

BANNER CORP  
Form 10-K  
February 29, 2016

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2015

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

Commission File Number 0-26584

BANNER CORPORATION

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of  
incorporation  
or organization)

91-1691604

(I.R.S. Employer

Identification Number)

10 South First Avenue, Walla Walla, Washington 99362

(Address of principal executive offices and zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$.01 per share

The NASDAQ Stock Market LLC  
(Name of Each Exchange on Which  
Registered)

(Title of Each Class)

Securities registered pursuant to section 12(g) of the Act:

None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes  No

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

Act Yes  No

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

X No

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

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

Edgar Filing: BANNER CORP - Form 10-K

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

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

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

The aggregate market value of the voting and non-voting common equity held by nonaffiliates of the registrant based on the closing sales price

of the registrant's common stock quoted on The NASDAQ Stock Market on June 30, 2015, was:

Common Stock – \$979,733,679

(The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the Registrant that such person is an affiliate of the Registrant.)

The number of shares outstanding of the registrant's classes of common stock as of January 31, 2016:

Common Stock, \$.01 par value – 32,817,789 shares

Non-voting Common Stock, \$.01 par value – 1,424,466 shares

Documents Incorporated by Reference

Portions of Proxy Statement for Annual Meeting of Shareholders to be held April 26, 2016 are incorporated by reference into Part III.

## BANNER CORPORATION AND SUBSIDIARIES

## Table of Contents

PART I	Page	
Item 1.	Business	<u>4</u>
	General	<u>4</u>
	Recent Developments and significant events	<u>5</u>
	Lending Activities	<u>5</u>
	Asset Quality	<u>10</u>
	Investment Activities	<u>11</u>
	Deposit Activities and Other Sources of Funds	<u>12</u>
	Personnel	<u>13</u>
	Taxation	<u>13</u>
	Competition	<u>14</u>
	Regulation	<u>14</u>
	Management Personnel	<u>20</u>
	Corporate Information	<u>22</u>
Item 1A.	Risk Factors	<u>23</u>
Item 1B.	Unresolved Staff Comments	<u>32</u>
Item 2.	Properties	<u>32</u>
Item 3.	Legal Proceedings	<u>32</u>
Item 4.	Mine Safety Disclosures	<u>32</u>
PART II		
Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	<u>33</u>
Item 6.	Selected Financial Data	<u>36</u>
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	<u>39</u>
	Executive Overview	<u>39</u>
	Comparison of Financial Condition at December 31, 2015 and 2014	<u>46</u>
	Comparison of Results of Operations	
	Years ended December 31, 2015 and 2014	<u>59</u>
	Years ended December 31, 2014 and 2013	<u>67</u>
	Market Risk and Asset/Liability Management	<u>70</u>
	Liquidity and Capital Resources	<u>74</u>
	Capital Requirements	<u>75</u>
	Effect of Inflation and Changing Prices	<u>75</u>
	Contractual Obligations	<u>76</u>
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	<u>76</u>
Item 8.	Financial Statements and Supplementary Data	<u>76</u>
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	<u>76</u>
Item 9A.	Controls and Procedures	<u>76</u>
Item 9B.	Other Information	<u>77</u>
PART III		
Item 10.	Directors, Executive Officers and Corporate Governance	<u>78</u>
Item 11.	Executive Compensation	<u>78</u>

Edgar Filing: BANNER CORP - Form 10-K

Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	<u>78</u>
Item 13.	Certain Relationships and Related Transactions, and Director Independence	<u>79</u>
Item 14.	Principal Accounting Fees and Services	<u>79</u>

PART IV

Item 15.	Exhibits and Financial Statement Schedules	<u>80</u>
	Signatures	<u>81</u>

## Forward-Looking Statements

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

accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the U.S. Securities and Exchange Commission, including this report on Form 10-K. Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to update any forward-looking statements included in this report or the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. These risks could cause our actual results to differ materially from those expressed in any forward-looking statements by, or on behalf of, us. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur, and you should not put undue reliance on any forward-looking statements.

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

PART 1

Item 1 – Business

General

Banner Corporation (the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly-owned subsidiaries, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of December 31, 2015, its 199 branch offices and nine loan production offices located in Washington, Oregon, California, Utah and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the the Federal Reserve Board. Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington DFI and the FDIC. As of December 31, 2015, we had total consolidated assets of \$9.80 billion, net loans of \$7.24 billion, total deposits of \$8.06 billion and total shareholders' equity of \$1.30 billion. Our voting common stock is traded on the NASDAQ Global Select Market under the ticker symbol "BANR."

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

Since becoming a public company in 1995, we have invested significantly in expanding our branch and distribution systems with a primary emphasis on strengthening our market presence in our five primary markets in the Northwest. Those markets include the four largest metropolitan areas in the Northwest: the Puget Sound region of Washington and the greater Portland, Oregon, Boise, Idaho, and Spokane, Washington markets, as well as our historical base in the vibrant agricultural communities in the Columbia Basin region of Washington and Oregon. Our aggressive franchise expansion during this period included the acquisition and consolidation of ten commercial banks, as well as the opening of 28 new branches, the acquisition of seven branches and relocating 12 others. More recently, our acquisition activity, which included two whole bank transactions in 2015 and the purchase of six branches in 2014, has expanded our geographic focus to include additional markets in southwest Oregon, as well as select markets in California and Utah and more than doubled the size of the Company. The acquisition of Starbuck Bancshares, Inc. (Starbuck), the holding company for AmericanWest, which closed on October 1, 2015, with 98 branches and approximately \$4.46 billion in assets, added scale to our operations, strengthened our Northwest presence and provided entry into attractive markets in California and Utah. Prior to that, the acquisition of Siuslaw Financial Group (Siuslaw), holding company of Siuslaw Bank, which closed on March 6, 2015, with ten branches and approximately \$369.8 million in assets, added further market penetration in western Oregon, including the Eugene market. Both the Starbuck and Siuslaw acquisitions complemented our June 2014 purchase of six branches on the southern Oregon coast (Branch purchase), together giving us meaningful market share in the southwest Oregon market area and have had a significant impact on the operating results of Banner. For additional details regarding these acquisitions and merger related expenses, see Note 3, Business Combinations, of the Notes to Consolidated Financial Statements contained in Item 8 of this report.

In addition to the acquisitions, branch openings and relocations, since changing our name in 2001, we also have invested heavily in marketing campaigns designed to significantly increase the brand awareness for Banner Bank as

well as expanded product offerings. These investments, which have been significant elements in our strategies to grow loans, deposits and customer relationships, have increased our presence within desirable marketplaces and allow us to better serve existing and future customers. This emphasis on growth and development resulted in an elevated level of non-interest expense during much of this period; however, we believe the expanded branch network, broader product line and heightened brand awareness have created a franchise that is well positioned and is allowing us to successfully execute on our super community bank model. That strategy is focused on delivering customers, including middle market and small businesses, business owners, their families and employees, a compelling value proposition by providing the financial sophistication and breadth of products of a regional bank while retaining the appeal, responsiveness, and superior service level of a community bank.

Banner Corporation's successful execution on its super community bank model and its strategic initiatives, have delivered solid profitability and growth. We have made substantial progress on our goals to achieve and maintain the Company's moderate risk profile as well as to develop and continue strong earnings momentum. Highlights of this success have included substantial improvement in our asset quality, outstanding client acquisition and account growth, significantly increased non-interest-bearing deposit balances and strong revenue generation from core operations.

Like most financial institutions, our operating results in recent years have been meaningfully impacted by the exceptionally low interest rate environment and our future operating results and financial performance will be significantly affected by the course of economic activity. However, over the past five years we have substantially added to our client relationships and account base, as well as significantly improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in stronger and sustainable revenues and low credit costs, and which we believe has positioned the Company well to meet a challenging economic environment with continued success.

As a result of elevated expenses related to the acquisition of Starbuck and Siuslaw, for the year ended December 31, 2015, our net income decreased to \$45.2 million, or \$1.89 earnings per diluted share, compared to \$54.1 million, or \$2.79 earnings per diluted share, for the prior year. Our results for both years were significantly impacted by merger and acquisition activity and the related expenses. Acquisition-related expenses



were \$26.1 million, or \$0.76 per diluted share net of tax benefit, in 2015 compared to \$4.3 million, or \$0.17 per diluted share net of tax benefit, in 2014. Results for 2014 also included a \$9.1 million bargain purchase gain related to the Branch purchase, which net of taxes contributed \$0.30 to diluted net income per share.

Our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits, Federal Home Loan Bank of Des Moines (FHLB) advances, other borrowings and junior subordinated debentures. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. Our net interest income before provision for loan losses increased 35% to \$242.3 million for the year ended December 31, 2015, compared to \$179.9 million for the year ended December 31, 2014.

Our net income also is affected by the level of our non-interest income, including deposit fees and service charges, results of mortgage banking operations, which includes loan origination and servicing fees and gains and losses on the sale of loans, and gains and losses on the sale of securities, as well as our non-interest expenses, provisions for loan losses and income tax provisions. In addition, net income is affected by the net change in the value of certain financial instruments carried at fair value.

Our total revenues (net interest income before the provision for loan losses plus non-interest income) for 2015 increased to \$304.6 million, compared to \$234.9 million for 2014. Our total non-interest income, which is a component of total revenue and includes the net gain on sale of securities and changes in the value of financial instruments carried at fair value, was \$62.3 million for the year ended December 31, 2015, compared to \$55.0 million for the year ended December 31, 2014.

As a result of adequate reserves already in place as well as low levels of non-performing loans and net recoveries in both years, we did not record a provision for loan losses in the years ended December 31, 2015 or 2014. Reflecting our continued focused efforts, non-performing loans decreased by 9% to \$15.2 million at December 31, 2015, compared to \$16.7 million a year earlier. Our allowance for loan losses at December 31, 2015 was \$78.0 million, representing 512% of non-performing loans. (See Note 5, Loans Receivable and the Allowance for Loan Losses, of the Notes to the Consolidated Financial Statements as well as “Asset Quality” below.)

Our non-interest expense increased to \$236.6 million for the year ended December 31, 2015, compared to \$153.7 million for the year ended December 31, 2014. The year-over-year increase in non-interest expense was largely attributable to acquisition-related expenses and incremental costs associated with operating the 98 branches acquired in the AmericanWest acquisition on October 1, 2015 and the ten Siuslaw Bank branches acquired in March 2015, as well as a full year's expense related to the Branch purchase and generally increased compensation, occupancy and payment and card processing services reflecting increased transaction volume.

## Recent Developments and Significant Events

### Acquisition of AmericanWest Bank

As of the close of business on October 1, 2015, the Company completed its acquisition of Starbuck and its subsidiary, AmericanWest, a Washington state chartered commercial bank headquartered in Spokane, Washington with 98 branches serving markets in Washington, Oregon, Idaho, California and Utah. On that date Starbuck merged with and into Banner and AmericanWest merged with and into Banner Bank. The merged banks are operating as Banner Bank. Pursuant to the previously announced terms of the merger, the equityholders of Starbuck received an aggregate of \$130.0 million in cash and 13.2 million shares of Banner common stock and non-voting common stock. At the time of

closing, Starbuck had \$4.46 billion in assets, \$3.00 billion in loans and \$3.64 billion in deposits.

#### Acquisition of Siuslaw Financial Group, Inc.

On March 6, 2015, the Company completed its acquisition of Siuslaw, the holding company of Siuslaw Bank, an Oregon state chartered commercial bank. Siuslaw shareholders received consideration of \$1.416 in cash plus 0.322 of a share of Banner common stock in exchange for each share of Siuslaw common stock, which reflects a payment of approximately 90% stock and 10% cash. Upon closing of the transaction Siuslaw was merged into Banner and Siuslaw Bank was merged into Banner Bank. At the time of closing, Siuslaw had \$369.8 million in assets, \$247.1 million in loans and \$316.4 million in deposits.

#### Acquisition of Six Sterling Savings Bank Branches

Effective as of the close of business on June 20, 2014, Banner Bank completed the purchase of the six branches in Oregon from Umpqua Bank, successor to Sterling Savings Bank. In the aggregate, Banner Bank acquired \$212.1 million in deposit accounts, \$87.9 million in loans, and \$3.1 million in branch properties. Banner Bank also received \$127.6 million in cash from the transaction.

#### Lending Activities

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

percentage of assets in the loan portfolio having more frequent interest rate repricing terms or shorter maturities than traditional long-term fixed-rate mortgage loans. As part of this effort, we offer a variety of floating or adjustable interest rate products that correlate more closely with our cost of interest bearing funds, particularly loans for commercial business and real estate, agricultural business, and construction and development purposes. However, in response to customer demand, we continue to originate fixed-rate loans, including fixed interest rate mortgage loans with terms of up to 30 years. The relative amount of fixed-rate loans and adjustable-rate loans that can be originated at any time is largely determined by the demand for each in a competitive environment. At December 31, 2015, our net loan portfolio totaled \$7.24 billion compared to \$3.76 billion at December 31, 2014. The AmericanWest acquisition accounted for \$2.82 billion of the year-end loan portfolio and the Siuslaw Bank acquisition accounted for \$227.1 million of the year-end loan portfolio, while organic loan growth accounted for \$441.4 million of the increase from the prior year.

Our lending activities are primarily directed toward the origination of real estate and commercial loans. Commercial real estate loans include owner-occupied, investment properties, multifamily residential real estate and construction and development loans for these types of properties. Although our level of activity and investment in commercial and multifamily real estate loans has been relatively stable for many years, we have experienced an increase in new originations in recent periods resulting in growth in these loan balances. In addition, the AmericanWest and Siuslaw Bank acquisitions substantially increased the balances of our commercial and multi-family real estate loans. Commercial real estate loans increased by \$1.77 billion and multifamily loans increased by \$309.1 million during the year ended December 31, 2015. We also originate residential construction, land and land development loans and, although our portfolio balances are well below the peak levels before the recent recession, since 2011 we have experienced increased demand for one- to four-family construction loans. While our origination of construction and development loans has been significant during this period, balances in this portion of the portfolio have only increased modestly in recent periods as brisk sales of new homes have produced rapid turnover through repayments. Our commercial business lending is directed toward meeting the credit and related deposit and treasury management needs of various small- to medium-sized business and agribusiness borrowers operating in our primary market areas. In recent years, our commercial business lending has also included participation in certain national syndicated loans. Reflecting the expanding Northwest economy, demand for these types of commercial business loans has strengthened and our production levels have increased in recent periods. Largely as a result of the AmericanWest acquisition, commercial and agricultural business loans increased by \$622.0 million during the year ended December 31, 2015.

Our residential mortgage loan originations have been relatively strong in recent years, as exceptionally low interest rates have supported demand for loans to refinance existing debt as well as loans to finance home purchases. However, most of the one- to four-family loans that we originate are sold in the secondary markets with net gains on sales and loan servicing fees reflected in our revenues from mortgage banking. As a result, excluding loans acquired through the acquisitions, growth in this portion of our portfolio has been modest. At December 31, 2015, our outstanding balance for residential mortgages was \$952.6 million, an increase of \$415.5 million compared to a year earlier largely as a result of the acquisitions.

Our consumer loan activity is primarily directed at meeting demand from our existing deposit customers. We have increased our emphasis on consumer lending in recent years, and while demand for consumer loans has been modest during most of this period as we believe many consumers have been focused on reducing their personal debt, we had meaningful growth from originations in 2014 and 2015, primarily related to increased home equity lines of credit. More recently, the AmericanWest acquisition nearly doubled the size of the consumer loan portfolio, although it remains a relatively small portion of the total loan portfolio. At December 31, 2015, consumer loans, including consumer loans secured by one- to four-family residences, increased to \$636.9 million, an increase of \$287.7 million compared to a year earlier largely as a result of the acquisitions of AmericanWest and Siuslaw Bank.

For additional information concerning our loan portfolio, see Item 7 of this report, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Loans and Lending” including Tables 3 and 4, which sets forth the composition and geographic concentration of our loan portfolio, and Tables 5 and 6, which contain information regarding the loans maturing in our portfolio.

**One- to Four-Family Residential Real Estate Lending:** At both Banner Bank and Islanders Bank, we originate loans secured by first mortgages on one- to four-family residences in the markets we serve. Through our mortgage banking activities, we sell residential loans on either a servicing-retained or servicing-released basis. In recent years, we have generally sold a significant portion of our conventional residential mortgage originations and nearly all of our government insured loans in the secondary market. At December 31, 2015, \$952.6 million, or 13% of our loan portfolio, consisted of permanent loans on one- to four-family residences.

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

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

**Construction and Land Lending:** Historically, we have invested a significant portion of our loan portfolio in residential construction and land loans to professional home builders and developers. We also make construction loans to qualified owner occupants, which upon completion of the construction phase convert to long-term amortizing one-to-four family residential loans that are eligible for sale in the secondary market. We regularly monitor our construction and land loan portfolios and the economic conditions and housing inventory in each of our markets and increase or decrease this type of lending as we observe market conditions change. Beginning in 2011, in response to improvement in certain sub-markets, our residential construction and land and land development lending has been increasing and has made a meaningful contribution to our net interest income and profitability. To a lesser extent, we also originate construction loans for commercial and multifamily real estate. Although well diversified with respect to sub-markets, price ranges and borrowers, our construction, land and land development loans are significantly concentrated in the greater Puget Sound region of Washington State and the Portland, Oregon market area. At December 31, 2015, construction, land and land development loans totaled \$574.4 million, or 8% of total loans; the balance was primarily comprised of one- to four-family construction and residential land or land development loans, and to a lesser extent commercial and multifamily real estate construction loans and commercial land or land development loans.

Construction and land lending affords us the opportunity to achieve higher interest rates and fees with shorter terms to maturity than are usually available on other types of lending. Construction and land lending, however, involves a higher degree of risk than other lending opportunities because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. Disagreements between borrowers and builders and the failure of builders to pay subcontractors may also jeopardize projects. Loans to builders to construct homes for which no purchaser has been identified carry additional risk because the payoff for the loan is dependent on the builder's ability to sell the property before the construction loan is due. We attempt to address these risks by adhering to strict underwriting policies, disbursement procedures and monitoring practices.

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

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

On a more limited basis, we also make land loans to developers, builders and individuals to finance the acquisition and/or development of improved lots or unimproved land. In making land loans, we follow underwriting policies and disbursement and monitoring procedures similar to those for construction loans. The initial term on land loans is typically one to three years with interest only payments, payable monthly, and provisions for principal reduction as lots are sold and released from the lien of the mortgage.

**Commercial and Multifamily Real Estate Lending:** We originate loans secured by multifamily and commercial real estate including, as noted above, loans for construction of multifamily and commercial real estate projects. Commercial real estate loans are made for both owner-occupied and investor properties. At December 31, 2015, our loan portfolio included \$1.77 billion in non-owner-occupied commercial real estate loans, \$1.33 billion in owner-occupied commercial real estate loans and \$473.0 million in multifamily loans which in aggregate comprised 49% of our total loans. Multifamily and commercial real estate lending affords us an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multifamily and commercial properties are generally greater in amount, more difficult to evaluate and monitor and, therefore, potentially riskier than one- to four-family residential mortgage loans. Because payments on loans secured by multifamily and commercial properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. In addition, many of our commercial and multifamily real estate loans often are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. In originating multifamily and commercial real estate loans, we consider the location, marketability and overall attractiveness of the properties. Our underwriting guidelines for multifamily and commercial real estate loans require an appraisal from a qualified independent appraiser and an economic analysis of each property with regard to the annual revenue and expenses, debt service coverage and

fair value to determine the maximum loan amount. In the approval process we assess the borrowers' willingness and ability to manage the property and repay the loan and the adequacy of the collateral in relation to the loan amount.

Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. A significant portion of our multifamily and commercial real estate loans are linked to various FHLB advance rates, certain prime rates or other market rate indices. Rates on these adjustable-rate loans generally adjust with a frequency of one to five years after an initial fixed-rate period ranging from one to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no large concentrations by property type, location or borrower. At December 31, 2015, the average size of our commercial real estate loans was \$632,000 and the largest commercial real estate loan in our portfolio was approximately \$19.3 million.

**Commercial Business Lending:** We are active in small- to medium-sized business lending and are engaged in agricultural lending primarily by providing crop production loans. Our commercial bankers are focused on local markets and devote a great deal of effort to developing customer relationships and providing these types of borrowers with a full array of products and services delivered in a thorough and responsive manner. While also strengthening our commitment to small business lending, our experienced commercial bankers and senior credit staff focus on corporate lending opportunities for borrowers with credit needs generally in a \$3 million to \$15 million range. In addition to providing earning assets, commercial business lending has helped us increase our deposit base. In recent years, our commercial business lending has included modest participation in certain national syndicated loans, including shared national credits. We also originate smaller balance business loans principally through our retail branch network, using our Quick Step business loan program, which is closely aligned with our consumer lending operations and relies on centralized underwriting procedures. Quick Step business loans and lines of credit are available from \$5,000 to \$500,000 and owner-occupied real estate loans are available up to \$1.0 million.

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

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

Our commercial business loans may be structured as term loans or as lines of credit. Commercial business term loans are generally made to finance the purchase of fixed assets and have maturities of five years or less. Commercial business lines of credit are typically made for the purpose of providing working capital and are usually approved with a term of one year. Adjustable- or floating-rate loans are primarily tied to various prime rate or LIBOR indices. At December 31, 2015, commercial business loans totaled \$1.21 billion, or 17% of our total loans, including \$123.7 million of shared national credits.

**Agricultural Lending:** Agriculture is a major industry in several of our markets. We make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operations of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile. At December 31, 2015, agricultural business loans, including collateral secured loans to purchase farm land and equipment, totaled \$376.5 million, or 5% of our loan portfolio.

Agricultural operating loans generally are made as a percentage of the borrower's anticipated income to support budgeted operating expenses. These loans are secured by a blanket lien on all crops, livestock, equipment, accounts and products and proceeds thereof. In the case of crops, consideration is given to projected yields and prices from each commodity. The interest rate is normally floating based on the prime rate or a LIBOR index plus a negotiated margin. Because these loans are made to finance a farm or ranch's annual operations, they are usually written on a one-year review and renewable basis. The renewal is dependent upon the prior year's performance and the forthcoming year's projections as well as the overall financial strength of the borrower. We carefully monitor these loans and related variance reports on income and expenses compared to budget estimates. To meet the seasonal operating needs of a farm, borrowers may qualify for single payment notes, revolving lines of credit and/or non-revolving lines of credit.

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



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

Among the more common risks to agricultural lending can be weather conditions and disease. These risks may be mitigated through multi-peril crop insurance. Commodity prices also present a risk, which may be reduced by the use of set price contracts. Normally, required beginning and projected operating margins provide for reasonable reserves to offset unexpected yield and price deficiencies. In addition to these risks, we also consider management succession, life insurance and business continuation plans when evaluating agricultural loans.

**Consumer and Other Lending:** We originate a variety of consumer loans, including home equity lines of credit, automobile, boat and recreational vehicle loans and loans secured by deposit accounts. While consumer lending has traditionally been a small part of our business, with loans made primarily to accommodate our existing customer base, it has received consistent emphasis in recent years. Part of this emphasis includes a Banner Bank-owned credit card program. Similar to other consumer loan programs, we focus this credit card program on our existing customer base to add to the depth of our customer relationships. In addition to earning balances, credit card accounts produce non-interest revenues through interchange fees and other activity-based revenues. Our underwriting of consumer loans is focused on the borrower's credit history and ability to repay the debt as evidenced by documented sources of income. At December 31, 2015, we had \$636.9 million, or 9% of our loan portfolio, in consumer related loans, including \$478.4 million, or 7% of our loan portfolio, in consumer loans secured by one- to four-family residences.

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

**Loan Solicitation and Processing:** We originate real estate loans in our market areas by direct solicitation of real estate brokers, builders, developers, depositors, walk-in customers and visitors to our Internet website. One- to four-family residential loan applications are taken by our mortgage loan officers or through our Internet website and are processed in branch or regional locations. In addition, we have specialized origination units, focused on

construction and land development, commercial real estate and multifamily loans. Most underwriting and loan administration functions for our real estate loans are performed by loan personnel at central locations.

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

We originate consumer loans and small business (including Quick Step) commercial business loans through various marketing efforts directed primarily toward our existing deposit and loan customers. Consumer loans and Quick Step commercial business loan applications are primarily underwritten and documented by centralized administrative personnel.

#### Loan Originations, Sales and Purchases

While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. For the years ended December 31, 2015 and 2014, we originated loans, net of repayments, including our participation in syndicated loans and loans held for sale of \$741.7 million and \$506.0 million, respectively. The increase in originations net of repayments for 2015 compared with 2014 largely reflects increased production capacity, including production from the former AmericanWest and Siuslaw Bank lending teams, with both periods being effected by high levels of repayments.

We sell many of our newly originated one- to four-family residential mortgage loans to secondary market purchasers as part of our interest rate risk management strategy. In addition, beginning in 2015, in conjunction with the acquisition of AmericanWest, we began to sell many of our newly originated multifamily loans to the secondary market purchasers. Originations of loans for sale increased to \$709.0 million for the year

ended December 31, 2015 from \$361.9 million during 2014, reflecting low interest rates, strong housing markets and our increased production capacity, including \$41.2 million of multifamily held for sale loan production subsequent to the acquisition of AmericanWest. Sales of loans generally are beneficial to us because these sales may generate income at the time of sale, provide funds for additional lending and other investments, increase liquidity or reduce interest rate risk. During the year ended December 31, 2015, we sold \$677.2 million of loans held for sale compared to \$367.9 million for the year ended December 31, 2014. The held for sale loans sold in 2015 were primarily one- to four-family loans, although \$66.8 million of multifamily loans held for sale were sold in the fourth quarter of 2015. In 2014 all held for sale loans sold were one- to four-family loans. In addition, during the fourth quarter of 2015, we sold \$85.1 million of portfolio multifamily loans acquired through the merger with AmericanWest. We sell loans on both a servicing-retained and a servicing-released basis. All loans are sold without recourse. The decision to hold or sell loans is based on asset liability management goals, strategies and policies and on market conditions. See “Loan Servicing.”

We periodically purchase whole loans and loan participation interests or participate in syndicates originating new loans, including shared national credits, primarily during periods of reduced loan demand in our primary market area and at times to support our Community Reinvestment Act lending activities. Any such purchases or loan participations are made generally consistent with our underwriting standards; however, the loans may be located outside of our normal lending area. During the years ended December 31, 2015 and 2014, we purchased \$323.5 million and \$194.4 million, respectively, of loans and loan participation interests.

#### Loan Servicing

We receive fees from a variety of institutional owners in return for performing the traditional services of collecting individual payments and managing portfolios of sold loans. At December 31, 2015, we were servicing \$2.33 billion of loans for others. Loan servicing includes processing payments, accounting for loan funds and collecting and paying real estate taxes, hazard insurance and other loan-related items such as private mortgage insurance. In addition to earning fee income, we retain certain amounts in escrow for the benefit of the lender for which we incur no interest expense but are able to invest the funds into earning assets.

**Mortgage Servicing Rights:** We record mortgage servicing rights (MSRs) with respect to loans we originate and sell in the secondary market on a servicing-retained basis. The value of MSRs is capitalized and amortized in proportion to, and over the period of, the estimated future net servicing income. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. MSRs generally are adversely affected by higher levels of current or anticipated prepayments resulting from decreasing interest rates. These carrying values are adjusted when the valuation indicates the carrying value is impaired. At December 31, 2015, our MSRs were carried at a value of \$13.3 million, net of amortization. For additional information see Note 17, Goodwill, Other Intangible Assets and Mortgage Servicing Rights, of the Notes to the Consolidated Financial Statements.

#### Asset Quality

**Classified Assets:** State and federal regulations require that the Banks review and classify their problem assets on a regular basis. In addition, in connection with examinations of insured institutions, state and federal examiners have authority to identify problem assets and, if appropriate, require them to be classified. Historically, we have not had any meaningful differences of opinion with the examiners with respect to asset classification. Banner Bank’s Credit Policy Division reviews detailed information with respect to the composition and performance of the loan portfolios, including information on risk concentrations, delinquencies and classified assets for both Banner Bank and Islanders Bank. The Credit Policy Division approves all recommendations for new classified loans or, in the case of smaller-balance homogeneous loans including residential real estate and consumer loans, it has approved policies

governing such classifications, or changes in classifications, and develops and monitors action plans to resolve the problems associated with the assets. The Credit Policy Division also approves recommendations for establishing the appropriate level of the allowance for loan losses. Significant problem loans are transferred to Banner Bank's Special Assets Department for resolution or collection activities. The Banks' and Banner Corporation's Boards of Directors are given a detailed report on classified assets and asset quality at least quarterly. For additional information regarding asset quality and non-performing loans, see Item 7 of this report, "Management's Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Asset Quality," and Table 11 contained therein.

**Allowance for Loan Losses:** In originating loans, we recognize that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. As a result, we maintain an allowance for loan losses consistent with U.S. generally accepted accounting principles (GAAP) guidelines. We increase our allowance for loan losses by charging provisions for possible loan losses against our income. The allowance for losses on loans is maintained at a level which, in management's judgment, is sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon continuing analysis of the factors underlying the quality of the loan portfolio. For additional information concerning our allowance for loan losses, see Item 7 of this report, "Management's Discussion and Analysis of Financial Condition—Comparison of Results of Operations for the Years Ended December 31, 2015 and 2014—Provision and Allowance for Loan Losses," and Tables 14 and 15 contained therein.

**Real Estate Owned:** Real estate owned (REO) is property acquired by foreclosure or receiving a deed in lieu of foreclosure, and is recorded at the estimated fair value of the property, less expected selling costs. Development and improvement costs relating to the property are capitalized to the extent they add value to the property. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are credited or charged to operations in the period in which they are realized. The amounts we will ultimately recover from REO may differ substantially from the carrying value of the assets because of market factors beyond our control or because of changes in our strategies for recovering the

investment. For additional information on REO, see Item 7 of this report, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Asset Quality” and Table 11 contained therein and Note 6, Real Estate Owned, Held for Sale, Net, of the Notes to the Consolidated Financial Statements.

#### Investment Activities

#### Investment Securities

Under Washington state law, banks are permitted to invest in various types of marketable securities. Authorized securities include but are not limited to Treasury obligations, securities of various federal agencies (including government-sponsored enterprises), mortgage-backed and asset-backed securities, certain certificates of deposit of insured banks and savings institutions, bankers’ acceptances, repurchase agreements, federal funds, commercial paper, corporate debt and equity securities and obligations of states and their political subdivisions. Our investment policies are designed to provide and maintain adequate liquidity and to generate favorable rates of return without incurring undue interest rate or credit risk. Our policies generally limit investments to U.S. Government and agency (including government-sponsored entities) securities, municipal bonds, certificates of deposit, corporate debt obligations and mortgage-backed securities. Investment in mortgage-backed securities may include those issued or guaranteed by Freddie Mac, Fannie Mae, Government National Mortgage Association (Ginnie Mae or GNMA) and investment grade privately-issued mortgage-backed securities, as well as collateralized mortgage obligations (CMOs). All of our investment securities, including those that have high credit ratings, are subject to market risk in so far as a change in market rates of interest or other conditions may cause a change in an investment’s earnings performance and/or market value.

At December 31, 2015, our consolidated investment portfolio totaled \$1.39 billion and consisted principally of U.S. Government agency obligations, mortgage-backed securities, municipal bonds, corporate debt obligations, and asset-backed securities. From time to time, investment levels may be increased or decrease in order to manage balance sheet liquidity, interest rate risk, market risk and provide appropriate risk adjusted returns. The acquisition of AmericanWest significantly added to the size of our investment portfolio, in particular our residential mortgage-backed securities and municipal bonds, although certain securities acquired in that transaction were sold prior to year-end, as we intentionally reduced total assets below \$10.0 billion by December 31, 2015 to avoid the additional regulatory consequences associated with exceeding that asset size. For additional information regarding these regulatory consequences, see Item 1A, Risk Factors, “We may be subject to additional regulatory scrutiny if and when Banner or Banner Bank’s total assets exceed \$10.0 billion.”

For detailed information on our investment securities, see Item 7, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Investments,” and Tables 1 and 2 contained therein.

#### Derivatives

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

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

#### Derivatives Designated in Hedge Relationships

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

#### Derivatives Not Designated in Hedge Relationships

**Interest Rate Swaps:** Banner Bank uses an interest rate swap program for commercial loan customers, in which, we provide the client with a variable rate loan and enter into an interest rate swap in which the client receives a fixed rate payment in exchange for a variable rate payment. We offset our risk exposure by entering into an offsetting interest rate swap with a dealer counterparty for the same notional amount and length of term as the client interest rate swap providing the dealer counterparty with a fixed rate payment in exchange for a variable rate payment. Banner Bank also has a few interest rate swaps from a prior interest rate swap program that were also not designated in hedge relationships. These swaps do not qualify as designated hedges; therefore, each swap is accounted for as a free standing derivative.

**Mortgage Banking:** In the normal course of business, we sell originated one- to four-family residential mortgage loans into the secondary mortgage loan markets. During the period of loan origination and prior to the sale of the loans in the secondary market, we have exposure to

movements in interest rates associated with written rate lock commitments with potential borrowers to originate loans that are intended to be sold and for closed loans that are awaiting sale and delivery into the secondary market. Written loan commitments that relate to the origination of mortgage loans that will be held for resale are considered free-standing derivatives and do not qualify for hedge accounting. Written loan commitments generally have a term of up to 60 days before the closing of the loan. The loan commitment does not bind the potential borrower to enter into the loan, nor does it guarantee that we will approve the potential borrower for the loan. Therefore, when determining fair value, we make estimates of expected “fallout” (loan commitments not expected to close), using models which consider cumulative historical fallout rates, current market interest rates and other factors.

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

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

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

In connection with the interest rate swaps between Banner Bank and the dealer counterparties, the agreements contain a provision where if Banner Bank fails to maintain its status as a well/adequately capitalized institution, then the counterparty could terminate the derivative positions and Banner Bank would be required to settle its obligations. Similarly, we could be required to settle our obligations under certain of these agreements if specific regulatory events occur, such as a publicly issued prompt corrective action directive, cease and desist order, or a capital maintenance agreement that required Banner Bank to maintain a specific capital level. If we had breached any of these provisions at December 31, 2015 or 2014, we could have been required to settle our obligations under the agreements at the termination value. We generally post collateral against derivative liabilities in the form of government agency-issued bonds, mortgage-backed securities, or commercial mortgage-backed securities.

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

#### Deposit Activities and Other Sources of Funds

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

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

capabilities are all directed at providing products and services that enhance customer relationships and result in growing deposit balances as well as fee income. Growing core deposits (transaction and savings accounts) is a fundamental element of our business strategy. Core deposits increased to 83% of total deposits at December 31, 2015 compared to 80% a year earlier and 76% two years ago.

**Deposit Accounts:** We generally attract deposits from within our primary market areas by offering a broad selection of deposit instruments, including demand checking accounts, interest-bearing checking accounts, money market deposit accounts, regular savings accounts, certificates of deposit, cash management services and retirement savings plans. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of deposit accounts, we consider current market interest rates, profitability to us, matching deposit and loan products and customer preferences and concerns. At December 31, 2015, we had \$8.06 billion of deposits. In addition to our organic growth in deposits, the acquisitions of AmericanWest and Siuslaw Bank resulted in a \$3.82 billion increase in deposits, including \$1.09 billion in non-interest bearing deposits, \$2.11 billion in interest-bearing transaction and savings accounts, and \$620.8 million in certificates of deposit as of December 31, 2015. For additional information concerning our deposit accounts, see Item 7 in this report, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Deposit Accounts,” including Table 7 contained therein, which sets forth the balances of deposits in the various types of accounts, and Table 8, which sets forth the amount of our certificates of deposit greater than \$100,000 by time remaining until maturity as of December 31, 2015. In addition, see Note 8, Deposits of the Notes to the Consolidated Financial Statements.



**Borrowings:** While deposits are the primary source of funds for our lending and investment activities and for general business purposes, we also use borrowings to supplement our supply of lendable funds, to meet deposit withdrawal requirements and to more efficiently leverage our capital position. The FHLB serves as our primary borrowing source. Although in recent years we have significantly reduced our use of FHLB advances, we assumed additional advances in connection with the AmericanWest acquisition. The FHLB provides credit for member financial institutions such as Banner Bank and Islanders Bank. As members, the Banks are required to own capital stock in the FHLB and are authorized to apply for advances on the security of that stock and certain of their mortgage loans and securities provided certain credit worthiness standards have been met. Limitations on the amount of advances are based on the financial condition of the member institution, the adequacy of collateral pledged to secure the credit, and FHLB stock ownership requirements. At December 31, 2015, we had \$133.4 million of borrowings from the FHLB. At that date, Banner Bank had been authorized by the FHLB to borrow up to \$1.77 billion under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to \$28.0 million under a similar agreement. The Federal Reserve Bank also serves as an important source of borrowing capacity. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging to the FHLB. At December 31, 2015, based upon our available unencumbered collateral, Banner Bank was eligible to borrow \$735.0 million from the Federal Reserve Bank, although at that date we had no funds borrowed under this arrangement. Although eligible to participate, Islanders Bank has not applied for approval to borrow from the Federal Reserve Bank. For additional information concerning our borrowings, see Item 7 in this report, “Management’s Discussion and Analysis of Financial Condition—Comparison of Financial Condition at December 31, 2015 and 2014—Borrowings,” and Table 10 contained therein, and Notes 9 and 10 of the Notes to the Consolidated Financial Statements.

At December 31, 2015, Banner Bank had an uncommitted federal funds line of credit agreement with another financial institution totaling \$25 million, while Islanders Bank had an uncommitted federal funds line of credit agreement with another financial institution total \$5 million. No balances were outstanding under these agreements as of December 31, 2015. Availability of lines is subject to federal funds balances available for loan and continued borrower eligibility. These lines are intended to support short-term liquidity needs and the agreements may restrict consecutive day usage.

We issue retail repurchase agreements, generally due within 90 days, as an additional source of funds, primarily in connection with cash management services provided to our larger deposit customers. At December 31, 2015, we had issued retail repurchase agreements totaling \$93.3 million. We also may borrow funds through the use of secured wholesale repurchase agreements with securities brokers; at December 31, 2015, we had one wholesale repurchase borrowing with a carrying value of \$5.0 million. The retail and wholesale repurchase borrowings were secured by pledges of certain U.S. Government and agency notes and mortgage-backed securities with a market value of \$110.1 million.

We have also issued \$120.0 million of junior subordinated debentures in connection with the sale of trust preferred securities (TPS). The TPS were issued from 2002 through 2007 by special purpose business trusts formed by Banner Corporation and were sold in private offerings to pooled investment vehicles. In addition, Banner has \$16.0 million of junior subordinated debentures that were acquired through the Siuslaw Bank and AmericanWest acquisitions, for a total of \$136.0 million in debentures at December 31, 2015. The junior subordinated debentures associated with the TPS have been recorded as liabilities and are reported at fair value on our Consolidated Statements of Financial Condition. As of December 31, 2015 the fair value of the junior subordinate debentures was \$92.5 million. All of the debentures issued to the trusts, measured at their fair value, less the common stock of the trusts, qualified as Tier I capital as of December 31, 2015, under guidance issued by the Board of Governors of the Federal Reserve System. We invested substantially all of the proceeds from the issuance of the TPS as additional paid in capital at Banner Bank. See Note 11, Junior Subordinated Debentures and Mandatorily Redeemable Trust Preferred Securities, of the Notes to the Consolidated Financial Statements.

## Personnel

As of December 31, 2015, we had 1,918 full-time and 225 part-time employees. Banner Corporation has no employees except for those who are also employees of Banner Bank, its subsidiaries, and Islanders Bank. The employees are not represented by a collective bargaining unit. We believe our relationship with our employees is good.

## Taxation

### Tax-Sharing Agreement

Banner Corporation files its federal and state income tax returns on a consolidated basis under a tax-sharing agreement between the Company and each bank subsidiary. The Company prepares each subsidiary's minimum income tax which would be required if the individual subsidiary were to file federal and state income tax returns as a separate entity. Each subsidiary pays to the Company an amount equal to the estimated income tax due if it were to file as a separate entity. The payment is made on or about the time the subsidiary would be required to make such tax payments to the United States Treasury or the applicable State Departments of Revenue. In the event the computation of the subsidiary's federal or state income tax liability, after taking into account any estimated tax payments made, would result in a refund if the subsidiary were filing income tax returns as a separate entity, then the Company pays to the subsidiary an amount equal to the hypothetical refund. The Company is an agent for each subsidiary with respect to all matters related to the consolidated tax returns and refunds claims. If Banner's consolidated federal or state income tax liability is adjusted for any period, the liability of each party under the tax-sharing agreement is recomputed to give effect to such adjustments and any additional payments required as a result of the adjustments are made within a reasonable time after the corresponding additional tax payments are made or refunds are received.

## Federal Taxation

General: For tax reporting purposes, we report our income on a calendar year basis using the accrual method of accounting on a consolidated basis. We are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the reserve for bad debts. Reference is made to Note 12, Income Taxes, of the Notes to the Consolidated Financial Statements for additional information concerning the income taxes payable by us.

## State Taxation

Washington Taxation: We are subject to a Business and Occupation (B&O) tax which is imposed under Washington law at the current rate of 1.50% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities is not subject to this tax.

California, Oregon, Idaho and Utah Taxation: Corporations with nexus in the states of California, Oregon, Idaho and Utah are subject to a corporate level income tax. As our operations in these states increase, the state income tax provision will have an increasing effect on our effective tax rate and results of operations.

## Competition

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

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

## Regulation

### Banner Bank and Islanders Bank

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

Federal and state banking laws and regulations govern all areas of the operation of the Banks, including reserves, loans, investments, deposits, capital, issuance of securities, payment of dividends and establishment of

branches. Federal and state bank regulatory agencies also have the general authority to limit the dividends paid by insured banks and bank holding companies if such payments should be deemed to constitute an unsafe and unsound practice. The Federal Reserve Board and FDIC as the respective primary federal regulators of Banner Corporation and each of Banner Bank and Islanders Bank have authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks from engaging in unsafe or unsound practices.

The laws and regulations affecting banks and bank holding companies have changed significantly, particularly in connection with the enactment of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Among other changes, the Dodd-Frank Act established the Consumer Financial Protection Bureau (CFPB) as an independent bureau of the Federal Reserve Board. The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new federal or state legislation may have in the future. For additional information concerning the Dodd-Frank Act and the CFPB, see Item 1A., “Risk Factors—We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations that are expected to increase our costs of operation” and “We may be subject to additional regulatory scrutiny if and when Banner or Banner Bank’s total assets exceed \$10.0 billion.”

The following is a summary discussion of certain laws and regulations applicable to Banner and the Banks which is qualified in its entirety by reference to the actual laws and regulations.

**State Regulation and Supervision:** As a Washington state-chartered commercial bank with branches in the States of Washington, Oregon, Idaho, California, and Utah, Banner Bank is subject not only to the applicable provisions of Washington law and regulations, but is also subject to Oregon, Idaho, California and Utah law and regulations. These state laws and regulations govern Banner Bank's ability to take deposits and pay interest thereon, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers and to establish branch offices. In a similar fashion, Washington state laws and regulations for state-chartered commercial banks also apply to Islanders Bank.

**Deposit Insurance:** The Deposit Insurance Fund of the FDIC insures deposit accounts of the Banks up to \$250,000 per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions.

The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the reserve ratio for the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as the Banks. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the deposit insurance fund.

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

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

unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Capital Requirements: Bank holding companies, such as Banner Corporation, and federally insured financial institutions, such as Banner Bank and Islanders Bank, are required to maintain a minimum level of regulatory capital.

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), Banner Corporation and the Banks became subject to new capital regulations adopted by the Federal Reserve and the FDIC, which create a new required ratio for common equity Tier 1 (“CET1”) capital, increase the minimum leverage and Tier 1 capital ratios, change the risk-weightings of certain assets for purposes of the risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios, and change what qualifies as capital for purposes of meeting the capital requirements. These regulations implement the regulatory capital reforms required by the Dodd Frank Act and the “Basel III” requirements.

Under the new capital regulations, the minimum capital ratios are: (1) a CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total risk-based capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio (the ratio of Tier 1 capital to average total consolidated assets) of 4.0%. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income (“AOCI”) unless an institution elects to exclude AOCI from regulatory capital; and certain minority interests; all subject to applicable regulatory adjustments and deductions. Tier 1 capital generally consists of CET1 and noncumulative perpetual preferred stock. Tier 2 capital generally consists of other preferred stock and subordinated debt meeting certain conditions plus an amount of the allowance for loan and lease losses up to 1.25% of assets. Total capital is the sum of Tier 1 and Tier 2 capital.

There are a number of changes in what constitutes regulatory capital compared to the rules in effect prior to January 1, 2015, some of which are subject to transition periods. These changes include the phasing-out of certain instruments as qualifying capital and eliminate or significantly reduce the use of hybrid capital instruments, especially trust preferred securities, as regulatory capital. Trust preferred securities issued by a company, such as the Company, with total consolidated assets of less than \$15 billion before May 19, 2010 and treated as regulatory capital are grandfathered, but any such securities issued later are not eligible as regulatory capital under the new regulations. Mortgage servicing assets and deferred tax assets over designated percentages of CET1 will be deducted from capital. In addition, Tier 1 capital includes AOCI, which includes all unrealized gains and losses on available for sale debt and equity securities. However, because of our asset size, we were eligible for the one-time option of permanently opting out of the inclusion of unrealized gains and losses on available for sale debt and equity securities in our capital calculations. We elected this option in the first quarter of 2015.

For purposes of determining risk-based capital, assets and certain off-balance sheet items are risk-weighted from 0% to 1,250%, depending on the risk characteristics of the asset or item. The new regulations make certain changes in the risk-weighting of assets to better reflect credit risk and other risk exposure compared to the earlier capital rules. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (up from 0%); and a 250% risk weight (up from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital.

In addition to the minimum CET1, Tier 1, leverage ratio and total capital ratios, Banner and each of the Banks must maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, repurchasing shares, and paying discretionary bonuses. The new capital conservation buffer requirement is to be phased in beginning on January 1, 2016 when a buffer greater than 0.625% of risk-weighted assets will be required, which amount will increase each year until the buffer requirement is fully implemented on January 1, 2019.

To be considered "well capitalized," a bank holding company must have, on a consolidated basis, a total risk-based capital ratio of 10.0% or greater and a Tier 1 risk-based capital ratio of 6.0% or greater and must not be subject to an individual order, directive or agreement under which the FRB requires it to maintain a specific capital level. To be considered "well capitalized," a depository institution must have a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10%, a CET1 capital ratio of at least 5% and a leverage ratio of at least 5% and not be subject to an individualized order, directive or agreement under which its primary federal banking regulator requires it to maintain a specific capital level.

As of December 31, 2015, Banner Corporation and each of the Banks met the requirements to be "well capitalized" and the fully phased-in capital conservation buffer requirement.

**Prompt Corrective Action:** Federal statutes establish a supervisory framework for FDIC-insured institutions based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures. The well-capitalized category is described above. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. To be considered adequately capitalized, an institution must have the minimum capital ratios described above. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by either

Banner Bank and Islanders Bank to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At December 31, 2015, both Banner Bank and Islanders Bank were categorized as “well capitalized” under the prompt corrective action regulations of the FDIC. For additional information, see Note 16, Regulatory Capital Requirements, of the Notes to the Consolidated Financial Statements.

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

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



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

The guidance provides that the strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory guidance on evaluation of capital adequacy. As of December 31, 2015, Banner Bank's and Islanders Bank's aggregate recorded loan balances for construction, land development and land loans were 58% and 27% of total regulatory capital, respectively. In addition, at December 31, 2015, Banner Bank's and Islanders Bank's loans on commercial real estate were 292% and 215% of total regulatory capital, respectively.

Activities and Investments of Insured State-Chartered Financial Institutions: Federal law generally limits the activities and equity investments of FDIC insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (1) acquiring or retaining a majority interest in a subsidiary, (2) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank's total assets, (3) acquiring up to 10% of the voting stock of a company that solely provides or re-insures directors', trustees' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (4) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

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

Environmental Issues Associated With Real Estate Lending: The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) is a federal statute that generally imposes strict liability on all prior and present "owners and operators" of sites containing hazardous waste. However, Congress acted to protect secured creditors by providing that the term "owner and operator" excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this "secured creditor exemption" has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including Banner Bank and Islanders Bank, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System: The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Interest-bearing checking accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits at a bank. At December 31, 2015, the Banks' deposits with the Federal Reserve Bank and vault cash exceeded their reserve requirements.

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

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

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

require FDIC and DFI approval because Banner Bank remains in a cumulative negative retained earnings position primarily as a result of goodwill impairment recorded in 2010 and more recently the special dividend paid to the Company to fund the acquisition of Starbuck.

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

**Anti-Money Laundering and Customer Identification:** The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act) was signed into law on October 26, 2001. The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on Bank Holding Company Act and Bank Merger Act applications. Banner Bank's and Islanders Bank's policies and procedures comply with the requirements of the USA Patriot Act.

**Other Consumer Protection Laws and Regulations:** The Dodd-Frank Act established the CFPB and empowered it to exercise broad regulatory, supervisory and enforcement authority with respect to both new and existing consumer financial protection laws. The Banks are subject to consumer protection regulations issued by the CFPB, but as financial institutions with assets of less than \$10 billion, the Banks are generally subject to supervision and enforcement by the FDIC and the Washington DFI with respect to our compliance with consumer financial protection laws and CFPB regulations.

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

#### Banner Corporation

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

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

**The Bank Holding Company Act:** Under the BHCA, we are supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd-Frank Act and earlier Federal Reserve policy provide that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial distress to the banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. No regulations have yet been proposed by the Federal Reserve to implement the source of strength doctrine required by the Dodd-Frank Act. Banner Corporation and any subsidiaries that it may control are considered "affiliates" within the meaning of the Federal Reserve Act, and transactions between Banner Bank and affiliates are subject to numerous restrictions. With some exceptions, Banner Corporation and its subsidiaries are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by Banner Corporation or by its affiliates.

**Acquisitions:** The BHCA prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. Under the BHCA, the Federal Reserve may approve the ownership of shares by a bank holding company in any company, the activities of which the Federal Reserve has determined to be so closely related to the

business of banking or managing or controlling banks as to be a proper incident thereto. These activities include: operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

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

**The Dodd-Frank Act:** On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank-Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations for Banner Corporation and the Banks are subject to and that are discussed above under the section entitled "Capital Requirements."

In addition, among other changes, the Dodd-Frank Act requires public companies, like Banner Corporation, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a "say on pay" vote every one, two or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees. For certain of these changes, the implementing regulations have not been promulgated, so the full impact of the Dodd-Frank Act on public companies cannot be determined at this time.

The federal banking agencies have issued final rules to implement the provisions of Section 619 of the Dodd Frank Act commonly referred to as the Volcker Rule. The regulations contain prohibitions and restrictions on the ability of financial institutions holding companies and their affiliates to engage in proprietary trading and to hold certain interests in, or to have certain relationships with, various types of investment funds, including hedge funds and private equity funds. The regulations became effective on April 1, 2014 with full compliance required by July 21, 2015. Banner Corporation is continuously reviewing its investment portfolio to determine if changes in its investment strategies are in compliance with the various provisions of the Volcker Rule regulations.

**Sarbanes-Oxley Act of 2002:** As a public company that files periodic reports with the Securities and Exchange Commission (SEC), under the Securities Exchange Act of 1934, Banner Corporation is subject to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), which addresses, among other issues, corporate governance, auditing and accounting, executive compensation and enhanced and timely disclosure of corporate information. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

**Interstate Banking and Branching:** The Federal Reserve must approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding

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

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

Dividends: The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses its view that although there are no specific regulations restricting dividend payments by bank holding companies other than state corporate laws, a bank holding company must maintain an adequate capital position and generally should not pay cash dividends unless the company's net income for the past year is sufficient to fully fund the cash dividends and that the prospective rate of earnings appears consistent with the company's capital needs, asset quality, and overall financial condition. The Federal Reserve policy statement also indicates that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. As described above under "Capital

Requirements,” beginning January 1, 2016 the capital conversion buffer requirement can also restrict Banner Corporation’s and the Banks’ ability to pay dividends.

Stock Repurchases: A bank holding company, except for certain “well-capitalized” and highly rated bank holding companies, is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding twelve months, is equal to 10% or more of its consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order or any condition imposed by, or written agreement with, the Federal Reserve. During the year ended December 31, 2015, Banner Corporation had no repurchases of its common stock.

## Management Personnel

### Executive Officers

The following table sets forth information with respect to the executive officers of Banner Corporation and Banner Bank as of December 31, 2015:

Name	Age	Position with Banner Corporation	Position with Banner Bank
Mark J. Grescovich	51	President, Chief Executive Officer, Director	President, Chief Executive Officer, Director
Lloyd W. Baker	67	Executive Vice President, Chief Financial Officer	Executive Vice President
Richard B. Barton	72		Executive Vice President, Chief Lending Officer
Douglas M. Bennett	63		Executive Vice President, Real Estate Lending Operations
Tyrone J. Bliss	58		Executive Vice President, Risk Management and Compliance Officer
James R. Claffee	70		Executive Vice President, Chief Integration Officer
Peter J. Conner	50		Executive Vice President, Chief Financial Officer
Kenneth A. Larsen	46		Executive Vice President, Mortgage Banking
Cynthia D. Purcell	58		Executive Vice President, Retail Banking and Administration
M. Kirk Quillin	53		Executive Vice President, East Region, Commercial Banking
James T. Reed, Jr.	53		Executive Vice President, West Region, Commercial Banking
Steven W. Rust	68		Executive Vice President, Chief Information Officer
Gary W. Wagers	55		Executive Vice President, Retail Products and Services
Keith A. Western	60		Executive Vice President, California & S. Oregon Commercial Banking

Biographical Information

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

20

---



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

Lloyd W. Baker joined First Savings Bank of Washington (now Banner Bank) in 1995 as Asset/Liability Manager, has been a member of the executive management committee since 1998 and has served as the Chief Financial Officer of Banner Corporation since 2000 and of Banner Bank from 2000 to October 2015. His banking career began in 1973.

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

Douglas M. Bennett, who joined First Federal Savings and Loan (now Banner Bank) in 1974, has over 39 years of experience in real estate lending. He has served as a member of Banner Bank's executive management committee since 2004.

Tyrone J. Bliss joined Banner Bank in 2002 and has served in his current position since 2006. Mr. Bliss is a Certified Regulatory Compliance Manager with more than 36 years of commercial banking experience. Prior to joining Banner Bank, his career included senior risk management and compliance positions with Bank of America's Consumer Finance Group, Barnett Banks, Inc., and Florida-based community banks.

James R. Claffee joined Banner Bank in 2015 upon the acquisition of AmericanWest. Mr. Claffee has more than 40 years of experience in banking and has served in senior executive positions with banks located in Washington, Arizona, California and New England. Mr. Claffee was President and Chief Operating Officer of AmericanWest and Starbuck, responsible for strategic growth in the region and for the integration of nine acquisitions over the previous four years. Mr. Claffee is a graduate of Tufts University. He holds an M.B.A. from San Diego State University. He also completed the Liberal Arts Program for Senior Managers at Stanford, The J.L. Kellogg School of International Management, and attended the Stonier Graduate School of Banking. He has been active in charitable and philanthropic organizations throughout his career. Mr. Claffee is a Vietnam veteran and served as an officer in the U.S. Navy.

Peter J. Conner joined Banner Bank in 2015 upon the acquisition of AmericanWest. Prior to joining Banner, Mr. Conner was the Chief Financial Officer for SKBHC LLC, the holding company for Starbuck, (SKBHC) and AmericanWest from 2010 until he joined Banner Bank in 2015. Mr. Conner has 25 years of experience in executive finance positions at Wells Fargo Bank as well as regional community banks. Additionally, he spent time as a managing director for FSI Group, where he evaluated and placed equity fund investments in community banks. He earned a B.S. in Quantitative Economics from the University of California at San Diego and a Masters of Business from the Haas School of Business at U.C. Berkeley.

Kenneth A. Larsen joined Banner Bank in 2005 as the Real Estate Administration Manager and was promoted to Mortgage Banking Director in 2010. Mr. Larsen is responsible for Banner Bank's mortgage banking activities from origination, administration, secondary marketing, through loan servicing. Mr. Larsen has had a 24-year career in mortgage banking, including holding positions in all facets of operations and management. A graduate of Eastern

Washington University, he earned a Bachelor of Arts in Education with a degree in Social Science and earned certificates from the Pacific Coast Banking School and the School of Mortgage Banking. He is also a Certified Mortgage Banker, the highest designation recognized by the Mortgage Bankers Association. Mr. Larsen began his career at Action Mortgage/Sterling Savings, later moving to Peoples Bank of Lynden where he managed the mortgage banking operation. Mr. Larsen also served as the 90th President of the Seattle Mortgage Bankers Association. Currently he is the Chairman of the Washington Mortgage Bankers Association and a recent appointee by the Governor of Washington State to serve as a commissioner on the Washington State Housing Finance Commission. He was promoted to Executive Vice President in 2015.

Cynthia D. Purcell was formerly the Chief Financial Officer of Inland Empire Bank (now Banner Bank), which she joined in 1981. She has served as Executive Vice President since 2000. Ms. Purcell is responsible for managing Retail Banking including Mortgage Banking, Small Business Banking and Digital Delivery Channels, as well as administrative support functions for the organization.

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

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

Steven W. Rust joined Banner Bank in October 2005 as Senior Vice President and Chief Information Officer and was named to his current position as Executive Vice President and Chief Information Officer in September 2007. Mr. Rust has over 37 years of relevant industry experience prior to joining Banner Bank and was founder and President of InfoSoft Technology, through which he worked for nine years as a technology consultant and interim Chief Information Officer for banks and insurance companies. He also worked 19 years with US Bank/West One Bancorp as Senior Vice President & Manager of Information Systems.

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

Keith A. Western is Executive Vice President, Commercial Banking for Banner Bank, joining Banner upon the merger of AmericanWest and Banner Bank. Prior to the merger, Mr. Western was President of Northwest Banking for AmericanWest since 2011. Mr. Western has 38 years of banking experience across multiple markets including the western, eastern and mid-western United States and Canada. The bulk of Mr. Western's career was with Bank of America (approximately 15 years) and Citibank (approximately 12 years) in a variety of assignments including asset based lending, commercial and business banking, and credit risk management.

#### Corporate Information

Our principal executive offices are located at 10 South First Avenue, Walla Walla, Washington 99362. Our telephone number is (509) 527-3636. We maintain a website with the address [www.bannerbank.com](http://www.bannerbank.com). The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own Internet access charges, we make available free of charge through our website our Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we have electronically filed such material with, or furnished such material to, the Securities and Exchange Commission.

Item 1A – Risk Factors

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

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

Our operations are significantly affected by national and regional economic conditions. Weakness in the national economy or the economies of the markets in which we operate could have a material adverse effect on our financial condition, results of operations and prospects. Most of our loans are to businesses and individuals in the states of Washington, Oregon, California, Utah and Idaho. All of our branches and most of our deposit customers are also located in these five states. Further, as a result of a high concentration of our customer base in the Puget Sound area and eastern Washington state regions, the deterioration of businesses in these areas, or one or more businesses with a large employee base in these areas, could have a material adverse effect on our business, financial condition, liquidity, results of operations and prospects. Weakness in the global economy has adversely affected many businesses operating in our markets that are dependent upon international trade. In addition, adverse weather conditions as well as decreases in market prices for agricultural products grown in our primary markets can adversely affect agricultural businesses in our markets. As we expand our presence in areas such as San Diego and Sacramento, California and Salt Lake City, Utah, we will be exposed to concentration risks in those areas as well.

A deterioration in economic conditions in the market areas we serve, in particular the Puget Sound area of Washington State, the Portland, Oregon metropolitan area, Spokane, Washington, Boise, Idaho, Eugene and southwest Oregon, San Diego and Sacramento, California and Salt Lake City, Utah and the agricultural regions of the Columbia Basin, could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, liquidity and results of operations:

- demand for our products and services may decline;
- loan delinquencies, problem assets and foreclosures may increase;
- collateral for loans, especially real estate, may decline in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our low-cost or non-interest-bearing deposits may decrease.

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

Economic conditions have improved since the end of the economic recession that officially ended in June, 2009; however, economic growth has been slow and uneven, and concerns still exist over the federal deficit, government spending, along with the global economy and geopolitical risks which have all contributed to diminished expectations for the economy. A return of recessionary conditions and/or negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments,

and our ongoing operations, costs and profitability. Declines in real estate values and sales volumes and high unemployment levels may result in higher than expected loan delinquencies and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect our capital, liquidity, and financial condition.

Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. The Federal Reserve Board has recently increased the federal funds rate by 25 basis points and indicated further increases in the federal funds rate in 2016. As the federal funds rate increases, market interest rates would likely rise, which may negatively affect the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

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

In addition to first-lien one- to four -family residential real estate lending, we originate construction and land loans, commercial and multifamily mortgage loans, commercial business loans, agricultural mortgage loans and agricultural loans, and consumer loans, primarily within our market areas. We had \$6.36 billion outstanding in these types of higher risk loans at December 31, 2015 compared to \$3.29 billion at December 31, 2014. These loans typically present different risks to us for a number of reasons, including those discussed below:

Construction and Land Loans. At December 31, 2015, construction and land loans were \$574.4 million or 8% of our total loan portfolio. This type of lending contains the inherent difficulty in estimating both a property's value at completion of the project and

the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Loans on land under development or held for future construction also pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand conditions. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell the property, rather than the ability of the borrower or guarantor to independently repay principal and interest. While our origination of these types of loans has decreased significantly from earlier periods, as a result of the recent improvement in real estate values in certain of our market areas, this category of lending has increased in recent years and our investment in construction and land loans increased by \$163.4 million or 40% in 2015. At December 31, 2015, construction and land loans that were non-performing were \$2.3 million, or 15% of our total non-performing loans.

**Commercial and Multifamily Real Estate Loans.** At December 31, 2015, commercial and multifamily real estate loans were \$3.57 billion, or 49% of our total loan portfolio. These loans typically involve higher principal amounts than other types of loans and some of our commercial borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan. Repayment of these loans is dependent upon income being generated from the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. This risk was exacerbated in the recent recession and could remain an elevated risk in the current slow recovery economic environment. At December 31, 2015, commercial and multifamily real estate loans that were non-performing were \$3.8 million, or 25% of our total non-performing loans.

**Commercial Business Loans.** At December 31, 2015, commercial business loans were \$1.21 billion, or 17% of our total loan portfolio. Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may prove to be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise, may be illiquid and may fluctuate in value based on the success of the business. At December 31, 2015, commercial business loans that were non-performing were \$2.2 million, or 14% of our total non-performing loans.

**Agricultural Loans.** At December 31, 2015, agricultural loans were \$376.5 million, or 5% of our total loan portfolio. Repayment is dependent upon the successful operation of the business, which is greatly dependent on many things outside the control of either us or the borrowers. These factors include weather, commodity prices, and interest rates among others. Collateral securing these loans may be difficult to evaluate, manage or liquidate and may not provide an adequate source of repayment. At December 31, 2015, there were \$697,000 of agricultural loans that were non-performing or 5% of total non-performing loans.

**Consumer Loans.** At December 31, 2015, consumer loans were \$636.9 million, or 9% of our total loan portfolio. Consumer loans (such as personal lines of credit) are collateralized, if at all, with assets that may not

provide an adequate source of payment of the loan due to depreciation, damage, or loss. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. At December 31, 2015, consumer loans that were non-performing were \$748,000, or 5% of our total non-performing loans.

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

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

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

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

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

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, we may need additional provisions to replenish the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and, most likely, capital, and may have a material negative effect on our financial condition and results of operations.

We pursue a strategy of supplementing internal growth by acquiring other financial companies or their assets and liabilities that we believe will help us fulfill our strategic objectives and enhance our earnings. There are risks associated with this strategy, including the following:

- We may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets, and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;
- Prices at which acquisitions can be made fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we will experience this condition in the future;
- The acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal adverse effect on the acquired business and its customers, we may not realize the anticipated economic benefits of particular acquisitions within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful;
- To the extent our costs of an acquisition exceed the fair value of the net assets acquired, the acquisition will generate goodwill. As discussed below, we are required to assess our goodwill for impairment at least annually, and any goodwill impairment charge could have a material adverse effect on our results of operations and financial condition;
- To finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders; and
- We have completed various acquisitions in the past few years that enhanced our rate of growth. We may not be able to continue to sustain our past rate of growth or to grow at all in the future.

The success of our acquisitions of Siuslaw Bank and of AmericanWest is dependent on a number of factors beyond our control.



The success of our acquisitions of Siuslaw Bank and AmericanWest, including Greater Sacramento Bancorp ("GSB"), which was recently acquired by AmericanWest prior to its merger with Banner Bank, is subject to a number of uncertain factors, including, but not limited to:

our ability to realize expected revenues, cost savings, synergies and other benefits from the Siuslaw Bank and AmericanWest acquisitions within the expected time frames or at all, and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, might be greater than expected; and the credit quality of loans and other assets acquired from AmericanWest and Siuslaw Bank.

Banner, AmericanWest and Siuslaw Bank each operated independently before the completion of the relevant acquisition. The success of the acquisitions, including anticipated benefits and cost savings, will depend, in part, on Banner's ability to successfully combine the businesses of Banner, AmericanWest and Siuslaw Bank. To realize these anticipated benefits and cost savings, Banner has begun to integrate AmericanWest's and Siuslaw Bank's businesses into its own. It is possible that as we continue to fully integrate these businesses, the process could result in the loss of key employees, the disruption of our ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect the combined company's ability to maintain relationships with clients, customers, depositors and employees or to achieve the anticipated benefits and cost savings of the mergers. The loss of key employees could adversely affect Banner's ability to successfully conduct its business in the markets in which AmericanWest or Siuslaw Bank's branches have operated and could have an adverse effect on Banner's financial results and the value of its common stock.

Prior to the acquisitions, neither Starbuck nor Siuslaw nor their respective subsidiaries were subject to the requirements of the Exchange Act with respect to internal controls over financial reporting. If the internal controls over financial reporting by Starbuck or Siuslaw or their respective subsidiaries was found to be ineffective, a material weakness in internal controls could result and the integrity of our financial reporting could be compromised, which could result in a material adverse effect on our reported financial results. In addition, the integration of the financial reporting functions of each of Starbuck, Siuslaw and their respective subsidiaries into our own will require significant effort and any failure could affect the quality of our financial reporting, and could result in a material adverse effect on our reported financial results.

If Banner experiences difficulties with the integration process, the anticipated benefits of the acquisitions may not be realized fully or at all, or may take longer to realize than expected. As with any merger of financial institutions, there also may be business disruptions, including upon the conversion of customers from the legacy systems of AmericanWest or Siuslaw Bank to our own, that cause Banner, AmericanWest or Siuslaw Bank to lose customers or cause customers to close their accounts with Banner, AmericanWest or Siuslaw Bank and move their business to competing financial institutions. Integration efforts between the companies will also divert management attention and require significant resources, including an increase in compliance costs. Any such distraction on the part of management, if significant, could affect Banner's ability to service existing business and develop new business and adversely affect our business and earnings.

These acquisitions may also have an effect on the value of Banner common stock because market participants may look at factors different from those currently affecting the values of Banner common stock. See also "We may be subject to additional regulatory scrutiny if and when Banner Bank's total assets exceed \$10.0 billion."

In connection with any acquisition, we may incur material acquisition-related or restructuring charges, which may have a material adverse effect on our results of operations. These charges relate to items such as severance and benefits costs, expenses related to branch consolidation charges, vendor contract termination costs, expenses related to IT systems integration and conversion, incurrence of professional services and consulting fees and other items.

The required accounting treatment of loans we acquire through acquisitions including purchase credit impaired loans could result in higher net interest margins and interest income in current periods and lower net interest margins and interest income in future periods.

Under GAAP, we are required to record loans acquired through acquisitions, including purchase credit impaired loans, at fair value. Estimating the fair value of such loans requires management to make estimates based on available information and facts and circumstances on the acquisition date. Actual performance could differ from management's initial estimates. If these loans outperform our original fair value estimates, the difference between our original estimate and the actual performance of the loan (the "discount") is accreted into net interest income. Thus, our net interest margins may initially increase due to the discount accretion. We expect the yields on our loans to decline as our acquired loan portfolio pays down or matures and the discount decreases, and we expect downward pressure on our interest income to the extent that the runoff on our acquired loan portfolio is not replaced with comparable high-yielding loans. This could result in higher net interest margins and interest income in current periods and lower net interest rate margins and lower interest income in future periods.

Our expansion into new market areas in California and Utah may present increased risk.

AmericanWest's lending operations were concentrated in the states of California, Utah, Oregon, Idaho and Washington. The merger with AmericanWest resulted in Banner's initial entry into the states of California and Utah where Banner has little or no operating experience. Although Banner retained a number of AmericanWest's lending and business development officers with experience in these markets, Banner is new to these market areas and has

conducted only limited banking business in California and Utah. Our entry into these markets presents us with different competitive conditions, customer preferences and banking products than we have experienced in the Pacific Northwest markets we know. As a result, it is possible that our operations in these states may be less successful than our operations in the Pacific Northwest. In addition, our financial condition and results of operations will be subject to general economic conditions and the conditions in the real estate markets prevailing in California and Utah as well as the Pacific Northwest markets we know. If economic conditions in any one of these states worsens or if the real estate market declines, we may suffer decreased net income or losses associated with higher default rates and decreased collateral values on our existing portfolio, and we may not be able to originate loans at acceptable risk levels and upon acceptable terms to maintain our risk profile and asset quality.

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

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. We may at some point, however, need to raise additional capital to support continued growth or be required by our regulators to increase our capital resources. Any capital we obtain may result in the dilution of the interests of existing holders of our common stock. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. Accordingly, we cannot make assurances that we will be able to raise additional capital if needed on terms that are acceptable to us, or at all. If we cannot raise additional capital when needed, our ability to further expand our operations could be materially impaired and our financial condition and liquidity could be materially and adversely affected. In addition, if we are unable to raise additional capital when required by our bank regulators, we may be subject to adverse regulatory action.

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

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

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

Our securities portfolio may be negatively impacted by fluctuations in market value and interest rates.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. Fluctuations in market value may be caused by changes in market interest rates, lower market prices for securities and limited investor demand. Our securities portfolio is evaluated for other-than-temporary impairment. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. Changes in interest rates can also have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.

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

Our mortgage banking operations provide a significant portion of our non-interest income. We generate mortgage banking revenues primarily from gains on the sale of one- to four-family and multifamily mortgage loans. The one- to four-family mortgage loans are sold pursuant to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae and non-Government Sponsored Enterprise (GSE) investors. These entities account for a substantial portion of the secondary market in residential one- to four-mortgage loans. Multifamily mortgage loans are sold primarily to non-GSE investors.

Any future changes in the one- to four-family programs, our eligibility to participate in these programs, the criteria for loans to be accepted or laws that significantly affect the activity of such entities, or a reduction in the size of the secondary market for multifamily loans could, in turn, materially adversely affect our results of operations. Mortgage banking is generally considered a volatile source of income because it depends largely on the level of loan volume which, in turn, depends largely on prevailing market interest rates. In a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold to investors. This would result in a decrease in mortgage banking revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations. In addition,

although we sell loans into the secondary market without recourse, we are required to give customary representations and warranties about the loans to the buyers. If we breach those representations and warranties, the buyers may require us to repurchase the loans and we may incur a loss on the repurchase.

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

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

A prolonged period of exceptionally low market interest rates, such as we are currently experiencing, limits our ability to lower our interest expense, while the average yield on our loan portfolio may continue to decrease as our loans reprice or are originated at these low market rates, which could have an adverse effect on our results of operations. As a result of the exceptionally low interest rate environment, an increasing percentage of our deposits have been comprised of deposits bearing no or a relatively low rate of interest. We would incur a higher cost of funds to retain these deposits in a rising interest rate environment. In addition, a substantial amount of our loans have adjustable interest rates. As a result, these loans may experience a higher rate of default in a rising interest rate environment. Further, a significant portion of our adjustable rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately 66% of our loan portfolio was comprised of adjustable or floating-rate loans at December 31, 2015, and approximately \$2.5 billion, or 52%, of those loans contained interest rate floors, below which the loans' contractual interest rate may not adjust. At December 31, 2015, the weighted average floor interest rate of these loans was 4.78%. At that date, approximately \$1.58 billion, or 63%, of these loans were at their floor interest rate. The inability

of our loans to adjust downward can contribute to increased income in periods of declining interest rates, although this result is subject to the risks that borrowers may refinance these loans during periods of declining interest rates. Also, when loans are at their floors, there is a further risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates which could have a material adverse effect on our results of operations.

Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition, liquidity and results of operations. Also, our interest rate risk modeling techniques and assumptions may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations that are expected to increase our costs of operations.

As state-chartered, federally insured commercial banks, Banner Bank and Islanders Bank (the Banks) are currently subject to extensive examination, supervision and comprehensive regulation by the FDIC and the Washington DFI and as a bank holding company Banner is subject to examination, supervision and regulation by the FRB. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution's operations, reclassify assets, determine the adequacy of an institution's allowance for loan losses and determine the level of deposit insurance premiums assessed.

Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) has significantly changed the bank regulatory structure and affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Certain provisions of the Dodd-Frank Act may have an indeterminable impact on us in the near term. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act created a new Consumer Financial Protection Bureau (the CFPB) with broad powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Financial institutions such as Banner Bank with \$10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators but are subject to the rules of the CFPB. See "We may be subject to additional regulatory scrutiny if and when Banner or Banner Bank's total assets exceed \$10.0 billion."

The CFPB has issued a number of final regulations and changes to certain consumer protections under existing laws. These final rules generally prohibit creditors from extending mortgage loans without regard for the consumer's ability-to-repay and add restrictions and requirements to mortgage origination and servicing practices. In addition, these rules limit prepayment penalties and require the creditor to retain evidence of compliance with the ability-to-repay requirement for three years. Compliance with these rules has increased our overall regulatory compliance costs and may require changes to our underwriting practices with respect to mortgage loans. This includes

compliance with The Truth in Lending Act and the Real Estate Settlement Procedures Act Integrated Disclosure (TRID) rule, which combines certain disclosures that consumers receive in connection with applying for and closing a mortgage loan. Moreover, these rules may adversely affect the volume of mortgage loans that we underwrite and may subject us to increased potential liabilities related to such residential loan origination activities.

The Dodd-Frank Act requires minimum leverage (Tier 1) and risk-based capital requirements for bank holding companies that are no less stringent than those applicable to banks, which could limit our ability to borrow at the holding company level and invest the proceeds from such borrowings as capital in the Banks, and excludes certain instruments that previously have been eligible for inclusion by bank holding companies as Tier 1 capital, such as trust preferred securities.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the rules and regulations implementing it will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs, which could adversely affect key operating efficiency ratios, and could increase our interest expense. See “Business - Regulation” contained in Part I, Item I of this report.

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

The banking industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company’s shareholders. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in this report under the heading “Item 1. Business-Regulation.” These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time. Any new regulations or legislation, change in existing regulations or oversight, whether a

change in regulatory policy or a change in a regulator's interpretation of a law or regulation, could have a material impact on our operations, increase our costs of regulatory compliance and of doing business and or otherwise adversely affect us and our profitability. Further, changes in accounting standards can be both difficult to predict and involve judgment and discretion in their interpretation by us and our independent registered public accounting firm. These changes could materially impact, potentially even retroactively, how we report our financial condition and results of our operations as could our interpretation of those changes.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions.

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions and limit our ability to get regulatory approval of acquisitions. Recently several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, no assurance can be given that these policies and procedures will be effective in preventing violations of these laws and regulations.

We may be subject to additional regulatory scrutiny if and when Banner or Banner Bank's total assets exceed \$10.0 billion.

Banner's total assets were \$9.80 billion and Banner Bank's total assets were \$9.52 billion at December 31, 2015. As a result of the closing of their respective mergers with Starbuck and AmericanWest, Banner and Banner Bank's assets are approaching \$10 billion. Following the fourth consecutive quarter where the total assets of Banner or Banner Bank exceed \$10 billion, Banner or Banner Bank, as applicable, will become subject to a number of additional requirements (such as annual stress testing requirements implemented pursuant to the Dodd-Frank Act and general oversight by the CFPB) that will impose additional compliance costs on our business. As a result, there may also be additional higher expectations from regulators. The CFPB has near exclusive supervision authority, including examination authority, over institutions of that size and their affiliates to assess compliance with federal consumer financial laws, to obtain information about the institutions' activities and compliance systems and procedures, and to detect and assess risks to consumers and markets.

Under the Dodd-Frank Act, the minimum ratio of net worth to insured deposits of the Deposit Insurance Fund was increased from 1.15% to 1.35% and the FDIC is required, in setting deposit insurance assessments, to offset the effect of the increase on institutions with assets of less than \$10 billion, which results in institutions with assets greater than \$10 billion paying higher assessments. In addition, if Banner Bank exceeds \$10 billion in assets, its assessment base for federal deposit insurance would change from the amount of insured deposits to consolidated average assets less tangible capital to a scorecard method. The scorecard method uses a performance score and a loss severity score, which are combined and converted into an initial base assessment rate. The performance score is based on measures of the bank's ability to withstand asset-related stress and funding-related stress and weighted CAMELS ratings, which are ratings ascribed under the CAMELS supervisory rating system and assigned based on a supervisory authority's analysis of a bank's financial statements and on-site examinations. The loss severity score is a measure of potential losses to the FDIC in the event of the bank's failure. Under a formula, the performance score and loss severity score are combined and converted to a total score that determines the bank's initial base assessment rate. The FDIC has the discretion to alter the total score based on factors not captured by the scorecard. The resulting initial base assessment rate is also subject to adjustments downward based on long term unsecured debt issued by the bank, to adjustment upward based on long term unsecured debt held by the bank that is issued by other FDIC-insured institutions, and to



further adjustment upward if the bank's brokered deposits exceed 10% of its domestic deposits.

Further, Banner Bank and Islanders Bank may be affected by the Durbin Amendment to the Dodd-Frank Act regarding limits on debit card interchange fees. The Durbin Amendment gave the Federal Reserve Board the authority to establish rules regarding interchange fees charged for electronic debit transactions by a payment card issuer that, together with its affiliates, has assets of \$10 billion or more and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The Federal Reserve Board has adopted rules under this provision that limit the swipe fees that a debit card issuer can charge a merchant for a transaction to the sum of 21 cents and five basis points times the value of the transaction, plus up to one cent for fraud prevention costs. Based on expected debit card volume, we believe we could experience a reduction of approximately \$10 million a year in debit card related fee income and pre-tax earnings following the implementation of the Durbin Amendment.

The Dodd-Frank Act also requires publicly-traded bank holding companies with assets of \$10 billion or more to perform capital stress testing and establish a risk committee responsible for enterprise-wide risk management practices, comprised of independent directors, including one risk management expert.

As a result of the above, if and when Banner's or Banner Bank's total assets exceed \$10 billion, deposit insurance assessments, expenses related to regulatory compliance are likely to increase, and interchange fee income will decrease, the cumulative effect of which may be significant.

We may experience future goodwill impairment.

In accordance with GAAP, we record assets acquired and liabilities assumed at their fair value with the excess of the purchase consideration over the net assets acquired resulting in the recognition of goodwill. As a result, acquisitions typically result in recording goodwill. We perform a goodwill evaluation at least annually to test for goodwill impairment. As part of our testing, we first assess qualitative factors to determine

whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If we determine the fair value of a reporting unit is less than its carrying amount using these qualitative factors, we then compare the fair value of goodwill with its carrying amount, and then measure impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. Adverse conditions in our business climate, including a significant decline in future operating cash flows, a significant change in our stock price or market capitalization, or a deviation from our expected growth rate and performance may significantly affect the fair value of our goodwill and may trigger additional impairment losses, which could be materially adverse to our operating results and financial position.

We cannot provide assurance that we will not be required to take an impairment charge in the future. Any impairment charge has an adverse effect on our results of shareholders' equity and financial results and could cause a decline in our stock price. The recent acquisitions of Starbuck, Siuslaw and their subsidiaries, AmericanWest and Siuslaw Bank, respectively, has substantially increased our goodwill.

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

Liquidity is essential to our business. We rely on a number of different sources in order to meet our potential liquidity demands. Our primary sources of liquidity are increases in deposit accounts, cash flows from loan payments and our securities portfolio. Borrowings also provide us with a source of funds to meet liquidity demands. An inability to raise funds through deposits, borrowings, the sale of loans or investment securities and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities or on terms which are acceptable to us could be impaired by factors that affect us specifically, or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the markets in which our loans are concentrated, negative operating results, or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry or deterioration in credit markets.

Additionally, collateralized public funds are bank deposits of state and local municipalities. These deposits are required to be secured by certain investment grade securities to ensure repayment, which on the one hand tends to reduce our contingent liquidity risk by making these funds somewhat less credit sensitive, but on the other hand reduces standby liquidity by restricting the potential liquidity of the pledged collateral. Although these funds historically have been a relatively stable source of funds for us, availability depends on the individual municipality's fiscal policies and cash flow needs.

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

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

impact the affected banking operations.

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

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

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

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

Our exposure to operational risks may adversely affect us.

Similar to other financial institutions, we are exposed to many types of operational risk, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, the risk that sensitive customer data or other data is compromised, and the risk of unauthorized transactions by employees or operational errors, including clerical or record-keeping errors. Nationally, reported incidents of fraud and other

financial crimes have increased. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur. If any of these risks occur, it could result in material adverse consequences for us.

We are subject to certain risks in connection with our use of technology.

Our security measures may not be sufficient to mitigate the risk of a cyber attack. Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger and virtually all other aspects of our business. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious code and cyber attacks that could have a security impact. If one or more of these events occur, this could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us. We could also suffer significant reputational damage.

Security breaches in our Internet banking activities could further expose us to possible liability and damage our reputation. Any compromise of our security also could deter customers from using our Internet banking services that involve the transmission of confidential information. We rely on standard Internet security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures, which could result in significant legal liability and significant damage to our reputation and our business.

Our security measures may not protect us from systems failures or interruptions. While we have established policies and procedures to prevent or limit the impact of systems failures and interruptions, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. The conversion of customers from legacy AmericanWest communication and information systems to our systems will be challenging and the complexity of the conversion may result in systems failures and interruptions. In addition, we outsource certain aspects of our data processing and other operational functions to certain third-party providers. If our third-party providers encounter difficulties, or if we have difficulty in communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely impacted. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

The occurrence of any failures or interruptions may require us to identify alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Further, the occurrence of any systems failure or interruption could damage our reputation and result in a loss of customers and business, could subject us to additional regulatory scrutiny, or could expose us to legal liability. Any of these occurrences could have a material adverse effect on our financial condition and results of operations.

Sales of substantial amounts of Banner's common stock in the open market by former Siuslaw and SKBHC shareholders could depress Banner's stock price.

Sales of a substantial number of shares of our common stock in the public markets and the availability of those shares for sale could adversely affect the market price of our common stock. The 1.32 million shares of Banner common

stock that were issued to shareholders of Siuslaw in the Siuslaw merger are freely tradeable without restrictions or further registration under the Securities Act of 1933. The 13.23 million shares of Banner common stock and non-voting common stock that were issued to equity holders of SKBHC in the merger of Banner and AmericanWest who did not become affiliates of Banner will be freely tradeable without restrictions or further registration in April 2016. In addition, certain of such equity holders of SKBHC benefit from registration rights that permit them to cause Banner to register their shares of Banner common stock and non-voting common stock for resale. Although the holders of the currently outstanding 1,424,466 shares of Banner non-voting common stock issued in connection with the acquisition of AmericanWest cannot vote on most matters today, upon a permitted transfer, such shares of non-voting common stock will convert into Banner common stock. Permitted transfers include, among others, transfers as part of a widely distributed public offering of Banner common stock. A registration statement contemplating such a public offering is currently on file with the SEC. That offering and any future sales of our common stock by former shareholders of Siuslaw and SKBHC, or anticipation that such sales may occur, may cause the market price of Banner common stock to decrease. These sales might also make it more difficult for Banner to sell equity or equity related securities at a time and price that it otherwise would deem appropriate.

We rely on dividends from Banner Bank for substantially all of our revenue at the holding company level.

We are an entity separate and distinct from our principal subsidiary, Banner Bank, and derive substantially all of our revenue at the holding company level in the form of dividends from that subsidiary. Accordingly, we are, and will be, dependent upon dividends from Banner Bank to pay the principal of and interest on our indebtedness, to satisfy our other cash needs and to pay dividends on our common stock. Banner Bank's ability to pay dividends is subject to its ability to earn net income and to meet certain regulatory requirements. In the event Banner Bank is unable to pay dividends to us, we may not be able to pay dividends on our common stock. Also, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors.

Our articles of incorporation contains a provision which could limit the voting rights of a holder of our common stock.

Our charter provides that any person or group who acquires beneficial ownership of our common stock in excess of 10.0% of the outstanding shares may not vote the excess shares. Accordingly, if you acquire beneficial ownership of more than 10.0% of the outstanding shares of our common stock, your voting rights with respect to our common stock will not be commensurate with your economic interest in our company.

Anti-takeover provisions could negatively affect our shareholders.

Provisions in our articles of incorporation and bylaws, the corporate laws of the state of Washington and federal laws and regulations could delay or prevent a third party from acquiring us, despite the possible benefit to our shareholders, or otherwise negatively affect the market value of our stock. These provisions, among others, include: a prohibition on voting shares of our common stock beneficially owned in excess of 10.0% of total shares outstanding; advance notice requirements for nominations for election to our board of directors and for proposing matters that shareholders may act on at shareholder meetings; and staggered three-year terms for directors. Our articles of incorporation also authorize our board of directors to issue preferred or other stock, and preferred or other stock could be issued as a defensive measure in response to a takeover proposal. In addition, because we are a bank holding company, the ability of a third party to acquire us is limited by applicable banking laws and regulations. The Bank Holding Company Act requires any bank holding company to obtain the approval of the Federal Reserve Board before acquiring 5% or more of any class of our voting securities. Any entity that is a holder of 25% or more of any class of our voting securities, or in some circumstances a holder of a lesser percentage, is subject to regulation as a bank holding company under the Bank Holding Company Act. Under the Change in Bank Control Act of 1978, as amended, any person (or persons acting in concert), other than a bank holding company, is required to notify the Federal Reserve Board before acquiring 10% or more of any class of our voting securities.

#### Item 1B – Unresolved Staff Comments

None.

#### Item 2 – Properties

Banner Corporation maintains its administrative offices and main branch office, which is owned by us, in Walla Walla, Washington. In total, as of December 31, 2015, we have 202 branch offices located in Washington, Oregon, California, Utah and Idaho. One hundred ninety-nine branches are Banner Bank branches and three of those 202 are Islanders Bank branches. Ninety-eight branches are located in Washington, 45 in Oregon, 37 in California, seven in Utah, and 15 in Idaho. Of these branch locations, approximately half are owned and the other half are leased facilities. In addition to the branch locations, we also have nine loan production offices spread throughout the same five-state area. All loan production offices are leased facilities. The lease terms for our branch and loan production offices are not individually material. Lease expirations range from one to 25 years. Administrative support offices are primarily in Washington, where we have eight facilities, of which we own four and lease four. Additionally, we have one leased administrative support office in Idaho and own one located in Oregon. In the opinion of management, all properties are adequately covered by insurance, are in a good state of repair and are appropriately designed for their present and future use.

#### Item 3 – Legal Proceedings

In the normal course of business, we have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. These claims and counter-claims typically arise during the course of collection efforts on problem loans

or with respect to action to enforce liens on properties in which we hold a security interest. We are not a party to any pending legal proceedings that we believe would have a material adverse effect on our financial condition or operations.

Item 4 – Mine Safety Disclosures

Not applicable.

## PART II

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

## Price Range of Common Stock and Dividend Information

Our voting common stock is principally traded on the NASDAQ Global Select Market under the symbol “BANR.” Shareholders of record as of December 31, 2015 totaled 1,717 based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or “street” name through various brokerage firms. The following tables show the reported high and low sale prices of our listed voting common stock for the periods presented as well as the cash dividends declared per share of common stock for each of those periods.

Year Ended December 31, 2015	High	Low	Cash Dividend Declared
First quarter	\$53.55	\$44.13	\$0.18
Second quarter	50.16	42.42	0.18
Third quarter	50.50	43.87	0.18
Fourth quarter	46.26	39.00	0.18
Year Ended December 31, 2014	High	Low	Cash Dividend Declared
First quarter	\$44.88	\$35.64	\$0.18
Second quarter	42.02	37.59	0.18
Third quarter	40.69	37.77	0.18
Fourth quarter	43.70	37.77	0.18

The timing and amount of cash dividends paid on our common stock depends on our earnings, capital requirements, financial condition and other relevant factors and is subject to the discretion of our board of directors. As a result of improved earnings, levels of capital, asset quality and financial condition, beginning in the first quarter of 2013 we increased the dividend, further increased it in the third quarter of 2013 and again increased it in the first quarter of 2014. There can be no assurance that we will pay dividends on our common stock in the future.

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

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



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

Payments of the distributions on our trust preferred securities (TPS) from the special purpose subsidiary trusts we sponsored are fully and unconditionally guaranteed by us. The junior subordinated debentures that we have issued to our subsidiary trusts are ranked senior to our shares of common stock. We must make required payments on the junior subordinated debentures before any dividends can be paid on our TPS and our common stock and, in the event of our bankruptcy, dissolution or liquidation, the interest and principal obligations under the junior subordinated debentures must be satisfied before any distributions can be made on our common stock. We may defer the payment of interest on each of the junior subordinated debentures for a period not to exceed 20 consecutive quarters, provided that the deferral period does not extend beyond the stated maturity. During such deferral period, distributions on the corresponding TPSs will also be deferred and we may not pay cash dividends to the holders of shares of our common stock. At December 31, 2015, we were current on all interest payments.

#### Issuer Purchases of Equity Securities

There were no repurchases of common stock by the Company during the quarter ended December 31, 2015. Further, no shares were surrendered by employees to satisfy tax withholding obligations upon the vesting of restricted stock grants in the fourth quarter of 2015.

On March 25, 2015, the Company announced that its Board of Directors had authorized the repurchase of up to 1,044,922 shares of the Company's common stock, or 5% of the Company's outstanding shares, all of which remain available for repurchase at December 31, 2015. Under the plan, shares may be repurchased by the Company in open market purchases. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

## Equity Compensation Plan Information

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

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

Index	Period Ended					
	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Banner Corporation	100.00	106.64	191.45	283.47	276.94	299.80
NASDAQ Composite	100.00	99.21	116.82	163.75	188.03	201.40
SNL Bank \$1B-\$5B	100.00	99.24	116.73	180.10	185.52	211.33
SNL Bank NASDAQ	100.00	88.73	105.75	152.00	157.42	169.94

\*Assumes \$100 invested in Banner Corporation common stock and each index at the close of business on December 31, 2010 and that all dividends were reinvested. Information for the graph was provided by SNL Financial L.C. © 2016.

## Item 6 – Selected Financial Data

The following condensed consolidated statements of financial condition and operations and selected performance ratios as of December 31, 2015, 2014, 2013, 2012, and 2011 and for the years then ended have been derived from our audited consolidated financial statements.

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

## FINANCIAL CONDITION DATA:

(In thousands)	December 31				
	2015	2014	2013	2012	2011
Total assets	\$9,796,298	\$4,723,163	\$4,388,257	\$4,265,264	\$4,257,312
Cash and securities <sup>(1)</sup>	1,655,290	708,609	772,614	811,902	754,396
Loans receivable, net	7,236,496	3,755,127	3,344,187	3,158,223	3,210,419
Deposits	8,055,068	3,898,950	3,617,926	3,557,804	3,475,654
Borrowings	324,186	187,436	184,234	160,000	212,649
Common shareholders’ equity	1,300,059	582,888	538,331	506,919	411,748
Preferred shareholders’ equity	—	—	—	—	120,702
Total shareholders’ equity	1,300,059	582,888	538,331	506,919	532,450
Shares outstanding	34,242	19,572	19,544	19,455	17,553
Shares outstanding excluding unearned, restricted shares held in ESOP	34,242	19,572	19,509	19,421	17,519

## OPERATING DATA:

(In thousands)	For the Year Ended December 31				
	2015	2014	2013	2012	2011
Interest income	\$254,433	\$190,661	\$179,712	\$187,162	\$197,563
Interest expense	12,154	10,789	12,996	19,514	32,992
Net interest income before provision for loan losses	242,279	179,872	166,716	167,648	164,571
Provision for loan losses	—	—	—	13,000	35,000
Net interest income	242,279	179,872	166,716	154,648	129,571
Deposit fees and other service charges	40,607	30,553	26,581	25,266	22,962
Mortgage banking operations revenue	17,720	10,249	11,170	13,812	6,146
Other-than-temporary impairment recoveries (losses)	—	—	409	(409)	) 3,000
Net change in valuation of financial instruments carried at fair value	(813)	) 1,374	(2,278)	) (16,515)	) (624)
All other non-interest income	4,778	12,815	8,780	5,136	3,531
Total non-interest income	62,292	54,991	44,662	27,290	35,015
REO operations expense (recoveries), net	397	(446)	) (689)	) 3,354	22,262
All other non-interest expenses	236,203	154,187	141,664	138,099	135,842
Total non-interest expense	236,600	153,741	140,975	141,453	158,104
Income before provision for income tax expense (benefit)	67,971	81,122	70,403	40,485	6,482
Provision for income tax expense (benefit)	22,749	27,052	24,189	(24,372)	) 1,025
Net income	\$45,222	\$54,070	\$46,214	\$64,857	\$5,457

(footnotes follow)

36

---

## PER COMMON SHARE DATA:

	At or For the Years Ended December 31				
	2015	2014	2013	2012	2011
Net income (loss):					
Basic	\$ 1.90	\$ 2.79	\$ 2.39	\$ 3.17	\$(0.15 )
Diluted	1.89	2.79	2.38	3.16	(0.15 )
Common shareholders' equity per share (2)(9)	37.97	29.78	27.59	26.09	23.50
Common shareholders' tangible equity per share (2)(9)	29.66	29.64	27.42	25.87	23.14
Cash dividends	0.72	0.72	0.54	0.04	0.10
Dividend payout ratio (basic)	37.89	% 25.78	% 22.62	% 1.26	% (66.67 )%
Dividend payout ratio (diluted)	38.10	% 25.84	% 22.67	% 1.27	% (66.67 )%

## OTHER DATA:

	As of December 31				
	2015	2014	2013	2012	2011
Full time equivalent employees	2,063	1,150	1,084	1,074	1,078
Number of branches	202	93	88	88	89

(footnotes follow)

## KEY FINANCIAL RATIOS:

	At or For the Years Ended December 31					
	2015	2014	2013	2012	2011	
Performance Ratios:						
Return on average assets <sup>(3)</sup>	0.72	% 1.17	% 1.09	% 1.54	% 0.13	%
Return on average common equity <sup>(4)</sup>	5.56	9.59	8.79	11.63	1.37	
Average common equity to average assets	12.87	12.20	12.35	13.22	9.31	
Interest rate spread <sup>(5)</sup>	4.09	4.04	4.08	4.13	3.99	
Net interest margin <sup>(6)</sup>	4.10	4.07	4.11	4.17	4.05	
Non-interest income to average assets	0.99	1.19	1.05	0.65	0.79	
Non-interest expense to average assets	3.75	3.32	3.31	3.35	3.69	
Efficiency ratio <sup>(7)</sup>	77.68	65.46	67.11	72.71	79.62	
Average interest-earning assets to funding liabilities	107.59	108.78	108.28	109.11	106.90	
Selected Financial Ratios:						
Allowance for loan losses as a percent of total loans at end of period	1.07	1.98	2.17	2.37	2.52	
Net charge-offs (recoveries) as a percent of average outstanding loans during the period	0.04	0.05	0.08	0.57	1.50	
Non-performing assets as a percent of total assets	0.28	0.43	0.66	1.18	2.79	
Allowance for loan losses as a percent of non-performing loans <sup>(8)</sup>	512.47	453.56	299.81	223.20	110.09	
Common shareholders' tangible equity to tangible assets <sup>(9)</sup>	10.68	12.29	12.23	11.80	9.54	
Consolidated Capital Ratios:						
Total capital to risk-weighted assets	13.63	16.80	16.99	16.96	18.07	
Tier 1 capital to risk-weighted assets	12.65	15.54	15.73	15.70	16.80	
Tier 1 capital to average leverage assets	11.06	13.41	13.64	12.74	13.44	
Common equity tier I capital to risk-weighted assets	12.13					

(1) Includes securities available-for-sale and held-to-maturity.

(2) Calculated using shares outstanding excluding unearned restricted shares held in ESOP and adjusted for 1-for-7 reverse stock split.

(3) Net income divided by average assets.

(4) Net income divided by average common equity.

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

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

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

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

(9) Common shareholders' tangible equity per share and the ratio of tangible common shareholders' equity to tangible assets are non-GAAP financial measures. We calculate tangible common equity by excluding the balance of goodwill, other intangible assets and preferred equity from shareholders' equity. We calculate tangible assets by excluding the balance of goodwill and other intangible assets from total assets. We believe that this is consistent with the treatment by our bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. In addition, excluding preferred equity, the level of which may vary from company to company, allows investors to more easily compare our capital adequacy to other companies in the industry that also use this measure. Management believes that these non-GAAP financial measures provide

information to investors that is useful in understanding the basis of our capital position. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Because not all companies use the same calculation of tangible common equity and tangible assets, this presentation may not be comparable to other similarly titled measures as calculated by other companies. For a reconciliation of these non-GAAP measures, see Item 7, "Management's Discussion and Analysis of Financial Condition—Executive Overview."



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

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

### Executive Overview

Banner Corporation's successful execution of its strategic plan and operating initiatives continued in 2015, as evidenced by our solid operating results and profitability. Highlights for the year included further improvement in our asset quality, substantially increased core deposits (transaction and savings accounts) and loans, significantly increased revenues from core operations and additional client acquisition. The year ended December 31, 2015 was also highlighted by the completed acquisitions of Siuslaw Bank and AmericanWest Bank. In addition to these acquisitions, over the past five years we have significantly added to our client relationships and account base, as well as substantially improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in lower credit costs and stronger and sustainable revenues.

For the year ended December 31, 2015, our net income was \$45.2 million or \$1.89 per diluted share, compared to net income of \$54.1 million, or \$2.79 per diluted share for the year ended December 31, 2014 and \$46.2 million or \$2.38 per diluted share for the year ended December 31, 2013. While our results for both years were significantly impacted by merger and acquisition activity and the related expenses, the decline in net income from the prior year was largely due to expenses related to the acquisition of AmericanWest. Acquisition-related expenses were \$26.1 million, or \$0.76 per diluted share net of tax benefit, in 2015 compared to \$4.3 million, or \$0.17 per diluted share net of tax benefit, in 2014. Results for 2014 also included a \$9.1 million bargain purchase gain related to the Branch purchase, which net of taxes contributed \$0.30 to diluted net income per share.

Aside from the acquisition related expenses, our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits, FHLB advances, other borrowings and junior subordinated debentures. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. Our net interest income before provision for loan losses increased 35% to \$242.3 million for the year ended December 31, 2015, compared to \$179.9 million for the year earlier. This increase in net interest income reflects the acquisitions of Siuslaw Bank in March 2015 and AmericanWest in October 2015, as well as the Branch purchase in June 2014, and significant organic loan and deposit growth from the legacy Banner Bank franchise. During the year ended December 31, 2015, our interest spread increased to 4.09% from 4.04% for the prior year while our net interest margin increased to 4.10% compared to 4.07% for the prior year. Our net interest margin was modestly enhanced in 2015 by the amortization of acquisition accounting discounts on purchased loans received in the acquisitions, which are accreted into loan interest income, as well as by net premiums on non-market-rate certificate of deposit liabilities assumed in the acquisitions which are amortized as a reduction to deposit interest expense; however, setting aside acquisition accounting adjustments, our net interest margin demonstrated remarkable relative stability despite continuing pressure on asset yields in the very low interest rate environment.

As a result of adequate reserves already in place and declining loan charge-offs, as well as net recoveries for the past two years, we did not record a provision for loan losses in the years ended December 31, 2015, 2014, and 2013. By contrast, we recorded substantially larger provisions in the three years immediately prior to 2013. The decrease in loan loss provisioning in recent years compared to the earlier years reflects our significant progress in reducing the levels

of delinquencies, non-performing loans and net charge-offs. As a result of our continued focused efforts, non-performing loans decreased by 9% to \$15.2 million at December 31, 2015, compared to \$16.7 million a year earlier. Our allowance for loan losses at December 31, 2015 was \$78.0 million, representing 512% of non-performing loans. (See Note 5, Loans Receivable and the Allowance for Loan Losses, of the Notes to the Consolidated Financial Statements as well as “Asset Quality” below in this Form 10-K.)

Our net income also is affected by the level of our non-interest income, including deposit fees and service charges, results of mortgage banking operations, which includes loan origination and servicing fees and gains and losses on the sale of loans, and gains and losses on the sale of loans and securities, as well as our non-interest expense and income tax provisions. In addition, our net income is affected by the net change in the value of certain financial instruments carried at fair value, and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries. Our total non-interest income was \$62.3 million for the year ended December 31, 2015, compared to \$55.0 million for the year ended December 31, 2014, including the acquisition bargain purchase gain. For the year ended December 31, 2015, we recorded a net charge of \$813,000 for fair value adjustments and \$540,000 in net losses on the sale of securities. In comparison, for the year ended December 31, 2014, we recorded a positive net change of \$1.4 million for fair value adjustments, \$42,000 in net gains on the sale of securities, and a \$9.1 million bargain purchase gain. Non-interest income excluding the net gain on sale of securities, OTTI adjustments, changes in the value of financial instruments carried at fair value, and the acquisition bargain purchase gain, which we believe is more indicative of our core operations, increased 43% to \$63.6 million for the year ended December 31, 2015 compared to \$44.5 million for the same period a year earlier, as we experienced meaningful increases in deposit fees and service charges and mortgage banking revenues.

Our total revenues (net interest income before the provision for loan losses plus total non-interest income) for the year ended December 31, 2015 increased \$69.7 million, or 30%, to \$304.6 million, compared to \$234.9 million for the same period a year earlier, largely as a result of the benefits from our acquisitions and organic growth more than offsetting the bargain purchase gain and favorable fair value adjustments recorded in the prior year. Our total revenues from core operations, which excludes net gains on sale of securities, fair value adjustments and the bargain purchase gain, increased by \$81.6 million, or 36%, to \$305.9 million for the year ended December 31, 2015, compared to \$224.4 million for the same period a year earlier.

For the year ended December 31, 2015, non-interest expense increased 54% to \$236.6 million, compared to \$153.7 million for the year ended December 31, 2014, largely attributable to our acquisition-related expenses and incremental costs associated with operating the 98 branches acquired in the AmericanWest acquisition on October 1, 2015 and the ten Siuslaw Bank branches acquired in March 2015, as well as generally increased compensation, occupancy and payment and card processing services reflecting increased transaction volume.

Non-interest income, revenues and other earnings information excluding fair value adjustments, OTTI losses or recoveries, net gains or losses on sale of securities and, in certain periods, acquisition-related bargain purchase gains and costs, are non-GAAP financial measures. Management has presented these non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations and in understanding our capital position. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP financial measures, see the tables below. Because not all companies use the same calculations, our presentation may not be comparable to other similarly titled measures as calculated by other companies. See “Comparison of Results of Operations for the Years Ended December 31, 2015 and 2014” for more detailed information about our financial performance.

Edgar Filing: BANNER CORP - Form 10-K

The following tables set forth reconciliations of non-GAAP financial measures discussed in this report (dollars in thousands, except share and per share data):

	For the Years Ended December 31		
	2015	2014	2013
Total non-interest income (GAAP)	\$62,292	\$54,991	\$44,662
Exclude net loss (gain) on sale of securities	540	(42	) (1,022
Exclude other-than-temporary impairment (recovery) loss	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	813	(1,374	) 2,278
Exclude one-time acquisition termination fee	—	—	(2,954
Exclude acquisition bargain purchase gain	—	(9,079	) —
Total non-interest income from core operations (non-GAAP)	\$63,645	\$44,496	\$42,555
Net interest income before provision for loan losses	\$242,279	\$179,872	\$166,716
Total non-interest income	62,292	54,991	44,662
Total GAAP revenue	304,571	234,863	211,378
Exclude net loss (gain) on sale of securities	540	(42	) (1,022
Exclude other-than-temporary impairment (recovery) loss	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	813	(1,374	) 2,278
Exclude one-time acquisition termination fee	—	—	(2,954
Exclude acquisition bargain purchase gain	—	(9,079	) —
Revenue from core operations (non-GAAP)	\$305,924	\$224,368	\$209,271
Income before provision for taxes (GAAP)	\$67,971	\$81,122	\$70,403
Exclude net loss (gain) on sale of securities	540	(42	) (1,022
Exclude other-than-temporary impairment (recovery) loss	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	813	(1,374	) 2,278
Exclude one-time acquisition termination fee	—	—	(2,954
Exclude acquisition bargain purchase gain	—	(9,079	) —
Exclude acquisition related costs	26,110	4,325	550
Income from core operations before provision for taxes (non-GAAP)	\$95,434	\$74,952	\$68,846
Net income (GAAP)	\$45,222	\$54,070	\$46,214
Exclude net loss (gain) on sale of securities	540	(42	) (1,022
Exclude other-than-temporary impairment (recovery) loss	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	813	(1,374	) 2,278
Exclude one-time acquisition termination fee	—	—	(2,954
Exclude acquisition bargain purchase gain	—	(9,079	) —
Exclude acquisition related costs	26,110	4,325	550
Exclude related tax expense (benefit)	(8,552	) 3,166	561
Total earnings from core operations (non-GAAP)	\$64,133	\$51,066	\$45,218
Acquisition bargain purchase gain	\$—	\$9,079	\$—
Acquisition termination fee	—	—	2,954
Acquisition related costs	(26,110	) (4,325	) (550
Related tax expense	8,065	(2,656	) (865
Total net effect of acquisitions (including proposed acquisitions) on earnings	\$(18,045	) \$2,098	\$1,539
Diluted weighted shares outstanding	23,866,621	19,402,656	19,397,360
Total net effect of acquisitions on diluted earnings per share	\$(0.76	) \$0.11	\$0.08



Edgar Filing: BANNER CORP - Form 10-K

	December 31			
	2015	2014	2013	
Loans receivable (GAAP)	\$7,314,504	\$3,831,034	\$3,415,711	
Net loan discount on acquired loans	43,657	—	—	
Adjusted loans (non-GAAP)	7,358,161	3,831,034	3,415,711	
Allowance for loan losses (GAAP)	78,008	75,907	74,258	
Net loan discount on acquired loans	43,657	—	—	
Adjusted allowance for loan losses (non-GAAP)	121,665	75,907	74,258	
Adjusted allowance for loan losses/Adjusted total loans (non-GAAP)	1.65	% 1.98	% 2.17	%

	December 31			
	2015	2014	2013	
Net interest income before provision for loan losses (GAAP)	242,279	179,872	166,716	
Exclude discount accretion on purchased loans	(3,566 )	(223 )	—	
Excluded premium amortization on acquired certificates of deposit	(748 )	(139 )	—	
Net interest income before discount accretion (non-GAAP)	237,965	179,510	166,716	
Net interest margin (GAAP)	4.10	% 4.07	% 4.11	%
Exclude impact on net interest margin from discount accretion	(0.06 )%	(0.01 )%	—	%
Excluded impact on net interest margin from CD premium amortization	(0.01 )%	—	—	%
Net margin before discount accretion (non-GAAP)	4.03	% 4.06	% 4.11	%

Common shareholders' tangible equity per share and the ratio of tangible common shareholders' equity to tangible assets referred to in footnote(9) to Item 6 - Selected Financial Data above are also non-GAAP financial measures. We calculate tangible common equity by excluding other intangible assets from shareholders' equity. We calculate tangible assets by excluding the balance of other intangible assets from total assets. We believe that this is consistent with the treatment by our bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. Management believes that this non-GAAP financial measure provides information to investors that is useful in understanding our capital position (dollars in thousands).

	December 31			
	2015	2014	2013	
Shareholders' equity (GAAP)	\$1,300,059	\$582,888	\$538,331	
Exclude other intangible assets, net	284,500	2,831	2,449	
Tangible common shareholders' equity (non-GAAP)	\$1,015,559	\$580,057	\$535,882	
Total assets (GAAP)	\$9,796,298	\$4,723,163	\$4,388,257	
Exclude other intangible assets, net	284,500	2,831	2,449	
Total tangible assets (non-GAAP)	\$9,511,798	\$4,720,332	\$4,385,808	
Tangible common shareholders' equity to tangible assets (non-GAAP)	10.68	% 12.29	% 12.22	%
Common shares outstanding	34,242,255	19,571,548	19,543,769	
Common shareholders' tangible equity per share (non-GAAP)	\$29.66	\$29.64	\$27.42	

Loans and lending: Loans are our most significant and generally highest yielding earning assets. We attempt to maintain a portfolio of loans in a range of 90% to 95% of total deposits to enhance our revenues, while adhering to sound underwriting practices and appropriate diversification guidelines in order to maintain a moderate risk profile. At

December 31, 2015, our net loan portfolio totaled \$7.24 billion compared to \$3.76

42

---

billion at December 31, 2014, with much of the increase coming from the AmericanWest and Siuslaw Bank acquisitions. The AmericanWest and Siuslaw Bank acquisitions accounted for \$2.82 billion and \$227.1 million, respectively, of the total loan portfolio at December 31, 2015.

Our lending activities are primarily directed toward the origination of real estate and commercial loans. Commercial real estate loans for both owner-occupied and investment properties, including construction and development loans for these types of properties, totaled \$3.20 billion, or approximately 44% of our loan portfolio at December 31, 2015. In addition, multifamily residential real estate loans, including construction and development loans for these types of properties, totaled \$536.8 million and comprise approximately 7% of our loan portfolio at that date. While our level of activity and investment in commercial and multifamily real estate loans has been relatively stable for many years, we have experienced an increase in new originations in recent periods resulting in growth in these loan balances. In addition, both Siuslaw Bank and AmericanWest had significant commercial real estate loan portfolios at the time of their respective acquisitions. AmericanWest also had a significant portfolio of multifamily loans. Commercial real estate loans increased by \$1.77 billion and multifamily loans increased by \$309.1 million during the year ended December 31, 2015.

We also originate residential construction, land and land development loans and, although our portfolio balances are well below the peak levels before the financial crisis, in recent years we have experienced increased demand for one-to four-family construction loans and our origination activity has been significant. Outstanding residential construction, land and land development balances increased \$82.9 million, or 26%, to \$405.2 million at December 31, 2015 compared to \$322.3 million at December 31, 2014. Still, residential construction, land and land development loans represented only approximately 6% of our total loan portfolio at December 31, 2015.

Our commercial business lending is directed toward meeting the credit and related deposit needs of various small- to medium-sized business and agribusiness borrowers operating in our primary market areas. In recent years our commercial lending has also included participation in certain national syndicated loans, including share national credits, which totaled \$123.7 million at December 31, 2015. Reflecting the recovering national economy and more robust activity in the Northwest, demand for these types of commercial business loans has increased significantly in recent periods and our balances have increased from organic growth as well as from the acquisitions of AmericanWest and Siuslaw Bank. Commercial and agricultural business loans increased \$622.0 million, or 65%, to \$1.58 billion at December 31, 2015, compared to \$962.5 million at December 31, 2014. Commercial and agricultural business loans represented approximately 22% of our portfolio at December 31, 2015.

Our residential mortgage loan originations have been relatively strong in recent years, as exceptionally low interest rates have supported demand for loans to refinance existing debt as well as loans to finance home purchases. At December 31, 2015, our outstanding balances for residential mortgages increased \$415.5 million to \$952.6 million, compared to \$537.1 million at December 31, 2014. The increase from the prior year primarily reflects the loans acquired in the acquisition of AmericanWest, as the majority of loans originated during the year were sold. One- to four-family residential real estate loans represented nearly 13% of our loan portfolio at December 31, 2015. Most of the one- to four-family loans that we originate are sold in the secondary markets with net gains on sales and loan servicing fees reflected in our revenues from mortgage banking.

Our consumer loan activity is primarily directed at meeting demand from our existing deposit customers. We have increased our emphasis on consumer lending in recent years, and while demand for consumer loans has been modest during this period as we believe many consumers have been focused on reducing their personal debt, we began to see some meaningful growth in 2014. For the year 2015, consumer loans, including consumer loans secured by one- to four-family residences, increased \$287.7 million to \$636.9 million, or 9% of our portfolio at December 31, 2015, with most of the increase arising from the AmericanWest acquisition and increased usage of our home equity lines of credit.



Deposits, customer retail repurchase agreements and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits and we generally attract deposits within our primary market areas. Much of the focus of our branch expansion over many years, including the Branch purchase, and our current marketing efforts have been directed toward attracting additional deposit customer relationships and balances. This effort has been particularly directed towards increasing transaction and savings accounts and for the past three years we have been very successful in increasing these core deposit balances. The long-term success of our deposit gathering activities is reflected not only in the growth of deposit balances, but also in increases in the level of deposit fees, service charges and other payment processing revenues compared to periods prior to that expansion.

Total deposits were \$8.06 billion at December 31, 2015 compared to \$3.90 billion a year earlier. Non-interest-bearing account balances increased 102% to \$2.62 billion at December 31, 2015, compared to \$1.30 billion a year ago. Interest-bearing transaction and savings accounts totaled \$4.08 billion at December 31, 2015, compared to \$1.83 billion a year ago, while certificates of deposit increased to \$1.35 billion compared to \$770.5 million a year earlier. Non-certificate core deposits represented 83% of total deposits at December 31, 2015, compared to 80% of total deposits a year ago and 76% two years earlier. The AmericanWest and Siuslaw Bank acquisitions accounted for \$3.50 billion and \$324.2 million, respectively, of the total deposit portfolio at December 31, 2015.

#### Critical Accounting Policies

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

Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions

inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including OTTI losses, (iv) the valuation of intangibles, such as core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale, (vi) the valuation of assets and liabilities acquired in business combinations and subsequent recognition of related income and expense, and (vii) the valuation of or recognition of deferred tax assets and liabilities. These policies and judgments, estimates and assumptions are described in greater detail below. Management believes the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and our financial condition and operating results in future periods. There have been no significant changes in our application of accounting policies since December 31, 2014. For additional information concerning critical accounting policies, see Notes 1, 3, 5, 12, 17 and 18 of the Notes to the Consolidated Financial Statements and the following:

**Interest Income:** (Notes 1 and 5) Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the amounts owed, principal or interest, may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.

**Provision and Allowance for Loan Losses:** (Notes 1 and 5) The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and value impaired loans.

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

of the underlying collateral less selling costs and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported. Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment.

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

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance for loan losses are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the Banks' allowance for loan losses is subject to review by

bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

**Fair Value Accounting and Measurement:** (Notes 1 and 18) We use fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. We include in the Notes to the Consolidated Financial Statements information about the extent to which fair value is used to measure financial assets and liabilities, the valuation methodologies used and the impact on our results of operations and financial condition. Additionally, for financial instruments not recorded at fair value we disclose, where appropriate, our estimate of their fair value. For more information regarding fair value accounting, please refer to Note 18 in the Notes to the Consolidated Financial Statements.

**Business Combinations:** (Notes 1 and 3) Business combinations are accounted for using the acquisition method of accounting and, accordingly, assets acquired and liabilities assumed, both tangible and intangible, and consideration exchanged are recorded at acquisition date fair values. The excess purchase consideration over fair value of net assets acquired is recorded as goodwill. In the event that the fair value of net assets acquired exceeds the purchase price, including fair value of liabilities assumed, a bargain purchase gain is recorded on that acquisition. Expenses incurred in connection with a business combination are expensed as incurred. Changes in deferred tax asset valuation allowances related to acquired tax uncertainties are recognized in net income after the measurement period.

**Acquired Loans:** (Notes 3 and 5) Purchased loans, including loans acquired in business combinations, are recorded at their fair value at the acquisition date. Credit discounts are included in the determination of fair value; therefore, an allowance for loan losses is not recorded at the acquisition date. Acquired loans are evaluated upon acquisition and classified as either purchased credit-impaired or purchased non-credit-impaired. Purchased credit-impaired (PCI) loans reflect credit deterioration since origination such that it is probable at acquisition that the Company will be unable to collect all contractually required payments. The accounting for PCI loans is periodically updated for changes in cash flow expectations, and reflected in interest income over the life of the loans as accretable yield. Any subsequent decreases in expected cash flows attributable to credit deterioration are recognized by recording a provision for loan losses.

For purchased non-credit-impaired loans, the difference between the fair value and unpaid principal balance of the loan at the acquisition date is amortized or accreted to interest income over the life of the loans. Any subsequent deterioration in credit quality is recognized by recording a provision for loan losses.

**Goodwill:** (Notes 1 and 17) Goodwill represents the excess of the purchase considerations paid over the fair value of the assets acquired, net of the fair values of liabilities assumed in a business combination and is not amortized but is reviewed annually, or more frequently as current circumstances and conditions warrant, for impairment. An assessment of qualitative factors is completed to determine if it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the qualitative analysis concludes that further analysis is required, then a quantitative impairment test would be completed. The quantitative goodwill impairment test is a two-step process. The first step compares the reporting unit's estimated fair values, including goodwill, to its carrying amount. If the carrying amount exceeds its fair value, then goodwill impairment may be indicated. The second step allocates the reporting units fair value to its assets and liabilities. If the unallocated fair value does not exceed the carrying amount of goodwill then an impairment loss would be recognized as a charge to earnings.

**Other Intangible Assets:** (Notes 1 and 17) Other intangible assets consists primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their

recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

**Mortgage Servicing Rights:** (Note 17) Mortgage servicing rights (MSRs) are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased MSRs are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of the MSR is estimated and capitalized. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized MSRs are reported in other assets and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Real Estate Owned Held for Sale:** (Notes 1 and 6) Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Development and improvement costs relating to the property may be capitalized, while other holding costs are expensed. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts the Banks will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of market factors beyond the Banks' control or because of changes in the Banks' strategies for recovering the investment.

**Income Taxes and Deferred Taxes:** (Note 12) The Company and its wholly-owned subsidiaries file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation

allowance is required to be recognized if it is “more likely than not” that all or a portion of our deferred tax assets will not be realized. The ultimate realization of the deferred tax assets is dependent upon the existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible.

Accounting Standards Recently Adopted or Issued - See Note 2 of the Notes to the Consolidated Financial Statements for a description of recently adopted and new accounting pronouncements, including the respective dates of adoption and expected effects on the Company's financial position and results of operations.

#### Comparison of Financial Condition at December 31, 2015 and 2014

General. Total assets increased \$5.07 billion, or 107%, to \$9.80 billion at December 31, 2015, compared to \$4.72 billion at December 31, 2014. During 2015, we completed acquisitions of AmericanWest, which at the time of acquisition included \$4.46 billion of assets, \$3.00 billion of net loans, and \$3.64 billion of deposits, and of Siuslaw Bank which at the time of acquisition included \$369.8 million of assets, \$247.1 million of loans, and \$316.4 million of deposits. Net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) increased \$3.48 billion, or 93%, to \$7.24 billion at December 31, 2015, from \$3.76 billion at December 31, 2014. The increase in net loans included increases of \$1.69 billion in commercial real estate loans, \$305.5 million in multifamily real estate loans, \$58.6 million in one- to four-family construction loans, \$58.4 million in multifamily and commercial construction loans and \$46.4 million in land and land development loans. Commercial business loans increased by \$484.0 million while agricultural business loans increased \$138.0 million. Consumer loans increased by \$287.7 million and one- to four-family real estate loans increased by \$415.5 million.

The increase in commercial real estate loans included \$908.4 million for investment properties and \$781.0 million for owner-occupied properties and was largely influenced by the two bank acquisitions. The increase in multifamily loans, which was almost entirely a result of the AmericanWest acquisition, was net of a sale of \$151.9 million from the acquired loan portfolio subsequent to the acquisition date. The increase in construction and development loans was particularly helpful to the net interest margin as interest rates, loan fees and the velocity of turnover in this lending activity are generally higher than for most other categories of loans. The increase in one-to four-family loans was also primarily a result of the AmericanWest acquisition. While much of the year-over-year growth in the loan portfolios was a result of the two bank acquisitions, our organic production of new commercial real estate, construction and development, and commercial business loans was solid throughout the year and generally reflected the robust Northwest economy.

Securities increased to \$1.39 billion at December 31, 2015, from \$582.5 million at December 31, 2014, and the aggregate total of securities and interest-bearing deposits increased \$900.1 million, or 141%, to \$1.54 billion at December 31, 2015, compared to \$637.5 million a year earlier. The increase in securities balances reflects the \$1.04 billion of securities acquired in the AmericanWest acquisition which were primarily MBS and municipals. Securities purchases during 2015 were modest and were primarily mortgage-backed securities and intermediate-term taxable and tax-exempt municipal securities. Securities sales also were modest and were primarily sales of mortgage-backed securities following the AmericanWest acquisition which were undertaken in part to insure that our total assets remained below \$10.0 billion at December 31, 2015. The average effective duration of Banner's securities portfolio was approximately 3.3 years at December 31, 2015. Primarily reflecting significant adjustments in prior years, the fair value of our trading securities was \$5.2 million less than their amortized cost at December 31, 2015. In addition, fair value adjustments for securities designated as available-for-sale reflected a decrease of \$645,000 for the year ended December 31, 2015, which was included net of the associated tax benefit of \$249,000 as a component of other comprehensive income and largely occurred as a result of slightly increased market interest rates. Periodically, we also acquire securities (primarily municipal bonds) which are designated as held-to-maturity and this portfolio increased by \$89.4 million from the prior year-end balances largely as result of additions from the AmericanWest portfolio. (See

Notes 4 and 18 of the Notes to the Consolidated Financial Statements.)

REO increased \$8.3 million, to \$11.6 million at December 31, 2015 compared to \$3.4 million at December 31, 2014 and \$4.0 million at December 31, 2013. The increase largely reflects REO acquired from the two bank acquisitions in 2015. During the year ended December 31, 2015, we transferred \$4.4 million of loans into REO, capitalized additional investments of \$298,000 in previously acquired properties, added \$8.2 million of properties as a result of the acquisitions, disposed of approximately \$4.7 million of properties and recognized \$135,000 of gains in current earnings, net of valuation adjustments, for REO properties sold. (See "Asset Quality" discussion below.)

Deposits increased \$4.16 billion, or 107%, to \$8.06 billion at December 31, 2015, from \$3.90 billion at December 31, 2014, largely as a result of the acquisitions of AmericanWest and Siuslaw, but also augmented by continued strong organic growth. Non-interest-bearing deposits increased by \$1.32 billion, or 102%, to \$2.62 billion from \$1.30 billion, interest-bearing transaction and savings accounts increased by \$2.25 billion, or 123%, to \$4.08 billion at December 31, 2015 from \$1.83 billion at December 31, 2014, and certificates of deposit increased \$583.4 million, or 76%, to \$1.35 billion at December 31, 2015 from \$770.5 million at December 31, 2014. Core deposits increased to 83% of total deposits at December 31, 2015, compared to 80% of total deposits one year earlier. In addition to our organic growth in deposits, the acquisitions of AmericanWest and Siuslaw resulted in a \$3.82 billion increase in deposits, including \$1.09 billion in non-interest bearing deposits, \$2.11 billion in interest-bearing transactions and savings accounts, and \$620.8 million in certificates of deposit as of December 31, 2015.

FHLB advances increased \$101.1 million, to \$133.4 million at December 31, 2015 from \$32.3 million at December 31, 2014. The increase primarily reflects FHLB advances assumed in the acquisition of AmericanWest that are still outstanding as of the end of the year. Other borrowings, consisting of retail and wholesale repurchase agreements primarily related to customer cash management accounts, increased \$21.1 million to \$98.3 million at December 31, 2015, compared to \$77.2 million at December 31, 2014. Junior subordinated debentures, which are carried at fair value, increased \$14.5 million to \$92.5 million at December 31, 2015 from \$78.0 million a year ago, primarily as a result of the \$11.8 million assumed in the acquisitions of AmericanWest and Siuslaw Bank. For more information, see Notes 9, 10 and 11 of the Notes to the Consolidated Financial Statements.

Total shareholders' equity increased \$717.2 million, or 123%, to \$1.30 billion at December 31, 2015 compared to \$582.9 million at December 31, 2014. The increase primarily reflects the \$688.8 million value of the 14.6 million common shares issued for the acquisitions of Starbuck and Siuslaw and \$45.2 million of earnings from operations, which was partially offset by the declaration and accrual of \$19.9 million in cash dividends to common shareholders. Tangible common shareholders' equity, which excludes intangible assets, also increased \$435.5 million to \$1.02 billion, or 10.68% of tangible assets at December 31, 2015, compared to \$580.1 million, or 12.29% at December 31, 2014.

**Investments.** At December 31, 2015, our consolidated investment portfolio totaled \$1.39 billion and consisted principally of U.S. Government and agency obligations, mortgage-backed and mortgage-related securities, municipal bonds, corporate debt obligations, and asset-backed securities. From time to time, our investment levels may be increased or decreased depending upon yields available on investment alternatives and management's projections as to the demand for funds to be used in our loan origination, deposit and other activities. During the year ended December 31, 2015, our aggregate investment in securities increased \$810.8 million primarily due to the \$1.04 billion of securities acquired in the AmericanWest acquisition. Holdings of mortgage-backed securities increased \$658.1 million, municipal bonds increased \$135.0 million, corporate bonds increased \$13.0 million and asset-backed securities increased \$5.3 million. Partially offsetting those increases, U.S. Government and agency obligations decreased \$716,000.

**U.S. Government and Agency Obligations:** Our portfolio of U.S. Government and agency obligations had a carrying value of \$32.7 million (also with an amortized cost of \$32.5 million) at December 31, 2015, a weighted average contractual maturity of 8.8 years and a weighted average coupon rate of 3.08%. Nearly half of the U.S. Government and agency obligations we own include call features which allow the issuing agency the right to call the securities at various dates prior to the final maturity.

**Mortgage-Backed Obligations:** At December 31, 2015, our mortgage-backed and mortgage-related securities had a carrying value of \$984.4 million (\$984.5 million at amortized cost, with a net fair value adjustment of \$100,000). The weighted average coupon rate of these securities was 3.54% and the weighted average contractual maturity was 14.5 years, although we receive principal payments on these securities each period resulting in a much shorter expected average life. As of December 31, 2015, 96% of the mortgage-backed and mortgage-related securities pay interest at a fixed rate and 4% pay at an adjustable interest rate.

**Municipal Bonds:** The carrying value of our tax-exempt bonds at December 31, 2015 was \$170.8 million (\$170.2 million at amortized cost, with a net fair value adjustment of \$563,000), and was comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by revenues from the specific project being financed) issued by cities and counties and various housing authorities, and hospital, school, water and sanitation districts. We also had taxable bonds in our municipal bond portfolio, which at December 31, 2015 had a carrying value of \$135.7 million (also \$135.8 million at amortized cost). Many of our qualifying municipal bonds are not rated by a nationally recognized credit rating agency due to the smaller size of the total issuance and a portion of these bonds have been acquired through direct private placement by the issuers. We have not experienced any defaults or payment deferrals on our current portfolio of municipal bonds. Our combined municipal bond portfolio is geographically diverse, with over half within our geographic footprint. At December 31, 2015, our municipal bond portfolio, including taxable and tax-exempt, had a weighted average maturity of approximately 9.6 years and a weighted average coupon rate of 4.50%.

**Corporate Bonds:** Our corporate bond portfolio had a carrying value of \$39.0 million (\$45.3 million at amortized cost, with a net fair value adjustment of \$6.3 million) at December 31, 2015. Long-term adjustable-rate capital securities issued by financial institutions make up nearly half of our corporate bond portfolio. The market for these



capital securities deteriorated significantly in 2008 and 2009 and in our opinion is still not currently functioning in a meaningful manner. As a result, the fair value estimates for many of these securities are more subjective. Nonetheless, it is apparent that the values have declined appreciably since purchase, which is reflected in our financial statements and results of operations, although values have recently improved. During 2015 and 2014 we had approximately \$1.9 million and \$5.1 million, respectively, of recovery in our fair value adjustments as a result of the full payoff and sales of several investments in similar collateralized debt obligations that had previously been valued substantially below their amortized cost. (See “Critical Accounting Policies” above and Note 18 of the Notes to the Consolidated Financial Statements.) At December 31, 2015, the portfolio had a weighted average maturity of 16.5 years and a weighted average coupon rate of 2.50%.

Asset-Backed Securities: At December 31, 2015, our asset-backed securities portfolio had a carrying value of \$30.7 million (also with an amortized cost of \$31.3 million), and was comprised of securitized pools of student loans issued or guaranteed by the Student Loan Marketing Association (SLMA) and credit card receivables. The weighted average coupon rate of these securities was 1.67% and the weighted average contractual maturity was 9.7 years. Approximately 68% of these securities have adjustable interest rates tied to three-month LIBOR while the remaining securities have fixed interest rates.

The following tables set forth certain information regarding carrying values and percentage of total carrying values of our portfolio of securities—trading and securities—available-for-sale, both carried at estimated fair market value, and securities—held-to-maturity, carried at amortized cost as of December 31, 2015, 2014 and 2013 (dollars in thousands):

Table 1: Securities

	December 31		2014		2013			
	Carrying Value	Percent of Total	Carrying Value	Percent of Total	Carrying Value	Percent of Total		
<b>Trading</b>								
U.S. Government and agency obligations	\$1,368	4.0	% \$1,505	3.7	% \$1,481	2.4	%	
Municipal bonds	341	1.0	1,440	3.6	5,023	8.0		
Corporate bonds	18,699	54.8	19,118	47.5	35,140	56.2		
Mortgage-backed or related securities:	13,663	40.0	18,136	45.1	20,760	33.3		
Equity securities	63	0.2	59	0.1	68	0.1		
Total securities—trading	\$34,134	100.0	% \$40,258	100.0	% \$62,472	100.0	%	
<b>Available-for-Sale</b>								
U.S. Government and agency obligations	\$30,231	2.7	% \$29,770	7.2	% \$58,660	12.5	%	
Municipal bonds	143,319	12.6	50,028	12.2	52,855	11.2		
Corporate bonds	15,981	1.4	5,018	1.2	6,964	1.5		
Mortgage-backed or related securities	918,259	80.6	300,810	73.2	326,610	69.5		
Asset-backed securities	30,685	2.7	25,395	6.2	25,191	5.3		
Equity securities	98	—	—	—	—	—		
Total securities—available-for-sale	\$1,138,573	100.0	% \$411,021	100.0	% \$470,280	100.0	%	
<b>Held-to-Maturity</b>								
U.S. Government and agency obligations	\$1,106	0.5	% \$2,146	1.6	% \$1,186	1.2	%	
Municipal bonds	162,778	73.8	119,951	91.4	95,926	93.6		
Corporate bonds	4,273	1.9	1,800	1.4	2,050	2.0		
Mortgage-backed or related securities	52,509	23.8	7,361	5.6	3,351	3.2		
Total securities—held-to-maturity	\$220,666	100.0	% \$131,258	100.0	% \$102,513	100.0	%	
Estimated market value	\$226,627		\$137,608		\$103,610			

The following table shows the maturity or period to repricing of our consolidated portfolio of securities as of December 31, 2015 (dollars in thousands):

Table 2: Securities—Maturity/Repricing and Rates  
December 31, 2015

	One Year or Less		After One to Five Years		After Five to Ten Years		After Ten to Twenty Years		After Twenty Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield
U.S. Government and agency obligations:												
Fixed-rate	\$—	— %	\$15,168	1.19%	\$1,338	5.19%	\$3,786	1.38%	\$—	— %	\$20,292	1.40%
Adjustable-rate	11,152	1.87	458	1.00	—	—	803	1.96	—	—	12,413	1.84
	11,152	1.87	15,626	1.19	1,338	5.19	4,589	1.48	—	—	32,705	1.63
Municipal bonds:												
Fixed-rate taxable	8,049	2.58	39,644	1.19	79,798	2.84	8,166	3.61	—	—	135,657	2.64
Fixed-rate tax exempt	4,052	2.21	18,040	1.65	26,983	2.66	110,827	3.20	—	2.48	168,948	2.88
Adjustable-rate tax exempt	—	—	—	—	—	—	—	—	1,833	3.15	1,833	3.15
	12,101	2.46	57,684	1.93	106,781	2.79	118,993	3.23	10,879	2.60	306,438	2.78
Corporate bonds:												
Fixed-rate	250	3.00	5,653	2.75	1,050	3.52	—	—	2,473	—	9,426	2.12
Adjustable-rate	29,527	2.63	—	—	—	—	—	—	—	—	29,527	2.63
	29,777	2.63	5,653	2.75	1,050	3.52	—	—	2,473	—	38,953	2.52
Mortgage-backed or related securities:												
Fixed-rate	4,994	1.25	206,174	1.50	129,297	2.26	302,582	2.33	303,199	2.50	946,246	2.19
Adjustable-rate	16,027	2.37	17,237	2.05	4,921	2.63	—	—	—	—	38,185	2.20
	21,021	2.10	223,411	1.54	134,218	2.28	302,582	2.33	303,199	2.50	984,431	2.19
Asset-backed securities:												
Fixed-rate	—	—	—	—	9,792	1.65	—	—	—	—	9,792	1.65
Adjustable-rate	20,893	1.60	—	—	—	—	—	—	—	—	20,893	1.60
	20,893	1.60	—	—	9,792	1.65	—	—	—	—	30,685	1.62
Equity securities	161	—	—	—	—	—	—	—	—	—	161	—
Total securities—carrying value	\$95,105	2.20	\$302,374	1.62	\$253,179	2.49	\$426,164	2.57	\$316,551	2.48	\$1,393,373	2.30
Total securities—estimated market value	\$95,155		\$302,477		\$253,860		\$431,009		\$316,833		\$1,399,334	



Loans and Lending. Our loan portfolio increased \$3.48 billion, or 91%, during the year ended December 31, 2015, compared to an increase of \$415.0 million, or 12%, during the year ended December 31, 2014. The AmericanWest acquisition accounted for \$2.82 billion of the year-end loan portfolio and the Siuslaw acquisition accounted for \$227.1 million of the year-end loan portfolio, while organic loan growth accounted for \$441.4 million of the increase from the prior year. While we originate a variety of loans, our ability to originate each type of loan is dependent upon the relative customer demand and competition in each market we serve. We have implemented strategies designed to capture more market share and achieve increases in targeted loans resulting in strong loan originations in 2015 and 2014. Nonetheless, looking forward, new loan originations and portfolio balances will continue to be significantly affected by the course of economic activity. For the years ended December 31, 2015, 2014 and 2013, we originated loans, net of repayments and charge-offs, of \$741.7 million, \$506.0 million and \$594.6 million, respectively. The level of net originations during all three years was significantly impacted by a substantial amount of loan repayments. We generally sell a significant portion of our newly originated one- to four-family residential mortgage loans to secondary market purchasers. As a result of the acquisition of AmericanWest Bank in 2015, we began originating multifamily loans for sale, in addition to the multifamily loans originated for portfolio. Proceeds from sales of loans for the years ended December 31, 2015, 2014 and 2013 totaled \$801.6 million (including \$151.9 million from the sale of multifamily loans acquired through the merger with AmericanWest), \$379.2 million and \$462.5 million, respectively. See “Loan Servicing Portfolio” below. Loans held for sale increased \$41.9 million to \$44.7 million at December 31, 2015, compared to \$2.8 million at December 31, 2014.

At various times, we also purchase whole loans and participation interests in loans. During the years ended December 31, 2015, 2014 and 2013, we purchased \$323.5 million, \$194.4 million and \$48.7 million, respectively, of loans and loan participation interests. The significant increase in loan purchases in the current year primarily reflects participations in commercial real estate loans.

One- to Four-Family Residential Real Estate Lending: At December 31, 2015, \$952.6 million, or 13%, of our loan portfolio, consisted of permanent loans on one- to four-family residences. We are active originators of one- to four-family residential loans in most communities where we have established offices in Washington, Oregon, California, Idaho and Utah. Our one- to four-family loan originations, including loans held for sale and originated for portfolio, totaled \$710.7 million for the year ended December 31, 2015, compared to \$410.0 million and \$511.0 million for the years ended December 31, 2014 and 2013, respectively. Despite the majority of our loan origination volume being sold during the year, our balance of loans for one- to four-family residences increased by \$415.5 million in 2015, largely as a result of loans acquired in the acquisition of AmericanWest.

Construction and Land Lending: Our construction loan originations have increased for each of the past three years as builders have expanded production and experienced strong sales in many markets where we operate. We have also experienced a meaningful increase in originations of construction loans for owner occupants, although construction balances for these loans are modest as the loans convert to one-to-four family loans upon completion of the homes. As a result, one-to four-family construction loans have increased by \$40.0 million in 2013, \$19.0 million in 2014 and \$58.6 million in 2015, to total \$278.5 million at December 31, 2015. In addition, during the year ended December 31, 2015, land development loans (both residential and commercial) increased by \$46.4 million to \$160.0 million at December 31, 2015. Our construction and land development loan originations including loans for residential and commercial properties totaled \$987.5 million for the year ended December 31, 2015, compared to \$684.4 million for the year ended December 31, 2014, and \$655.3 million for the year ended December 31, 2013. At December 31, 2015, construction and land loans totaled \$574.4 million (including \$278.5 million of one- to four-family construction loans, \$126.8 million of residential land or land development loans, \$135.9 million of commercial and multifamily real estate construction loans and \$33.2 million of commercial land or land development loans), or 8% of total loans, compared to \$411.0 million, or 11%, at December 31, 2014. At December 31, 2015, only \$2.3 million of these loans were non-performing. For the years ended December 31, 2015 and 2014, performing construction loans contributed significantly to our net interest income and profitability.

**Commercial and Multifamily Real Estate Lending:** We also originate loans secured by multifamily and commercial real estate. Multifamily and commercial real estate loans originated by us are both fixed- and adjustable-rate loans generally with intermediate terms of five to ten years. Our commercial real estate portfolio consists of loans on a variety of property types with no significant concentrations by property type, borrowers or locations. Total balances of multifamily and commercial real estate loans increased \$1.99 billion or 127% from the prior year end, largely as a result of the two bank acquisitions and strong organic growth. At December 31, 2015, our loan portfolio included \$3.09 billion of commercial real estate loans, or 42% of the total loan portfolio. Our portfolio of multifamily loans was much smaller, at \$473.0 million, or 6% of total loans.

**Commercial Business Lending:** We are active in small- to medium-sized business lending. In addition to providing earning assets, this type of lending has helped increase our deposit base. For 2015, the acquisitions of AmericanWest and Siuslaw Bank and good production levels for targeted business loans resulted in a \$484.0 million, or 67%, increase in commercial business loans. Although business credit line utilizations remain low, the increase in commercial business loans is an encouraging sign of improving economic activity as well as additional successful sales results for our lending offices. At December 31, 2015, commercial business loans totaled \$1.21 billion, or 17% of total loans, compared to \$724.0 million, or 19%, at December 31, 2014.

**Agricultural Lending:** Agriculture is a major industry in many Washington, Oregon, California, Idaho and Utah locations in our service area. While agricultural loans are not a large part of our portfolio, we routinely make agricultural loans to borrowers with a strong capital base, sufficient management depth, proven ability to operate through agricultural cycles, reliable cash flows and adequate financial reporting. Payments on agricultural loans depend, to a large degree, on the results of operation of the related farm entity. The repayment is also subject to other economic and weather conditions as well as market prices for agricultural products, which can be highly volatile at times. Generally, in recent years, weather conditions, production levels and market prices have been good for most of our agricultural borrowers. Our 2015 production levels for agricultural loans were consistent with recent years and at December 31, 2015, agricultural loans totaled \$376.5 million, or 5% of the loan portfolio, compared to \$238.5 million, or 6%, at December 31, 2014.

**Consumer and Other Lending:** Consumer lending has traditionally been a modest part of our business with loans made primarily to accommodate our existing customer base. In recent years, demand for consumer loans has been restrained; however, outstanding balances have increased modestly from organic production despite mortgage refinancing activity that has resulted in elevated repayments on home equity lines of credit. The significant increase in consumer loan balances in 2015 and 2014 largely reflects loans acquired as part of the bank acquisitions in 2015 and the Branch purchase in 2014. At December 31, 2015, our consumer loans increased \$287.7 million to \$636.9 million, or 9% of our loan portfolio, compared to \$349.2 million, or 9%, at December 31, 2014. As of December 31, 2015, 75% of our consumer loans were secured by one- to four-family real estate, including home equity lines of credit. Credit card balances totaled \$28 million at December 31, 2015 compared to \$24 million a year earlier.

**Loan Servicing Portfolio:** At December 31, 2015, we were servicing \$2.33 billion of loans serviced for others and held \$9.6 million in escrow for our portfolio of loans serviced for others. The loan servicing portfolio at December 31, 2015 was composed of \$976.8 million of Freddie Mac residential mortgage loans, \$700.8 million of Fannie Mae residential mortgage loans, \$404.6 million of Oregon Housing residential mortgage loans and \$251.1 million of other loans serviced for a variety of investors. The portfolio included loans secured by property located primarily in the states of Washington, Oregon and Idaho. For the year ended December 31, 2015, we recognized \$1.7 million of loan servicing fees in our results of operations, which was net of \$3.2 million of amortization for mortgage servicing rights (MSRs) and included no impairment charges or reversals for a valuation adjustment to MSRs.

**Mortgage Servicing Rights:** For the years ended December 31, 2015, 2014 and 2013, we capitalized \$5.3 million, \$3.0 million, and \$2.9 million, respectively, of MSRs relating to loans sold with servicing retained. We acquired \$2.2 million in MSRs from Siuslaw Bank in 2015, while no MSRs were purchased in 2014 and 2013. Amortization of MSRs for the years ended December 31, 2015, 2014 and 2013 was \$3.2 million, \$2.1 million, and \$2.4 million, respectively. Management periodically evaluates the estimates and assumptions used to determine the carrying values of MSRs and the amortization of MSRs. At December 31, 2015, our MSRs were carried at a value of \$13.3 million, net of amortization, compared to \$9.0 million at December 31, 2014.

The following table sets forth the composition of the Company's loan portfolio, by type of loan as of the dates indicated (dollars in thousands):

Table 3: Loan Portfolio Analysis

	December 31 2015		2014		2013		2012		2011	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Commercial real estate:										
Owner-occupied	\$1,327,807	18.2 %	\$546,783	14.3 %	\$502,601	14.7 %	\$489,581	15.1 %	\$469,806	14.2 %
Investment properties	1,765,353	24.1	856,942	22.4	692,457	20.2	583,641	18.0	621,622	18.9
Multifamily real estate	472,976	6.5	167,524	4.4	137,153	4.0	137,504	4.3	139,710	4.2
Commercial construction	72,103	1.0	17,337	0.5	12,168	0.4	30,229	0.9	42,391	1.3
Multifamily construction	63,846	0.9	60,193	1.6	52,081	1.5	22,581	0.7	19,436	0.6
One- to four-family construction	278,469	3.8	219,889	5.7	200,864	5.9	160,815	5.0	144,177	4.4
Land and land development:										
Residential	126,773	1.7	102,435	2.7	75,695	2.2	77,010	2.4	97,491	3.0
Commercial	33,179	0.5	11,152	0.3	10,450	0.3	13,982	0.4	15,197	0.5
Commercial business	1,207,944	16.5	723,964	18.9	682,169	20.0	618,049	19.1	601,440	18.2
Agricultural business, including secured by farmland	376,531	5.1	238,499	6.2	228,291	6.7	230,031	7.1	218,171	6.6
One- to four-family real estate	952,633	13.0	537,108	14.0	529,494	15.5	581,670	18.0	642,501	19.5
Consumer secured by one- to four-family real estate	478,420	6.5	222,205	5.8	173,188	5.1	170,123	5.3	181,049	5.5
Consumer—other	58,470	2.2	127,003	3.3	121,834	3.5	120,498	3.7	103,347	3.1
Total loans outstanding	7,314,504	100.0%	3,831,034	100.0%	3,418,445	100.0%	3,235,714	100.0%	3,296,338	100.0%
Less allowance for loan losses	(78,008 )		(75,907 )		(74,258 )		(77,491 )		(82,912 )	
Net loans	\$7,236,496		\$3,755,127		\$3,344,187		\$3,158,223		\$3,213,426	



The following table sets forth the Company's loans by geographic concentration at December 31, 2015 (dollars in thousands):

Table 4: Loans by Geographic Concentration

	Washington	Oregon	California	Idaho	Utah	Other	Total	
Total loans outstanding	\$3,343,112	\$1,446,531	\$1,234,016	\$496,870	\$325,011	\$468,964	\$7,314,504	
Percent of total loans	45.7	% 19.8	% 16.9	% 6.8	% 4.4	% 6.4	% 100.0	%

The following table sets forth certain information at December 31, 2015 regarding the dollar amount of loans maturing in our portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances are net of unamortized premiums and discounts, include loans held for sale and exclude the allowance for loan losses (in thousands):

Table 5: Loans by Maturity

	Maturing in One Year or Less	Maturing After One to Three Years	Maturing After Three to Five Years	Maturing After Five to Ten Years	Maturing After Ten Years	Total
Commercial real estate:						
Owner-occupied	\$60,326	\$147,167	\$109,230	\$756,519	\$254,565	\$1,327,807
Investment properties	98,208	225,880	124,114	895,065	422,086	1,765,353
Multifamily real estate	25,049	31,451	10,054	131,689	274,733	472,976
Commercial construction	40,786	19,520	—	6,273	5,524	72,103
Multifamily construction	40,430	23,172	—	244	—	63,846
One- to four-family construction	252,422	20,127	—	3,962	1,958	278,469
Land and land development:						
Residential	65,667	57,953	3,153	—	—	126,773
Commercial	16,331	10,097	2,996	3,230	525	33,179
Commercial business	543,500	167,435	233,738	199,789	63,482	1,207,944
Agricultural business, including secured by farmland	157,467	56,539	48,575	98,867	15,083	376,531
One- to four-family real estate	24,428	20,839	22,326	56,935	828,105	952,633
Consumer secured by one- to four-family real estate	7,050	9,738	5,376	23,896	432,360	478,420
Consumer—other	23,643	18,026	16,586	34,951	65,264	158,470
Total loans	\$1,355,307	\$807,944	\$576,148	\$2,211,420	\$2,363,685	\$7,314,504

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



The following table sets forth the dollar amount of all loans maturing after December 31, 2016 which have fixed interest rates and floating or adjustable interest rates (in thousands):

Table 6: Loans Maturing after One Year

	Fixed Rates	Floating or Adjustable Rates	Total
Commercial real estate:			
Owner-occupied	\$290,340	\$977,141	\$1,267,481
Investment properties	643,872	1,023,273	1,667,145
Multifamily real estate	102,312	345,615	447,927
Commercial construction	1,850	29,467	31,317
Multifamily construction	7,608	15,809	23,417
One- to four-family construction	5,980	20,066	26,046
Land and land development:			
Residential	9,063	52,043	61,106
Commercial	9,437	7,410	16,847
Commercial business	354,907	309,538	664,445
Agricultural business, including secured by farmland	80,415	138,649	219,064
One- to four-family real estate	612,953	315,252	928,205
Consumer secured by one- to four-family real estate	19,003	452,367	471,370
Consumer—other	88,934	45,893	134,827
Total loans maturing after one year	\$2,226,674	\$3,732,523	\$5,959,197

Deposits. We made further progress in 2015 implementing our strategies to strengthen our franchise by remixing our deposits away from higher cost certificates of deposit and emphasizing core deposit activity in non-interest-bearing and other transaction and savings accounts. This progress was significantly augmented by the acquisitions of Siuslaw Bank and AmericanWest, as both banks had strong core deposit balances and franchises. Increasing core deposits (transaction and savings accounts) is a fundamental element of our business strategy. This strategy continues to improve our cost of funds and increase the opportunity for deposit fee revenues, while stabilizing our funding base. Total deposits increased \$4.16 billion, or 107%, to \$8.06 billion at December 31, 2015 from \$3.90 billion at December 31, 2014, non-interest-bearing deposits increased by \$1.32 billion, or 102%, to \$2.62 billion at year end from \$1.30 billion at December 31, 2014, and interest-bearing transaction and savings accounts increased by \$2.25 billion, or 123%, to \$4.08 billion at December 31, 2015 compared to \$1.83 billion a year earlier. Our organic growth of core deposits followed similarly strong results in 2014 and, coupled with the acquired deposits, was primarily responsible for the reduced deposit costs and helped us to achieve the strong net interest margin we experienced in 2015 and a 33% increase in deposit fees and service charges compared to the preceding year. Certificates of deposit increased \$583.4 million, or 76%, to \$1.35 billion at December 31, 2015 from \$770.5 million at December 31, 2014. The increase in certificate balances in 2015 includes a \$158.1 million increase in brokered deposits to \$162.9 million at December 31, 2015, reflecting brokered deposits acquired in the AmericanWest acquisition. In addition to our organic growth in deposits, the acquisitions of AmericanWest and Siuslaw resulted in a \$3.82 billion increase in deposits, including \$1.09 billion in non-interest bearing deposits, \$2.11 billion in interest-bearing transaction and savings accounts, and \$620.8 million in certificates of deposit as of December 31, 2015.

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

Table 7: Deposits

	December 31 2015			2014			2013		
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	
Non-interest-bearing checking	\$2,619,618	32.5 %	\$1,320,752	\$1,298,866	33.3 %	\$183,520	\$1,115,346	30.8 %	
Interest-bearing checking	1,159,846	14.4	720,366	439,480	11.3	16,570	422,910	11.7	
Regular savings	1,284,642	16.0	383,500	901,142	23.1	102,378	798,764	22.1	
Money market	1,637,092	20.3	1,148,146	488,946	12.5	80,735	408,211	11.3	
Total transaction and savings accounts	6,701,198	83.2	3,572,764	3,128,434	80.2	383,203	2,745,231	75.9	
Certificates maturing:									
Within one year	985,193	12.2	420,692	564,501	14.5	(95,893 )	660,394	18.2	
After one year, but within two years	226,381	2.8	108,657	117,724	3.1	(65 )	117,789	3.3	
After two years, but within five years	139,082	1.7	55,350	83,732	2.1	(7,148 )	90,880	2.5	
After five years	3,214	0.1	(1,345 )	4,559	0.1	927	3,632	0.1	
Total certificate accounts	1,353,870	16.8	583,354	770,516	19.8	(102,179 )	872,695	24.1	
Total Deposits	\$8,055,068	100.0 %	\$4,156,118	\$3,898,950	100.0 %	\$281,024	\$3,617,926	100.0 %	
Included in Total Deposits:									
Public transaction accounts	\$209,430	2.6 %	\$106,576	\$102,854	2.6 %	\$15,333	\$87,521	2.4 %	
Public interest-bearing certificates	31,281	0.4	(4,065 )	35,346	0.9	(16,119 )	51,465	1.4	
Total public deposits	\$240,711	3.0 %	\$102,511	\$138,200	3.5 %	\$(786 )	\$138,986	3.8 %	
Total brokered deposits	\$162,936	2.0 %	\$158,137	\$4,799	0.1 %	\$508	\$4,291	0.1 %	

The following table indicates the amount of the Banks' certificates of deposit with balances equal to or greater than \$100,000 by time remaining until maturity as of December 31, 2015 (in thousands):

Table 8: Maturity Period—\$100,000 or greater CDs

	Certificates of Deposit \$100,000 or Greater
Maturing in three months or less	\$229,253
Maturing after three months through six months	82,908
Maturing after six months through twelve months	164,022
Maturing after twelve months	173,391
Total	\$649,574

The following table provides additional detail on geographic concentrations of our deposits at December 31, 2015 (in thousands):

Table 9: Geographic Concentration of Deposits

	Washington	Oregon	California	Idaho	Utah	Total	
Total deposits	\$4,219,304	\$1,648,421	\$1,592,365	\$435,099	\$159,879	\$8,055,068	
Percent of total deposits	52.4	% 20.4	% 19.8	% 5.4	% 2.0	% 100.0	%

**Borrowings.** The FHLB-Des Moines serves as our primary borrowing source. To access funds, we are required to own a sufficient level of capital stock in the FHLB-Des Moines and may apply for advances on the security of such stock and certain of our mortgage loans and securities provided that certain creditworthiness standards have been met. At December 31, 2015, we had \$133.4 million of FHLB advances outstanding (at fair value) at a weighted average rate of 0.68%, an increase of \$101.1 million compared to a year earlier. Also at December 31, 2015, we had an investment of \$16.1 million in FHLB capital stock. At that date, Banner Bank was authorized by the FHLB-Des Moines to borrow up to \$1.77 billion under a blanket floating lien security agreement, while Islanders Bank was approved to borrow up to \$28.0 million under a similar agreement.

The following table provides additional detail on our FHLB advances as of December 31, 2015 and 2014 (dollars in thousands):

Table 10: FHLB Advances Outstanding

	December 31		2014			
	2015	Weighted Average Rate	Amount	Weighted Average Rate		
Maturing in one year or less	\$107,600	0.55	% \$32,000	0.27		%
Maturing after one year through three years	25,000	1.19	—	—		
Maturing after three years through five years	—	—	—	—		
Maturing after five years	188	5.94	196	5.94		
Total FHLB advances, at par	132,788	0.68	32,196	0.27		
Fair value adjustment	593		54			
Total FHLB advances, carried at fair value	\$133,381		\$32,250			

At certain times the Federal Reserve Bank has also served as an important source of borrowings. The Federal Reserve Bank provides credit based upon acceptable loan collateral, which includes certain loan types not eligible for pledging

to the FHLB-Des Moines. At December 31, 2015, based upon our available unencumbered collateral, Banner Bank was eligible to borrow \$735.0 million from the Federal Reserve Bank; however, at that date we had no funds borrowed under this arrangement.

We also issue retail repurchase agreements to customers that are primarily related to customer cash management accounts and in the past have borrowed funds through the use of secured wholesale repurchase agreements with securities brokers. In each case, the repurchase agreements are generally due within 90 days. At December 31, 2015, retail and wholesale repurchase agreements totaling \$98.3 million, with a weighted average rate of 0.29%, were secured by pledges of certain mortgage-backed securities and agency securities. Retail repurchase agreement balances, which are primarily associated with customer sweep account arrangements, increased \$16.1 million, or 21%, from the 2014 year-end balance. We had \$5.0 million of borrowings under wholesale repurchase agreements at December 31, 2015, compared to none at December 31, 2014.

We have an aggregate of \$136.0 million, net of repayments, of trust preferred securities (TPS). This includes \$120.0 million issued by us and \$16.0 million acquired in the acquisitions of Starbuck and Siuslaw. The junior subordinated debentures associated with the TPS have been recorded as liabilities on our Consolidated Statements of Financial Condition, although portions of the TPS qualify as Tier 1 or Tier II capital for regulatory capital purposes. The junior subordinated debentures are carried at fair value on our Consolidated Statements of Financial Condition and have an estimated fair value of \$92.5 million at December 31, 2015. At December 31, 2015, the TPS had a weighted average rate of 2.76%. See Note 11, Junior Subordinated Debentures and Mandatorily Redeemable Trust Preferred Trust Preferred Securities, of the Notes to the Consolidated Financial Statements for additional information with respect to the TPS.

**Asset Quality.** Achieving and maintaining a moderate risk profile by employing appropriate underwriting standards, avoiding excessive asset concentrations and aggressively managing troubled assets has been and will continue to be a primary focus for us. As a result, our non-performing assets declined substantially from 2011 to 2014. The increase in non-performing assets in 2015 was primarily the result of REO properties acquired in the acquisitions of AmericanWest and Siuslaw Bank. All of our key credit quality metrics have improved compared to a year ago, and as a result our collection costs have been further reduced. In addition, our reserve levels are substantial and, as a result of our impairment analysis and charge-off actions, reflect current appraisals and valuation estimates as well as recent regulatory examination results. While our non-performing assets and credit costs have been materially reduced, we continue to be actively engaged with our borrowers in resolving remaining problem assets and with the effective management of real estate owned as a result of foreclosures.

Non-performing assets increased to \$27.1 million, or 0.28% of total assets, at December 31, 2015, from \$20.2 million, or 0.43% of total assets, at December 31, 2014, and decreased from \$28.9 million, or 0.66% of total assets, at December 31, 2013. Reflecting lingering weakness in certain segments of the economy and property values which now have generally stabilized but are lower than when many of the related loans were originated, we continued to maintain a strong allowance for loan losses at year end even though non-performing loans declined. At December 31, 2015, our allowance for loan losses was \$78.0 million, or 512% of non-performing loans, compared to \$75.9 million, or 454% of non-performing loans at December 31, 2014. We continue to believe our level of non-performing loans and assets is manageable and further believe that we have sufficient capital and human resources to manage the collection of our non-performing assets in an orderly fashion.

Loans are reported as restructured when we grant concessions to a borrower experiencing financial difficulties that we would not otherwise consider. As a result of these concessions, restructured loans or TDRs are impaired as the Banks will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. If any restructured loan becomes delinquent or other matters call into question the borrower's ability to repay full interest and principal in accordance with the restructured terms, the restructured loan(s) would be reclassified as nonaccrual. At December 31, 2015, we had \$21.8 million of restructured loans currently performing under their restructured terms.

Loans acquired in the merger transactions with deteriorated credit quality are accounted for as purchased credit impaired pools. Typically this would include loans that were considered non-performing or restructured as of the acquisition date. Accordingly, subsequent to acquisition, loans included in the purchased credit impaired pools are not reported as non-performing loans based upon their individual performance status, so the categories of nonaccrual, impaired and 90 day past due and accruing do not include any purchased credit impaired loans. Purchase credit impaired loans were \$58.6 million at December 31, 2015, compared to none in the prior years.





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

Table 11: Non-Performing Assets

	December 31					
	2015	2014	2013	2012	2011	
Nonaccrual loans: <sup>(1)</sup>						
Secured by real estate:						
Commercial	\$3,751	\$1,132	\$6,287	\$6,579	\$9,226	
Multifamily	—	—	—	—	362	
Construction/land	2,260	1,275	1,193	3,672	27,731	
One- to four-family	4,700	8,834	12,532	12,964	17,408	
Commercial business	2,159	537	723	4,750	13,460	
Agricultural business, including secured by farmland	697	1,597	—	—	1,896	
Consumer	703	1,187	1,173	3,396	2,905	
	14,270	14,562	21,908	31,361	72,988	
Loans more than 90 days delinquent, still on accrual:						
Secured by real estate:						
One- to four-family	899	2,095	2,611	2,877	2,147	
Commercial business	8	—	—	—	4	
Agricultural business, including secured by farmland	—	—	105	—	—	
Consumer	45	79	144	152	173	
	952	2,174	2,860	3,029	2,324	
Total non-performing loans	15,222	16,736	24,768	34,390	75,312	
Securities on nonaccrual	—	—	—	—	500	
REO assets held for sale, net <sup>(2)</sup>	11,627	3,352	4,044	15,778	42,965	
Other repossessed assets held for sale, net	268	76	115	75	74	
Total non-performing assets	\$27,117	\$20,164	\$28,927	\$50,243	\$118,851	
Total non-performing loans to net loans before allowance for loan losses	0.21	% 0.44	% 0.72	% 1.06	% 2.28	%
Total non-performing loans to total assets	0.16	% 0.35	% 0.56	% 0.81	% 1.77	%
Total non-performing assets to total assets	0.28	% 0.43	% 0.66	% 1.18	% 2.79	%
Restructured loans <sup>(3)</sup>	\$21,786	\$29,154	\$47,428	\$57,462	\$54,533	
Loans 30-89 days past due and on accrual	\$18,834	\$8,387	\$8,784	\$11,685	\$9,962	

Includes \$2.3 million of non-accrual restructured loans. For the year ended December 31, 2015, \$1.1 million in <sup>(1)</sup> interest income would have been recorded had nonaccrual loans been current, and no interest income on these loans was included in net income for this period.

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

<sup>(3)</sup> These loans are performing under their restructured terms.

In addition to the non-performing loans noted in Table 11 and purchased credit impaired loans as of December 31, 2015, we had other classified loans with an aggregate outstanding balance of \$35.8 million that are not on nonaccrual status with respect to which known information concerning possible credit problems with the borrowers or the cash flows of the properties securing the respective loans has caused management to be concerned about the ability of the borrowers to comply with present loan repayment terms. This may result in the future inclusion of such loans in the nonaccrual loan category.

From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current appraised value of property. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the years ended December 31, 2015, 2014 and 2013, we recognized \$216,000, \$36,000 and \$785,000, respectively, of these impairment charges. During the years ended December 31, 2015, 2014 and 2013, we received net

proceeds from the sale of REO of \$4.7 million, \$4.9 million and \$16.9 million, respectively, and recorded net gains on those sales of \$351,000, \$973,000 and \$2.5 million, respectively. At December 31, 2015, REO totaled \$11.6 million.

#### Comparison of Results of Operations for the Years Ended December 31, 2015 and 2014

For the year ended December 31, 2015, we had net income of \$45.2 million, or \$1.89 per diluted share. This compares to net income of \$54.1 million, or \$2.79 per diluted share, for the year ended December 31, 2014. Results for 2014 included a \$9.1 million bargain purchase gain (\$5.8 million net of income tax) related to the Branch purchase, which net of related acquisition expenses and taxes contributed \$0.30 to diluted net income per share. Acquisition-related expenses were \$26.1 million, or \$0.76 per diluted share net of tax benefit, in 2015 compared to \$4.3 million, or \$0.17 per diluted share net of tax benefit, in 2014.

Our operating results depend largely on our net interest income which, as explained below, increased by \$62.4 million to \$242.3 million, primarily because of the acquisition of AmericanWest and Siuslaw Bank, as well as significant organic loan and deposit growth. Our operating results for the year ended December 31, 2015 also reflected an increase in non-interest income, as strong growth in deposit fees and other service charges and revenues from mortgage banking operations more than offset the adverse variance from changes in valuation of financial instruments carried at fair value and the nonrecurring 2014 bargain purchase gain. Excluding fair value and OTTI adjustments, net gains on sale of securities and the bargain purchase gain in 2014, our non-interest income from core operations increased by \$19.1 million to \$63.6 million for the year ended December 31, 2015 compared to \$44.5 million the preceding year, primarily as a result of a \$10.1 million increase in deposit fees and other service charges and a \$7.5 million increase in mortgage banking operations. This increase in non-interest income from core operations, coupled with the increase in net interest income, produced an increase of \$81.6 million, or 36%, in revenue from core operations to \$305.9 million for the year ended December 31, 2015 compared to \$224.4 million for the year ended December 31, 2014. Non-interest expense increased to \$236.6 million for the year ended December 31, 2015 compared with \$153.7 million for the year ended December 31, 2014 largely as a result of acquisition-related expenses and incremental costs associated with acquiring and operating the 98 branches acquired in the AmericanWest acquisition on October 1, 2015 and the ten Siuslaw branches acquired in March 2015, as well as a full year's expense related to the Branch purchase in June 2014 and generally increased compensation, occupancy and payment and card processing services reflecting increased transaction volume.

**Net Interest Income.** Net interest income before provision for loan losses increased by \$62.4 million, or 35%, to \$242.3 million for the year ended December 31, 2015, compared to \$179.9 million one year earlier largely reflecting the acquisitions of AmericanWest and Siuslaw Bank and continued client acquisition. Net interest margin was enhanced by the amortization of acquisition accounting discounts on purchased loans received in Banner's acquisitions, which is accreted into loan interest income, as well as by net premiums on non-market-rate certificate of deposit liabilities assumed which are amortized as a reduction to deposit interest expense. The net interest margin of 4.10% for the year ended December 31, 2015 was three basis points higher than the prior year reflecting seven basis points from acquisition accounting adjustments, compared to just one basis point from acquisition accounting adjustments in 2014. The average yield on interest-earning assets for the year ended December 31, 2015 of 4.31% was flat compared to the prior year as favorable purchase accounting adjustments and modest changes in the mix of earning assets offset the impact of the low interest rate environment on loan yields. Funding costs were lower, as the average cost of funding liabilities decreased by five basis points to 0.22% as compared to the prior year. As a result, the net interest spread increased to 4.09% for the year ended December 31, 2015 compared to 4.04% for the prior year.

**Interest Income.** Interest income for the year ended December 31, 2015 was \$254.4 million, compared to \$190.7 million for the prior year, an increase of \$63.8 million, or 33%. The increase in interest income occurred as a result of the significant increase in the average balances of interest-earning assets. The average balance of interest-earning

assets was \$5.90 billion for the year ended December 31, 2015, an increase of \$1.48 billion, or 34%, compared to \$4.42 billion one year earlier. The yield on average interest-earning assets was 4.31% for both the years ended December 31, 2015 and 2014. The flat yield on earning assets reflects the continuing erosion of yields as loans mature or prepay and are replaced by lower yielding assets in the current low interest rate environment partially offset by the positive impact of the purchase accounting loan discount accretion, as well as modest improvement in securities yields and changes in the asset mix. Loan yields decreased five basis points to 4.78% for the year ended December 31, 2015 compared to 4.83% in the preceding year, reflecting a further decline in average loan rates which was only partially offset by the loan discount accretion. Average loans receivable for the year ended December 31, 2015 increased \$1.28 billion, or 35%, to \$4.96 billion, compared to \$3.68 billion for the prior year. Interest income on loans increased by \$59.8 million, or 34%, to \$237.3 million for the year ended December 31, 2015, from \$177.5 million for the prior year, reflecting the impact of the \$1.28 billion increase in average loan balances and the five basis point decrease in the average yield on loans.

The combined average balance of mortgage-backed securities, other investment securities, daily interest-bearing deposits and FHLB stock increased to \$941.0 million for the year ended December 31, 2015 (excluding the effect of fair value adjustments), compared to \$740.3 million for the year ended December 31, 2014, accounting for most of the \$4.0 million increase in interest and dividend income compared to the prior year. The average yield on the combined portfolio increased to 1.82% for the year ended December 31, 2015, from 1.77% for the prior year. Portfolio yields improved from higher interest rates on the securities acquired in the AmericanWest acquisition. The average yield on this portfolio also benefited from a \$15.2 million reduction in the average balance of FHLB stock which had a very low 0.67% dividend yield. For the year ended December 31, 2015, the average yield on mortgage-backed securities increased 17 basis points to 1.85% compared to the prior year, while the yield on other securities increased four basis points to 2.45% compared to the prior year.

Interest Expense. Interest expense for the year ended December 31, 2015 was \$12.2 million, compared to \$10.8 million for the prior year, an increase of \$1.4 million, or 13%. The increase in interest expense occurred as a result of a \$1.42 billion, or 35%, increase in average funding liabilities, partially offset by a five basis point decrease in the average cost of all funding liabilities to 0.22% for the year ended December 31, 2015, from 0.27% for the year ended December 31, 2014. This increase in average funding liabilities reflects increases in core deposits, including

non-interest-bearing deposits, interest-bearing transaction and savings accounts, and certificates of deposits reflecting the acquisitions of AmericanWest and Siuslaw Bank as well as organic growth. The growth in non-interest-bearing deposits and other core deposits continues to significantly contribute to our reduced funding costs.

Deposit interest expense increased \$807,000, or 11%, to \$8.4 million for the year ended December 31, 2015 compared to \$7.6 million for the prior year as a result of a \$1.39 billion, or 37%, increase in the average balance of deposits, partially offset by a four basis point decrease in the cost of deposits. Average deposit balances increased to \$5.21 billion for the year ended December 31, 2015, from \$3.82 billion for the year ended December 31, 2014, while the average rate paid on deposit balances decreased to 0.16% in the current year from 0.20% for the prior year. The cost of interest-bearing deposits decreased by five basis points to 0.24% for the year ended December 3, 2015 compared to 0.29% in the prior year. Also contributing to the decrease in total deposit costs was a \$570.9 million increase in the average balances of non-interest-bearing accounts during 2015. In addition, amortization of acquisition accounting net premiums on certificates of deposit reduced the cost of deposits by three basis points in the fourth quarter 2015 and by one basis point for the full year. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits frequently tend to lag changes in market interest rates and there was no noticeable effect from the recent increase in certain short-term market rates on our cost of deposits. Further, continuing changes in our deposit mix, especially growth in lower cost transaction and savings accounts, in particular non-interest-bearing deposits, through both acquisitions and organic growth meaningfully contributed to the decrease in our funding costs.

Average FHLB advances (excluding the effect of fair value adjustments) increased to \$49.8 million for the year ended December 31, 2015, compared to \$39.1 million for the prior year, and the average rate paid on FHLB advances for the year ended December 31, 2015 increased to 0.62% from 0.32% for the year ended December 31, 2014. Average FHLB advances increased primarily as a result of the acquisition of AmericanWest. The increases in average balances and the average rate paid on FHLB advances were responsible for the \$186,000 increase in the related interest expense to \$311,000 for the year ended December 31, 2015, from \$125,000 in the prior year.

Other borrowings consist primarily of retail repurchase agreements with customers secured by certain investment securities. The average balance for other borrowings increased \$10.1 million to \$94.2 million during the current year from \$84.1 million one year earlier, and the average rate on other borrowings increased to 0.22% from 0.20% a year earlier. As a result, interest expense for other borrowing increased to \$211,000 for the year ended December 31, 2015, compared to \$172,000 for the year ended December 31, 2014.

Junior subordinated debentures which were issued in connection with trust preferred securities had an average balance of \$132.6 million (excluding the effect of fair value adjustments) for the year ended December 31, 2015, compared to \$123.7 million for the year ended December 31, 2014. The increase in the average balance of junior subordinated debentures compared to a year earlier reflects the obligations assumed in connection with the two bank acquisitions. During 2015, the average rate increased to 2.45% compared to 2.36% for 2014. Our junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index. A higher level of LIBOR, particularly in the fourth quarter of 2015, resulted in the higher cost of the junior subordinated debentures for the year ended December 31, 2015 compared to the prior year.

Table 12, Analysis of Net Interest Spread, presents, for the periods indicated, our condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets and interest expense and rates paid on average interest-bearing liabilities. Average balances are computed using daily average balances. (See the footnotes to the tables for more information on average balances.)



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

Table 12: Analysis of Net Interest Spread

	Year Ended December 31, 2015			Year Ended December 31, 2014			Year Ended December 31, 2013		
	Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>	Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>	Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>
Interest-earning assets:									
Mortgage loans	\$3,754,386	\$183,260	4.88 %	\$2,681,747	\$133,576	4.98 %	\$2,388,222	\$124,859	5.23 %
Commercial/agricultural loans	1,076,440	46,053	4.28	882,291	36,793	4.17	783,076	35,622	4.55
Consumer and other loans	130,367	7,979	6.12	115,226	7,172	6.22	104,469	6,723	6.44
Total loans <sup>(1)</sup>	4,961,193	237,292	4.78	3,679,264	177,541	4.83	3,275,767	167,204	5.10
Mortgage-backed securities	490,002	9,049	1.85	344,571	5,779	1.68	335,680	5,168	1.54
Other securities	311,701	7,646	2.45	295,082	7,103	2.41	320,283	7,108	2.22
Interest-bearing deposits with banks	122,479	334	0.27	68,696	204	0.30	85,178	214	0.25
FHLB stock	16,768	112	0.67	31,981	34	0.11	36,154	18	0.05
Total investment securities	940,950	17,141	1.82	740,330	13,120	1.77	777,295	12,508	1.61
Total interest-earning assets	5,902,143	254,433	4.31	4,419,594	190,661	4.31	4,053,062	179,712	4.43
Non-interest-earning assets	413,503			205,378			204,077		
Total assets	\$6,315,646			\$4,624,972			\$4,257,139		
Deposits:									
Interest-bearing checking accounts	\$634,398	\$518	0.08	\$428,875	\$347	0.08	\$398,668	\$380	0.10
Savings accounts	1,134,849	1,511	0.13	856,736	1,310	0.15	763,318	1,572	0.21
Money market accounts	747,019	1,538	0.21	461,372	776	0.17	410,031	950	0.23
Certificates of deposit	928,545	4,818	0.52	875,340	5,145	0.59	943,268	6,835	0.72
Total interest-bearing deposits	3,444,811	8,385	0.24	2,622,323	7,578	0.29	2,515,285	9,737	0.39
Non-interest-bearing deposits	1,764,539	—	—	1,193,656	—	—	1,000,208	—	—
Total deposits	5,209,350	8,385	0.16	3,815,979	7,578	0.20	3,515,493	9,737	0.28
Other interest-bearing liabilities:									
FHLB advances	49,808	311	0.62	39,121	125	0.32	18,935	99	0.52
Other borrowings	94,176	211	0.22	84,126	172	0.20	84,961	192	0.23
Junior subordinated debentures	132,597	3,247	2.45	123,716	2,914	2.36	123,716	2,968	2.40
Total borrowings	276,581	3,769	1.36	246,963	3,211	1.30	227,612	3,259	1.43
Total funding liabilities	5,485,931	12,154	0.22	4,062,942	10,789	0.27	3,743,105	12,996	0.35
Other									
non-interest-bearing liabilities <sup>(2)</sup>	17,051			(1,991 )			(11,970 )		
Total liabilities	5,502,982			4,060,951			3,731,135		

Edgar Filing: BANNER CORP - Form 10-K

Shareholders' equity	812,664		564,021		526,004
Total liabilities and shareholders' equity	\$6,315,646		\$4,624,972		\$4,257,139
Net interest income/rate spread	\$242,279	4.09 %	\$179,872	4.04 %	\$166,716 4.08 %
Net interest margin		4.10 %		4.07 %	4.11 %
Average interest-earning assets / average interest-bearing liabilities		158.60%		154.03%	147.77%
Average interest-earning assets / average funding liabilities		107.59%		108.78%	108.28%
(footnotes follow)					

61

---



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

The following table sets forth the effects of changing rates and volumes on our net interest income during the periods shown (in thousands). Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate) and (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume). Effects on interest income attributable to changes in rate and volume (changes in rate multiplied by changes in volume) have been allocated between changes in rate and changes in volume (in thousands):

Table 13: Rate/Volume Analysis

	Year Ended December 31, 2015 Compared to Year Ended December 31, 2014			Year Ended December 31, 2014 Compared to Year Ended December 31, 2013		
	Increase (Decrease) in Income/Expense Due to			Increase (Decrease) in Income/Expense Due to		
	Rate	Volume	Net	Rate	Volume	Net
<b>Interest-earning assets:</b>						
Mortgage loans	\$(2,725 )	\$52,408	\$49,683	\$(6,105 )	\$14,822	\$8,717
Commercial/agricultural loans	977	8,284	9,261	(3,116 )	4,286	1,170
Consumer and other loans	(123 )	928	805	(226 )	675	449
Total loans <sup>(1)</sup>	(1,871 )	61,620	59,749	(9,447 )	19,783	10,336
Mortgage-backed securities	632	2,638	3,270	471	139	610
Other securities	137	406	543	579	(582 )	(3 )
Interest-bearing deposits with banks	(18 )	148	130	35	(45 )	(10 )
FHLB stock	180	(102 )	78	20	(4 )	16
Total investment securities	931	3,090	4,021	1,105	(492 )	613
Total net change in interest income on interest-earning assets	(940 )	64,710	63,770	(8,342 )	19,291	10,949
<b>Interest-bearing liabilities:</b>						
Deposits <sup>(2)</sup>	(608 )	1,413	805	(2,033 )	(126 )	(2,159 )
FHLB advances	145	41	186	(49 )	75	26
Other borrowings	17	22	39	(18 )	(2 )	(20 )
Junior subordinated debentures	119	214	333	(54 )	—	(54 )
Total borrowings	281	277	558	(121 )	73	(48 )
Total net change in interest expense on interest-bearing liabilities	(327 )	1,690	1,363	(2,154 )	(53 )	(2,207 )
Net change in net interest income	\$(613 )	\$63,020	\$62,407	\$(6,188 )	\$19,344	\$13,156

- (1) Includes loans accounted for on a nonaccrual basis and loans 90 days or more past due. Amortization of net deferred loan fees/costs is included with interest on loans.
- (2) Includes non-interest-bearing deposits.

**Provision and Allowance for Loan Losses.** As a result of adequate reserves already in place and declining delinquencies and loan charge-offs, as well as net recoveries for the past two years, we did not record a provision for loan losses in the year ended December 31, 2015. Similarly, we did not record a provision for the year ended

December 31, 2014. As discussed in the “Summary of Critical Accounting Policies” section above and in Note 1 of the Notes to the Consolidated Financial Statements, the provision and allowance for loan losses is one of the most critical accounting estimates included in our Consolidated Financial Statements.

The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management’s evaluation of the adequacy of general and specific loss reserves, trends in delinquencies, net charge-offs and current economic conditions. Our credit quality indicators have continued to improve, eliminating the need for a provision for loan losses for the years ended December 31, 2015 and 2014. Nonetheless, we continue to maintain a strong allowance for loan losses at December 31, 2015.

In accordance with acquisition accounting, loans acquired from AmericanWest and Siuslaw Bank were recorded at their estimated fair value, which resulted in a net discount to the loans contractual amounts, of which a portion reflects a discount for possible credit losses. Credit discounts are included in the determination of fair value and as a result no allowance for loan and lease losses is recorded for acquired loans at the acquisition date. Although the discount recorded on the acquired loans is not reflected in the allowance for loan losses, or related allowance coverage ratios, we believe it should be considered when comparing the current ratios to similar ratios in periods prior to the acquisitions of AmericanWest and Siuslaw Bank.

We recorded net recoveries of \$2.1 million for the year ended December 31, 2015, compared to net recoveries of \$1.6 million for the prior year, and non-performing loans decreased by \$1.5 million during the year to \$15.2 million at December 31, 2015, compared to \$16.7 million at December 31, 2014. A comparison of the allowance for loan losses at December 31, 2015 and 2014 reflects an increase of \$2.1 million, or 3%, to \$78.0 million at December 31, 2015, from \$75.9 million at December 31, 2014. Included in our allowance at December 31, 2015 was an unallocated portion of \$2.8 million, which was based upon our evaluation of various factors that were not directly measured in the determination of the formula and specific allowances. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) decreased to 1.07% at December 31, 2015, compared to 1.98% at December 31, 2014. If the allowance for loan losses and loans were grossed up for the remaining acquisition accounting loan discount, the adjusted allowance for loans to adjusted loans would have been 1.65% as of December 31, 2015.

We believe that the allowance for loan losses was adequate to absorb the known and inherent risks of loss in the loan portfolio as of December 31, 2015. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that these estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

The following table sets forth an analysis of our allowance for loan losses for the periods indicated (dollars in thousands):

Table 14: Changes in Allowance for Loan Losses

	Years Ended December 31					
	2015	2014	2013	2012	2011	
Balance, beginning of period	\$75,907	\$74,258	\$76,759	\$82,180	\$96,669	
Provision	—	—	—	13,000	35,000	
Recoveries of loans previously charged off:						
Commercial real estate	819	1,507	2,367	921	53	
Multifamily real estate	113	—	—	—	—	
Construction and land	1,811	1,776	2,275	2,954	1,602	
Commercial business	772	988	1,673	2,425	1,082	
Agricultural business, including secured by farmland	948	1,576	697	49	20	
One- to four-family real estate	1,927	618	145	586	356	
Consumer	570	528	340	531	304	
	6,960	6,993	7,497	7,466	3,417	
Loans charged off:						
Commercial real estate	(64 )	(1,239 )	(2,569 )	(4,065 )	(6,079 )	
Multifamily real estate	—	(20 )	—	—	(682 )	
Construction and land	(891 )	(207 )	(1,821 )	(6,546 )	(26,328 )	
Commercial business	(419 )	(1,344 )	(1,782 )	(6,485 )	(8,396 )	
Agricultural business, including secured by farmland	(746 )	(179 )	(248 )	(456 )	(477 )	
One- to four-family real estate	(1,225 )	(885 )	(2,139 )	(5,328 )	(9,910 )	
Consumer	(1,514 )	(1,470 )	(1,439 )	(3,007 )	(1,034 )	
	(4,859 )	(5,344 )	(9,998 )	(25,887 )	(52,906 )	
Net (charge-offs) recoveries	2,101	1,649	(2,501 )	(18,421 )	(49,489 )	
Balance, end of period	\$78,008	\$75,907	\$74,258	\$76,759	\$82,180	
Allowance for loan losses as a percent of total loans	1.07	% 1.98	% 2.17	% 2.37	% 2.49	%
Net loan (charge-offs) recoveries as a percent of average outstanding loans during the period	0.04	% 0.04	% (0.08)	)% (0.57)	)% (1.50)	)%
Allowance for loan losses as a percent of non-performing loans	512	% 454	% 300	% 223	% 109	%
Net loan discount on acquired loans	\$43,657	\$—	\$—	\$—	\$—	
Adjusted allowance for loan losses/Adjusted loans (non-GAAP)	1.65	% 1.98	% 2.17	% 2.37	% 2.49	%

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated (dollars in thousands):

Table 15: Allocation of Allowance for Loan Losses

	December 31		2014		2013		2012		2011	
	2015									
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
Specific or allocated loss allowances <sup>(1)</sup> :										
Commercial real estate	\$20,716	42.3 %	\$18,784	36.7 %	\$16,759	34.9 %	\$15,322	33.1 %	\$16,457	33.1 %
Multifamily real estate	4,195	6.5	4,562	4.4	5,306	4.0	4,506	4.3	3,952	4.2
Construction and land	27,131	7.9	23,545	10.8	17,640	10.3	14,991	9.4	18,184	9.8
One-to-four-family real estate	4,732	13.0	12,043	18.9	11,773	20.0	9,957	19.1	15,159	18.2
Commercial business	13,856	16.5	2,821	6.2	2,841	6.7	2,295	7.1	1,548	6.6
Agricultural business, including secured by farmland	3,645	5.1	8,447	14.0	11,486	15.5	16,475	18.0	12,299	19.5
Consumer	902	8.7	483	9.0	1,335	8.6	1,348	9.0	1,253	8.6
Total allocated	75,177		70,685		67,140		64,894		68,852	
Unallocated <sup>(1)</sup>	2,831	n/a	5,222	n/a	7,118	n/a	11,865	n/a	13,328	n/a
Total allowance for loan losses	\$78,008	100.0 %	\$75,907	100.0 %	\$74,258	100.0 %	\$76,759	100.0 %	\$82,180	100.0 %

We establish specific loss allowances when individual loans are identified that present a possibility of loss (i.e., <sup>(1)</sup> that full collectability is not reasonably assured). The remainder of the allocated and unallocated allowance for loan losses is established for the purpose of providing for estimated losses which are inherent in the loan portfolio.

Non-interest Income. The following table presents the key components of non-interest income for the years ended December 31, 2015, 2014, 2013 (dollars in thousands):

Table 16: Non-interest Income

	2015 compared to 2014				2014 compared to 2013				
	2015	2014	Change Amount	Change Percent	2014	2013	Change Amount	Change Percent	
Deposit fees and other service charges	\$40,607	\$30,553	\$10,054	32.9	% \$30,553	\$26,581	\$3,972	14.9	%
Mortgage banking operations	17,720	10,249	7,471	72.9	% 10,249	11,170	(921)	(8.2)	)%
Bank owned life insurance	2,497	1,809	688	38.0	% 1,809	2,020	(211)	(10.4)	)%
Miscellaneous	2,821	1,885	936	49.7	% 1,885	2,784	(899)	(32.3)	)%
Net gain on sale of securities	(540)	) 42	(582)	(1,385.7)	)% 42	1,022	(980)	(95.9)	)%
Other-than-temporary impairment recovery (loss)	—	—	—	—	% —	409	(409)	(100.0)	)%
Net change in valuation of financial instruments carried at fair value	(813)	) 1,374	(2,187)	(159.2)	)% 1,374	(2,278)	) 3,652	(160.3)	)%
Proposed acquisition termination fee	—	—	—	—	% —	2,954	(2,954)	(100.0)	)%
Acquisition bargain purchase gain	—	9,079	(9,079)	(100.0)	)% 9,079	—	9,079	100.0	%
Total non-interest income	\$62,292	\$54,991	\$7,301	13.3	% \$54,991	\$44,662	\$10,329	23.1	%

Non-interest income, which includes changes in the valuation of financial instruments carried at fair value, net gain on sale of securities, and an acquisition bargain purchase gain in 2014, as well as non-interest revenues from core operations, increased \$7.3 million, or 13%, to \$62.3 million for the year ended December 31, 2015, compared to \$55.0 million for the year ended December 31, 2014. This increase was primarily due to the strong growth in deposit fees and other service charges and mortgage banking operations, more than offsetting the \$9.1 million bargain purchase gain on the Branch purchase recorded in 2014. Excluding fair value adjustments, net gains on the sale of securities and the bargain purchase gain in the prior year, non-interest income from core operations increased \$19.1 million to \$63.6 million for the year ended December 31, 2015 compared to \$44.5 million at December 31, 2014. Reflecting growth in the number of deposit accounts both through the acquisitions and organic growth as well as increased transaction activity, income from deposit fees and other service charges increased by \$10.1 million, or 33%, to \$40.6 million for the year ended December 31, 2015, compared to \$30.6 million for the prior year. Mortgage banking revenues increased by \$7.5 million to \$17.7 million for the year ended December 31, 2015, compared to \$10.2 million in the prior year. Sales of one-to-four family loans held for sale for the year ended December 31, 2015 totaled \$610.4 million compared to \$367.9 million for the year ended December 31, 2014, reflecting increased refinancing activity, as well as a strong home purchase market and our increased market presence.

For the year ended December 31, 2015, we recorded a net loss of \$813,000 for changes in the valuation of financial instruments carried at fair value, compared to a net gain of \$1.4 million for the year ended December 31, 2014. The adjustments in 2015 primarily reflect changes in the valuation of certain investment securities, which resulted in \$2.0 million in net gains, as well as changes in the valuation of the junior subordinated debentures we have issued, which resulted in \$2.7 million in charges. The net fair value gains in 2014 primarily reflected changes in the valuation of

certain investment securities resulting in \$5.5 million in net gains and changes in the valuation of the junior subordinated debentures, which resulted in \$4.1 million in charges. As discussed more thoroughly in Note 18 of the Notes to the Consolidated Financial Statements, the valuation for many of these financial instruments has been difficult and more subjective in recent periods as current and reliable observable transaction data is very limited.

Non-interest Expense. The following table represents key elements of non-interest expense for the years ended December 31, 2015, 2014, 2013 (dollars in thousands).

Table 17: Non-interest Expense

	2015 compared to 2014				2014 compared to 2013				
	2015	2014	Change Amount	Change Percent	2014	2013	Change Amount	Change Percent	
Salaries and employee benefits	\$ 127,282	\$ 89,778	\$ 37,504	41.8 %	\$ 89,778	\$ 84,388	\$ 5,390	6.4 %	
Less capitalized loan origination costs	(14,379 )	(11,730 )	(2,649 )	22.6 %	(11,730 )	(11,227 )	(503 )	4.5 %	
Occupancy and equipment	30,366	22,743	7,623	33.5 %	22,743	21,423	1,320	6.2 %	
Information/computer data services	12,110	8,131	3,979	48.9 %	8,131	7,309	822	11.2 %	
Payment and card processing expenses	16,430	11,460	4,970	43.4 %	11,460	9,870	1,590	16.1 %	
Professional services	4,828	3,753	1,075	28.6 %	3,753	3,781	(28 )	(0.7 )%	
Advertising and marketing	7,649	6,266	1,383	22.1 %	6,266	6,885	(619 )	(9.0 )%	
Deposit insurance	3,189	2,415	774	32.0 %	2,415	2,329	86	3.7 %	
State/Municipal business and use taxes	1,889	1,437	452	31.5 %	1,437	1,941	(504 )	(26.0 )%	
REO operations	397	(446 )	843	189.0 %	(446 )	(689 )	243	35.3 %	
Amortization of core deposit intangibles	3,164	1,990	1,174	59.0 %	1,990	1,941	49	2.5 %	
Acquisition related costs	26,110	4,325	21,785	503.7 %	4,325	550	3,775	686.4 %	
Miscellaneous	17,565	13,619	3,946	29.0 %	13,619	12,474	1,145	9.2 %	
Total non-interest expense	\$ 236,600	\$ 153,741	\$ 82,859	53.9 %	\$ 153,741	\$ 140,975	\$ 12,766	9.06 %	

Non-interest expense for the year ended December 31, 2015 was \$236.6 million, an increase of \$82.9 million, or 54%, as compared to the same period in 2014. The increase is largely attributable to acquisition-related expenses and incremental costs associated with the acquired branches, support facilities and yet to be consolidated operation systems, as well as generally increased compensation, occupancy and payment and card processing services reflecting increased transaction volume. Acquisition-related costs added \$26.1 million to non-interest expense in the current year compared to \$4.3 million in the year ended December 31, 2014. Compensation expense increased \$37.5 million to \$127.3 million for the year ended December 31, 2015 from \$89.8 million for the year ended December 31, 2014, primarily reflecting additional staffing as a result of our acquisitions and to a lesser extent normal salary and wage adjustments, partially offset by a \$2.6 million increase in the amount of the credit for capitalized loan origination costs, reflecting an increase in loan originations. Payment and card processing expenses increased by \$5.0 million, reflecting the significant growth in core deposits and account activity from acquisitions and organic growth. Occupancy and equipment expenses increased \$7.6 million, or 34%, to \$30.4 million in 2015, compared to \$22.7 million in 2014 largely as a result of the branches and support facilities acquired. Information and computer data services expense increased \$4.0 million, or 49%, to \$12.1 million in the current year, compared to \$8.1 million in the prior year, reflecting additional costs required for expanding systems and operations associated with the acquisitions and the Branch purchase, and the additional expense of operating two core systems prior to the AmericanWest system conversion. REO operations for the year ended December 31, 2015 resulted in expense of \$397,000, compared to a net credit of \$446,000 in the prior year, and included \$216,000 of valuation adjustments and \$351,000 of net gains on the



sale of properties in addition to the carrying costs related to repossessed properties.

**Income Taxes.** For the year ended December 31, 2015, we recognized \$22.7 million in income tax expense for an effective rate of 33.5%, which reflects our normal statutory rate reduced by the impact of tax-exempt income and certain tax credits partially offset by certain non-deductible acquisition expense. Our normal, expected statutory income tax rate is 37.2%, representing a blend of the statutory federal income tax rate of 35.0% and apportioned effects of the state and local jurisdictions where we do business. For the year ended December 31, 2014, we recognized \$27.1 million in income tax expense for an effective tax rate of 33.3%. For more information on income taxes and deferred taxes, see Note 12 of the Notes to the Consolidated Financial Statements.

#### Comparison of Results of Operations for the Years Ended December 31, 2014 and 2013

For the year ended December 31, 2014, we had net income of \$54.1 million, or \$2.79 per diluted share. This compared to net income of \$46.2 million, or \$2.38 per diluted share, for the year ended December 31, 2013. Our 2014 operating results were influenced by very low interest rates

which produced downward pressure on asset yields. Nonetheless, significant growth in earning assets, as well as changes in the asset mix and further reductions in funding costs combined to offset this yield pressure. In addition, credit costs remained low and deposit fees and other payment processing revenues increased compared to the prior year reflecting growth in client relationships. In the year ended December 31, 2014, net income was also significantly augmented by a \$9.1 million bargain purchase gain (\$5.8 million net of income tax) realized from the Branch purchase. As a result, Banner's net income for the year ended December 31, 2014 increased 17% compared to a year earlier, and produced a return on average assets of 1.17%, an improvement from 1.09% for the year ended December 31, 2013.

Our net interest income, as explained below, increased by \$13.2 million to \$179.9 million, primarily because of a significant increase in average interest-earning assets and reductions in deposit and funding costs, despite a reduction in loan yields. Our operating results for the year ended December 31, 2014 also reflected a significant increase in non-interest income, which was particularly influenced by the bargain purchase gain related to the Branch purchase and a \$3.7 million favorable variance in the net change in valuation of financial instruments carried at fair value. Excluding fair value and OTTI adjustments, net gains on sale of securities, the bargain purchase gain in 2014, and, in 2013 a proposed acquisition termination fee, our non-interest income from core operations increased by \$1.9 million to \$44.5 million for the year ended December 31, 2014 compared to \$42.6 million the preceding year, primarily as a result of a \$4.0 million increase in deposit fees and other service charges. This increase in non-interest income from core operations, coupled with the increase in net interest income, produced an increase of \$15.1 million, or 7%, in revenue from core operations to \$224.4 million for the year ended December 31, 2014 compared to \$209.3 million for the year ended December 31, 2013. Non-interest expense increased to \$153.7 million for the year ended December 31, 2014 compared with \$141.0 million for the year ended December 31, 2013 largely as a result of costs related to transaction, integration and conversion expenses for the Branch purchase, acquisition expenses related to the Siuslaw and Starbuck transactions and increased compensation expense.

**Net Interest Income.** Net interest income before provision for loan losses increased by \$13.2 million, or 8%, to \$179.9 million for the year ended December 31, 2014, compared to \$166.7 million one year earlier, as a decrease in the net interest margin was more than offset by an increase in the average balance of interest-earning assets. The net interest margin of 4.07% for the year ended December 31, 2014 was four basis points lower than the prior year reflecting the impact of persistently low market interest rates on earning asset yields, which was only partially offset by changes in the earning asset mix and reductions in deposit and other funding costs. As a result of low market interest rates, the yield on interest-earning assets for the year ended December 31, 2014 decreased by 12 basis points compared to the prior year. Funding costs were also significantly lower, although not enough to offset the entire decline in asset yields, as the cost of funding liabilities decreased by eight basis points compared to the prior year. As a result, the net interest spread decreased to 4.04% for the year ended December 31, 2014 compared to 4.08% for the prior year.

**Interest Income.** Interest income for the year ended December 31, 2014 was \$190.7 million, compared to \$179.7 million for the prior year, an increase of \$10.9 million, or 6%. The increase in interest income occurred as a result of an increase in the average balances of interest-earning assets, which was partially offset by a decline in the average yield. The average balance of interest-earning assets was \$4.42 billion for the year ended December 31, 2014, an increase of \$366.5 million, or 9%, compared to \$4.05 billion one year earlier. The yield on average interest-earning assets decreased 12 basis points to 4.31% for the year ended December 31, 2014, compared to 4.43% one year earlier. The decrease in the yield on earning assets reflected the erosion of yields as loans matured or prepaid and are replaced by lower yielding assets in the low interest rate environment. The pressure from lower market interest rates was particularly evident as our loan yields decreased 27 basis points to 4.83% for the year ended December 31, 2014 compared to 5.10% in the preceding year. Average loans receivable for the year ended December 31, 2014 increased \$403.5 million, or 12%, to \$3.68 billion, compared to \$3.28 billion for the prior year. Interest income on loans increased by \$10.3 million, or 6%, to \$177.5 million for the year ended December 31, 2014, from \$167.2 million for the prior year, reflecting the impact of the \$403.5 million increase in average loan balances, partially offset by the 27 basis point decrease in the average yield on loans.

The combined average balance of mortgage-backed securities, other investment securities, daily interest-bearing deposits and FHLB stock decreased to \$740.3 million for the year ended December 31, 2014 (excluding the effect of

fair value adjustments), compared to \$777.3 million for the year ended December 31, 2013; however, the interest and dividend income from those investments increased by \$612,000 compared to the prior year. The average yield on the combined portfolio increased to 1.77% for the year ended December 31, 2014, from 1.61% for the prior year.

Portfolio yields improved from higher rates on new purchases and from the maturity or sale of some lower yielding securities. The yield on this portfolio also benefited from a \$4.2 million reduction in the average balance of FHLB stock which had a very low 0.11% dividend yield.

**Interest Expense.** Interest expense for the year ended December 31, 2014 was \$10.8 million, compared to \$13.0 million for the prior year, a decrease of \$2.2 million, or 17%. The decrease in interest expense occurred as a result of an eight basis point decrease in the average cost of all funding liabilities to 0.27% for the year ended December 31, 2014, from 0.35% one year earlier, partially offset by a \$319.8 million, or 9%, increase in average funding liabilities. The increase in average funding liabilities reflected increases in core deposits including non-interest-bearing accounts and advances from the FHLB, partially offset by a continued decline in certificates of deposits. The growth in non-interest-bearing deposits and other core deposits during both years significantly contributed to the reduced funding costs.

Deposit interest expense decreased \$2.1 million, or 22%, to \$7.6 million for the year ended December 31, 2014 compared to \$9.7 million for the prior year as a result of an eight basis point decrease in the cost of deposits, partially offset by a \$300.5 million, or 9%, increase in the average balance of deposits. Average deposit balances increased to \$3.82 billion for the year ended December 31, 2014, from \$3.52 billion for the year ended December 31, 2013, while the average rate paid on deposit balances decreased to 0.20% in the current year from 0.28% for the prior year. The cost of interest-bearing deposits decreased by ten basis points to 0.29% for the year ended December 31, 2014, compared to 0.39% in the prior year. Also contributing to the decrease in total deposit costs was a \$193.4 million increase in the average balances of non-interest-bearing accounts. Deposit costs are significantly affected by changes in the level of market interest rates; however, changes in the average rate paid for interest-bearing deposits frequently tend to lag changes in market interest rates as evidenced by the continuing decline in deposit costs despite relatively stable short-term market interest rates during the year ended December 31, 2014. Further, changes in our deposit mix, especially

growth in lower cost transaction and savings accounts, in particular non-interest-bearing deposits, meaningfully contributed to the decrease in our funding costs compared to earlier periods.

Average FHLB advances (excluding the effect of fair value adjustments) increased to \$39.1 million for the year ended December 31, 2014, compared to \$18.9 million for the prior year, while the average rate paid on FHLB advances for the year ended December 31, 2014 decreased to 0.32% from 0.52% for the year ended December 31, 2013. Average FHLB advances increased as a result of certain cash management activities at Banner Bank, while the cost of the advances declined as a result of the maturity of a higher rate fixed-term advance in February 2013. The increase in average balances on FHLB advances was responsible for the \$26,000 increase in the related interest expense to \$125,000 for the year ended December 31, 2014, from \$99,000 in the prior year, despite the decrease in the average rate paid for the year.

Other borrowings consisted primarily of retail repurchase agreements with customers secured by certain investment securities. The average balance for other borrowings decreased \$835,000 to \$84.1 million during the year ended December 31, 2014 from \$85.0 million one year earlier, while the average rate on other borrowings decreased to 0.20% from 0.23% a year earlier. As a result, interest expense for other borrowing decreased to \$172,000 for the year ended December 31, 2014, compared to \$192,000 for the year ended December 31, 2013.

Our junior subordinated debentures had an average balance of \$123.7 million (excluding the effect of fair value adjustments) for both the years ended December 31, 2014 and 2013. During 2014, the average rate decreased to 2.36% compared to 2.40% for 2013. A modestly lower level of LIBOR resulted in the lower cost of the junior subordinated debentures for the year ended December 31, 2014 compared to the prior year.

**Non-interest Income.** Non-interest income, which includes changes in the valuation of financial instruments carried at fair value, OTTI charges and recoveries, net gain on sale of securities, an acquisition bargain purchase gain in 2014 and a proposed acquisition termination fee in 2013, as well as non-interest revenues from core operations, increased \$10.3 million to \$54.9 million for the year ended December 31, 2014, compared to \$44.7 million for the year ended December 31, 2013. This increase was primarily due to a \$9.1 million bargain purchase gain on the Branch purchase. Excluding fair value and OTTI adjustments, net gains on the sale of securities, the bargain purchase gain in 2014, and, in the prior year a fee received from the termination of a proposed acquisition, non-interest income from core operations increased \$1.9 million to \$44.5 million for the year ended December 31, 2014 compared to \$42.6 million at December 31, 2013, largely as a result of increased revenues from deposit fees and other service charges. Reflecting growth in the number of deposit accounts, increased transaction activity and our decision to change our debit card relationship to MasterCard®, income from deposit fees and other service charges increased by \$4.0 million, or approximately 15%, to \$30.6 million for the year ended December 31, 2014, compared to \$26.6 million for the prior year. Mortgage banking revenues decreased by \$921,000 to \$10.2 million for the year ended December 31, 2014, compared to \$11.2 million in the prior year; however, revenues from mortgage banking operations for the year ended December 31, 2013 included \$1.3 million as a result of reversing prior-period valuation adjustments for mortgage servicing rights. Loan sales for the year ended December 31, 2014 totaled \$379.2 million, compared to \$462.5 million for the year ended December 31, 2013 reflecting reduced refinancing activity. Miscellaneous revenues decreased \$527,000, largely because of a \$450,000 recovery from the IRS as a result of amending certain prior-period income tax returns that was recorded in income in 2013.

For the year ended December 31, 2014, we recorded a net gain of \$1.4 million for changes in the valuation of financial instruments carried at fair value, compared to a net charge of \$2.3 million for the year ended December 31, 2013. The adjustments in 2014 primarily reflected changes in the valuation of certain investment securities, which resulted in \$5.5 million in net gains, as well as changes in the valuation of the junior subordinated debentures we have issued, which resulted in \$4.1 million in charges. The net fair value loss in 2013 primarily reflected changes in the valuation of certain investment securities resulting in \$1.5 million in net charges and changes in the valuation of the junior subordinated debentures, which resulted in \$865,000 in charges.

**Non-interest Expense.** Non-interest expense for the year ended December 31, 2014 totaled \$153.7 million compared to \$141.0 million in 2013, an increase of \$12.8 million, or 9%, compared to the prior year, largely attributable to acquisition-related costs and incremental costs associated with operating the six acquired branches, as well as generally increased compensation and activity-based expenses. Acquisition-related costs added \$4.3 million to

non-interest expense in 2014 compared to \$550,000 in the year ended December 31, 2013. Compensation expense increased \$5.4 million to \$89.8 million for the year ended December 31, 2014 from \$84.4 million for the year ended December 31, 2013, primarily reflecting salary and wage adjustments, increased staffing and higher benefit costs, partially offset by a \$503,000 increase in the amount of the credit for capitalized loan origination costs, reflecting an increase in loan originations. Payment and card processing expenses increased by \$1.6 million, reflecting the significant growth in core deposits and account activity. Occupancy and equipment expenses increased \$1.3 million, or 6%, to \$22.7 million in 2014, compared to \$21.4 million in 2013 largely as a result of the Branch purchase. Information and computer data services expense increased \$822,000, or 11%, to \$8.1 million in 2014, compared to \$7.3 million in the prior year. REO operations for the year ended December 31, 2014 resulted in a net credit of \$446,000, compared to a net credit of \$689,000 in the prior year, and included \$36,000 of valuation adjustments and \$973,000 of net gains on the sale of properties. Partially offsetting these increases, advertising and marketing decreased \$619,000 (9%) and state/municipal business and use taxes decreased \$504,000 (26%) for the year ended December 31, 2014 compared to the prior year. Most other categories of non-interest expense were little changed from a year earlier.

**Income Taxes.** For the year ended December 31, 2014, we recognized \$27.1 million in income tax expense for an effective rate of 33.3%, which reflects our normal statutory rate reduced by the impact of tax-exempt income and certain tax credits. Our normal, expected statutory income tax rate is 33.3%, representing a blend of the statutory federal income tax rate of 35.0% and apportioned effects of the 7.6% Oregon and 7.4% Idaho income tax rates. For the year ended December 31, 2013, we recognized \$24.2 million in income tax expense for an effective tax rate of 34.4%.

## Market Risk and Asset/Liability Management

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

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

The greatest source of interest rate risk to us results from the mismatch of maturities or repricing intervals for rate sensitive assets, liabilities and off-balance sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets, although our floating-rate assets tend to be more immediately responsive to changes in market rates than most funding deposit liabilities. Additional interest rate risk results from mismatched repricing indices and formula (basis risk and yield curve risk), and product caps and floors and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to us. An exception to this generalization is the beneficial effect of interest rate floors on a substantial portion of our performing floating-rate loans, which help us maintain higher loan yields in periods when market interest rates decline significantly. However, in a declining interest rate environment, as loans with floors are repaid they generally are replaced with new loans which have lower interest rate floors. As of December 31, 2015, our loans with interest rate floors totaled approximately \$2.50 billion and had a weighted average floor rate of 4.78%. An additional source of interest rate risk, which is currently of concern, is a prolonged period of exceptionally low market interest rates. Because interest-bearing deposit costs have been reduced to nominal levels, there is very little possibility that they will be significantly further reduced and our non-interest-bearing deposits are an increasingly significant percentage of total deposits. By contrast, if market rates remain very low, loan and securities yields will likely continue to decline as longer-term instruments mature or are repaid. As a result, a prolonged period of very low interest rates will likely result in compression of our net interest margin. While this pressure on the margin may be mitigated by further changes in the mix of assets and deposits, particularly increases in non-interest-bearing deposits, a prolonged period of low interest rates will present a very difficult operating environment for most banks, including us.

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

## Sensitivity Analysis

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

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

The following table sets forth as of December 31, 2015 and 2014, the estimated changes in our net interest income over one-year and two-year time horizons and the estimated changes in economic value of equity based on the indicated interest rate environments (dollars in thousands):

Table 21: Interest Rate Risk Indicators

Change (in Basis Points) in Interest Rates (1)	December 31, 2015					
	Estimated Increase (Decrease) in					
	Net Interest Income Next 12 Months		Net Interest Income Next 24 Months		Economic Value of Equity	
+400	\$(9,589 )	(2.7 )%	\$(235 )	—	%	\$(97,268 ) (6.6 )%
+300	(7,233 )	(2.0 )	265	—		(55,534 ) (3.8 )
+200	(4,950 )	(1.4 )	627	0.1		(21,436 ) (1.5 )
+100	(2,382 )	(0.7 )	1,218	0.2		3,988 0.3
0	—	—	—	—		—
-25	(514 )	(0.1 )	(3,631 )	(0.5 )		(32,013 ) (2.2 )
Change (in Basis Points) in Interest Rates (1)	December 31, 2014					
	Estimated Increase (Decrease) in					
	Net Interest Income Next 12 Months		Net Interest Income Next 24 Months		Economic Value of Equity	
+400	\$(2,541 )	(1.4 )%	\$7,254	2.0	%	\$(49,388 ) (6.3 )%
+300	(1,807 )	(1.0 )	6,201	1.7		(30,791 ) (3.9 )
+200	(1,040 )	(0.6 )	5,157	1.4		(15,628 ) (2.0 )
+100	(1,088 )	(0.6 )	2,088	0.6		(2,209 ) (0.3 )
0	—	—	—	—		—
-25	264	0.1	(826 )	(0.2 )		(9,681 ) (1.2 )

(1) Assumes an instantaneous and sustained uniform change in market interest rates at all maturities; however, no rates are allowed to go below zero. The current targeted federal funds rate is between 0.25% and 0.50%.

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

Certain shortcomings are inherent in gap analysis. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as ARM loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the



event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of some borrowers to service their debt may decrease in the event of a severe change in market rates.

Table 22, Interest Sensitivity Gap, presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at December 31, 2015 and 2014. The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities which are anticipated by us, based upon certain assumptions, to reprice or mature in each of the future periods shown. At December 31, 2015, total interest-earning assets maturing or repricing within one year exceeded total interest-bearing liabilities maturing or repricing in the same time period by \$723.3 million, representing a one-year cumulative gap to total assets ratio of 7.38%.

Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible. The interest rate risk indicators and interest sensitivity gaps as of December 31, 2015 and 2014 are within our internal policy guidelines and management considers that our current level of interest rate risk is reasonable.

The following tables provide a GAP analysis as of December 31, 2015 and 2014 (dollars in thousands):

Table 22: Interest Sensitivity Gap

	December 31, 2015						Total
	Within 6 Months	After 6 Months Within 1 Year	After 1 Year Within 3 Years	After 3 Years Within 5 Years	After 5 Years Within 10 Years	Over 10 Years	
Interest-earning assets: (1)							
Construction loans	\$298,602	\$36,319	\$31,000	\$6,656	\$2,609	\$491	\$375,677
Fixed-rate mortgage loans	228,392	171,715	480,522	283,369	364,149	163,960	1,692,107
Adjustable-rate mortgage loans	984,844	340,300	1,112,548	615,662	146,183	232	3,199,769
Fixed-rate mortgage-backed securities	114,691	97,844	289,341	153,941	184,217	101,420	941,454
Adjustable-rate mortgage-backed securities	—	—	—	—	—	—	—
Fixed-rate commercial/agricultural loans	95,694	81,036	178,125	89,924	28,199	10,690	483,668
Adjustable-rate commercial/agricultural loans	908,505	22,225	18,345	41,520	3,992	—	994,587
Consumer and other loans	434,670	27,209	79,210	27,596	29,543	14,160	612,388
Investment securities and interest-earning deposits	192,606	14,361	41,411	143,727	130,975	29,646	552,726
Total rate sensitive assets	3,258,004	791,009	2,230,502	1,362,395	889,867	320,599	8,852,376
Interest-bearing liabilities: (2)							
Regular savings	192,696	192,696	449,625	449,625	—	—	1,284,642
Interest-bearing checking accounts	180,737	172,784	403,163	403,163	—	—	1,159,847
Money market deposit accounts	818,547	491,128	327,419	—	—	—	1,637,094
Certificates of deposit	569,205	361,810	313,619	90,152	17,184	44	1,352,014
FHLB advances	107,600	—	25,000	—	—	—	132,600
Other borrowings	5,000	—	—	—	—	—	5,000
Trust preferred securities	140,212	—	—	—	—	—	140,212
Retail repurchase agreements	93,325	—	—	—	—	—	93,325
	2,107,322	1,218,418	1,518,826	942,940	17,184	44	5,804,734

Edgar Filing: BANNER CORP - Form 10-K

Total rate sensitive liabilities							
Excess (deficiency) of interest-sensitive assets over interest-sensitive liabilities	\$ 1,150,682	\$ (427,409)	\$ 711,676	\$ 419,455	\$ 872,683	\$ 320,555	\$ 3,047,642
Cumulative excess of interest-sensitive assets	\$ 1,150,682	\$ 723,273	\$ 1,434,949	\$ 1,854,404	\$ 2,727,087	\$ 3,047,642	\$ 3,047,642
Cumulative ratio of interest-earning assets to interest-bearing liabilities	154.60	% 121.75	% 129.62	% 132.04	%		