BANNER CORP
Form 10-Q
May 10, 2007

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

FORM 10-Q

(Mark One)

[**X**]

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR
THE QUARTERLY PERIOD ENDED MARCH 31, 2007 .

OR

[ ]

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

Commission File Number 0-26584

BANNER CORPORATION

(Exact name of registrant as specified in its charter)

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 X No ___

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

Large accelerated filer __________ Accelerated filer X Non-accelerated filer __________

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

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, 2007
Common Stock, $.01 par value per share	**13,003,808 shares***

* Includes 240,381 shares held by the Employee Stock Ownership Plan that have not been released, committed to be released, or allocated to participant accounts and does not include approximately 2,593,000 shares issued in May 2007 in connection with acquisitions.

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BANNER CORPORATION AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

Item 1 - Financial Statements. The Consolidated Financial Statements of Banner Corporation and Subsidiaries filed as a part of the report are as follows:

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

ASSETS	March 31 2007	December 31 2006
Cash and due from banks	$ 105,643	$ 73,385
Securities at fair value, cost $221,426 and $0, respectively; encumbered $26,294 and $0, respectively	218,477	--
Securities available for sale, cost $0 and $230,189, respectively;		

encumbered $0 and $27,107, respectively	--	226,153
Securities held to maturity, fair value $48,999 and $49,008, respectively	47,831	47,872
Federal Home Loan Bank stock	35,844	35,844
Loans receivable:		
Held for sale, fair value $5,413 and $5,136	5,340	5,080

Held for portfolio	3,006,481	2,960,910
Allowance for loan losses	(36,299)	(35,535)
	2,975,522	2,930,455
Accrued interest receivable	22,064	23,272
Real estate owned, held for sale, net		

	918
	918
Property and equipment, net	
	63,091
	58,003
Goodwill and other intangibles, net	
	36,248
	36,287
Deferred income tax asset, net	
	7,609
	7,533
Bank-owned life insurance	
	38,935

		38,527
Other assets		17,593
		17,317
	$	3,569,775
	$	3,495,566
LIABILITIES		
Deposits:		
Non-interest-bearing	$	348,890
	$	332,372

Interest-bearing transactions and savings accounts	
	959,593
	905,746
Interest-bearing certificates	
	1,612,665
	1,556,474
	2,921,148
	2,794,592
Advances from Federal Home Loan Bank	
	--
	177,430
Advances from Federal Home Loan Bank at fair value	
	93,431

--

Other borrowings

94,369

103,184

Junior subordinated debentures (issued in connection with Trust Preferred Securities)

--

123,716

Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)

124,119

--

Accrued expenses and other liabilities

42,105

36,888

Deferred compensation	7,588	7,025
Income taxes payable	5,545	2,504
	3,288,305	3,245,339
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred stock - $0.01 par value, 500,000 shares authorized, none issued	--	--

Common stock - $0.01 par value per share, 25,000,000 shares authorized, 13,201,418 shares issued: 12,739,298 shares and 12,073,889 shares outstanding at March 31, 2007 and December 31, 2006, respectively	161,845	135,149
Retained earnings	122,070	120,206
Accumulated other comprehensive income (loss):		
Unrealized loss on securities available for sale and/or transferred to held to maturity	(215)	(2,852)
Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost:		

240,381 and 240,381 restricted shares outstanding at March 31, 2007 and December 31, 2006, respectively

(1,987

)

(1,987

)

Carrying value of shares held in trust for stock related compensation plans

(7,331

)

(7,262

)

Liability for common stock issued to deferred, stock related, compensation plans

7,088

6,973

(243

)

(289

)

281,470

250,227

$

3,569,775

$

3,495,566

See selected notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited) (In thousands except for per share amounts)
For the Quarters Ended March 31, 2007 and 2006

2007

2006

INTEREST INCOME:		
Loans receivable	$ 61,828	$ 49,126
Mortgage-backed securities	1,775	2,083
Securities and cash equivalents	1,843	1,778
	65,446	52,987

INTEREST EXPENSE:		
Deposits	27,610	17,431
Federal Home Loan Bank advances	2,277	3,126
Other borrowings	928	698
Junior subordinated debentures	2,454	1,828

	33,269
	23,083
Net interest income before provision for loan losses	
	32,177
	29,904
PROVISION FOR LOAN LOSSES	
	1,000
	1,200
Net interest income	
	31,177
	28,704
OTHER OPERATING INCOME:	
Deposit fees and other service charges	

	2,963
	2,492
Mortgage banking operations	
	1,355
	1,152
Loan servicing fees	
	375
	390
Miscellaneous	
	461
	468
	5,154
	4,502

Gain on sale of securities	--	--
Change in valuation of financial instruments carried at fair value	1,180	--
Total other operating income	6,334	4,502
OTHER OPERATING EXPENSES:		
Salary and employee benefits	16,468	15,489

Less capitalized loan origination costs	(2,594)	(2,592)
Occupancy and equipment	4,352	3,794
Information/computer data services	1,369	1,300
Professional services	559	532

Advertising	1,857	1,442
Miscellaneous	4,060	3,233
Total other operating expenses	26,071	23,198
Income before provision for income taxes	11,440	10,008
PROVISION FOR INCOME TAXES		

	3,627
	3,220
NET INCOME	
$	7,813
$	6,788
Earnings per common share (see Note 6):	
Basic	
$	0.63
$	0.58
Diluted	
$	

0.62

$

0.56

Cumulative dividends declared per common share:

$

0.19

$

0.18

See selected notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited) (In thousands)
For the Quarters Ended March 31, 2007 and 2006

2007

2006

NET INCOME

$

7,813

$

6,788

OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:

Unrealized holding gain (loss) during the period, net of deferred income tax (benefit) of $0 and $(893), respectively

--

(1,658

)

Less adjustment for (gains) losses included in net income, net of income tax (benefit) of $0 and $0, respectively

--

--

Amortization of unrealized gain (loss) on securities transferred from available-for-sale to held-to-maturity net of deferred income tax of $0 and $0, respectively

14

	10
Other comprehensive income (loss)	
	14
	(1,648)
COMPREHENSIVE INCOME	
$	7,827
$	5,140

See selected notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited) (In thousands, except per share amounts)

For the Quarters Ended March 31, 2007 and 2006

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders' Equity
BALANCE, January 1, 2006	$ 130,573	$ 96,783	$ (2,736)	$ (2,480)	$ (475)	$ 261,665
Net income		6,788				6,788
Change in valuation of securities available for sale, net of income taxes			(1,648)			(1,648)
Cash dividend on common stock ($.18/share cumulative)		(2,154)				(2,154)
Purchase and retirement of common stock	(258)					(258)
Proceeds from issuance of common stock for exercise of stock options	1,089					1,089
Net issuance of stock through employer's stock plans, including tax benefit	(10)			(14)		(24)
Accrual of compensation expense related to stock options	180					180
Accrual of compensation expense related to MRP					47	47
BALANCE, March 31, 2006	$ 131,574	$ 101,417	$ (4,384)	$ (2,494)	$ (428)	$ 225,685
BALANCE, January 1, 2007	$ 135,149	$ 120,206	$ (2,852)	$ (1,987)	$ (289)	$ 250,227

Net income		7,813				7,813
Cumulative effect of early adoption of SFAS Nos. 157 & 159 Fair Value Option		(3,520)	2,623			(897)
Amortization of discount on securities transferred from available for sale to held to maturity, net of income taxes			14			14
Cash dividend on common stock ($.19/share cumulative)		(2,429)				(2,429)
Purchase and retirement of common stock	(335)					(335)
Proceeds from issuance of common stock for exercise of stock options	502					502
Proceeds from issuance of common stock for stockholder reinvestment program	26,445					26,445
Net issuance of stock through employer's stock plans, including tax benefit						--
Accrual of compensation expense related to stock options	84					84
Accrual of compensation expense related to MRP					46	46
BALANCE, March 31, 2007	$ 161,845	$ 122,070	$ (215)	$ (1,987)	$ (243)	$ 281,470

See selected notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (continued)
(Unaudited) (In thousands)
For the Quarters Ended March 31, 2007 and 2006

	2007	2006
Common stock, shares issued, beginning of period	12,314	12,082
Purchase and retirement of common stock	(8)	(8)
Issuance of common stock for exercised stock options and/or employee stock plans	27	73
Issuance of common stock for stockholder reinvestment program	646	--
Number of shares (retired) issued during the period	665	65
SHARES ISSUED AND OUTSTANDING, END OF PERIOD	12,979	12,147
UNEARNED, RESTRICTED ESOP SHARES:		
Number of shares, beginning of period	(240)	(300)
Adjustment of earned shares	--	(2)
Number of shares, end of period	(240)	(302)
NET SHARES OUTSTANDING	12,739	11,845

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)
For the Quarters Ended March 31, 2007 and 2006

	2007	2006
OPERATING ACTIVITIES:		
Net income	$ 7,813	$ 6,788
Adjustments to reconcile net income to net cash provided by operating activities: Depreciation	1,654	1,187
Deferred income and expense, net of amortization	(851)	252

Loss (gain) on sale of securities	--	--
Net change in valuation of financial instruments carried at fair value	(1,180)	--
Deferred taxes	429	11
Equity-based compensation	46	47
Stock options compensation	84	180
Equity-based long term incentive plan	152	

--

Tax benefits realized from equity-based compensation

--

(23

)

Increase in cash surrender value of bank-owned life insurance

(408

)

(383

)

Gain on sale of loans, excluding capitalized servicing rights

(1200

)

(788

)

Loss (gain) on disposal of real estate held for sale and
property and equipment

(113

)

(35

)

Provision for losses on loans and real estate held for sale	1,000
	1,200
Net change in: Loans held for sale	(260)
	571
Other assets	(335)
	4,867
Other liabilities	9,221
	(1,581)
Net cash provided by operating activities	16,052
	12,293

INVESTING ACTIVITIES:

Purchases of securities at fair value

(769

)

--

Principal repayments and maturities of securities at fair value

6,285

--

Proceeds from sales of securities at fair value

3,122

--

Principal repayments and maturities of securities available for sale

--

8,621

Purchases of securities held to maturity

--

--

Principal repayments and maturities of securities held to maturity

	21	
	938	
Origination of loans, net of principal repayments	(127,296	)
	(209,215	)
Purchases of loans and participating interest in loans	(10	)
	(16	)
Proceeds from sales of loans and participating interest in loans	83,627	
	78,308	
Purchases of property and equipment, net	(6,634	)
	(2,345	)

Proceeds from sale of real estate held for sale, net	33	221
Other	(735)	(115)
Net cash used by investing activities	(42,356)	(123,603)
FINANCING ACTIVITIES:		
Increase in deposits	126,556	93,143
Proceeds from FHLB advances	86,500	

	408,900
Repayment of FHLB advances	(170,000)
	(405,000)
Repayment of repurchase agreement borrowings	(7,802)
	(869)
Increase (decrease) in other borrowings, net	(1,013)
	(17,080)
Cash dividends paid	(2,291)
	(2,116)
Repurchases of stock, net of forfeitures	

	(335)
	(258)
Tax benefits realized from equity-based compensation	--
	23
ESOP shares earned (returned)	--
	(47)
Issuance of stock	26,445
	--
Exercise of stock options	502
	1,089
Net cash provided by financing activities	58,562
	77,785

NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	32,258	(33,525)
CASH AND DUE FROM BANKS, BEGINNING OF PERIOD	73,385	116,448
CASH AND DUE FROM BANKS, END OF PERIOD	$ 105,643	$ 82,923

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BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited) (In thousands)
For the Quarters Ended March 31, 2007 and 2006

	2007	2006

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid in cash	$ 29,664	$ 22,115
Taxes paid in cash	163	10
Non-cash investing and financing transactions:		
Loans, net of discounts, specific loss allowances and unearned income, transferred to real estate owned and other repossessed assets	67	9
Net change in accrued dividends payable	138	38
Change in other assets/liabilities	805	1,426
Adoption of SFAS Nos. 157 and 159:		
Securities available for sale transferred to fair value	226,153	--
FHLB advances adjustment to fair value	678	--
Junior subordinated debentures including unamortized origination costs adjustment to fair value	2,079	--
Deferred tax asset related to fair value adjustments	(504)	--

See selected notes to consolidated financial statements

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BANNER CORPORATION AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation and Critical Accounting Policies

Banner Corporation (Banner or the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries, Banner Bank and, subsequent to May 1, 2007, Islanders Bank, a recent acquisition, as explained below. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of March 31, 2007, its 62 branch offices and 12 loan production offices located in 27 counties in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. We are subject to regulation by the Board of Governors of the Federal Reserve System. Banner Bank and Islanders Bank are subject to regulation by the

Washington State Department of Financial Institutions, Division of Banks and the Federal Deposit Insurance Corporation (FDIC). The consolidated financial statements and results of operation presented in this report on Form 10-Q do not include any of financial information for San Juan Financial Holding Company or its subsidiary, Islanders Bank, nor our other recent acquisition, F&M Bank

In the opinion of management, the accompanying consolidated statements of financial condition and related interim consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows reflect all adjustments (which include reclassifications and normal recurring adjustments) that are necessary for a fair presentation in conformity with generally accepted accounting principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses and (iii) the valuation of financial assets and liabilities recorded at fair value, goodwill, mortgage servicing rights and real estate held for sale. These policies and the judgments, estimates and assumptions are described in greater detail below in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 1 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission (SEC). Management believes that the judgments, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of different judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. There have been no significant changes in our application of accounting policies since December 31, 2006, except for the adoption of SFAS No. 157 and 159 (for additional information, see Notes 2 and 5 of the Selected Notes to the Consolidated Financial Statements).

Certain information and disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the rules and regulations of the SEC. Certain reclassifications have been made to the 2006 Consolidated Financial Statements and/or schedules to conform to the 2007 presentation. These reclassifications may have affected certain ratios for the prior periods. The effect of these reclassifications is considered immaterial. All significant intercompany transactions and balances have been eliminated.

The information included in this Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC. Interim results are not necessarily indicative of results for a full year.

Note 2: Recent Developments and Significant Events

Adoption of SFAS Nos. 157 and 159:

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

Upon adoption of SFAS No. 159, we selected fair value measurement for all of our "available for sale" investment securities, Federal Home Loan Bank advances and junior subordinated debentures, which had fair values of approximately $226.2 million, $176.8 million and $124.4 million, respectively, on January 1, 2007. The initial fair value measurement of these instruments resulted in a $3.5 million adjustment for the cumulative effect, net of tax, as a result of the change in accounting, which was recorded as a reduction in retained earnings as of January 1, 2007, and which under SFAS No. 159 has not been recognized in current earnings. While the adjustment to retained earnings is permanent, approximately $2.6 million of the amount was previously reported as accumulated other comprehensive loss at December 31, 2006, so the reduction in total stockholders' equity was $897,000 on January 1, 2007. Following the initial election, changes in the value of financial instruments recorded at fair value are recognized as gains or losses in subsequent financial reporting periods. As a result of the adoption of SFAS No. 159 and changes in the fair value measurement of the financial assets and liabilities noted above, we recorded a net gain of $1.2 million ($755,000 after tax) in the quarter ended March 31, 2007. (For further information, see Note 5 of the Selected Notes to the Consolidated Financial Statements.)

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Acquisition of F&M Bank

: On May 1, 2007, we completed the acquisition of F&M Bank, Spokane, Washington, in a stock and cash transaction valued at approximately $98.8 million in cash and common stock for all of the outstanding common shares and stock options of F&M Bank. According to the terms of the definitive agreement, F&M Bank shareholders will receive 0.8500 shares of Banner Corporation common stock and $9.30 in cash for each F&M Bank share, plus a pro-ration of the annual cash dividend through the date of closing. Banner Corporation will issue approximately 1,773,494 shares to complete this transaction. F&M Bank was merged into Banner Bank. Founded in 1906, F&M Bank was a state-chartered commercial community bank with $422 million in assets, $379 million in loans, $365 million in deposits and stockholders' equity of $39 million as of March 31, 2007. F&M Bank operated 13 branches in and around the Spokane, Washington area, the fourth largest metropolitan market in the Pacific Northwest.

Acquisition of San Juan Financial Holding Company

: On May 1, 2007, we completed the acquisition of San Juan Financial Holding Company, the parent company of Islanders Bank, Friday Harbor, Washington, in a stock and cash transaction valued at approximately $40.8 million in cash and common stock for all of the outstanding common shares and stock options of San Juan Financial. According to the terms of the definitive agreement, San Juan Financial shareholders will receive 2.2503 shares of Banner Corporation common stock and $16.48 in cash for each San Juan Financial share. Banner Corporation will issue approximately 819,277 shares to complete this transaction. Upon acquisition, San Juan Financial Holding Company merged into Banner Corporation. Founded in 1981, Islanders Bank is a state-chartered commercial community bank with $157 million in assets, $116 million in loans, $122 million in deposits and $19 million in stockholders' equity at March 31, 2007. Islanders Bank operates three full service branches in the North Puget Sound region and will continue to operate as a separate subsidiary of Banner Corporation.

Sale of $25 Million of Trust Preferred Securities:

In December 2006, we completed the issuance of $25.8 million of junior subordinated debentures (debentures) in connection with a private placement of pooled trust preferred securities. The trust preferred securities were issued by Banner Capital Trust VI, a special purpose business trust formed by Banner Corporation. The debentures have been recorded as a liability on the Consolidated Statement of Financial Condition and, subject to limitation under current Federal Reserve guidelines, a portion of the trust preferred securities qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering were retained by us to provide future flexibility with respect to regulatory capital requirements. Under the terms of the transaction, the trust preferred securities and debentures have a maturity of 30 years and are redeemable after five years, with certain exceptions. The holders of the trust preferred securities and debentures are entitled to receive cumulative cash distributions at a variable annual rate. The interest rate is fixed at 6.56% until March 1, 2012 and subsequent to that date will reset quarterly to equal the three month London Interbank Offered Rate Index (LIBOR) plus 1.62%. Our previously issued trust preferred securities have similar reset provisions but carry different spreads to LIBOR and interest rates than this most recent issuance. At March 31, 2007, the interest rates on the other trust preferred securities range from 6.94% to 9.09%. In accordance with Financial Interpretation No. (FIN) 46, the trusts are not consolidated with our financial statements. Effective January 1, 2007, our junior subordinated debentures are being recorded at fair value.

Early redemption of $25 million of Trust Preferred Securities:

Effective April 22, 2007, we repaid $26 million of junior subordinated debentures (debentures) issued in connection with Banner Capital Trust I as provided for under the early redemption provisions of the governing indenture at a price of 100% of the outstanding principal balance. The interest rate on the debentures supporting Banner Capital Trust I was 9.09% during the quarter ended March 31, 2007. The adjustable rate provisions of these debentures provided for changes in the interest rate every six months such that the rate would be equal to six month LIBOR plus 3.70%. The cash required to redeem these debentures came from our general operating funds.

Issuance of Shares through Dividend Reinvestment and Direct Stock Purchase and Sale Plan:

During the quarter ended March 31, 2007, we strengthened our capital structure by issuing 646,472 new shares at an average net price of $40.91 through our Dividend Reinvestment and Direct Stock Purchase Plan. In addition, we issued a net 18,937 shares in connection with the exercise of vested stock options. This stock issuance, combined with the changes in retained earnings as a result of operations and the effects of fair value accounting, net of quarterly dividend distributions, resulted in a $31.2 million increase in stockholders' equity. The additional capital will be available to support our continued growth initiatives and the just-completed acquisitions of F&M Bank and San Juan Financial Holding Company.

Branch Expansion:

Over the past three years, we have invested significantly in expanding Banner Bank's branch and distribution systems with a primary emphasis on the greater Boise, Idaho and Portland, Oregon markets and the Puget Sound region of Washington. This branch expansion is a significant element in our strategy to grow loans, deposits and customer relationships. This emphasis on growth has resulted in an elevated level of operating expenses; however, management believes that over time these new branches should help improve profitability by providing low cost core deposits which will allow Banner Bank to proportionately reduce higher cost borrowings as a source of funds. Since March 2004, Banner Bank has opened 20 new branch offices, relocated six additional branch offices and significantly refurbished its main office in Walla Walla.

Long-Term Incentive Plan:

In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan ("Plan") effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is indirectly related to changes in the value of Banner Corporation stock and changes in Banner Bank's average earnings rate. The primary objective of the Plan is for key employees who remain with the Company or the Bank for a sufficient period of time to share in the increases in the value of our stock. Although the Plan benefits are tied to the value of Banner Corporation stock, the Plan benefit is paid in cash rather than shares of our stock. Detailed information with respect to the plan was disclosed on a Form 8-K filed with SEC on July 19, 2006. We have recorded $152,000 of compensation cost relating to this Plan for the quarter ended March 31, 2007.

Recently Issued Accounting Pronouncements:

We elected early adoption of Statement of Financial Accounting Standards (SFAS) No. 159*, The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157*, Fair Value Measurements*, effective January 1, 2007. (See the earlier discussion above and Note 5 of the Selected Notes to the Consolidated Financial Statements for further information.)

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In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140, *Accounting for Transfers of Financial Assets and Extinguishment of Liabilities*. The Statement specifies under what situations servicing assets and servicing liabilities must be recognized. It requires these assets and liabilities to be initially measured at fair value and specifies acceptable measurement methods subsequent to their recognition. Separate presentation in the financial statements and additional disclosures are also required. This Statement became effective January 1, 2007. The adoption of the Statement has not had a material effect on our Consolidated Financial Statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, we adopted FIN 48. Currently, we are subject to U.S. federal income tax and income tax of the States of Idaho and Oregon. The years 2003 through 2005 remain open to examination for federal income taxes, and years 2003 through 2006 remain open for State examination. As of January 1, 2007 and March 31, 2007, we had insignificant unrecognized tax benefits or uncertain tax positions. In addition, we have no material accrued interest or penalties as of January 1, 2007 or March 31, 2007. It is our policy to record interest and penalties as a component of income tax expense. The amount of interest and penalties for the three months ended March 31, 2007 was immaterial. The adoption of this accounting standard did not have a material impact on our Consolidated Financial Statements.

Note 3: Business Segments

We are managed by legal entity and not by lines of business. Banner Bank is a community oriented commercial bank chartered in the State of Washington. Banner Bank's primary business is that of a traditional banking institution, gathering deposits and originating loans for its portfolio in its primary market area. Banner Bank offers a wide variety of deposit products to its consumer and commercial customers. Lending activities include the origination of real estate, commercial and agricultural business and consumer loans. Banner Bank does not engage and has not engaged in any sub-prime lending programs. Banner Bank is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, Banner Bank receives other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of Banner Bank is reviewed by Banner Corporation's executive management and Board of Directors on a monthly basis. All of the executive officers of Banner Corporation are members of Banner Bank's executive 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 shareholders. We have determined that our current business and operations consist of a single business segment.

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Note 4: Additional Information Regarding Interest-Bearing Deposits and Securities

Encumbered Securities:

Securities labeled "Encumbered" are pledged securities that are subject to certain agreements which may allow the secured party to either sell and replace them with similar but not the same security or otherwise pledge the securities. In accordance with SFAS No. 140, the amounts have been separately identified in the Consolidated Statements of Financial Condition as "encumbered."

The following table sets forth additional detail on our interest-bearing deposits and securities at the dates indicated (at carrying value) (in thousands):

	March 31 2007	December 31 2006	March 31 2006
Interest-bearing deposits included in Cash and due from banks	$ 46,122	$ 5,068	$ 18,166
Mortgage-backed securities	145,490	150,166	168,856
Other securities-taxable	74,577	77,332	82,599
Other securities-tax exempt	42,777	42,817	43,957
Equity securities with dividends	3,464	3,710	3,593
Total securities	266,308	274,025	299,005
FHLB stock	35,844	35,844	35,844
	$ 348,274	$ 314,937	$ 353,015

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

	Quarters Ended March 31	
	2007	2006
Mortgage-backed securities interest	$ 1,775	$ 2,083
Taxable interest income	1,328	1,269
Tax-exempt interest income	465	493
Other stock-dividend income	14	16
FHLB stock dividends	36	--

	1,843	1,778
	$ 3,618	$ 3,861

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Note 5: Fair Value Accounting and Measurement

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

The following table outlines the adjustments recorded at the dates indicated (in thousands)

	Cumulative Adjustment on Adoption of SFAS 159 January 1, 2007					March 31, 2007			
	Amortized Cost	Fair Market Valuation Adjustment	Fair Value	Related Taxes	Cumulative Effect of Adoption	Amortized Cost	Fair Market Valuation Adjustment	Fair Value	Char in F
s:									
rities - lable for assified to value	$ 230,189	$ (4,036)	$ 226,153	$ 1,413	$ (2,623)	$ 221,427	$ (2,950)	$ 218,477	$ 1,0
ities:									
ances FHLB	$ 177,430	$ (678)	$ 176,752	$ 244	$ 434	$ 93,930	$ (499)	$ 93,431	$ (1
or rdinated									

entures, of nortized rred nation	122,287	2,079	124,366	(748)	(1,331)	122,313	1,806	124,119	2
	$ 299,717	$ 1,401	$ 301,118	$ (504)	$ (897)	$ 216,243	$ 1,307	$ 217,051	$
adjustment					$ (3,520)				$ 1,1
transfer from mulated other prehensive loss tained earnings					(2,623)				
nulative reduction pening stockholders' ty, at January 1,2007 n adoption of S No. 159					$ (897)				