \$704 million at March 31, 2014. Interest-earning deposits increased \$4 million during the quarter to \$71 million, while our total investment in securities decreased \$2 million to \$633 million at March 31, 2014. Securities purchases in recent periods have been modest and were primarily mortgage-backed securities and, to a lesser extent, intermediate-term taxable and tax-exempt municipal securities. The average effective duration of Banner's securities portfolio was approximately 3.3 years at March 31, 2014. Net fair value adjustments to the portfolio of securities held for trading, which are included in net income, were \$45,000 in the three months ended March 31, 2014. In addition, fair value adjustments for securities designated as available for sale reflected an increase of \$2 million for the three months ended March 31, 2014, which was included net of the associated tax expense of \$889,000 as a component of other comprehensive income and largely occurred as a result of modestly decreased interest rates. (See Note 11 of the Selected Notes to the Consolidated Financial Statements, in this Form 10-Q.)

REO decreased \$808,000, to \$3 million at March 31, 2014, compared to \$4 million at December 31, 2013, continuing the improving trend with respect to these non-earning assets. The March 31, 2014 total included \$2 million in residential construction, land or land development projects and \$1 million in single-family homes. During the three months ended March 31, 2014, we transferred \$707,000 of loans into REO, disposed of \$2 million of REO properties recognizing \$159,000 in gains related to those sales, and charged-off \$37,000 in valuation adjustments (see "Asset Quality" discussion below).

Deposits increased \$65 million, or 2%, to \$3.683 billion at March 31, 2014 from \$3.618 billion at December 31, 2013. However, following expected seasonal behavior, non-interest-bearing deposits decreased by \$20 million, or 2%, to \$1.096 billion at March 31, 2014, compared to \$1.115 billion at December 31, 2013, yet have increased by 14% compared to a year earlier. Interest-bearing transaction and savings accounts increased by \$52 million, or 3%, to \$1.682 billion at March 31, 2014 from \$1.630 billion at December 31, 2013 and have increased by 7% compared to a year earlier. Certificates of deposit increased \$32 million, or 4%, to \$905 million at March 31, 2014 from \$873 million at December 31, 2013, but have decreased by 8% compared to a year earlier. Non-certificate core deposits increased to 75% of total deposits at the end of the first quarter, compared to 72% of total deposits a year earlier.

FHLB advances increased \$21 million to \$48 million at March 31, 2014 from \$27 million at December 31, 2013 to fund loan demand. The new advances are all very short-term maturities with correspondingly low interest rates. Other borrowings, consisting of retail repurchase agreements primarily related to customer cash management accounts, increased \$7 million to \$90 million at March 31, 2014, compared to \$83 million at December 31, 2013. No additional junior subordinated debentures were issued or matured during the quarter and the estimated fair value of these instruments was unchanged at \$74 million at March 31, 2014 and December 31, 2013. For more information, see Notes 10, 11 and 12 of the Selected Notes to the Consolidated Financial Statements.

Total stockholders' equity increased \$9 million, or 2%, to \$548 million at March 31, 2014 compared to \$539 million at December 31, 2013. The increase in equity primarily reflects the year-to-date net income reduced by payment of dividends to common stockholders. In addition, there was an improvement of \$1.6 million in accumulated other comprehensive income representing a decline in the unrealized loss, net of tax, on securities available-for-sale. Tangible common stockholders' equity, which excludes intangible assets, also increased \$9 million to \$546 million, or 12.16% of tangible assets at March 31, 2014, compared to \$537 million, or 12.23% at December 31, 2013. We did not have any repurchases of our common stock from December 31, 2013 through March 31, 2014 except for 537 shares surrendered by employees to satisfy tax withholding obligations upon the vesting of restricted stock grants. Additionally, there were 47,890 shares redeemed and canceled that related to the termination of the ESOP during the quarter ended March 31, 2014.

#### Comparison of Results of Operations for the Three Months Ended March 31, 2014 and 2013

For the quarter ended March 31, 2014, we had net income of \$10.6 million, or \$0.54 per diluted share. This compares to net income of \$11.6 million, or \$0.60 per diluted share, for the quarter ended March 31, 2013. As expected, our first quarter operating results continued to be influenced by very low interest rates and modest economic growth, which pressured asset yields and reduced mortgage banking revenues. Nonetheless, significant growth in earning assets, as well as changes in the asset mix and further reductions in funding costs combined to offset much of this yield pressure. In addition, credit costs remained low and deposit fees and other payment processing revenues increased compared to a year earlier reflecting further growth in client relationships. As a result, net income for the current quarter, while decreased modestly from the first quarter a year ago principally because of reduced mortgage banking revenues, remained solid, represented a good start to 2014 and produced an annualized return on average assets of 0.97%.

**Net Interest Income.** Net interest income before provision for loan losses increased by \$1.4 million, or 3%, to \$42.3 million for the quarter ended March 31, 2014, compared to \$41.0 million for the same quarter one year earlier, as a decrease in the net interest margin was more than offset by an increase in the average balance of interest-earning assets. The net interest margin of 4.07% for the quarter ended March 31, 2014 was nine basis points lower than for the same quarter in the prior year. The decrease in the net interest margin compared to a year earlier reflects the impact of persistently low market interest rates on earning asset yields, which was only partially offset by reductions in deposit and other funding costs as well as further reductions in the adverse effect of non-performing assets. Nonaccrual loans reduced the margin by two basis points in the first quarter of 2014, while nonaccruing loans reduced the margin by four basis points in the first quarter of 2013. In addition, the further decrease in the average balance of real estate

owned reduced the adverse effect of this non-interest-earning asset on the net interest margin.

The net interest spread decreased to 4.04% for the quarter ended March 31, 2014 compared to 4.13% for the same quarter a year earlier. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on earning assets for the quarter ended March 31, 2014 was 4.33%, a decrease of 19 basis points compared to the same quarter a year earlier. While declining less than asset yields, funding costs were also significantly lower, especially deposit costs which decreased nine basis points to 0.22% from 0.31% a year earlier, leading to a decrease of ten basis points for all funding liabilities to 0.29% for the quarter ended March 31, 2014.

**Interest Income.** Interest income for the quarter ended March 31, 2014 was \$45.1 million, compared to \$44.5 million for the same quarter in the prior year, an increase of \$598,000, or 1%. The increase in interest income occurred as a result of an increase in the average balances of interest-earning assets, which was partially offset by a decline in the yield. The average balance of interest-earning assets was \$4.221 billion for the quarter ended March 31, 2014, an increase of \$225 million, or 6%, compared to \$3.996 billion one year earlier. The yield on average interest-earning assets decreased to 4.33% for the quarter ended March 31, 2014, compared to 4.52% for the same quarter one year earlier. The decrease in the yield on earning assets reflects the continuing erosion of yields as loans and investments mature or prepay and are replaced by lower yielding assets in the current low interest rate environment. Average loans receivable for the quarter ended March 31, 2014 increased \$260 million, or 8%, to \$3.475 billion, compared to \$3.215 billion for the same quarter in the prior year. Interest income on loans increased by \$254,000, or 1%, to \$41.7 million for the current quarter from \$41.5 million for the quarter ended March 31, 2013, reflecting the impact of the \$260 million increase in average loan balances, offset by a 36 basis point decrease in the average yield on loans. The average yield on loans was 4.87% for the quarter ended March 31, 2014, compared to 5.23% for the same quarter one year earlier.

The combined average balance of mortgage-backed securities, investment securities, and daily interest-bearing deposits decreased to \$746 million for the quarter ended March 31, 2014 (excluding the effect of fair value adjustments), compared to \$781 million for the quarter ended March 31, 2013; however, the interest and dividend income from those investments increased by \$344,000 compared to the same quarter in the prior year.

The average yield on the combined portfolio increased to 1.83% for the quarter ended March 31, 2014, from 1.57% for the same quarter one year earlier. The adverse impact of relatively low market rates on the combined yield on these investments was offset by changes in the mix to include lower balances of daily interest-bearing deposits and more higher-yielding securities. The yield on mortgage-backed securities improved compared to recent periods, including the first quarter a year ago, as a result of reduced amortization of purchased premiums due to slower prepayments on the underlying loans. In addition, the yield on other securities benefited in the current quarter from an unexpected early redemption of a municipal bond that had been purchased at a discount.

**Interest Expense.** Interest expense for the quarter ended March 31, 2014 was \$2.8 million, compared to \$3.5 million for the same quarter in the prior year, a decrease of \$773,000, or 22%. The decrease in interest expense occurred as a result of a ten basis point decrease in the average cost of all funding liabilities to 0.29% for the quarter ended March 31, 2014, from 0.39% for the same quarter one year earlier, partially offset by a \$169 million increase in average funding liabilities. This increase in average funding liabilities reflects increases in transaction and savings accounts including non-interest-bearing accounts, and advances from FHLB, offset by a continued decline in certificates of deposit compared to one year ago.

Deposit interest expense decreased \$755,000, or 28%, to \$2.0 million for the quarter ended March 31, 2014, compared to \$2.7 million for the same quarter in the prior year, as a result of a nine basis point decrease in the cost of deposits. Average deposit balances increased to \$3.619 billion for the quarter ended March 31, 2014, from \$3.502 billion for the quarter ended March 31, 2013, and the average rate paid on deposit balances decreased to 0.22% in the first quarter of 2014 from 0.31% for the quarter ended March 31, 2013. The cost of interest-bearing deposits decreased by 12 basis points to 0.31% for the quarter ended March 31, 2014 compared to 0.43% in the same quarter a year earlier and the average balance of interest-bearing accounts decreased by \$11 million. Also contributing to the decrease in total deposit costs was a \$128 million increase in the average balances of non-interest-bearing accounts. While we do not anticipate further reductions in market interest rates, we do expect additional modest declines in deposit costs over the near term as maturities of certificates of deposit will present further repricing opportunities and competitive pricing should remain restrained 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. However, it is clear that the pace of decline in deposit costs compared to prior periods has slowed and that the opportunity for future reductions is limited.

Average FHLB advances (excluding the effect of fair value adjustments) were \$50 million for the quarter ended March 31, 2014, compared to \$4 million for the same quarter one year earlier, and the average rate paid on FHLB advances for the quarter ended March 31, 2014 decreased to 0.31% from 2.66% for the same quarter one year earlier. Average FHLB advances increased as a result of certain cash management activities at Banner Bank, while the cost of the advances declined as a result of the maturity of a higher rate fixed-term advance in February 2013. Interest expense on FHLB advances increased to \$38,000 for the quarter ended March 31, 2014 from \$24,000 for the quarter ended March 31, 2013.

Other borrowings consist of retail repurchase agreements with customers secured by certain investment securities. The average balance for other borrowings increased \$5 million to \$88 million during the current quarter from \$83 million during the same quarter a year earlier, while the rate on other borrowings decreased to 0.20% from 0.27% a year earlier. As a result, interest expense for other borrowings decreased to \$44,000 for the quarter ended March 31, 2014, compared to \$56,000 for the quarter ended March 31, 2013.

Junior subordinated debentures which were issued in connection with trust preferred securities had an average balance of \$124 million (excluding the effect of fair value adjustments) and an average cost of 2.36% for the quarter ended March 31, 2014. Junior subordinated debentures outstanding in the same period in the prior year had the same average balance of \$124 million (excluding the effect of fair value adjustments) with higher average costs of 2.43% for the

quarter ended March 31, 2013. The junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index.



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Analysis of Net Interest Spread. The following table 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 with additional comparative data on our operating performance (dollars in thousands):

|  | Three Months Ended March 31,<br>2014 |                              |                               | Three Months Ended March 31,<br>2013 |                              |                               |        |   |
|--|--------------------------------------|------------------------------|-------------------------------|--------------------------------------|------------------------------|-------------------------------|--------|---|
|  | Average<br>Balance                   | Interest<br>and<br>Dividends | Yield/<br>Cost <sup>(3)</sup> | Average<br>Balance                   | Interest<br>and<br>Dividends | Yield/<br>Cost <sup>(3)</sup> |        |   |
| Interest-earning assets:   |                                      |                              |                               |                                      |                              |                               |        |   |
| Mortgage loans   | \$2,511,528                          | \$31,152                     | 5.03                          | %                                    | \$2,359,325                  | \$31,229                      | 5.37   | % |
| Commercial/agricultural loans  | 852,654                              | 8,853                        | 4.21                          |                                      | 752,372                      | 8,479                         | 4.57   |   |
| Consumer and other loans   | 111,187                              | 1,738                        | 6.34                          |                                      | 103,531                      | 1,781                         | 6.98   |   |
| Total loans <sup>(1)</sup>   | 3,475,369                            | 41,743                       | 4.87                          |                                      | 3,215,228                    | 41,489                        | 5.23   |   |
| Mortgage-backed securities   | 352,355                              | 1,471                        | 1.69                          |                                      | 299,299                      | 1,172                         | 1.59   |   |
| Other securities   | 300,257                              | 1,838                        | 2.48                          |                                      | 337,343                      | 1,780                         | 2.14   |   |
| Interest-bearing deposits with banks                                   | 58,352                               | 45                           | 0.31                          |                                      | 107,950                      | 67                            | 0.25   |   |
| FHLB stock   | 35,152                               | 9                            | 0.10                          |                                      | 36,655                       | —                             | —      |   |
| Total investment securities  | 746,116                              | 3,363                        | 1.83                          |                                      | 781,247                      | 3,019                         | 1.57   |   |
| Total interest-earning assets  | 4,221,485                            | 45,106                       | 4.33                          |                                      | 3,996,475                    | 44,508                        | 4.52   |   |
| Non-interest-earning assets  | 200,227                              |                              |                               |                                      | 219,211                      |                               |        |   |
| Total assets   | \$4,421,712                          |                              |                               |                                      | \$4,215,686                  |                               |        |   |
| Deposits:  |                                      |                              |                               |                                      |                              |                               |        |   |
| Interest-bearing checking accounts                                     | \$418,988                            | 85                           | 0.08                          |                                      | \$391,446                    | 96                            | 0.10   |   |
| Savings accounts   | 819,323                              | 197                          | 0.10                          |                                      | 744,248                      | 381                           | 0.21   |   |
| Money market accounts  | 414,959                              | 320                          | 0.31                          |                                      | 412,010                      | 264                           | 0.26   |   |
| Certificates of deposit  | 889,907                              | 1,362                        | 0.62                          |                                      | 1,005,992                    | 1,978                         | 0.80   |   |
| Total interest-bearing deposits  | 2,543,177                            | 1,964                        | 0.31                          |                                      | 2,553,696                    | 2,719                         | 0.43   |   |
| Non-interest-bearing deposits  | 1,076,122                            | —                            | —                             |                                      | 948,276                      | —                             | —      |   |
| Total deposits   | 3,619,299                            | 1,964                        | 0.22                          |                                      | 3,501,972                    | 2,719                         | 0.31   |   |
| Other interest-bearing liabilities:                                    |                                      |                              |                               |                                      |                              |                               |        |   |
| FHLB advances  | 50,491                               | 38                           | 0.31                          |                                      | 3,654                        | 24                            | 2.66   |   |
| Other borrowings   | 88,171                               | 44                           | 0.20                          |                                      | 83,092                       | 56                            | 0.27   |   |
| Junior subordinated debentures   | 123,716                              | 721                          | 2.36                          |                                      | 123,716                      | 741                           | 2.43   |   |
| Total borrowings   | 262,378                              | 803                          | 1.24                          |                                      | 210,462                      | 821                           | 1.58   |   |
| Total funding liabilities  | 3,881,677                            | 2,767                        | 0.29                          |                                      | 3,712,434                    | 3,540                         | 0.39   |   |
| Other non-interest-bearing liabilities <sup>(2)</sup>                  | (6,083 )                             |                              |                               |                                      | (11,558 )                    |                               |        |   |
| Total liabilities  | 3,875,594                            |                              |                               |                                      | 3,700,876                    |                               |        |   |
| Stockholders' equity   | 546,118                              |                              |                               |                                      | 514,811                      |                               |        |   |
| Total liabilities and stockholders' equity                             | \$4,421,712                          |                              |                               |                                      | \$4,215,687                  |                               |        |   |
| Net interest income/rate spread  |                                      | \$42,339                     | 4.04                          | %                                    |                              | \$40,968                      | 4.13   | % |
| Net interest margin  |                                      |                              | 4.07                          | %                                    |                              |                               | 4.16   | % |
| Additional Key Financial Ratios:                                       |                                      |                              |                               |                                      |                              |                               |        |   |
| Return on average assets   |                                      |                              | 0.97                          | %                                    |                              |                               | 1.11   | % |
| Return on average equity   |                                      |                              | 7.85                          |                                      |                              |                               | 9.12   |   |
| Average equity / average assets  |                                      |                              | 12.35                         |                                      |                              |                               | 12.21  |   |
| Average interest-earning assets / average interest-bearing liabilities |                                      |                              | 150.47                        |                                      |                              |                               | 144.58 |   |
| Average interest-earning assets / average funding liabilities          |                                      |                              | 108.75                        |                                      |                              |                               | 107.65 |   |

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|  |       |       |
|--|-------|-------|
| Non-interest (other operating) income /<br>average assets  | 0.81  | 0.96  |
| Non-interest (other operating) expense /<br>average assets | 3.26  | 3.28  |
| Efficiency ratio <sup>(4)</sup>                            | 69.50 | 66.91 |

- (1) Average balances include loans accounted for on a nonaccrual basis and loans 90 days or more past due. Amortization of net deferred loan fees/costs is included with interest on loans.
- (2) Average other non-interest-bearing liabilities include fair value adjustments related to FHLB advances and junior subordinated debentures.
- (3) Yields and costs have not been adjusted for the effect of tax-exempt interest.
- (4) Other operating expense divided by the total of net interest income (before provision for loan losses) and other operating income (non-interest income).

Provision and Allowance for Loan Losses. As a result of substantial reserves already in place representing 2.11% of total loans outstanding, as well as declining delinquencies and net charge-offs, we did not record a provision for loan losses in the quarter ended March 31, 2014. This compares to no provision in the preceding quarter and no provision in the first quarter a year ago, as we also had substantial reserves at the end of each of those periods and were experiencing improving credit quality trends during those periods. As discussed in the Summary of Critical Accounting Policies section above and in Note 1 of the Selected Notes to the Consolidated Financial Statements in this Form 10-Q, the provision and allowance for loan losses is one of the most critical accounting estimates included in our Consolidated Financial Statements.

The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves, trends in delinquencies and net charge-offs and current economic conditions.

Reflecting lingering weakness in the economy, we continue to maintain a substantial allowance for loan losses at March 31, 2014 even though non-performing loans declined during the quarter. Nonetheless, our credit quality indicators have continued to improve, eliminating the need for a provision for loan losses for the first three months of 2014.

We recorded net recoveries of \$113,000 for the quarter ended March 31, 2014, compared to net charge-offs of \$363,000 for the same quarter in the prior year. Non-performing loans decreased by \$2 million during the quarter ended March 31, 2014 to \$23 million, and decreased by \$11 million compared to the quarter ended March 31, 2013. A comparison of the allowance for loan losses at March 31, 2014 and 2013 reflects a decrease of \$2 million to \$74 million at March 31, 2014, from \$76 million at March 31, 2013. Included in our allowance at March 31, 2014 was an unallocated portion of \$7 million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) decreased to 2.11% at March 31, 2014, from 2.36% at March 31, 2013. However, with the decrease in problem loans, the allowance as a percentage of non-performing loans increased to 325% at March 31, 2014, compared to 300% of non-performing loans at December 31, 2013 and 229% a year earlier.

As of March 31, 2014, we had identified \$63 million of impaired loans. Impaired loans are comprised of loans on nonaccrual, TDRs that are performing under their restructured terms and loans that are 90 days or more past due, but are still on accrual. Impaired loans may be evaluated for reserve purposes using either a specific impairment analysis or collectively evaluated as part of homogeneous pools. For more information on these impaired loans, refer to Note 11 of the Selected Notes to the Consolidated Financial Statements, Fair Value Accounting and Measurement, in this Form 10-Q.

We believe that the allowance for loan losses as of March 31, 2014 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that these 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 allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

Other Operating Income. Other operating income, which includes changes in the valuation of financial instruments carried at fair value, OTTI charges and recoveries, and gain on sale of securities, as well as non-interest revenues from core operations, was \$8.9 million for the quarter ended March 31, 2014, compared to \$10.0 million for the same

quarter in the prior year. Our other operating income for the three months ended March 31, 2014 included a gain on the sale of securities of \$35,000 and a \$255,000 net loss for fair value adjustments as a result of changes in the valuation of our securities portfolios. During the quarter ended March 31, 2013, fair value adjustments resulted in a net loss of \$1.3 million which was generally offset by a \$409,000 OTTI recovery. For a more detailed discussion of our fair value adjustments, please refer to Note 11 in the Selected Notes to the Consolidated Financial Statements in this Form 10-Q.

Excluding the fair value and OTTI adjustments and gain on sale of securities, other operating income from core operations decreased by \$851,000, or 9%, to \$9.1 million for the quarter ended March 31, 2014, compared to \$9.9 million for the quarter ended March 31, 2013, largely as a result of decreased revenues from mortgage banking operations. Mortgage banking revenues decreased by \$1.0 million as increased mortgage rates slowed originations for refinancing. By contrast, deposit fees and service charges increased by \$301,000 compared to the first quarter a year ago reflecting growth in the number of deposit accounts and increased transaction activity.

Other Operating Expenses. Other operating expenses increased by \$1.5 million, to \$35.6 million for the quarter ended March 31, 2014, compared to \$34.1 million for the quarter ended March 31, 2013, largely as a result of increased compensation expenses, and a reduction in the credit for capitalized loan origination costs, which were partially offset by decreases in advertising expenses and business and use tax expense. Compensation expense increased \$427,000, or 2%, to \$21.2 million for the quarter ended March 31, 2014, compared to \$20.7 million for the quarter ended March 31, 2013, primarily reflecting salary and wage adjustments and increased health insurance and other benefit costs somewhat offset by reduced mortgage bank commissions. Occupancy expense increased \$367,000, or 7%, to \$5.7 million for the quarter ended March 31, 2014, compared to \$5.3 million for the quarter ended March 31, 2013 due largely to increased depreciation expense related to computer hardware and software upgrades, higher cost of utilities and building repair and maintenance expenses. Data processing and payment and card processing expenses increased \$215,000 (13%) and \$210,000 (9%), respectively, compared to the same period one year earlier. Advertising expenses decreased \$442,000, or 29%. Business and use tax expense of \$159,000 was \$305,000 lower than in the same period one year earlier due to the refund of \$250,000 in overpaid taxes from prior periods. REO costs at \$39,000 for the quarter ended March 31, 2014 were fairly low, but were a negative variance as compared to the net gains on sale of REO of \$251,000 for the quarter ended March 31, 2013.

**Income Taxes.** In the quarter ended March 31, 2014, we recognized \$5.0 million in income tax expense for an effective tax rate of 32.3%, which reflects our normal statutory tax rate reduced by the impact of tax-exempt income and certain tax credits. Our normal, expected statutory income tax rate is 36.5%, representing a blend of the statutory federal income tax rate of 35.0% and apportioned effects of the 7.6% Oregon and Idaho income tax rates. For the quarter ended March 31, 2013, we recognized \$5.3 million in income tax expense for an effective tax rate of 31.3%. For more discussion on our deferred tax asset, please refer to Note 12 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

#### Asset Quality

Achieving and maintaining a moderate risk profile by aggressively managing troubled assets has been and will continue to be a primary focus for us. As a result, our non-performing assets declined substantially in 2013 and have decreased further in the first three months of 2014. All of our key credit quality metrics have improved compared to a year ago, including improvement during the first quarter of this year, and as a result our collection costs have been further reduced. In addition, 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. While our non-performing assets and credit costs have been materially reduced, we continue to be actively engaged with our borrowers in resolving remaining problem assets and with the effective management of real estate owned as a result of foreclosures.

**Non-Performing Assets:** Non-performing assets decreased to \$26 million, or 0.59% of total assets, at March 31, 2014, from \$29 million, or 0.66% of total assets, at December 31, 2013, and \$45 million, or 1.06% of total assets, at March 31, 2013. Construction and land development loans, including related REO, represented approximately 15% of our non-performing assets at March 31, 2014. 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 maintain a substantial allowance for loan losses even though non-performing loans declined. At March 31, 2014, our allowance for loan losses was \$74 million, or 2.11% of total loans and 325% of non-performing loans, compared to \$74 million, or 2.17% of total loans and 300% of non-performing loans at December 31, 2013. Included in our allowance at March 31, 2014 was an unallocated portion of \$7 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 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 \$26 million in non-performing assets are \$21 million in nonaccrual loans and \$3.5 million in REO and other repossessed assets. The geographic distribution of non-performing assets included approximately \$11 million, or 42%, in the Puget Sound region, \$7 million, or 29%, in the greater Portland market area, \$1 million, or 4%, in the greater Boise market area, and \$7 million, or 25%, 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 or TDRs 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 March 31, 2014, we had \$40 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):

|  | March 31, 2014 | December 31, 2013 | March 31, 2013 |   |
|--|----------------|-------------------|----------------|---|
| Nonaccrual Loans: <sup>(1)</sup>                                     |                |                   |                |   |
| Secured by real estate:  |                |                   |                |   |
| Commercial   | \$6,201        | \$6,287           | \$6,727        |   |
| Multifamily  | —              | —                 | 339            |   |
| Construction and land  | 2,135          | 1,193             | 3,728          |   |
| One- to four-family  | 10,587         | 12,532            | 12,875         |   |
| Commercial business  | 977            | 723               | 4,370          |   |
| Agricultural business, including secured by farmland                 | —              | —                 | —              |   |
| Consumer   | 1,399          | 1,173             | 3,078          |   |
|  | 21,299         | 21,908            | 31,117         |   |
| Loans more than 90 days delinquent, still on accrual:                |                |                   |                |   |
| Secured by real estate:  |                |                   |                |   |
| Commercial   | —              | —                 | —              |   |
| Multifamily  | —              | —                 | —              |   |
| Construction and land  | —              | —                 | —              |   |
| One- to four-family  | 1,465          | 2,611             | 2,243          |   |
| Commercial business  | —              | —                 | —              |   |
| Agricultural business, including secured by farmland                 | 104            | 105               | —              |   |
| Consumer   | —              | 144               | 46             |   |
|  | 1,569          | 2,860             | 2,289          |   |
| Total non-performing loans   | 22,868         | 24,768            | 33,406         |   |
| Securities on nonaccrual at fair value                               | —              | —                 | —              |   |
| REO and other repossessed assets held for sale, net <sup>(2)</sup>   | 3,236          | 4,044             | 11,160         |   |
| Total non-performing assets  | \$26,377       | \$28,927          | \$44,864       |   |
| Total non-performing loans to loans before allowance for loan losses | 0.65           | % 0.72            | % 1.03         | % |
| Total non-performing loans to total assets                           | 0.51           | % 0.56            | % 0.79         | % |
| Total non-performing assets to total assets                          | 0.59           | % 0.66            | % 1.06         | % |
| Restructured loans <sup>(3)</sup>                                    | \$40,165       | \$47,428          | \$54,611       |   |
| Loans 30-89 days past due and on accrual                             | \$12,662       | \$8,784           | \$6,984        |   |

(1) Includes \$6.9 million of non-accrual restructured loans. For the three months ended March 31, 2014, \$264,000 in interest income would have been recorded had nonaccrual loans been current.

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.





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The following table sets forth the Company's non-performing assets by geographic concentration at March 31, 2014 (dollars in thousands):

|  | Washington | Oregon  | Idaho | Total    |   |
|--|------------|---------|-------|----------|---|
| Secured by real estate:                              |            |         |       |          |   |
| Commercial   | \$6,201    | \$—     | \$—   | \$6,201  |   |
| Construction and land                                |            |         |       |          |   |
| One- to four-family construction                     | —          | 269     | —     | 269      |   |
| Residential land acquisition & development           | —          | 750     | —     | 750      |   |
| Residential land improved lots                       | 560        | 556     | —     | 1,116    |   |
| Total construction and land                          | 560        | 1,575   | —     | 2,135    |   |
| One- to four-family                                  | 7,770      | 3,691   | 591   | 12,052   |   |
| Commercial business                                  | 919        | 58      | —     | 977      |   |
| Agricultural business, including secured by farmland | 104        | —       | —     | 104      |   |
| Consumer   | 1,221      | 40      | 138   | 1,399    |   |
| Total non-performing loans                           | 16,775     | 5,364   | 729   | 22,868   |   |
| Real Estate Owned (REO)                              | 1,241      | 1,787   | 208   | 3,236    |   |
| Other repossessed assets                             | 273        | —       | —     | 273      |   |
| Total non-performing assets                          | \$18,289   | \$7,151 | \$937 | \$26,377 |   |
| Percent of non-performing assets                     | 69         | % 27    | % 4   | % 100    | % |

In addition to the non-performing loans as of March 31, 2014, we had other classified loans with an aggregate outstanding balance of \$60 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.

Included in our non-performing loans, are three nonaccrual lending relationships with aggregate loan exposures in excess of \$1 million that collectively comprise \$4.7 million, or 20.5% of our total non-performing loans as of March 31, 2014. At that date the single largest relationship consisted of a commercial real estate loan that totaled \$1.8 million which is secured by a commercial building located in the greater Spokane, Washington area. The second largest non-performing lending relationship consisted of a \$1.5 million commercial real estate loan secured by a commercial building located in central Washington State. The third largest non-performing lending relationship totals \$1.3 million and is secured by eleven single family residences in the greater Portland, Oregon area. The remaining balance of our non-performing loans consists of 106 loans with borrowers located throughout our market areas.

We record REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at the lower of the estimated fair value of the property, less estimate selling costs, or the carrying value of the loan. From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current appraised value of property. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the quarters ended March 31, 2014 and 2013, we recognized \$37,000 and \$73,000, respectively, of impairment charges related to these types of assets.

At March 31, 2014, we had \$3.2 million of REO, the most significant component of which is a subdivision in the greater Portland, Oregon area consisting of eight residential buildable lots and 33.2 acres of undeveloped land with a book value of \$798,000. All other REO holdings have individual book values of less than \$500,000. The geographic distribution of REO included approximately \$1.8 million, or 55%, in the greater Portland market area, \$993,000, or 31%, in the Puget Sound region, \$208,000, or 7%, in the greater Boise market area, and \$247,000, or 7%, in other areas of Washington, Oregon and Idaho.

## Liquidity and Capital Resources

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

Our primary investing activity is the origination and purchase of loans and, in certain periods, the purchase of securities. During the three months ended March 31, 2014 and 2013, our loan originations exceeded our loan repayments by \$121 million and \$141 million, respectively. During those periods we purchased loans of \$54 million and \$91,000, respectively. During the three months ended March 31, 2014 and 2013, we sold \$70 million and \$137 million, respectively, of loans. Securities purchased during the three months ended March 31, 2014 and 2013 totaled \$39 million and \$59 million, respectively, and securities repayments, maturities and sales were \$43 million and \$55 million, respectively.

Our primary financing activity is gathering deposits. Deposits increased by \$65 million during the first three months of 2014, including a \$32 million increase in certificates of deposits. As expected, we experienced a seasonal decline in non-interest-bearing deposits; however, non-interest-bearing deposits increased 14% compared to a year earlier. The increase in certificate balances in the current quarter reflects a \$55 million increase in brokered deposits issued to provide additional funding to support the strong loan growth. Certificates of deposits are generally more price sensitive than other retail deposits and our pricing of those deposits varies significantly based upon our liquidity management strategies at any point in time. At March 31, 2014, certificates of deposit amounted to \$905 million, or 25% of our total deposits, including \$704 million which were scheduled to mature within one year. While no assurance can be given as to future periods, historically, we have been able to retain a significant amount of our deposits as they mature.

FHLB advances (excluding fair value adjustments) increased \$21 million to \$48 million for the quarter ended March 31, 2014 and increased \$48 million from March 31, 2013 to fund loan growth. As of March 31, 2014, FHLB advances were for short-term borrowings. Other borrowings at March 31, 2014 increased \$7 million to \$90 million for the quarter ended March 31, 2014 and increased \$1 million from one year ago. The increase in other borrowings in the quarter ended March 31, 2014 was due to an increase of retail repurchase agreements.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to accommodate deposit withdrawals, to support loan growth, to satisfy financial commitments and to take advantage of investment opportunities. During the three months ended March 31, 2014 and 2013, we used our sources of funds primarily to fund loan commitments, purchase securities, and pay maturing savings certificates and deposit withdrawals. At March 31, 2014, we had outstanding loan commitments totaling \$1.126 billion, including undisbursed loans in process and unused credit lines totaling \$1.102 billion. While representing potential growth in the loan portfolio and lending activities, this level of commitments is proportionally consistent with our historical experience and does not represent a departure from normal operations.

We generally maintain sufficient cash and readily marketable securities to meet short-term liquidity needs; however, our primary liquidity management practice to supplement deposits is to increase or decrease short-term borrowings, including FHLB advances and Federal Reserve Bank of San Francisco (FRBSF) borrowings. We maintain credit facilities with the FHLB-Seattle, which at March 31, 2014 provide for advances that in the aggregate may equal the lesser of 35% of Banner Bank's assets or adjusted qualifying collateral (subject to a sufficient level of ownership of FHLB stock), up to a total possible credit line of \$747 million, and 25% of Islanders Bank's assets or adjusted qualifying collateral, up to a total possible credit line of \$28 million. Advances under these credit facilities (excluding fair value adjustments) totaled \$48 million, or 1.1% of our assets at March 31, 2014. In addition, Banner Bank has been approved for participation in the FRBSF's Borrower-In-Custody (BIC) program. Under this program Banner Bank had available lines of credit of approximately \$592 million as of March 31, 2014, subject to certain collateral requirements, namely the collateral type and risk rating of eligible pledged loans. We had no funds borrowed from the FRBSF at March 31, 2014 or December 31, 2013. Management believes it has adequate resources and funding potential to meet our foreseeable liquidity requirements.

Banner Corporation is a separate legal entity from the Banks and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. Banner's primary sources of funds consist of capital raised through dividends or capital distributions from the Banks, although there are regulatory restrictions on the ability of the Banks to pay dividends. At March 31, 2014, the Company (on an unconsolidated basis) had liquid assets of \$41.8 million.

As noted below, Banner Corporation and its subsidiary banks continued to maintain capital levels significantly in excess of the requirements to be categorized as "Well-Capitalized" under applicable regulatory standards. During the three months ended March 31, 2014, total equity increased \$9 million, or 2%, to \$548 million. Total equity at March 31, 2014 is entirely attributable to common stock. At March 31, 2014, tangible common stockholders' equity,

which excludes other intangible assets, was \$546 million, or 12.16% of tangible assets. See the discussion and reconciliation of non-GAAP financial information in the Executive Overview section of Management's Discussion and Analysis of Financial Condition and Results of Operation in this Form 10-Q for more detailed information with respect to tangible common stockholders' equity. Also, see the capital requirements discussion and table below with respect to our regulatory capital positions.

### Capital Requirements

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

The capital adequacy requirements are quantitative measures established by regulation that require Banner Corporation and the Banks to maintain minimum amounts and ratios of capital. The Federal Reserve requires Banner Corporation to maintain capital adequacy that generally parallels the FDIC requirements. The FDIC requires the Banks to maintain minimum ratios of Tier 1 total capital to risk-weighted assets as well as Tier 1 leverage capital to average assets. At March 31, 2014, Banner Corporation and the Banks each exceeded all regulatory capital requirements. (See Item 1, "Business-Regulation," and Note 18 of the Notes to the Consolidated Financial Statements included in the 2013 Form 10-K for additional information regarding regulatory capital requirements for Banner and the Banks.)

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The actual regulatory capital ratios calculated for Banner Corporation, Banner Bank and Islanders Bank as of March 31, 2014, along with the minimum capital amounts and ratios, were as follows (dollars in thousands):

|   | Actual    |       | Minimum for Capital Adequacy Purposes |       | Minimum to be Categorized as "Well-Capitalized" Under Prompt Corrective Action Provisions |         |
|---|-----------|-------|---------------------------------------|-------|---|---------|
|   | Amount    | Ratio | Amount                                | Ratio | Amount  | Ratio   |
| <b>Banner Corporation—consolidated</b>    |           |       |                                       |       |   |         |
| Total capital to risk-weighted assets     | \$643,656 | 16.95 | % \$303,820                           | 8.00  | % n/a   | n/a     |
| Tier 1 capital to risk-weighted assets    | 595,852   | 15.69 | 151,910                               | 4.00  | n/a   | n/a     |
| Tier 1 leverage capital to average assets | 595,852   | 13.53 | 176,114                               | 4.00  | n/a   | n/a     |
| <b>Banner Bank</b>                        |           |       |                                       |       |   |         |
| Total capital to risk-weighted assets     | 567,153   | 15.70 | 289,086                               | 8.00  | \$361,358   | 10.00 % |
| Tier 1 capital to risk-weighted assets    | 521,654   | 14.44 | 144,543                               | 4.00  | 216,815   | 6.00    |
| Tier 1 leverage capital to average assets | 521,654   | 12.50 | 166,854                               | 4.00  | 208,568   | 5.00    |
| <b>Islanders Bank</b>                     |           |       |                                       |       |   |         |
| Total capital to risk-weighted assets     | 35,235    | 18.90 | 14,911                                | 8.00  | 18,639  | 10.00   |
| Tier 1 capital to risk-weighted assets    | 32,902    | 17.65 | 7,456                                 | 4.00  | 11,183  | 6.00    |
| Tier 1 leverage capital to average assets | 32,902    | 14.04 | 9,373                                 | 4.00  | 11,716  | 5.00    |

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

### Market Risk and Asset/Liability Management

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

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

The greatest source of interest rate risk to us results from the mismatch of maturities or repricing intervals for rate sensitive assets, liabilities and off-balance-sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets, although our floating-rate assets tend to be more immediately responsive to changes in market rates than most funding deposit liabilities. Additional interest rate risk results from mismatched repricing indices and formula (basis risk and yield curve risk), and product caps and floors and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to us. An exception to this generalization is the beneficial effect of interest rate floors on a substantial portion of our performing floating-rate loans, which help us maintain higher loan yields in periods when market interest rates decline significantly. However, in a declining interest rate environment, as loans with floors are repaid they generally are replaced with new loans which have lower interest rate floors. As of March 31, 2014, our loans with interest rate floors totaled approximately \$1.6 billion and had a weighted average floor rate of 4.83%. An additional source of interest rate risk, which is currently of concern, is a prolonged period of exceptionally low market interest rates. Because interest-bearing deposit costs have been reduced to nominal levels, there is very little possibility that they will be significantly further reduced and our non-interest-bearing deposits are an increasingly significant percentage of total deposits. By contrast, if market rates remain very low, loan and securities yields will likely continue to decline as longer-term instruments mature or are repaid. As a result, a prolonged period of very low interest rates will likely result in compression of our net interest margin. While this pressure on the margin may be mitigated by further changes in the mix of assets and deposits, particularly increases in non-interest-bearing deposits, a prolonged period of low interest rates will present a very difficult operating environment for most banks, including us.

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

### Sensitivity Analysis

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

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

The following table sets forth, as of March 31, 2014, the estimated changes in our net interest income over one-year and two-year time horizons and the estimated changes in economic value of equity based on the indicated interest rate environments (dollars in thousands):

| Change (in Basis Points) in Interest Rates <sup>(1)</sup> | Estimated Increase (Decrease) in   |         |                                    |         |                          |          |
|---|------------------------------------|---------|------------------------------------|---------|--------------------------|----------|
|   | Net Interest Income Next 12 Months |         | Net Interest Income Next 24 Months |         | Economic Value of Equity |          |
| +400  | \$(675 )                           | (0.4 )% | \$8,132                            | 2.40 %  | \$(76,444 )              | (10.1 )% |
| +300  | (677 )                             | (0.4 )  | 6,186                              | 1.80    | (55,020 )                | (7.2 )   |
| +200  | (565 )                             | (0.3 )  | 4,492                              | 1.30    | (35,453 )                | (4.7 )   |
| +100  | (939 )                             | (0.6 )  | 1,533                              | 0.50    | (14,851 )                | (2.0 )   |
| 0   | —                                  | —       | —                                  | —       | —                        | —        |
| -25   | 155                                | 0.1     | (928 )                             | (0.30 ) | (5,138 )                 | (0.7 )   |
| -50   | (924 )                             | (0.5 )  | (4,825 )                           | (1.40 ) | (23,845 )                | (3.1 )   |

(1) Assumes an instantaneous and sustained uniform change in market interest rates at all maturities; however, no rates are allowed to go below zero. The current federal funds rate is 0.25%.

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

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



The following table presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at March 31, 2014 (dollars in thousands). The table sets forth the amounts of interest-earning assets and interest-bearing liabilities which are anticipated by us, based upon certain assumptions, to reprice or mature in each of the future periods shown. At March 31, 2014, total interest-earning assets maturing or repricing within one year exceeded total interest-bearing liabilities maturing or repricing in the same time period by \$589 million, representing a one-year cumulative gap to total assets ratio of 13.12%. Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible. The interest rate risk indicators and interest sensitivity gaps as of March 31, 2014 are within our internal policy guidelines and management considers that our current level of interest rate risk is reasonable.

|   | Within<br>6 Months | After<br>6 Months<br>Within<br>1 Year | After<br>1 Year<br>Within<br>3 Years | After<br>3 Years<br>Within<br>5 Years | After<br>5 Years<br>Within<br>10 Years | Over<br>10 Years | Total     |
|---|--------------------|---------------------------------------|--------------------------------------|---------------------------------------|--|------------------|-----------|
| Interest-earning assets:<br>(1)                           |                    |                                       |                                      |                                       |  |                  |           |
| Construction loans  | \$221,390          | \$8,198                               | \$14,977                             | \$5,079                               | \$6,033                                | \$74             | \$255,751 |
| Fixed-rate mortgage<br>loans                              | 138,739            | 87,949                                | 217,134                              | 139,134                               | 150,929                                | 79,213           | 813,098   |
| Adjustable-rate<br>mortgage loans                         | 508,404            | 149,835                               | 397,986                              | 260,697                               | 15,553                                 | —                | 1,332,475 |
| Fixed-rate<br>mortgage-backed<br>securities               | 61,692             | 39,115                                | 147,471                              | 57,302                                | 14,826                                 | 17,984           | 338,390   |
| Adjustable-rate<br>mortgage-backed<br>securities          | 2,421              | 136                                   | —                                    | —                                     | —                                      | —                | 2,557     |
| Fixed-rate<br>commercial/agricultural<br>loans            | 46,206             | 45,497                                | 96,330                               | 35,452                                | 13,536                                 | 840              | 237,861   |
| Adjustable-rate<br>commercial/agricultural<br>loans       | 551,259            | 13,407                                | 29,821                               | 20,229                                | 303                                    | —                | 615,019   |
| Consumer and other<br>loans                               | 172,865            | 14,649                                | 49,144                               | 22,990                                | 15,001                                 | 1,181            | 275,830   |
| Investment securities<br>and interest-earning<br>deposits | 175,408            | 23,308                                | 46,209                               | 35,034                                | 67,921                                 | 50,110           | 397,990   |
| Total rate sensitive<br>assets                            | 1,878,384          | 382,094                               | 999,072                              | 575,917                               | 284,102                                | 149,402          | 4,268,971 |
| Interest-bearing<br>liabilities: (2)                      |                    |                                       |                                      |                                       |  |                  |           |
| Regular savings and<br>interest checking<br>accounts      | 201,018            | 187,795                               | 438,189                              | 438,189                               | —                                      | —                | 1,265,191 |
| Money market deposit<br>accounts                          | 208,332            | 124,999                               | 83,333                               | —                                     | —                                      | —                | 416,664   |
| Certificates of deposit                                   | 433,258            | 254,336                               | 172,483                              | 41,436                                | 3,467                                  | 35               | 905,015   |
| FHLB advances   | 48,301             | —                                     | —                                    | —                                     | —                                      | —                | 48,301    |
| Other borrowings  | —                  | —                                     | —                                    | —                                     | —                                      | —                | —         |
|   | 123,716            | —                                     | —                                    | —                                     | —                                      | —                | 123,716   |

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|  |           |             |           |           |             |             |             |   |
|--|-----------|-------------|-----------|-----------|-------------|-------------|-------------|---|
| Junior subordinated debentures   |           |             |           |           |             |             |             |   |
| Retail repurchase agreements   | 89,921    | —           | —         | —         | —           | —           | 89,921      |   |
| Total rate sensitive liabilities   | 1,104,546 | 567,130     | 694,005   | 479,625   | 3,467       | 35          | 2,848,808   |   |
| Excess (deficiency) of interest-sensitive assets over interest-sensitive liabilities | \$773,838 | \$(185,036) | \$305,067 | \$96,292  | \$280,635   | \$149,367   | \$1,420,163 |   |
| Cumulative excess (deficiency) of interest-sensitive assets                          | \$773,838 | \$588,802   | \$893,869 | \$990,161 | \$1,270,796 | \$1,420,163 | \$1,420,163 |   |
| Cumulative ratio of interest-earning assets to interest-bearing liabilities          | 170.06    | % 135.22    | % 137.78  | % 134.80  | % 144.61    | % 149.85    | % 149.85    | % |
| Interest sensitivity gap to total assets   | 17.24     | % (4.12     | )% 6.80   | % 2.15    | % 6.25      | % 3.33      | % 31.64     | % |
| Ratio of cumulative gap to total assets  | 17.24     | % 13.12     | % 19.92   | % 22.06   | % 28.31     | % 31.64     | % 31.64     | % |

(Footnotes on following page)

Footnotes for Table of Interest Sensitivity Gap

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

Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, interest checking, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities. For the purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of (2) these accounts had been assumed to be short-term, the one-year cumulative gap of interest-sensitive assets would have been \$(371) million, or (8.26)% of total assets at March 31, 2014. Interest-bearing liabilities for this table exclude certain non-interest-bearing deposits which are included in the average balance calculations in the table contained in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Comparison of Results of Operations for the Three Months Ended March 31, 2014 and 2013" of this report on Form 10-Q.

ITEM 4 – Controls and Procedures

The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (Exchange Act). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer and several other members of our senior management as of the end of the period covered by this report. Based on their evaluation, our Chief Executive Officer and Chief (a) Financial Officer concluded that, as of March 31, 2014, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in Internal Controls Over Financial Reporting: In the quarter ended March 31, 2014, there was no change (b) in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

## ITEM 1 – Legal Proceedings

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

## ITEM 1A – Risk Factors

There have been no material changes in the risk factors previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013 (File No. 0-26584) or otherwise previously disclosed in our Form 10-Q reports filed subsequently.

## ITEM 2 – Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable

(b) Not applicable

(c) The following table provides information about repurchases of common stock by the Company during the quarter ended March 31, 2014:

| Period             | Total Number of Common Shares Purchased | Average Price Paid per Common Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Number of Remaining Shares that May be Purchased at Period End under the Plan |
|--------------------|---|-------------------------------------|---|---|
| 1/1/2014–1/31/2014 | —                                       | \$—                                 | n/a   | n/a   |
| 2/1/2014–2/28/2014 | 34,340                                  | 44.82                               | n/a   | n/a   |
| 3/1/2014–3/31/2014 | 14,087                                  | 41.00                               | n/a   | 978,826   |
| Total for quarter  | 48,427                                  | 43.71                               | n/a   | 978,826   |

The 34,340 shares were owned by the ESOP and were unallocated to plan participants. Those shares were redeemed upon the termination of the ESOP plan. Additionally, 13,550 shares allocated to ESOP participants were purchased upon the termination of the plan. The remaining 537 shares were surrendered by employees to satisfy tax withholding obligations upon the vesting of restricted stock grants.

## ITEM 3 – Defaults upon Senior Securities

Not Applicable.

## ITEM 4 – Mine Safety Disclosures

Not Applicable

## ITEM 5 – Other Information

Not Applicable.

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ITEM 6 – Exhibits

Exhibit Index of Exhibits

- 3{a} Amended and Restated Articles of Incorporation of Registrant [incorporated by reference to the Registrant’s Current Report on Form 8-K filed on April 28, 2010 (File No. 000-26584)], as amended on May 26, 2011 [incorporated by reference to the Current Report on Form 8-K filed on June 1, 2011 (File No. 000-26584)].
- 3{b} Bylaws of Registrant [incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed on April 1, 2011 (File No. 0-26584)].
- 4{a} Warrant to purchase shares of Company’s common stock dated November 21, 2008 [incorporated by reference to the Registrant’s Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].
- 10{a} Executive Salary Continuation Agreement with Gary L. Sirmon [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{b} Amended and Restated Employment Agreement with Mark J. Grescovich [incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].
- 10{c} Executive Salary Continuation Agreement with Michael K. Larsen [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 0-26584)].
- 10{d} 1996 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].
- 10{e} Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1997 (File No. 0-26584)].
- 10{f} Employment Agreement with Lloyd W. Baker [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 0-26584)].
- 10{g} Supplemental Executive Retirement Program Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].
- 10{h} Form of Supplemental Executive Retirement Program Agreement with Gary Sirmon, Michael K. Larsen, Lloyd W. Baker, Cynthia D. Purcell, Richard B. Barton and Paul E. Folz [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 and the exhibits filed with the Form 8-K on May 6, 2008].
- 10{i} 1998 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (File No. 333-71625)].
- 10{j} 2001 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 8, 2001 (File No. 333-67168)].
- 10{k}

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Form of Employment Contract entered into with Cynthia D. Purcell, Richard B. Barton, and Douglas M. Bennett [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 0-26584)].

- 10{l} 2004 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)].
- 10{m} 2004 Executive Officer and Director Investment Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 0-26584)].
- 10{n} Long-Term Incentive Plan and Form of Repricing Agreement [incorporated by reference to the exhibits filed with the Form 8-K on May 6, 2008].
- 10{o} 2005 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2008 (File No. 0-26584)]
- 10{p} Entry into an Indemnification Agreement with each of the Registrant's Directors [incorporated by reference to exhibits filed with the Form 8-K on January 29, 2010].
- 10{q} 2012 Restricted Stock and Incentive Bonus Plan [incorporated by reference as Appendix B to the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 19, 2013 (File No. 0-26584)].
- 10{r} Form of Performance-Based Restricted Stock Award Agreement [incorporated by reference to Exhibit 10.1 included in the Registrant's Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].
- 10{s} Form of Time-Based Restricted Stock Award Agreement [incorporated by reference to Exhibit 10.1 included in the Registrant's Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].



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

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

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

101 The following materials from Banner Corporation's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Statements of Financial Condition; (b) Consolidated Statements of Operations; (c) Consolidated Statements of Comprehensive Income (Loss); (d) Consolidated Statements of Stockholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Selected Notes to Consolidated Financial Statements.\*

\* Pursuant to Rule 406T of Regulations S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

Banner Corporation

May 9, 2014

/s/ Mark J. Grescovich  
Mark J. Grescovich  
President and Chief Executive Officer  
(Principal Executive Officer)

May 9, 2014

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