

NORTHWEST BANCORPORATION INC  
Form 10-Q  
August 14, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2009.

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 000-24151

**NORTHWEST BANCORPORATION, INC.**

(Exact name of registrant as specified in its charter)

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**Washington**  
(State or other jurisdiction of  
incorporation or organization)  
**421 West Riverside, Spokane, WA 99201-0403**  
(Address of principal executive offices)  
**(509) 456-8888**  
(Registrant's telephone number, including area code)

**91-1574174**  
(I.R.S. Employer  
identification No.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The Registrant has a single class of common stock, of which there were 2,376,539 shares issued and outstanding as of August 1, 2009.

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**NORTHWEST BANCORPORATION, INC.**

**FORM 10-Q**

**For the Quarter Ended June 30, 2009**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Financial Condition**

(unaudited)

(dollars in thousands)

|   | June 30,<br>2009  | December 31,<br>2008 |
|---|-------------------|----------------------|
| <b>ASSETS</b>   |                   |                      |
| Cash and due from banks   | \$ 7,175          | \$ 9,363             |
| Federal funds sold/interest bearing balances at other financial institutions            | 3,750             | 2,050                |
| Securities available for sale (amortized cost of \$11,592 and \$18,299, respectively)   | 11,951            | 18,722               |
| Securities held to maturity (fair value of \$9,652 and \$7,735, respectively)           | 9,452             | 7,512                |
| Federal Home Loan Bank stock, at cost   | 1,261             | 1,106                |
| Loans receivable, net of allowance for loan losses of \$4,425 and \$4,737, respectively | 331,912           | 334,305              |
| Loans held for sale   | 5,002             | 1,132                |
| Accrued interest receivable   | 1,419             | 1,531                |
| Foreclosed real estate and other repossessed assets                                     | 4,134             | 1,703                |
| Premises and equipment, net   | 16,696            | 16,598               |
| Bank owned life insurance   | 3,609             | 3,691                |
| Other assets  | 2,692             | 2,518                |
| <b>TOTAL ASSETS</b>   | <b>\$ 399,053</b> | <b>\$ 400,231</b>    |
| <b>LIABILITIES</b>  |                   |                      |
| Noninterest bearing demand deposits   | \$ 64,374         | \$ 46,900            |
| Money market accounts   | 27,245            | 29,924               |
| NOW accounts  | 17,316            | 14,278               |
| Savings accounts  | 40,688            | 38,363               |
| Time certificates of deposit, \$100,000 and over  | 80,329            | 86,145               |
| Time certificates of deposit, under \$100,000   | 100,117           | 100,444              |
| <b>TOTAL DEPOSITS</b>   | <b>330,069</b>    | <b>316,054</b>       |
| Securities sold under agreement to repurchase   | 616               | 22,101               |
| Federal funds purchased   |                   | 3,465                |
| Borrowed funds  | 23,875            | 23,382               |
| Capital lease liability   | 599               | 599                  |
| Junior subordinated debentures issued in connection with trust preferred securities     | 5,155             | 5,155                |
| Accrued interest payable  | 771               | 837                  |
| Other liabilities   | 1,871             | 1,719                |
| <b>TOTAL LIABILITIES</b>  | <b>362,956</b>    | <b>373,312</b>       |
| <b>SHAREHOLDERS EQUITY</b>  |                   |                      |
|   | 9,953             |                      |

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|   |                   |                   |
|---|-------------------|-------------------|
| Preferred stock - Series A Cumulative Perpetual; \$1,000 par value; \$1,000 liquidation value; 10,500 shares authorized and issued      |                   |                   |
| Preferred stock - Series B Cumulative Perpetual; \$0.01 par value; \$1,000 liquidation value; 525 shares authorized and issued          | 586               |                   |
| Common stock, no par, 5,000,000 shares authorized; issued and outstanding 2,372,446 on June 30, 2009 and 2,367,246 on December 31, 2008 | 23,252            | 23,211            |
| Retained earnings   | 2,069             | 3,429             |
| Accumulated other comprehensive income, net of tax effect of \$(122) for 2009 and \$(144) for 2008                                      | 237               | 279               |
| <b>TOTAL SHAREHOLDERS EQUITY</b>  | <b>36,097</b>     | <b>26,919</b>     |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>  | <b>\$ 399,053</b> | <b>\$ 400,231</b> |

See accompanying notes.

**Table of Contents****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Operations**

(unaudited)

(dollars in thousands, except per share data)

|  | Three months ended<br>June 30, |               | Six months ended<br>June 30, |               |
|--|--------------------------------|---------------|------------------------------|---------------|
|  | 2009                           | 2008          | 2009                         | 2008          |
| <b>Interest income:</b>                                    |                                |               |                              |               |
| Interest and fees on loans                                 | \$ 5,316                       | \$ 5,343      | \$ 10,446                    | \$ 10,719     |
| Interest on securities                                     | 228                            | 308           | 474                          | 687           |
| Interest on federal funds sold                             | 1                              | 15            | 4                            | 90            |
| <b>Total interest income</b>                               | <b>5,545</b>                   | <b>5,666</b>  | <b>10,924</b>                | <b>11,496</b> |
| <b>Interest expense:</b>                                   |                                |               |                              |               |
| Interest on deposits                                       | 1,780                          | 2,185         | 3,698                        | 4,509         |
| Interest on securities sold under agreement to repurchase  | 1                              | 49            | 7                            | 148           |
| Interest on borrowed funds                                 | 287                            | 254           | 599                          | 451           |
| <b>Total interest expense</b>                              | <b>2,068</b>                   | <b>2,488</b>  | <b>4,304</b>                 | <b>5,108</b>  |
| <b>Net interest income</b>                                 | <b>3,477</b>                   | <b>3,178</b>  | <b>6,620</b>                 | <b>6,388</b>  |
| Provision for loan losses                                  | 1,800                          | 225           | 2,900                        | 375           |
| <b>Net interest income after provision for loan losses</b> | <b>1,677</b>                   | <b>2,953</b>  | <b>3,720</b>                 | <b>6,013</b>  |
| <b>Noninterest income:</b>                                 |                                |               |                              |               |
| Fees and service charges                                   | 400                            | 317           | 705                          | 554           |
| Net gain from sale of loans                                | 209                            | 125           | 366                          | 259           |
| Other noninterest income                                   | 255                            | 216           | 618                          | 406           |
| <b>Total noninterest income</b>                            | <b>864</b>                     | <b>658</b>    | <b>1,689</b>                 | <b>1,219</b>  |
| <b>Noninterest expense:</b>                                |                                |               |                              |               |
| Salaries and employee benefits                             | 1,670                          | 1,639         | 3,400                        | 3,344         |
| Occupancy and equipment                                    | 343                            | 276           | 664                          | 567           |
| Depreciation and amortization                              | 249                            | 176           | 494                          | 349           |
| Other operating  | 1,629                          | 796           | 2,641                        | 1,580         |
| <b>Total noninterest expense</b>                           | <b>3,891</b>                   | <b>2,887</b>  | <b>7,199</b>                 | <b>5,840</b>  |
| <b>(Loss) income before income taxes</b>                   | <b>(1,350)</b>                 | <b>724</b>    | <b>(1,790)</b>               | <b>1,392</b>  |
| Income tax (benefit) expense                               | (504)                          | 226           | (688)                        | 454           |
| <b>Net (loss) income</b>                                   | <b>\$ (846)</b>                | <b>\$ 498</b> | <b>\$ (1,102)</b>            | <b>\$ 938</b> |
| Preferred stock dividends                                  | 145                            |               | 219                          |               |

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|   |            |           |            |           |
|---|------------|-----------|------------|-----------|
| Preferred stock discount accretion, net       | 26         |           | 39         |           |
| Net (loss) income applicable to common shares | \$ (1,017) | \$ 498    | \$ (1,360) | \$ 938    |
| Earnings (loss) per common share - basic      | \$ (0.43)  | \$ 0.21   | \$ (0.57)  | \$ 0.40   |
| Earnings (loss) per common share - diluted    | \$ (0.43)  | \$ 0.21   | \$ (0.57)  | \$ 0.39   |
| Weighted average shares outstanding - basic   | 2,370,732  | 2,365,433 | 2,368,998  | 2,365,433 |
| Weighted average shares outstanding - diluted | 2,370,732  | 2,380,297 | 2,368,998  | 2,384,472 |

See accompanying notes.

**Table of Contents****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Changes in Shareholders Equity and Comprehensive Loss**

(unaudited)

(dollars in thousands)

|  | <b>Total</b> | <b>Preferred<br/>Stock</b> | <b>Common<br/>Stock</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Comprehensive<br/>Loss</b> |
|--|--------------|----------------------------|-------------------------|------------------------------|---|-------------------------------|
| Balance, December 31, 2007   | \$ 27,346    | \$ 0                       | \$ 23,039               | \$ 4,178                     | \$ 129  |                               |
| Net loss   | (275)        |                            |                         | (275)                        |   | \$ (275)                      |
| Stock issued to directors  | 69           |                            | 69                      |                              |   |                               |
| Equity-based compensation expense, net                                   | 103          |                            | 103                     |                              |   |                               |
| Cash dividend (\$0.20 per share)   | (474)        |                            |                         | (474)                        |   |                               |
| Change in unrealized gain on securities available for sale, net of taxes | 150          |                            |                         |                              | 150   | 150                           |
| <b>Comprehensive loss</b>  |              |                            |                         |                              |   | <b>\$ (125)</b>               |
| Balance December 31, 2008  | 26,919       | 0                          | 23,211                  | 3,429                        | 279   |                               |
| Net loss   | (1,102)      |                            |                         | (1,102)                      |   | (1,102)                       |
| Stock issued to directors  | 22           |                            | 22                      |                              |   |                               |
| Issuance of preferred stock series A                                     | 9,909        | 9,909                      |                         |                              |   |                               |
| Issuance of preferred stock series B                                     | 591          | 591                        |                         |                              |   |                               |
| Cash dividends declared on preferred stock                               | (219)        |                            |                         | (219)                        |   |                               |
| Accretion of preferred stock discount, net                               | 0            | 39                         |                         | (39)                         |   |                               |
| Equity-based compensation expense, net                                   | 19           |                            | 19                      |                              |   |                               |
| Change in unrealized gain on securities available for sale, net of taxes | (42)         |                            |                         |                              | (42)  | (42)                          |
| <b>Comprehensive loss</b>  |              |                            |                         |                              |   | <b>\$ (1,144)</b>             |
| Balance, June 30, 2009   | \$ 36,097    | \$ 10,539                  | \$ 23,252               | \$ 2,069                     | \$ 237  |                               |
| <b>Disclosure of 2009 reclassification amount:</b>                       |              |                            |                         |                              |   |                               |
| Net change in unrealized holding gains on available for sale securities  | \$ (73)      |                            |                         |                              |   |                               |
| Reclassification adjustment for net gains realized in income             | 9            |                            |                         |                              |   |                               |
| Net change in unrealized gains   | (64)         |                            |                         |                              |   |                               |
| Tax effect   | 22           |                            |                         |                              |   |                               |
| Net of tax amount  | \$ (42)      |                            |                         |                              |   |                               |

See accompanying notes.



**Table of Contents****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Cash Flows**

(unaudited)

(dollars in thousands)

|   | Six months ended<br>June 30, |                 |
|---|------------------------------|-----------------|
|   | 2009                         | 2008            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                              |                 |
| Net (loss) income   | \$ (1,102)                   | \$ 938          |
| Adjustments to reconcile net (loss) income to cash provided by operating activities:                    |                              |                 |
| Provision for loan losses   | 2,900                        | 375             |
| Depreciation and amortization   | 494                          | 349             |
| Net (increase) decrease in loans held for sale  | (3,870)                      | 1,874           |
| Net (increase) decrease in bank owned life insurance  | 82                           | (65)            |
| Net (gain) loss on sale of foreclosed real estate and other repossessed assets                          | 246                          | (1)             |
| Equity-based compensation expense   | 19                           | 52              |
| Change in assets and liabilities:   |                              |                 |
| Accrued interest receivable   | 112                          | 47              |
| Other assets  | (152)                        | (57)            |
| Interest payable  | (66)                         | (219)           |
| Other liabilities   | 79                           | 69              |
| <b>Net cash (used) provided by operating activities</b>   | <b>(1,258)</b>               | <b>3,362</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                              |                 |
| Net (increase) decrease in federal funds sold/interest bearing balances at other financial institutions | (1,700)                      | 3,302           |
| Net decrease in investment securities   | 4,767                        | 13,033          |
| Purchases of FHLB stock   | (155)                        |                 |
| Net increase in loans   | (4,017)                      | (41,347)        |
| Purchase of premises and equipment, net of gain or loss on asset disposal                               | (592)                        | (3,697)         |
| Proceeds from sale of foreclosed real estate and other repossessed assets                               | 833                          | 7               |
| <b>Net cash used by investing activities</b>  | <b>(864)</b>                 | <b>(28,702)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                              |                 |
| Net increase in deposits  | 14,015                       | 26,052          |
| Net decrease in securities sold under agreement to repurchase   | (21,485)                     | (10,405)        |
| Net decrease in federal funds purchased   | (3,465)                      |                 |
| Repayment of borrowed funds   | (4,507)                      |                 |
| Proceeds from issuance of borrowed funds  | 5,000                        |                 |
| Proceeds from issuance of preferred stock   | 10,500                       | 8,588           |
| Proceeds from issuance of common stock  | 22                           | 69              |
| Cash dividend paid  | (146)                        | (474)           |
| <b>Net cash (used) provided by financing activities</b>   | <b>(66)</b>                  | <b>23,830</b>   |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>  | <b>(2,188)</b>               | <b>(1,510)</b>  |
| Cash and cash equivalents, beginning of year  | 9,363                        | 8,155           |
| <b>Cash and cash equivalents, end of period</b>   | <b>\$ 7,175</b>              | <b>\$ 6,645</b> |

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### SUPPLEMENTAL DISCLOSURES

Cash paid during the year for:

|              |          |          |
|--------------|----------|----------|
| Interest     | \$ 4,370 | \$ 5,327 |
| Income taxes | \$       | \$ 313   |

### SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

|  |          |         |
|--|----------|---------|
| Net change in fair value of securities available for sale                      | \$ (42)  | \$ (51) |
| Acquisition of real estate and other repossessed assets in settlement of loans | \$ 3,510 | \$ 293  |
| Preferred stock dividend accrued and paid in subsequent period                 | \$ 73    | \$      |

See accompanying notes.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. Basis of Presentation and Consolidation**

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

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2008. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented. The results of operations for the three-month and six-month periods ended June 30, 2009 and 2008 are not necessarily indicative of the operating results for the full year. Certain prior year balances have been reclassified to conform to the current year presentation. These reclassifications had no effect on retained earnings or net income as previously presented.

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

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition and disclosure through August 14, 2009, the date the financial statements were issued. In management's opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made.

**NOTE 2. New Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 141(R), *Business Combinations* (SFAS 141(R)). SFAS 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in an acquire, including the recognition and measurement of goodwill acquired in a business combination. SFAS 141(R) applies prospectively to business combinations entered into by the Company on or after January 1, 2009. The adoption of this standard did not have a material effect on the Company's results of operations or financial position, but could have a material effect depending on the Company's future level of business combinations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*. SFAS No. 161 changes the disclosure requirements for derivative instruments and hedging activities to require an explanation of how and why an entity uses derivative instruments, as well as how derivative instruments and related hedged items are accounted for. SFAS 161 is effective for fiscal years beginning on or after November 15, 2008. The adoption of this standard did not have a material effect on the Company's financial statements.

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In June 2008, the FASB issued Staff Position ( FSP ) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP requires unvested share-based payment awards with rights to receive nonforfeitable dividends be considered participating securities and requires entities to apply the two-class method of computing earnings per share. FSP EITF 03-6-1 is effective for years beginning after December 15, 2008, to be applied retrospectively. The adoption of this standard did not have a material effect on the Company's financial statements or earnings per share.

In April 2009, the FASB issued FSP No. 115-2 and No. 124-2, *Recognition and Presentation of Other-Than-Temporary-Impairments*, which amends existing guidance for determining whether impairment is other-than-temporary for debt securities. The FSP requires an entity to assess whether it intends to sell, or it is more likely than not that it will be required to sell a security in an unrealized loss position before recovery of its amortized cost basis. If either of these criteria is met, the entire difference between amortized cost and fair value is recognized in earnings. For securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. Additionally, the FSP expands and increases the frequency of existing disclosures about other-than-temporary impairments for debt and equity securities. This FSP is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this standard did not have a material effect on the Company's financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events ( SFAS 165 )*, which is effective for interim and annual periods ending after June 15, 2009. SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. The adoption of this standard did not have a material effect on the company's financial statements.

In June 2009, the FASB issues SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - A Replacement of FASB Statement No. 162*, which is effective for interim and annual periods ending after September 15, 2009. SFAS No. 168 defines a new hierarchy for U.S. generally accepted accounting principles and establishes the *FASB Accounting Standards Codification* as the authoritative guidance to be applied by nongovernmental entities. The adoption of SFAS No. 168 will change the manner in which U.S. generally accepted accounting principle guidance is referenced, but it will not have any impact on our financial position or results of operations.

**NOTE 3. Stock-Based Compensation**

On May 15, 2006, shareholders approved the Inland Northwest Bank 2006 Share Incentive Plan (the Plan) and the issuance of shares of common stock of the Company pursuant to the Plan. This Plan is an amendment and restatement of the Inland Northwest Bank Non-Qualified Stock Option Plan originally effective July 21, 1992, as revised December 21, 1993, December 21, 1999 and April 16, 2002. Prior to 2006, the Plan allowed only for the award of stock options; with the approval of the amendment and restatement of the Plan in May 2006, the Company was also authorized to grant restricted stock awards to key employees of the Bank.

Restricted stock-award activity in 2008 is detailed in Note 14 Stock Based Compensation in the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2008. There have been no restricted stock-award grants in 2009. Likewise, no shares have been issued in 2009 in connection with previously granted restricted stock-awards. The number of restricted stock-awards outstanding is as follows:

|                                | Number of<br>shares | Weighted<br>average<br>fair value |
|--------------------------------|---------------------|-----------------------------------|
| Outstanding, December 31, 2007 | 14,973              | \$ 16.41                          |
| Granted                        |                     |                                   |
| Forfeited                      |                     |                                   |
| Exercised                      |                     |                                   |
| Outstanding, December 31, 2008 | 14,973              | \$ 16.41                          |
| Granted                        |                     |                                   |
| Forfeited                      | (2,275)             | 16.53                             |
| Exercised                      |                     |                                   |

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|                            |        |          |
|----------------------------|--------|----------|
| Outstanding, June 30, 2009 | 12,698 | \$ 16.39 |
|----------------------------|--------|----------|

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Stock options outstanding at the end of last year are also detailed in Note 14 *Stock Based Compensation* in the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2008. Since the adoption of the amendments to the Plan in May 2006, stock options are, for the most part, expected to be awarded during the process of recruiting new employees to the Bank.

Stock options vest over a five-year period and expire ten years from the date of the grant. The exercise price of each option equals the fair market value of the Company's stock on the date of grant.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The Black-Scholes model uses a number of assumptions, including: a risk-free discount rate of interest, which is based on the U.S. Department of the Treasury (the Treasury Department) yield curve in effect at the time of grant; the expected life of options granted, which represents the period of time that options granted are expected to be outstanding; expected volatilities, based on the historical volatility of the Company's stock price; a historical forfeiture rate, which has been nominal; and, expected dividend yield, which reflects the Company's expected future dividend rate. The assumptions used in calculating the fair value of options granted in 2007 and 2008 are detailed in Note 14 *Stock Based Compensation* in the audited consolidated financial statements and the accompanying notes included in the Company's annual report on Form 10-K for the year ended December 31, 2008. No stock options have been awarded during 2009.

The number of stock options outstanding and exercisable as of June 30, 2009 is as follows:

|  | Number of<br>shares | Weighted-<br>average<br>exercise price |
|--|---------------------|--|
| Outstanding options, December 31, 2008 | 112,364             | \$ 10.06                               |
| Granted                                | 0                   | 0                                      |
| Exercised                              | 0                   | 0                                      |
| Forfeited                              | (2,100)             | 17.41                                  |
| <br>Outstanding options, June 30, 2009 | <br>110,264         | <br>\$ 9.92                            |
| <br>Options exercisable, June 30, 2009 | <br>102,029         |  |

The method of accounting for stock-based compensation expense is also detailed in Note 14 *Stock Based Compensation* in the audited consolidated financial statements and the accompanying notes included in the Company's annual report on Form 10-K for the year ended December 31, 2008. The expense related to the grant of stock options is recognized over the vesting period of the stock options in accordance with results obtained using the Black-Scholes option pricing model. The Black-Scholes option pricing model provides for a greater recognition of expense in the early years of the vesting period, with decreasing amounts to be recognized in subsequent years.

**Table of Contents****NOTE 4. Securities**

Most securities held by the Bank are classified as available for sale and are stated at fair value with unrealized holding gains and losses, net of related deferred taxes, reported as a separate component of shareholders' equity. Realized gains or losses on sales of available for sale securities are reported as part of noninterest income based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are recognized in interest income using the effective method over the period to maturity unless the security is called prior to maturity. When a security is called prior to maturity, any remaining premium or discount is reported as noninterest income. There were no securities sold in the six month periods ending June 30, 2009 and 2008; consequently, there were no gains or losses included in noninterest income due to the sale of securities. Some securities were called prior to maturity during the six month period ended June 30, 2009 and 2008; remaining net discounts on those securities resulted in \$9 thousand and \$18 thousand in noninterest income for that period, respectively.

The amortized cost of securities and their approximate fair values at June 30, 2009 and December 31, 2008 were as follows:

|                                       | Amortized<br>Cost | June 30, 2009                |                               | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                       |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| <b>Securities available for sale:</b> |                   |                              |                               |               |
| U.S. government agency securities     | \$ 2,501          | \$ 74                        | \$ 0                          | \$ 2,575      |
| U.S. treasury securities              | 3,000             |                              |                               | 3,000         |
| Corporate debt obligations            | 500               |                              | 20                            | 480           |
| Mortgage backed securities            | 5,591             | 305                          |                               | 5,896         |
|                                       | \$ 11,592         | \$ 379                       | \$ 20                         | \$ 11,951     |

|                                       | Amortized<br>Cost | December 31, 2008            |                               | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                       |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| <b>Securities available for sale:</b> |                   |                              |                               |               |
| U.S. government agency securities     | \$ 8,491          | \$ 155                       | \$ 0                          | \$ 8,646      |
| U.S. treasury securities              | 2,998             | 2                            |                               | 3,000         |
| Corporate debt obligations            | 500               |                              | 18                            | 482           |
| Mortgage backed securities            | 6,310             | 284                          |                               | 6,594         |
|                                       | \$ 18,299         | \$ 441                       | \$ 18                         | \$ 18,722     |

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|                                     | Amortized<br>Cost | June 30, 2009                |                               | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| <b>Securities held to maturity:</b> |                   |                              |                               |               |
| State and municipal securities      | \$ 9,452          | \$ 230                       | \$ 30                         | \$ 9,652      |

|                                     | Amortized<br>Cost | December 31, 2008            |                               | Fair<br>Value |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| <b>Securities held to maturity:</b> |                   |                              |                               |               |
| State and municipal securities      | \$ 7,512          | \$ 229                       | \$ 7                          | \$ 7,734      |

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

|                                    | Impaired Less<br>Than 12 Months |                      | Impaired 12<br>Months or More |                      | Total         |                      |
|------------------------------------|---------------------------------|----------------------|-------------------------------|----------------------|---------------|----------------------|
|                                    | Fair<br>Value                   | Unrealized<br>Losses | Fair<br>Value                 | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| June 30, 2009<br>(\$ in thousands) |                                 |                      |                               |                      |               |                      |
| Corporate debt obligations         | \$ 0                            | \$ 0                 | \$ 480                        | \$ 20                | \$ 480        | \$ 20                |
| State and municipal securities     | 1,441                           | 30                   |                               |                      | 1,441         | 30                   |
|                                    | \$ 1,441                        | \$ 30                | \$ 480                        | \$ 20                | \$ 1,921      | \$ 50                |

|  | Impaired Less<br>Than 12 Months |                      | Impaired 12<br>Months or More |                      | Total         |                      |
|--|---------------------------------|----------------------|-------------------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value                   | Unrealized<br>Losses | Fair<br>Value                 | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| December 31, 2008<br>(\$ in thousands) |                                 |                      |                               |                      |               |                      |
| Corporate debt obligations             | \$ 246                          | \$ 7                 | \$ 482                        | \$ 18                | \$ 482        | \$ 18                |
| State and municipal securities         |                                 |                      |                               |                      | 246           | 7                    |
|  | \$ 246                          | \$ 7                 | \$ 482                        | \$ 18                | \$ 728        | \$ 25                |



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Management has evaluated the above securities and does not believe that any individual unrealized loss as of June 30, 2009, represents an other-than-temporary impairment. The decline in fair market value of these securities is generally due to changes in interest rates since purchase and is not related to any known decline in the creditworthiness of the issuer. At June 30, 2009, eight securities have unrealized losses.

At June 30, 2009, the Bank owned \$1.3 million of stock of the Federal Home Loan Bank of Seattle ( FHLB ). As a condition of membership in the FHLB, the Bank is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. FHLB stock has a par value of \$100 per share, is carried at cost, and is subject to recoverability testing per SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The FHLB recently announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency ( FHFA ), its primary regulator, and that it would suspend future dividends and the repurchase and redemption of outstanding capital stock. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in the FHLB's balance sheet. As a result, an other than temporary impairment has not been recorded for the Bank's investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. Management will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of the Bank's investment.

Scheduled maturities of securities held to maturity and securities available for sale at June 30, 2009, are as follows:

|                                 | Held to maturity  |            | Available for sale |            |
|---------------------------------|-------------------|------------|--------------------|------------|
|                                 | Amortized Cost    | Fair Value | Amortized Cost     | Fair Value |
|                                 | (\$ in thousands) |            |                    |            |
| Due in one year or less         | \$ 100            | \$ 100     | \$ 4,000           | \$ 4,037   |
| Due from one year to five years | 2,471             | 2,544      | 1,501              | 1,538      |
| Due from five to ten years      | 5,608             | 5,720      | 500                | 480        |
| Due after ten years             | 1,273             | 1,288      |                    |            |
| Mortgage backed securities      |                   |            | 5,591              | 5,896      |
|                                 | \$ 9,452          | \$ 9,652   | \$ 11,592          | \$ 11,951  |

At June 30, 2009, securities with an amortized cost of \$20.1 million were pledged to secure public deposits, repurchase agreements, and for other purposes as required or permitted by law. The market value for these securities was \$20.7 million at June 30, 2009.

**Table of Contents****NOTE 5. Loans**

Loan detail by category is as follows:

|   | June 30,<br>2009  | December 31,<br>2008 |
|---|-------------------|----------------------|
|   | (\$ in thousands) |                      |
| 1-4 family and multi-family real estate | \$ 45,642         | \$ 41,453            |
| Commercial real estate                  | 137,394           | 131,597              |
| Commercial construction                 | 45,896            | 53,039               |
| Commercial non-real estate              | 61,200            | 65,656               |
| Land and land development               | 36,853            | 37,927               |
| Consumer                                | 10,189            | 10,316               |
|   | 337,174           | 339,988              |
| Allowance for loan losses               | (4,425)           | (4,737)              |
| Net deferred loan fees                  | (837)             | (946)                |
|   | \$ 331,912        | \$ 334,305           |

**NOTE 6. Allowance for Loan Losses**

The Bank maintains an allowance for loan losses at a level considered adequate by management to provide for probable credit losses in the Bank's loan portfolio. Future credit losses are estimated through an analysis of various factors affecting the performance of the loan portfolio, including: individual review of problem loans, including an evaluation of the quality of underlying collateral; current business conditions and the Bank's historical loan loss experience; the term, in years, that the average loan is expected to remain on the Bank's books; and other factors that management determines to be relevant at the time of the analysis. In accordance with accounting and regulatory requirements, the portion of the allowance relating to unused loan commitments and other off-balance sheet items is reclassified to Other liabilities. Changes in the allowance for loan losses for the periods indicated were as follows:

|  | Six months ended  |           |
|--|-------------------|-----------|
|  | 6/30/2009         | 6/30/2008 |
|  | (\$ in thousands) |           |
| Balance, beginning of period   | \$ 4,737          | \$ 2,711  |
| Add reserve for probable losses on unused loan commitments and off-balance sheet ( OBS ) items | 262               | 267       |
| Balance, beginning of period, including OBS reserve  | 4,999             | 2,978     |
| Provision for loan losses  | 2,900             | 375       |
| Loan charge-offs   | (3,316)           | (49)      |
| Loan recoveries  | 9                 | 17        |
| Balance, end of period, prior to adjustment for OBS items                                      | 4,592             | 3,321     |
| Reclassification of OBS reserve to Other liabilities   | (167)             | (96)      |
| Balance, end of period   | \$ 4,425          | \$ 3,225  |

**Table of Contents****NOTE 7. Borrowed Funds**

Borrowed funds consist of the following:

|  | 6/30/2009                | 12/31/2008 |
|--|--------------------------|------------|
|  | <i>(\$ in thousands)</i> |            |
| Federal Home Loan Bank ( FHLB ) advances | \$ 23,875                | \$ 20,490  |
| Other borrowed funds                     |                          | 2,892      |
|  | \$ 23,875                | \$ 23,382  |

FHLB advances are secured by a blanket pledge on Bank assets and specifically by certain loan balances. Other borrowed funds consisted of a note payable to a local bank, which was paid in full on February 13, 2009.

The Bank has operating lines of credit with various correspondent banks. All of these lines are unsecured except the FHLB line which is secured by a blanket pledge on Bank assets as well as certain specific loans. Advances on the FHLB line may require additional purchases of FHLB stock. These lines of credit are available for short-term funding to meet current liquidity needs. Although general market trends in connection with the current distress in financial markets may impact the availability of such operating lines from other financial institutions, the Bank believes that the financial institutions with which it has relationships are stable and that the Bank will continue to have sufficient access to short term funding. There can be no assurance that short-term funding will continue to be available. The amount of federal funds purchased and outstanding balances on the credit lines for the periods covered in this report are detailed as follows:

|                            | June 30, 2009            |                        | December 31, 2008 |                        |
|----------------------------|--------------------------|------------------------|-------------------|------------------------|
|                            | Line<br>Amount           | Outstanding<br>Balance | Line<br>Amount    | Outstanding<br>Balance |
|                            | <i>(\$ in thousands)</i> |                        |                   |                        |
| Federal Home Loan Bank     | \$ 33,159                | \$                     | \$ 35,033         | \$                     |
| Pacific Coast Bankers Bank | 10,000                   |                        | 10,000            | 3,465                  |
| Zions Bank                 | 100                      |                        | 5,000             |                        |
| Key Bank                   |                          |                        | 10,000            |                        |
| U.S. Bank                  |                          |                        | 1,500             |                        |

During the first quarter of 2009, KeyBank and U.S. Bank cancelled the Bank's operating lines of credit. In addition, Zions Bank reduced the Bank's line of credit from \$5 million to \$100 thousand.

**NOTE 8. Capital Lease Liability**

The capital lease liability outstanding on June 30, 2009 and December 31, 2008 is related to a ground lease, with a purchase option, that the Bank entered into in early 2005 (a copy of the ground lease was filed as an Exhibit to the Company's annual report on Form 10-KSB filed with the SEC on March 24, 2005). As a capitalized lease, the value of the property is included as an asset on the consolidated statement of financial condition in Premises and equipment, net, and the net present value of future payments is included as a liability in Capital lease liability.

**NOTE 9. Material Contract**

In the third quarter of 2006, the Bank entered into an agreement with the Spokane Public Facilities District ( PFD ) for the purchase of naming rights to the Spokane Opera House; that facility is now known as the INB Performing Arts Center. Under the agreement, the Bank will pay the PFD \$150 thousand per year for a period of ten years. The contract expires July 20, 2016; however, the Bank has the right to extend the contract for an additional ten years, at an annual rate that will not exceed the current annual rate by more than twenty-percent. Expenses related to the agreement are recognized as Other operating expense.

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In March of 2009, the Bank entered into a renegotiated lease with Diamond Plaza, LLC for its principal office and main branch, which is located in the Paulsen Center Building in downtown Spokane. The new lease is for a 10-year term with additional renewal options on approximately 22,971 feet. The initial lease rate is \$30,839 per month and escalates approximately 3% per year. A copy of the lease agreement has been filed as Exhibit 99.1 to the current report on Form 8-K filed by the Company with the SEC on May 11, 2009.

In July of 2009, the Bank entered into an agreement to build a new branch office, to be located in Spokane Valley, Washington. Pursuant to the construction contract, the Bank has agreed to pay \$1.2 million to build the new office, not including sales tax and subject to any change orders that may occur during the course of construction.

**NOTE 10. Junior Subordinated Debentures**

In June 2005, the Company issued junior subordinated debentures with an aggregate value of \$5.16 million to Northwest Bancorporation Capital Trust I (the "Trust"), with interest fixed at 5.95% through June 30, 2010, thereafter re-pricing quarterly at three-month LIBOR plus 1.70%. The Trust issued \$155 thousand of common securities to the Company and capital securities with an aggregate liquidation amount of \$5 million to third-party investors. The common securities are included in "Other assets" on the consolidated statement of financial condition; the subordinated debentures are detailed individually in this report and are included in "Borrowed funds" in the consolidated financial statements included in the annual report on Form 10-K for the year ended December 31, 2008. The subordinated debentures are includable as Tier I capital for regulatory purposes. The subordinated debentures and the capital securities pay interest and dividends, respectively, on a quarterly basis, which are included in interest expense. The subordinated debentures will mature on June 30, 2035, at which time the capital securities must be redeemed. The subordinated debentures and capital securities can be redeemed prior to maturity, at the Company's discretion, in whole or in part, beginning June 30, 2010, at par value. The Company has provided a full and unconditional guarantee of the obligations of the Trust under the capital securities in the event of default. The Trust is not consolidated in these financial statements, pursuant to Financial Accounting Standards Board Interpretation No. 46(R), "Consolidation of Variable Interest Entities." The Company reports the junior subordinated debentures within the liabilities section of the consolidated statements of financial condition.

The following table presents a summary of trust preferred securities at June 30, 2009 and December 31, 2008:

| Name of Trust                            | Aggregate  | Aggregate                                       | Aggregate  | Stated maturity date | Per annum interest rate | Extension period        | Redemption option     |
|--|--|---|--|----------------------|-------------------------|-------------------------|-----------------------|
|  | liquidation amount of trust preferred securities | liquidation amount of common capital securities | liquidation amount of principal amount of junior subordinated debentures |                      |                         |                         |                       |
| Northwest Bancorporation Capital Trust I | \$ 5,000   | \$ 155  | \$ 5,155   | 2035                 | 5.95%                   | 20 consecutive quarters | On or after 6/30/2010 |

**Table of Contents****NOTE 11. Common Stock**

On April 15, 2008, the Board of Directors declared a twenty-cent (\$0.20) per share annual cash dividend that was paid on June 13, 2008 to shareholders of record as of May 9, 2008. No cash dividends have been declared in 2009.

**NOTE 12. Fair Value Measurements**

The Company determines the fair market value of its financial instruments based on the fair value hierarchy established in Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( Statement 157 ). The Statement provides enhanced guidance for measuring assets and liabilities using fair value and applies to situations where other standards require or permit assets or liabilities to be measured at fair value. Statement 157 also requires expanded disclosure of items that are measured at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings.

Valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions about market value. These two types of inputs create a fair value hierarchy. Level 1 includes quoted prices for identical instruments in active markets. Level 2 includes quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable. Level 3 includes instruments whose significant value drivers are unobservable. The level of a financial instrument within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following table summarizes the Company's financial instruments that were measured at fair value on a recurring basis at June 30, 2009:

| Description of Financial Instrument | Fair Value | Fair Value Measurement Level |          |         |
|-------------------------------------|------------|------------------------------|----------|---------|
|                                     |            | Level 1                      | Level 2  | Level 3 |
| Securities available for sale       | \$ 11,951  | \$ 3,000                     | \$ 8,951 | \$      |

Certain financial assets are measured at fair value on a non-recurring basis from application of lower of cost or market accounting or write-downs of individual assets due to impairment. The following table summarizes the Company's financial instruments that were measured at fair value on a non-recurring basis at June 30, 2009, and the total loss recognized as a result of fair value adjustments for the six months ended June 30, 2009:

| Description of Financial Instrument                 | Fair Value | Fair Value Measurement Level |         |           | Six months ended<br>6/30/2009<br>Total Loss |
|---|------------|------------------------------|---------|-----------|---|
|   |            | Level 1                      | Level 2 | Level 3   |   |
| Impaired loans                                      | \$ 11,014  | \$                           | \$      | \$ 11,014 | \$  |
| Foreclosed real estate and other repossessed assets | 4,134      |                              |         | 4,134     | 300   |

The following methods and significant assumptions were used to estimate fair values:

*Securities available for sale.* The fair values of securities available for sale are generally measured using information from a third-party pricing service. If quoted prices are available in an active market, securities are classified as Level 1 measurements and include Treasury Department securities. If quoted prices in active markets are not available, fair values are estimated using pricing models (quoted prices of securities with similar characteristics or discounted cash flows) and classified as Level 2 measurements.

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*Foreclosed real estate and other repossessed assets.* Fair values of foreclosed real estate and other repossessed assets are typically determined based on an independent appraisal. Appraised values may be discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the customer and the customer's business. Any write-downs of foreclosed or repossessed assets subsequent to the initial classification are recorded as an expense in the Consolidated Statements of Operations and in the Total Loss column above.

*Impaired loans.* Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or market value. Market value is measured based on the value of the collateral securing these loans. The value of real estate collateral is determined based on an independent appraisal. The value of business equipment, inventory and accounts receivable collateral is typically based on the net book value on the business's financial statements, but in some cases an appraisal is obtained for equipment and inventory. Appraised and reported values may be discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the customer and the customer's business. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses and is reported in the Total Loss column above.

The estimated fair values of the Bank's financial instruments are summarized below.

|  | June 30, 2009   |                      | December 30, 2008 |                      |
|--|-----------------|----------------------|-------------------|----------------------|
|  | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| <i>(\$ in thousands)</i>                       |                 |                      |                   |                      |
| <b>Financial Assets:</b>                       |                 |                      |                   |                      |
| Cash and cash equivalents                      | \$ 7,202        | \$ 7,202             | \$ 11,403         | \$ 11,403            |
| Federal funds sold                             | 3,723           | 3,723                | 11                | 11                   |
| Securities available for sale                  | 11,951          | 11,951               | 18,722            | 18,722               |
| Securities held to maturity                    | 9,452           | 9,652                | 7,512             | 7,735                |
| Federal Home Loan Bank stock                   | 1,261           | 1,261                | 1,106             | 1,106                |
| Loans and loans held for sale, net             | 336,914         | 337,364              | 335,437           | 340,478              |
| Bank owned life insurance                      | 3,609           | 3,609                | 3,691             | 3,691                |
| <b>Financial Liabilities:</b>                  |                 |                      |                   |                      |
| Deposits                                       | 330,069         | 329,699              | 316,054           | 318,961              |
| Securities sold under agreements to repurchase | 616             | 616                  | 22,101            | 22,101               |
| Federal funds purchased                        |                 |                      | 3,465             | 3,465                |
| Borrowed funds                                 | 23,875          | 24,352               | 23,381            | 24,025               |
| Junior subordinated debentures                 | 5,155           | 5,070                | 5,155             | 5,126                |

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

*Cash and cash equivalents and federal funds sold:* The carrying amount approximates fair value because of the short maturity of these investments.

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

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

**Federal funds purchased:** The carrying amount approximates fair value.

**Bank owned life insurance:** The carrying amount (the cash surrender value) approximates fair value.

**Deposits and securities sold under agreements to repurchase:** The fair value of demand deposits, savings accounts, NOW, securities sold under agreements to repurchase and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity time deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

**Borrowed funds and junior subordinated debentures:** The fair values of the Bank's long-term debt and junior subordinated debentures are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

**Loan commitments and letters of credit:** Fair values of commitments are estimated using fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of counterparties. The difference between the carrying value of commitments to fund loans or standby letters of credit and their fair values are not significant and, therefore, not included in the table above.

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

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

## **FORWARD-LOOKING STATEMENTS**

*This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see Forward-Looking Statements. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in the Company's 2008 annual report on Form 10-K.*

## **SUMMARY OF CRITICAL ACCOUNTING POLICIES**

The Securities and Exchange Commission (the SEC) defines critical accounting policies as those that require the application of management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. The accounting policies that the Company's management have identified as critical to understanding the Company's financial statements and operating results are described in Note 1 of the Notes to Consolidated Financial Statements in the Company's annual report on Form 10-K for the year ended December 31, 2008.

**Table of Contents****Results of Operations***Summary*

The Company reported a net loss of \$1.10 million for the six months ended June 30, 2009, compared to net income of \$938 thousand for the comparable period in 2008. The decline in operating results compared to the first six months of 2008 is largely attributable to an increase in the provision for loan losses. The provision for loan losses was \$2.90 million for the six months ended June 30, 2009, representing an increase of \$2.52 million from the same period in 2008. This increased provision for loan losses reflects a higher level of nonperforming loans, delinquencies and net charge-offs.

During the first six months of 2009, total assets decreased \$1.2 million or 0.3% and total gross loans decreased \$2.8 million or 0.8%; deposits grew \$14.0 million or 4.4% during the same period.

The table below summarizes the Company's financial performance for the six months ended June 30, 2009 and 2008:

**Financial Highlights**

|   | Six months ended |                  |          |
|---|------------------|------------------|----------|
|   | 2009             | June 30,<br>2008 | % Change |
| <i>(\$ in thousands, except per share data)</i>     |                  |                  |          |
| <b>Results of Operations:</b>                       |                  |                  |          |
| Interest income                                     | \$ 10,924        | \$ 11,496        | -5.0%    |
| Interest expense                                    | 4,304            | 5,108            | -15.7%   |
| Net interest income                                 | 6,620            | 6,388            | 3.6%     |
| Provision for loan losses                           | 2,900            | 375              | 673.3%   |
| Net interest income after provision for loan losses | 3,720            | 6,013            | -38.1%   |
| Noninterest income                                  | 1,689            | 1,219            | 38.6%    |
| Noninterest expense                                 | 7,199            | 5,840            | 23.3%    |
| (Loss) income before income taxes                   | (1,790)          | 1,392            | -228.6%  |
| Income tax (benefit) expense                        | (688)            | 454              | -251.5%  |
| Net (loss) income                                   | \$ (1,102)       | \$ 938           | -217.5%  |
| <b>Share Data:</b>                                  |                  |                  |          |
| Basic earnings (loss) per common share              | \$ (0.57)        | \$ 0.40          |          |
| Diluted earnings (loss) per common share            | \$ (0.57)        | \$ 0.39          |          |
| <b>Selected Ratios:</b>                             |                  |                  |          |
| Return on average assets                            | -0.55%           | 0.53%            |          |
| Return on average equity                            | -7.00%           | 6.72%            |          |
| Net interest income to average earning assets       | 3.59%            | 3.85%            |          |
| Efficiency ratio                                    | 86.64%           | 76.77%           |          |
| Noninterest income to average assets                | 0.85%            | 0.69%            |          |
| Noninterest expense to average assets               | 3.61%            | 3.29%            |          |
| Ending shareholders' equity to average assets       | 9.06%            | 7.75%            |          |
| Nonperforming loans to gross loans                  | 4.50%            | 0.85%            |          |
| Allowance for loan losses to gross loans            | 1.31%            | 0.95%            |          |





**Table of Contents***Net Interest Income*

The principal component of the Bank's revenues is net interest income. Net interest income is the difference between interest income derived from earning assets, primarily loans and investment securities, and interest expense associated with interest bearing liabilities, primarily deposits, securities sold under agreement to repurchase and borrowed funds. The volume and mix of earning assets and funding sources, market rates of interest, demand for loans, and the availability of deposits affect net interest income.

The following table presents an analysis of the Bank's net interest income and net interest margin for the six months ended June 30, 2009 and 2008:

|   | Six months ended June 30, |  |                             |                    |  |                             |
|---|---------------------------|--|-----------------------------|--------------------|--|-----------------------------|
|   | Average<br>Balance        | 2009<br>Interest<br>Income or<br>Expense | Average<br>Yield or<br>Cost | Average<br>Balance | 2008<br>Interest<br>Income or<br>Expense | Average<br>Yield or<br>Cost |
|   | (\$ in thousands)         |  |                             |                    |  |                             |
| <b>ASSETS</b>   |                           |  |                             |                    |  |                             |
| Loans, gross <sup>1,2</sup>                               | \$ 341,891                | \$ 10,446                                | 6.11%                       | \$ 295,828         | \$ 10,719                                | 7.25%                       |
| Taxable investments                                       | 14,372                    | 310                                      | 4.31%                       | 21,882             | 531                                      | 4.85%                       |
| Nontaxable investments <sup>3</sup>                       | 8,740                     | 164                                      | 3.75%                       | 7,309              | 152                                      | 4.16%                       |
| FHLB stock  | 1,140                     |  | 0.00%                       | 674                | 4  | 1.19%                       |
| Federal funds sold & interest-bearing deposits with banks | 3,013                     | 4  | 0.27%                       | 6,244              | 90                                       | 2.88%                       |
| <b>Total interest earning assets</b>                      | <b>369,156</b>            | <b>10,924</b>                            | <b>5.92%</b>                | <b>331,937</b>     | <b>11,496</b>                            | <b>6.93%</b>                |
| Less reserve for probable loan losses                     | (5,227)                   |  |                             | (2,890)            |  |                             |
| Cash and due from banks                                   | 8,085                     |  |                             | 7,305              |  |                             |
| Other non-earning assets                                  | 26,412                    |  |                             | 19,143             |  |                             |
| <b>Total assets</b>                                       | <b>\$ 398,426</b>         |  |                             | <b>\$ 355,495</b>  |  |                             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>               |                           |  |                             |                    |  |                             |
| NOW accounts  | 14,380                    | 31                                       | 0.43%                       | 14,386             | 60                                       | 0.83%                       |
| Money market accounts                                     | 29,583                    | 122                                      | 0.82%                       | 32,390             | 301                                      | 1.86%                       |
| Savings accounts  | 41,550                    | 270                                      | 1.30%                       | 24,675             | 272                                      | 2.20%                       |
| Time certificates of deposit                              | 182,992                   | 3,275                                    | 3.58%                       | 169,670            | 3,876                                    | 4.57%                       |
| <b>Total interest bearing deposits</b>                    | <b>268,505</b>            | <b>3,698</b>                             | <b>2.75%</b>                | <b>241,121</b>     | <b>4,509</b>                             | <b>3.74%</b>                |
| Securities sold under repurchase agreements               | 4,840                     | 7  | 0.29%                       | 19,070             | 148                                      | 1.55%                       |
| Borrowed funds  | 22,666                    | 444                                      | 3.92%                       | 12,045             | 295                                      | 4.90%                       |
| Junior subordinated note <sup>4</sup>                     | 5,155                     | 155                                      | 6.01%                       | 5,155              | 156                                      | 6.05%                       |
| <b>Total borrowed funds</b>                               | <b>32,661</b>             | <b>606</b>                               | <b>3.71%</b>                | <b>36,270</b>      | <b>599</b>                               | <b>3.30%</b>                |
| <b>Total interest bearing liabilities</b>                 | <b>301,166</b>            | <b>4,304</b>                             | <b>2.86%</b>                | <b>277,391</b>     | <b>5,108</b>                             | <b>3.68%</b>                |
| Demand deposits   | 60,375                    |  |                             | 46,163             |  |                             |
| Other liabilities   | 5,377                     |  |                             | 4,032              |  |                             |
| Shareholders' equity                                      | 31,508                    |  |                             | 27,910             |  |                             |
| <b>Total liabilities and shareholders' equity</b>         | <b>\$ 398,426</b>         |  |                             | <b>\$ 355,496</b>  |  |                             |
| <b>Net interest income</b>                                |                           | <b>\$ 6,620</b>                          |                             |                    | <b>\$ 6,388</b>                          |                             |
| Net interest spread                                       |                           |  | 3.06%                       |                    |  | 3.25%                       |

|  |       |       |
|--|-------|-------|
| Net interest income to average earning assets (margin) | 3.59% | 3.85% |
|--|-------|-------|

Comments:

1. Nonaccrual loan balances are included in average loan balances; however, no interest income is imputed to nonaccrual loans.
2. Loan fee income in the amount of \$314 thousand and \$330 thousand is included in loan interest income for 2009 and 2008, respectively.
3. Yields have not been adjusted on tax-exempt investments to determine a tax-equivalent yield.
4. Junior subordinated note interest is fixed at 5.95%. Interest is computed using 360/365, which results in a higher annual percentage rate.

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Interest income on earning assets for the six months ended June 30, 2009 was \$10.9 million representing a decrease of \$572 thousand, or 5.0%, compared to \$11.5 million for the same period in 2008. Interest expense on interest bearing liabilities for the six months ended June 30, 2009 was \$4.3 million representing a decrease of \$804 thousand, or 15.7%, compared to \$5.1 million for the same period in 2008. The decrease in interest income occurred despite a \$37.2 million increase in average interest earning assets, and the decrease in interest expense occurred despite a \$23.8 million increase in average interest bearing liabilities. The decrease in both interest income and interest expense reflect the effects of a decreasing interest rate environment. Also contributing to the decline in interest income are higher levels of nonperforming assets, including nonaccrual loans for which accrued interest is reversed upon reaching nonperforming status.

Loans, the highest yielding component of earning assets, represented 92.6% of average earning assets at June 30, 2009, compared to 89.1% at June 30, 2008. The average yield on loans declined 114 basis points to 6.11% for the first six months of 2009 from 7.25% for the comparable period in 2008, primarily as a result of decreases in the Prime Rate, a key index to which a majority of our loan rates are tied. During the first six months of 2009, the average Prime Rate was 3.25% compared to 5.66% during the same time last year. The increase in nonaccrual loans has also had a negative impact on the average loan yield.

The percentage of average interest earning assets funded by average interest bearing liabilities decreased to 81.6% during the first half of 2009, compared to 83.6% for the same period in 2008. Deposits represented 89.2% of average interest bearing liabilities at June 30, 2009, compared to 86.9% at June 30, 2008. The cost of interest bearing funds for first six months of 2009 decreased 82 basis points to 2.86% from 3.68% during the same period last year.

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Net interest income can be analyzed in terms of the impact of changing rates and changing volume. The following table sets forth the effect which varying levels of interest earning assets and interest bearing liabilities and applicable rates have had on changes in net interest income for the periods presented:

|   | Six months ended June 30,                        |                   |               |
|---|--|-------------------|---------------|
|   | 2009 vs. 2008                                    |                   |               |
|   | Increase (decrease) due to changes in:<br>Volume | Rate              | Total         |
|   | (\$ in thousands)                                |                   |               |
| <b>Interest earning assets</b>                          |  |                   |               |
| Loans   | \$ 3,088   | \$ (3,361)        | \$ (273)      |
| Securities  | (118)  | (95)              | (213)         |
| Fed funds sold/interest-bearing balances                | (31)   | (55)              | (86)          |
| <b>Total interest earning assets</b>                    | <b>2,939</b>                                     | <b>(3,511)</b>    | <b>(572)</b>  |
| <b>Interest bearing liabilities</b>                     |  |                   |               |
| NOW accounts  |  | (29)              | (29)          |
| Money market accounts                                   | (24)   | (155)             | (179)         |
| Savings accounts  | (5)  | 3                 | (2)           |
| Time certificates of deposit                            | 342  | (943)             | (601)         |
| Securities sold under repurchase agreements             | (67)   | (74)              | (141)         |
| Borrowed funds  | 192  | (44)              | 148           |
| <b>Total interest bearing liabilities</b>               | <b>438</b>                                       | <b>(1,242)</b>    | <b>(804)</b>  |
| <b>Total increase (decrease) in net interest income</b> | <b>\$ 2,501</b>                                  | <b>\$ (2,269)</b> | <b>\$ 232</b> |

Net interest income for the six months ended June 30, 2009 improved \$232 thousand, or 3.6%, to \$6.6 million from \$6.4 million for the six months ended June 30, 2008. The improvement in net interest income is a result of interest income decreasing \$572 thousand, which was more than offset by an \$804 thousand decrease in interest expense.

The annualized net interest margin was 3.59% for the first six months of 2009 compared to 3.85% for the corresponding period of 2008. The decrease in net interest margin from 2008 to 2009 is the result of greater decreases in yields on earning assets compared to the decreases in rates paid on deposits, repurchase accounts and borrowed funds.

The Bank anticipates that competition from other financial institutions and reduced loan demand will continue to place pressure on its net interest margin. Current Federal Reserve policy has resulted in a Prime Rate of 3.25% during the first half of 2009, and the pressure on net interest margin is expected to continue so long as the Federal Reserve maintains its Federal funds target at a rate that ranges from 0.0% to 0.25%. Nevertheless, with the additional capital received from the Treasury Department, the Bank has budgeted for modest loan growth in 2009, with a slight improvement in net interest income anticipated as a result of an expected reduction in rates paid on deposits.

*Rate Shock*

Presented in the table below are the results of an analysis of interest rate risk vulnerability performed using the Bank's financial information as of June 30, 2009. Generally, the results of our analysis indicate that our exposure to interest rate volatility is within management's target of no more than plus or minus ten-percent when applying an interest rate shock of plus or minus two hundred basis points. Rate increases of 1.00%, 2.00% and 3.00% were modeled, while a decrease of 0.25% was modeled since the Federal Reserve's current Target Discount Rate is 0.25% and cannot go lower than 0%. The results of the net interest income analysis performed as of June 30, 2009, are within guidelines established by the Bank's Board of Directors, as shown in the table below.

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It is management's goal to limit the negative impact of a change in rates of plus or minus two hundred basis points to no more than twenty-five percent of the economic value of equity. Management therefore modeled rate increases of 1.00%, 2.00%, 3.00% and a decrease of 0.25%. The results of the economic value of equity analysis performed as of June 30, 2009, are presented in the table below to illustrate the estimated effect of changing rates on book value of equity and are within limits established by the Bank's Board of Directors.

| Projected | June 30, 2009       |                  |                  | Economic Value of Equity |                  |                  |
|-----------|---------------------|------------------|------------------|--------------------------|------------------|------------------|
|           | Net Interest Income |                  |                  | Economic Value of Equity |                  |                  |
| Interest  |                     |                  |                  |                          |                  |                  |
| Rate      |                     | \$               | %                |                          | \$               | %                |
| Scenario  | Estimated Value     | Change from Base | Change from Base | Estimated Value          | Change from Base | Change from Base |
|           | (\$ in thousands)   |                  |                  |                          |                  |                  |
| +300      | \$ 14,843           | \$ 1,603         | 12.11%           | \$ 25,542                | \$ (10,555)      | -29.24%          |
| +200      | 13,890              | 650              | 4.91%            | 28,040                   | (8,057)          | -22.32%          |
| +100      | 13,270              | 30               | 0.23%            | 31,567                   | (4,530)          | -12.55%          |
| Base      | 13,240              | 0                | 0.00%            | 36,097                   | 0                | 0.00%            |
| -25       | 13,232              | (8)              | -0.06%           | 37,270                   | 1,173            | 3.25%            |

Compared to the results of a similar analysis performed on the Bank's financial information as of June 30, 2008, presented below, the potential effect of a significant (+300) change in market rates of interest on net interest income has increased by 5.0%, while the potential effect on economic value of equity decreased by 7.6%. Results for both periods are within the established guidelines of the Bank's Board of Directors.

| Projected | June 30, 2008       |                  |                  | Economic Value of Equity |                  |                  |
|-----------|---------------------|------------------|------------------|--------------------------|------------------|------------------|
|           | Net Interest Income |                  |                  | Economic Value of Equity |                  |                  |
| Interest  |                     |                  |                  |                          |                  |                  |
| Rate      |                     | \$               | %                |                          | \$               | %                |
| Scenario  | Estimated Value     | Change from Base | Change from Base | Estimated Value          | Change from Base | Change from Base |
|           | (\$ in thousands)   |                  |                  |                          |                  |                  |
| +300      | \$ 15,883           | \$ 1,052         | 7.09%            | \$ 24,433                | \$ (6,759)       | -21.67%          |
| +200      | 15,613              | 782              | 5.27%            | 26,681                   | (4,511)          | -14.46%          |
| +100      | 15,294              | 463              | 3.12%            | 28,977                   | (2,215)          | -7.10%           |
| Base      | 14,831              | 0                | 0.00%            | 31,192                   | 0                | 0.00%            |
| -100      | 14,469              | (362)            | -2.44%           | 32,289                   | (1,097)          | 3.52%            |
| -200      | 14,104              | (727)            | -4.90%           | 33,399                   | (2,207)          | 7.08%            |
| -300      | 13,753              | (1,078)          | -7.27%           | 34,549                   | (3,357)          | 10.76%           |

**Table of Contents***Loan Loss Provision and Allowance*

Below is a summary of changes in the Bank's allowance for loan losses ( ALLL ) for the first six months of 2009 and 2008, respectively:

|   | Six months ended  |           |
|---|-------------------|-----------|
|   | 6/30/2009         | 6/30/2008 |
|   | (\$ in thousands) |           |
| ALLL balance, beginning of period   | \$ 4,737          | \$ 2,711  |
| Add reserve for probable losses on unused loan commitments and off-balance sheet (OBS) items*                                 | 262               | 267       |
| ALLL balance, beginning of period, including OBS reserve  | 4,999             | 2,978     |
| Loan charge-offs:   |                   |           |
| Commercial  | (1,619)           |           |
| Real estate   | (1,684)           | (31)      |
| Installment and credit card   | (13)              | (18)      |
| Total charge-offs   | (3,316)           | (49)      |
| Recoveries of loans previously charged-off:   |                   |           |
| Commercial  | 1                 |           |
| Real estate   | 7                 | 14        |
| Installment and credit card   | 1                 | 3         |
| Total recoveries  | 9                 | 17        |
| Net charge-offs   | (3,307)           | (32)      |
| Provision charged to expense  | 2,900             | 375       |
| ALLL balance, end of year, prior to adjustment for off-balance sheet items  | 4,592             | 3,321     |
| Reclassification of reserve for probable losses on unused loan commitments and off-balance sheet items to Other liabilities * | (167)             | (96)      |
| ALLL balance, end of year   | \$ 4,425          | \$ 3,225  |
| Ratio of net charge-offs to average gross loans outstanding for the period  | 0.97%             | 0.01%     |

The provision for loan losses during the six months ended June 30, 2009 was \$2.9 million, which was a substantial increase of \$2.5 million over the \$375 thousand added to the provision for the same period in 2008. This increase was prompted both by continued growth in total loans and persistent credit quality issues related to the deteriorating economic conditions within the Bank's market. As a result of several larger borrowers experiencing financial difficulties, management has decided to write down some loans and reserve for others, as appropriate. Management expects to continue to add to the allowance for loan losses as prudent and necessary throughout the remainder of 2009.

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Net charge-offs for the six months ended June 30, 2009 were \$3.3 million, or 0.97% of average gross loans, compared to net charge-offs of \$32 thousand, or 0.01% of average gross loans, for the first six months of 2008. As a percentage of average loans outstanding during the first quarter, net charge-offs were significantly higher than the five-year average of 0.18% that the Bank had previously experienced.

The allowance for loan losses at June 30, 2009 was 1.31% of period end gross loans compared to 0.95% at June 30, 2008. The increase is the result of the large provision for loan losses allocated in the fourth quarter of 2008 and the first two quarters of 2009. Management believes that the increase in the loan loss provision was warranted because of deteriorating economic circumstances and evidence of higher evaluated risk in the portfolio. Management also wrote down or charged-off several loans due to the perceived additional risk associated with the specific loans.

At June 30, 2009 the allowance for loan losses as a percentage of nonperforming assets was 29% compared to 120% at June 30, 2008. The level of nonaccrual loans and foreclosed assets has increased significantly over the past year.

The following table details the allocation of balances in the reserve for loan losses, by category:

|   | June 30, 2009     |                  | December 31, 2008 |                  |
|---|-------------------|------------------|-------------------|------------------|
|   | Amount            | Percent of Total | Amount            | Percent of Total |
|   | (\$ in thousands) |                  |                   |                  |
| Construction and land development                 | \$ 1,300          | 28.3%            | \$ 1,293          | 25.9%            |
| Secured by farmland                               | 3                 | 0.1%             | 9                 | 0.2%             |
| Home equity loans                                 | 543               | 11.8%            | 205               | 4.1%             |
| Revolving loans secured by 1-4 family residential |                   | 0.0%             | 18                | 0.4%             |
| Secured by multi-family residential               | 36                | 0.8%             | 151               | 3.0%             |
| Secured by non-farm, non-residential real estate  | 777               | 16.9%            | 1,277             | 25.5%            |
| Commercial and industrial loans                   | 1,115             | 24.3%            | 1,448             | 29.0%            |
| Loans to individuals                              | 233               | 5.1%             | 138               | 2.8%             |
| Credit card loans                                 | 79                | 1.7%             | 37                | 0.7%             |
| All other loans and leases                        |                   | 0.0%             | 3                 | 0.1%             |
| Mortgage loans held for sale                      | 1                 | 0.0%             | 1                 | 0.0%             |
| Commitments under lines/letters of credit         | 167               | 3.6%             | 262               | 5.2%             |
| Supplementary allowance/non-specific factors      | 338               | 7.4%             | 157               | 3.1%             |
|   | \$ 4,592          | 100.0%           | \$ 4,999          | 100.0%           |

Classified and criticized loans are individually analyzed, at least quarterly, to determine loss exposure. Allocated reserves related to classified and criticized loans, which includes impaired loans, are specifically identified. When a loss on a loan is identified as probable, the loan is immediately written down to a level that collateral liquidation or other repayment sources are expected to support.

The following table shows a summary of nonaccrual loans, loans past due 90 days or more and still accruing interest, and foreclosed assets for the periods covered in this report:

|  | June 30,          |          |
|--|-------------------|----------|
|  | 2009              | 2008     |
|  | (\$ in thousands) |          |
| Loans accounted for on a nonaccrual basis                                | \$ 11,014         | \$ 2,383 |
| Loans contractually past due 90 days or more as to interest or principal |                   | 5        |
| Foreclosed assets  | 4,134             | 293      |
| Total nonperforming assets   | \$ 15,148         | \$ 2,681 |





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At June 30, 2009, nonperforming assets as a percentage of total assets was 3.8%, compared to 0.7% at June 30, 2008. Nonperforming assets have decreased \$3.7 million from December 31, 2008 as a result of sales and charge-offs. Of the approximately \$11 million in nonaccrual loans, management believes \$5.6 million is well protected by collateral and is expected to be paid in full.

The Bank is about eight months into a 12-month workout agreement on a \$1.5 million loan to a local borrower that is expected to bring the loan current by the end of 2009.

Two participation loans purchased by the Bank have required substantial write-downs and reserves for additional risk. Management believes the risk of loss has been adequately recognized. However, even though a resolution is pending the situation remains volatile. The remaining 12 loans totaling about \$2.1 million are in varying stages of foreclosure or negotiated workouts. For loans secured by real estate collateral, current appraisals have been obtained and the balances exposed to loss have been either written-off or an adequate reserve has been established. In most cases, there is some collateral protection and any anticipated shortfall in collateral has been factored into the loan loss provision.

All nonperforming loans and all other classified loans greater than \$50 thousand are reviewed at least quarterly. Action plans are aggressively established and are monitored to ensure progress is being made. Individual loans have been carefully analyzed for risk of loss, and specific reserves have been established to protect the Bank from further loss.

The \$4.1 million in foreclosed assets includes six single-family homes and six condos. Based on recent appraisals, three of the homes are priced at or below current market and are listed with a realtor. One of these three is under contract for sale and is expected to close by August 31, 2009. Management believes these three homes can be successfully marketed in the next six months without additional loss. In addition, the Bank also owns a high-end home that is also listed with a realtor. The majority of the exposure on this loan has been sold to a participating bank, and the balance written down to estimated fair market value less costs to sell.

Two additional high-end homes, together with eight building lots on a popular Northwest golf course, are also included in the Bank's foreclosed assets; these loans originated as purchased participation loans. Even though the properties were priced conservatively based on an outside appraisal, there has been little or no sales activity. An updated appraisal indicates that the values have further deteriorated and an additional charge to earnings has been taken. The properties have been listed with a qualified realtor, but the weak local economy suggests a quick resolution is unlikely.

Six condos from a purchased participation loan have recently been added to the Bank's foreclosed assets. The current appraisal suggests that the units are priced at or below market value.

The foreclosed assets total also includes nearly 50 building lots. Management believes these lots are priced at or below current market. Management continues to explore opportunities to liquidate the property with several realtors and investors, but believes it may take approximately a year or more to sell all of the lots.

Restructured loans, within the meaning of SFAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, were \$435 thousand as of June 30, 2009. This represents an increase of \$146 thousand from the \$289 thousand reported at December 31, 2008. All of the restructured loans were contractually current as of June 30, 2009.

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*Noninterest Income*

For the six months ended June 30, 2009, noninterest income was \$1.7 million, an increase of \$470 thousand, or 38.6%, from the same period in 2008. Fees and service charges on accounts increased \$151 thousand or 27.3% primarily as result of increased charges on nonsufficient funds checks. The net gain from sale of loans is \$107 thousand higher than the same period in 2008, largely due to an increased volume of mortgage loan refinancings that has more than offset the decline in income from new mortgage loan originations. Other noninterest income increased \$212 thousand year-over-year and includes \$145 thousand received during the first quarter of 2009 from life insurance proceeds from the death of a key employee; also contributing to the rise in other noninterest income are gains on sales of foreclosed assets totaling \$54 thousand.

*Noninterest Expense*

Noninterest expense for the six months ended June 30, 2009 was \$7.2 million, an increase of \$1.4 million or 23.3%, from the same period in 2008. Year-over-year, the largest increase in noninterest expense was in other operating expenses, which were \$1.1 million higher in 2009 than in 2008. Included in other operating expenses are FDIC insurance premiums, which increased \$335 thousand year-over-year as a result of higher insurable deposits, increases in assessment rates and the FDIC's June 30 special assessment of \$180 thousand. Also contributing to the increase in other operating expenses were \$300 thousand in write downs of foreclosed assets, \$153 thousand in higher legal expenses related to foreclosures and troubled credits as well as general increases in legal costs, and \$168 thousand in higher professional consulting fees. Occupancy and equipment expense in 2009, including depreciation expense, was \$242 thousand higher than the first six months of 2008 and is largely the result of branch expansion over the last year. The remainder of the increase in noninterest expense is a result of other costs associated with growth in the Bank's assets and an increase in the number of Bank customers.

**BALANCE SHEET**

*Loans*

At June 30, 2009, the Bank reported \$331.9 million in net loans, an increase of \$16.5 million or 5.2%, compared to June 30, 2008, and a decrease of \$2.4 million or 0.7%, compared to December 31, 2008.

In-house net loan production has slowed dramatically over the past two quarters. The Bank is no longer seeking to buy loans from other banks, and the Bank is also discouraging its loan officers from originating new loans for land development, speculative construction and non-owner occupied commercial real estate.

There is continued pressure on pricing in the Bank's local market area, especially for those loans considered to be the most profitable. The Bank, like many other banks, is setting floors on variable rate lines of credit, and overall, this has helped to improve the Bank's interest income despite a slight reduction in total loans. Many customers are requesting longer term fixed rates in anticipation of future rate increases. However, the Bank also believes that rates are likely to rise over the next one to five years and is attempting to minimize interest rate risk by keeping rates adjustable and by structuring loans to mature in five years or less.

Much of the Bank's current lending efforts are directed to the administration of the existing portfolio including the extra demands of managing an increasing level of problem loans. The most experienced loan officers are being asked to shoulder increasing workloads related to substandard loans.

Despite overall weaknesses in the marketplace, management is beginning to see evidence that its workout efforts are making some progress. The Bank obtained an independent review of significant problem loans to help ensure that all possible alternatives for resolution are being considered. The consultant did not identify resolution alternatives for 90% of the number of loans reviewed. For the remaining 10% of the problem loans reviewed, the consultant offered modest recommendations that were not materially different from the alternatives already contemplated by the Bank.

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### *Securities*

As of June 30, 2009, the Bank had \$12.0 million in securities classified as available for sale and \$9.5 million in securities classified as held to maturity. Of these securities, \$8.8 million have been pledged as collateral for various funding sources, including: public deposits from the states and municipalities of Washington and Idaho; the Bank's repurchase account program; the Federal Reserve's Treasury, Tax and Loan deposit account; and U.S. Bankruptcy Trustees' deposit accounts. Except for one corporate bond with a fair value of \$480 thousand, all of the securities are obligations of the Treasury Department, U.S. Agencies or, in the held to maturity portfolio, municipal governments. The securities portfolio decreased in size by approximately \$2.0 million from the same period last year as the funds were redeployed into higher yielding loans.

### *Deposits*

As of June 30, 2009, the Bank reported \$330.1 million in deposits; this is an increase of \$14.0 million and \$31.5 million, or 4.4% and 10.5%, compared to the deposits reported as of December 31, 2008 and June 30, 2008, respectively.

Deposit growth for the six months ended June 30, 2009 was especially strong for demand deposit accounts for which balances increased \$17.5 million or 37.3% during the period. This growth appears to be a continuation of increased customer confidence following the Bank's participation in the temporary unlimited guarantee of funds in noninterest-bearing transaction accounts at FDIC-insured institutions (the Transaction Account Guarantee Program). For participating FDIC-insured institutions, the Transaction Account Guarantee Program amended FDIC deposit insurance coverage for noninterest-bearing transaction accounts to 100% of the account balance. The Transaction Account Guarantee Program is set to expire on December 31, 2009.

Certificates of deposit (CD) balances declined \$6.1 million or 3.3% during the six months ended June 30, 2009. This decrease was primarily attributable to the Bank allowing certain brokered deposits to mature due to their relative cost, and because the CDs were not needed to fund loan growth.

Competition for deposits in the Bank's primary market area has made it difficult to significantly reduce the rates paid to customers on their deposits. Part of this competitive pressure is caused by larger financial institutions that have an increased need for liquidity, particularly those institutions that have responded to marketplace demand for refinancing and originating significant volumes of mortgage loans. In order to retain existing deposits, and to attract new deposits, the Bank has strived to remain competitive on deposit rates. Compared to the first six months of last year, the Bank has been successful in decreasing deposit rates and has reduced the Bank's average cost by nearly 100 basis points since June 30, 2008.

### *Junior Subordinated Debentures*

The Company had \$5.2 million in junior subordinated debentures at June 30, 2009; most of the proceeds have been invested in the Bank and have been primarily used by the Bank for branch expansion and relocation. The junior subordinated debentures bear interest at a rate of 5.95% that is fixed through June 30, 2010. As of June 30, 2009, the entire balance of the junior subordinated debentures qualified as Tier 1 capital under regulatory capital guidelines. Additional information regarding the terms of the junior subordinated debentures, including maturity, re-pricing dates and interest rate, is included in Note 8 of the Notes to Consolidated Financial Statements in the Company's 2008 annual report on Form 10-K, as filed with the SEC on March 27, 2009.

### *Capital Resources of the Company*

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

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Banking regulations require the Bank to maintain minimum levels of capital. The Bank manages its capital to maintain a well capitalized designation (the FDIC's highest rating). A well-capitalized rating from the FDIC requires that the Bank maintain capital levels of 10% of total risk-based assets. At June 30, 2009, the Bank's total capital to risk weighted assets was 12.02% compared to 10.23% at June 30, 2008. This is an increase over the ratio of 10.46% reported as of December 31, 2008 and reflects the Company's investment of \$7 million in the Bank, which was part of the proceeds received from the issuance and sale of 10,500 shares of Series A preferred stock and 525 shares of Series B preferred stock to the Treasury Department in February 2009.

Historically, the Board of Directors has scheduled its dividend considerations so that annual cash dividends, when and if declared by the Company, would be paid in mid-June of each year. The Company paid its first cash dividend in 2003, in the amount of \$0.10 per share. In each of the subsequent years, the Board of Directors has increased the amount of the cash dividend paid per share by \$0.02. The annual cash dividend per share declared and paid in 2008 was \$0.20. A number of financial institutions have announced reductions in the payment of cash dividends over the past several months or, in some cases, the total elimination of cash dividends. In April 2009, the Board decided to defer any decision on whether to pay a dividend this year until later in the year. The Company intends to continue evaluating whether to resume the payment of dividends to common shareholders as growth and earnings permit.

## **OFF-BALANCE SHEET ARRANGEMENTS AND COMMITMENTS**

In the normal course of business, the Bank commits to extensions of credit and issues letters of credit. The Bank uses the same credit policies in making commitments to lend funds and conditional obligations as it does for other credit products. In the event of nonperformance by the customer, the Bank's exposure to credit loss is represented by the contractual amount of the instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established by the contract. Since some commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. At June 30, 2009, the Bank had \$58.6 million in commitments to extend credit; for the most part, the distribution of loan commitments, both as to type and quality, mirrors the distribution of outstanding loans detailed in Note 4 and elsewhere in this Report.

Letters of credit are conditional commitments issued by the Bank to guarantee performance of a customer to a third party. The credit risk involved is essentially the same as that involved in extending loan facilities to customers. At June 30, 2009, the Bank had issued \$4.1 million in letters of credit.

The Bank also has internal guidance lines of credit established for certain borrowers, primarily in the residential construction industry. These guidance lines are not contractual commitments to extend credit, and may be terminated by the Bank for any reason without any obligation to the borrower. These lines provide the Bank's lending officers with limits on future extensions of credit that may be made to certain borrowers. The Bank uses the same credit policies in establishing internal guidance lines as it does for other credit products. The Bank has seldom, if ever, had to cancel a guidance line.

## **LIQUIDITY**

Liquidity is the term used to refer to the Bank's ability to meet its financial commitments. The Bank maintains sufficient liquidity to ensure that funds are available for both lending needs and the withdrawal of deposit funds. The Bank derives liquidity primarily through deposit growth, including core deposits, the maturity of investment securities, cash from operations and loan payments received. Traditionally, core deposits are considered non-volatile and include demand, interest checking, money market, savings and certain time deposits with balances under FDIC-insured limits. Additional liquidity is provided through sales of loans, sales of securities, and access to alternative funding sources. National time deposits, including brokered deposits, public deposits, and deposits available through various national listing programs are traditionally considered to be more volatile than core deposits; however, more recently, the volatility has been associated with pricing rather than with availability. FHLB borrowings and unsecured overnight Federal Reserve funds are referred to as alternative funding sources.

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The primary ongoing funding needs of the Company, separate from the Bank, include debt service on junior subordinated debentures and dividends on preferred stock. The Bank historically has relied upon the generation of local deposits to fund its investment in loans, securities and other assets. From time-to-time, the Bank generates funds by advertising its certificate of deposit rates on a national listing service. Public funds are another source of deposits and are typically received from the states of either Washington or Idaho. Public funds are stable, and are generally deposited with the Bank for as long as the Bank is willing to pay the required rate of interest on such funds. Recent Washington State regulations will require the Bank to collateralize any uninsured State funds with investments representing 100% of the uninsured balance by August 22, 2009. As of June 30, 2009, the Bank had uninsured Washington State public funds totaling \$4.0 million. Holding deposits of the State of Washington exposes the Bank to the risk of loss should another Washington State depository institution fail, assuming that failure results in a loss to the State. In the event that a bank failure results in a loss to the State of Washington, the remaining depositories holding State funds will be assessed a certain amount to help cover that loss; the exposure can be as much as 10% of the State deposits held by an approved depository institution. The Company is currently taking steps to limit its exposure to public fund losses, including allowing a \$3.5 million CD to mature without renewal on July 10, 2009.

Concerns over deposit fluctuations with respect to the overall banking industry were addressed by the FDIC in September and October 2008. The FDIC increased the amount of deposit insurance available on individual accounts from \$100,000 per account to \$250,000 per account through December 31, 2013. The FDIC also implemented the Transaction Account Guarantee Program, which provides for full FDIC coverage for noninterest-bearing transaction accounts and transaction accounts paying less than 0.50% interest, regardless of dollar amounts. The Bank elected to participate in this program, which is currently set to expire on December 31, 2009.

Additionally, the Company is a member of the Certificate of Deposit Account Registry Service ( CDARS® ) program. Through CDARS®, the Bank's customers can increase their FDIC insurance by up to \$50 million through reciprocal certificate of deposit accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer's large deposit is broken into amounts below the \$100,000 amount (or \$250,000 if the time deposit matures prior to December 31, 2013) and is placed with other banks that are members of the network. A reciprocal member bank issues certificates of deposit in amounts that ensure that the entire deposit is FDIC insured.

When the level of liquid assets (our primary liquidity) does not meet our liquidity needs, other available sources of liquid assets (our secondary liquidity), include: the purchase of federal funds, sales of securities under agreements to repurchase, purchase of brokered certificates of deposit, sales of loans, and our lines of credit with the FHLB and other correspondent banks, are employed to meet current and anticipated liquidity needs. At June 30, 2009, the Company had approximately \$33.2 million of funds available on its FHLB line and \$10.1 million of funds available on its federal funds lines with correspondent banks.

The Company can also increase its amount of brokered deposits. However, if the Bank were to become less than well-capitalized under the capital adequacy guidelines, regulatory approval would have to be obtained in order to continue purchasing brokered deposits. Additionally, as a member of the CDARS® program, the Company can purchase certificates of deposit through the program. At June 30, 2009, the Company was eligible to purchase certificates of deposit of up to five percent of its total assets through CDARS®. These sources provide significant secondary liquidity to the Company to service its customers' needs.

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

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### ***Forward-Looking Statements***

From time to time, the Company and its senior managers have made and will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be contained in this report and in other documents that the Company files with the Securities and Exchange Commission. Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Also, forward-looking statements can generally be identified by words such as *may*, *could*, *should*, *would*, *believe*, *anticipate*, *estimate*, *seek*, *expect*, *intend*, *plan* and similar expressions.

Forward-looking statements provide management's expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond the Company's control that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

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

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

applicable laws and regulations and legislative or regulatory changes;

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

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

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

the Company's ability to dispose of real estate acquired;

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

technological and management changes;

growth and acquisition strategies;

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

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

changes in consumer spending and saving habits;

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

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



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

Not applicable because the Company is a smaller reporting company.

### **Item 4. Controls and Procedures.**

#### *Evaluation of Disclosure Controls and Procedures*

The Company's Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of disclosure controls and procedures (as defined in Exchange Act Rules 240.13a-14(c) and 15d-14(c)) as of June 30, 2009, the date of this quarterly report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's current disclosure controls and procedures are effective and timely, providing them with material information relating to the Company required to be disclosed in the reports that are filed or submitted under the Exchange Act.

#### *Changes in Internal Controls*

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

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

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

### **Item 1A. Risk Factors.**

An investment in our common stock is subject to risks inherent to our business. Before making an investment decision, you should carefully consider the risks and uncertainties described both in this report and in our annual report on Form 10-K for the fiscal year ended December 31, 2008. These are not the only risks and uncertainties we face. Additional risks and uncertainties that management is not currently aware of or focused on or that management currently deems immaterial may also impair our business operations. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially affected.

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

Not applicable.

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

Not applicable.

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**Item 4. Submission of Matters to a Vote of Security Holders.**

The Company's Annual Meeting of Shareholders (the Meeting) was held on May 18, 2009. The following matters were submitted to a vote of the shareholders of the Company at the Meeting:

- (1) Election of three Directors to each serve three-year terms ending at the annual meeting of shareholders in the year 2012:

|                      |                      |                  |
|----------------------|----------------------|------------------|
| Anthony D. Bonanzino | Votes for: 1,790,244 | Withheld: 8,874  |
| Randall L. Fewel     | Votes for: 1,784,480 | Withheld: 14,638 |
| Bryan S. Norby       | Votes for: 1,738,720 | Withheld: 60,398 |

The following are the names of the other Directors whose terms continued after the meeting:

|                     |                       |
|---------------------|-----------------------|
| Dwight B. Aden, Jr. | Clark H. Gemmill      |
| Katie Brodie        | Frederick M. Schunter |
| Harlan D. Douglass  | William E. Shelby     |
| Freeman B. Duncan   | Jennifer West         |
| Donald A. Ellingsen |                       |

- (2) Ratification of the engagement of Moss Adams, LLP as the independent registered public accounting firm for the year ending December 31, 2009 and any interim periods. The proposal received the following votes:

Votes for: 1,791,401    Against: 7,717    Absentions: 0

- (3) Ratification of the compensation of the Company's executive officers. The proposal received the following votes:

Votes for: 1,723,736    Against: 48,702    Absentions: 26,678

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

- Exhibit 3.1 Restated Articles of Incorporation of the Company. Filed as Exhibit 3.1 to the Company's annual report on Form 10-K, filed with the SEC on March 27, 2009 and incorporated by reference herein.
- Exhibit 3.2 Bylaws of the Company. Filed as Exhibit 3.2 to the Company's registration statement on Form 10-SB, filed with the SEC on April 30, 1998 and incorporated by reference herein.
- Exhibit 4.1 Reference is made to Exhibits 3.1 and 3.2 as well as Exhibits 4.2, 4.3 and 4.4 below.
- Exhibit 4.2 Form of Certificate for the Company's Series A Preferred Stock. Filed as Exhibit 4.1 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.

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Exhibit 4.3 Form of Certificate for the Company's Series B Preferred Stock. Filed as Exhibit 4.2 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.

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|              |   |
|--------------|---|
| Exhibit 4.4  | Warrant to Purchase Shares of the Company's Series B Preferred Stock. Filed as Exhibit 4.3 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein. |
| Exhibit 31.1 | Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.  |
| Exhibit 31.2 | Certification of Holly A. Poquette, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.   |
| Exhibit 32.1 | Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to 18 U.S.C. 1350. Filed herewith.   |
| Exhibit 32.2 | Certification of Holly A. Poquette, Chief Financial Officer, pursuant to 18 U.S.C. 1350. Filed herewith.  |

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**SIGNATURES**

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

NORTHWEST BANCORPORATION, INC.  
(Registrant)

Dated: August 14, 2009

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

Dated: August 14, 2009

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

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- Exhibit 4.1 Reference is made to Exhibits 3.1 and 3.2 as well as Exhibits 4.2, 4.3 and 4.4 below.
- Exhibit 4.2 Form of Certificate for the Company's Series A Preferred Stock. Filed as Exhibit 4.1 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 4.3 Form of Certificate for the Company's Series B Preferred Stock. Filed as Exhibit 4.2 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
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