BANNER CORP
Form 10-Q
August 09, 2007

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

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007.**

OR

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

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

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

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

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Title of class:	As of July 31, 2007
Common Stock, $.01 par value per share	**15,723,880 shares***

* Includes 240,381 shares held by the Employee Stock Ownership Plan that have not been released, committed to be released, or allocated to participant.

BANNER CORPORATION AND SUBSIDIARIES
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PART I - FINANCIAL INFORMATION

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

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited) (In thousands, except shares)
June 30, 2007 and December 31, 2006

	June 30 2007	December 31 2006
ASSETS		
Cash and due from banks	$ 106,803	$ 73,385
Securities at fair value, cost $186,625 and $0, respectively; encumbered $0 and $0, respectively	182,969	
Securities available for sale, cost $0 and $230,189, respectively; encumbered $0 and $27,107, respectively		226,153
Securities held to maturity, fair value $48,928 and $49,008, respectively	48,196	47,872
Federal Home Loan Bank stock	37,291	35,844
Loans receivable:		
Held for sale, fair value $8,269 and $5,136	8,178	5,080
Held for portfolio	3,610,174	2,960,910
Allowance for loan losses	(43,248)	(35,535)
	3,575,104	2,930,455
Accrued interest receivable	24,885	23,272
Real estate owned, held for sale, net	1,700	918
Property and equipment, net	87,327	58,003
Goodwill and other intangibles, net	129,126	36,287
Deferred income tax asset, net	4,764	7,533
Bank-owned life insurance	50,441	38,527
Other assets	20,443	17,317
	$ 4,269,049	$ 3,495,566
LIABILITIES		
Deposits:		
Non-interest-bearing	$ 455,628	$ 332,372
Interest-bearing transactions and savings accounts	1,307,680	905,746
Interest-bearing certificates	1,829,473	1,556,474
	3,592,781	2,794,592
Advances from Federal Home Loan Bank		177,430
Advances from Federal Home Loan Bank at fair value	33,826	
Other borrowings	71,926	103,184
Junior subordinated debentures (issued in connection with Trust Preferred Securities)		123,716
Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)	98,419	
Accrued expenses and other liabilities	51,792	36,888
Deferred compensation	10,497	7,025
Income taxes payable	7,501	2,504
	3,866,742	3,245,339
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Preferred stock - $0.01 par value, 500,000 shares authorized, none issued		
Common stock - $0.01 par value per share, 25,000,000 shares authorized, 13,201,418 shares issued: 15,440,105 shares and 12,073,889 shares outstanding at June 30, 2007 and December 31, 2006, respectively	278,447	135,149
Retained earnings	126,249	120,206
Accumulated other comprehensive income (loss):		
Unrealized loss on securities available for sale and/or transferred to held to maturity	(202)	(2,852)

Unearned shares of common stock issued to Employee Stock Ownership Plan (ESOP) trust at cost:		
240,381 and 240,381 restricted shares outstanding at June 30, 2007 and December 31, 2006, respectively	(1,987)	(1,987)
Carrying value of shares held in trust for stock related compensation plans	(7,699)	(7,262)
Liability for common stock issued to deferred, stock related, compensation plans	7,499	6,973
	(200)	(289)
	402,307	250,227
	$ 4,269,049	$ 3,495,566

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited) (In thousands except for per share amounts)
For the Quarters and Six Months Ended June 30, 2007 and 2006

	Quarters Ended June 30		Six Months Ended June 30	
	2007	**2006**	**2007**	**2006**
INTEREST INCOME:				
Loans receivable	$ 71,047	$ 55,088	$ 132,875	$ 104,214
Mortgage-backed securities	1,535	2,011	3,310	4,094
Securities and cash equivalents	1,829	1,834	3,672	3,612
	74,411	58,933	139,857	111,920
INTEREST EXPENSE:				
Deposits	32,378	20,828	59,988	38,259
Federal Home Loan Bank advances	1,164	4,141	3,441	7,267
Other borrowings	790	766	1,718	1,464
Junior subordinated debentures	1,969	1,973	4,423	3,801
	36,301	27,708	69,570	50,791
Net interest income before provision for loan losses	38,110	31,225	70,287	61,129
PROVISION FOR LOAN LOSSES	1,400	2,300	2,400	3,500
Net interest income	36,710	28,925	67,887	57,629
OTHER OPERATING INCOME:				
Deposit fees and other service charges	4,090	2,891	7,053	5,383
Mortgage banking operations	1,808	1,454	3,163	2,606
Loan servicing fees	373	334	748	724
Miscellaneous	592	321	1,053	789
	6,863	5,000	12,017	9,502
Net change in valuation of financial instruments carried at fair value	(1,877)		(697)	
Total other operating income	4,986	5,000	11,320	9,502
OTHER OPERATING EXPENSES:				
Salary and employee benefits	19,635	16,553	36,103	32,042
Less capitalized loan origination costs	(3,175)	(3,228)	(5,769)	(5,820)
Occupancy and equipment	5,106	3,938	9,458	7,732
Information/computer data services	1,767	1,285	3,136	2,585
Professional services	723	534	1,282	1,066
Advertising	1,867	2,074	3,724	3,516
Insurance recovery, net proceeds		(5,350)		(5,350)
Miscellaneous	5,376	4,205	9,436	7,438
Total other operating expenses	31,299	20,011	57,370	43,209
Income before provision for income taxes	10,397	13,914	21,837	23,922
PROVISION FOR INCOME TAXES	3,286	4,555	6,913	7,775
NET INCOME	$ 7,111	$ 9,359	$ 14,924	$ 16,147
Earnings per common share (see Note 7):				
Basic	$ 0.49	$ 0.79	$ 1.11	$ 1.36

Diluted	$	0.48	$	0.77	$	1.09	$	1.33
Cumulative dividends declared per common share:	$	0.19	$	0.18	$	0.38	$	0.36

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited) (In thousands)
For the Quarters and Six Months Ended June 30, 2007 and 2006

	Quarters Ended June 30		Six Months Ended June 30	
	2007	**2006**	**2007**	**2006**
NET INCOME	$ 7,111	$ 9,359	$ 14,924	$ 16,147
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES:				
Unrealized holding gain (loss) during the period, net of deferred income tax (benefit) of $0, $(625), $0 and $(1,518), respectively		(1,161)		(2,819)
Less adjustment for (gains) losses included in net income, net of income tax (benefit) of $0, $0, $0 and $0, respectively				
Amortization of unrealized gain (loss) on securities transferred from available-for-sale to held-to-maturity net of deferred income tax of $0, $0, $0 and $0, respectively	13	13	27	23
Other comprehensive income (loss)	13	(1,148)	27	(2,796)
COMPREHENSIVE INCOME	$ 7,124	$ 8,211	$ 14,951	$ 13,351

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited) (In thousands, except per share amounts)
For the Six Months Ended June 30, 2007 and 2006

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Restricted ESOP Shares	Carrying Value, Net of Liability, Of Shares Held in Trust for Stock-Related Compensation Plans	Stockholders Equity
BALANCE, January 1, 2006	$ 130,573	$ 96,783	$ (2,736)	$ (2,480)	$ (475)	$ 221,665
Net income		16,147				16,147
Change in valuation of securities available for sale, net of income taxes			(2,796)			(2,796)
Cash dividend on common stock ($.36/share cumulative)		(4,304)				(4,304)
Purchase and retirement of common stock	(2,346)					(2,346)
Proceeds from issuance of common stock for exercise of stock options	3,720					3,720
Net issuance of stock through employer s stock plans, including tax benefit	28			(14)		14
Accrual of compensation expense related to stock options	309					309
Accrual of compensation expense related to MRP					93	93
BALANCE, June 30, 2006	$ 132,284	$ 108,626	$ (5,532)	$ (2,494)	$ (382)	$ 232,502
BALANCE, January 1, 2007	$ 135,149	$ 120,206	$ (2,852)	$ (1,987)	$ (289)	$ 250,227
Net income		14,924				14,924
Cumulative effect of early adoption of SFAS Nos. 157 & 159 Fair Value Option		(3,520)	2,623			(897)
Amortization of discount on securities transferred from available for sale to held to maturity, net of income taxes			27			27
Cash dividend on common stock ($.38/share cumulative)		(5,361)				(5,361)
Purchase and retirement of common stock	(430)					(430)
Proceeds from issuance of common stock for exercise of stock options	991					991
Proceeds from issuance of common stock for stockholder reinvestment program	29,368					29,368
Acquisitions:						
Shares issued to the shareholders of F&M Bank (F&M)	78,006					78,006
Shares issued to the shareholders of San Juan Financial Holding Company (SJFHC)	35,149					35,149
	58					58

Recognition of tax benefit related to the release of MRP shares						
Accrual of compensation expense related to stock options	156					156
Accrual of compensation expense related to MRP					89	89
BALANCE, June 30, 2007	$ 278,447	$ 126,249	$ (202)	$ (1,987)	$ (200)	$ 402,307

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2007 and 2006

	2007	2006
Common stock, shares issued, beginning of period	12,314	12,082
Purchase and retirement of common stock	(11)	(63)
Issuance of common stock for bank acquisitions	2,593	
Issuance of common stock for exercised stock options and/or employee stock plans	57	251
Issuance of common stock for stockholder reinvestment program	727	
Number of shares (retired) issued during the period	3,366	188
SHARES ISSUED AND OUTSTANDING, END OF PERIOD	15,680	12,270
UNEARNED, RESTRICTED ESOP SHARES:		
Number of shares, beginning of period	(240)	(300)
Adjustment of earned shares		(2)
Number of shares, end of period	(240)	(302)
NET SHARES OUTSTANDING	15,440	11,968

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2007 and 2006

	2007	2006
OPERATING ACTIVITIES:		
Net income	$ 14,924	$ 16,147
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,629	2,925
Deferred income and expense, net of amortization	(526)	864
Loss (gain) on sale of securities		
Net change in valuation of financial instruments carried at fair value	697	
Deferred taxes	(2,887)	(656)
Equity-based compensation	89	93
Stock options compensation	156	309
Equity-based long term incentive plan	49	
Tax benefits realized from equity-based compensation	(58)	(61)
Increase in cash surrender value of bank-owned life insurance	(937)	(779)
Gain on sale of loans, excluding capitalized servicing rights	(2,853)	(2,046)
Loss (gain) on disposal of real estate held for sale and property and equipment	(75)	(47)
Provision for losses on loans and real estate held for sale	2,400	3,500
Net change in:		
Loans held for sale	(3,098)	(929)
Other assets	(46)	(1,271)
Other liabilities	8,302	5,733
Net cash provided by operating activities	19,766	23,782
INVESTING ACTIVITIES:		
Purchases of securities at fair value	(125)	
Principal repayments and maturities of securities at fair value	14,219	
Proceeds from sales of securities at fair value	61,364	
Principal repayments and maturities of securities available for sale		15,269
Purchases of securities held to maturity	(661)	
Principal repayments and maturities of securities held to maturity	297	1,255
Origination of loans, net of principal repayments	(331,296)	(539,491)
Purchases of loans and participating interest in loans	(2,354)	(4,091)
Proceeds from sales of loans and participating interest in loans	198,957	160,545
Purchases of property and equipment, net	(14,660)	(4,917)
Proceeds from sale of real estate held for sale, net	74	179
Acquisition of F&M and SJFHC net of cash acquired	(6,839)	
Other	(9)	(525)
Net cash used by investing activities	(81,033)	(371,776)
FINANCING ACTIVITIES:		
Increase in deposits	325,103	256,144
Proceeds from FHLB advances	116,500	1,043,900
Repayment of FHLB advances	(295,486)	(940,000)
Repayment of repurchase agreement borrowings	(24,524)	(1,748)
Increase (decrease) in other borrowings, net	(26,359)	(17,979)
Repayment of trust securities	(25,774)	
Cash dividends paid	(4,710)	(4,244)
Repurchases of stock, net of forfeitures	(430)	(2,346)
Tax benefits realized from equity-based compensation	58	61
ESOP shares earned (returned)		(47)
Issuance of stock-net of costs	29,316	
Exercise of stock options	991	3,720

Net cash provided by financing activities	94,685	337,461
NET INCREASE (DECREASE) IN CASH AND DUE FROM BANKS	33,418	(10,533)
CASH AND DUE FROM BANKS, BEGINNING OF PERIOD	73,385	116,448
CASH AND DUE FROM BANKS, END OF PERIOD	$ 106,803	$ 105,915

(Continued on next page)

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited) (In thousands)
For the Six Months Ended June 30, 2007 and 2006

	2007	2006
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid in cash	$ 63,169	$ 48,239
Taxes paid in cash	388	3,481
Non-cash investing and financing transactions:		
Loans, net of discounts, specific loss allowances and unearned income, transferred to real estate owned and other repossessed assets	864	42
Net change in accrued dividends payable	651	60
Change in other assets/liabilities	1,075	1,436
Cash paid out in acquisitions	(26,481)	
Fair value of assets acquired	690,571	
Liabilities assumed in acquisition	550,883	
Stock based consideration issued for acquisition	(113,207)	
Adoption of SFAS Nos. 157 and 159:		
Securities available for sale transferred to fair value	226,153	
FHLB advances adjustment to fair value	678	
Junior subordinated debentures including unamortized origination costs adjustment to fair value	2,079	
Deferred tax asset related to fair value adjustments	(504)	

See selected notes to consolidated financial statements

BANNER CORPORATION AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation and Critical Accounting Policies

Banner Corporation (Banner or the Company) is a bank holding company incorporated in the State of Washington. We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries, Banner Bank and, subsequent to May 1, 2007, Islanders Bank, a recent acquisition, as explained below. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of June 30, 2007, its 77 branch offices and 13 loan production offices located in 28 counties in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank that conducts business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System. Banner Bank and Islanders Bank are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the Federal Deposit Insurance Corporation (FDIC). The consolidated financial statements and results of operation presented in this report on Form 10-Q include financial information for Islanders Bank and our other recent acquisition, F&M Bank, Spokane, Washington (F&M) which was merged into Banner Bank, subsequent to our acquisition of those banks on May 1, 2007. (See Note 3 of the Selected Notes to the Consolidated Financial Statements for additional information with respect to these acquisitions.)

In the opinion of management, the accompanying consolidated statements of financial condition and related interim consolidated statements of income, comprehensive income, changes in stockholders equity and cash flows reflect all adjustments (which include reclassifications and normal recurring adjustments) that are necessary for a fair presentation in conformity with generally accepted accounting principles (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses and (iii) the valuation of financial assets and liabilities recorded at fair value, goodwill, mortgage servicing rights and real estate held for sale. These policies and the judgments, estimates and assumptions are described in greater detail below in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 1 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission (SEC). Management believes that the judgments, estimates and assumptions used in the preparation of our consolidated financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of different judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. There have been no significant changes in our application of accounting policies since December 31, 2006, except for the adoption of SFAS No. 157 and 159 (for additional information, see Notes 2 and 6 of the Selected Notes to the Consolidated Financial Statements).

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

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

Note 2: Recent Developments and Significant Events

Sale of $25 Million of Trust Preferred Securities: On July 31, 2007, the Company completed the issuance of $25 million of Trust Preferred Securities in a private placement. The Trust Preferred Securities were issued by Banner Capital Trust VII, a special purpose business trust formed by Banner Corporation, and sold to pooled investment vehicles sponsored by various investment banking firms. The Trust Preferred Securities will be recorded as a liability on the consolidated statement of financial condition but are expected to qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering are expected to be used primarily to fund growth, including acquisitions, or may also be used to fund the Company s stock repurchase program and other general corporate purposes as necessary. Under the terms of the transaction, the Trust Preferred Securities have a maturity of 30 years and are redeemable after five years with certain exceptions. The holders of the Trust Preferred Securities will be entitled to receive cumulative cash distributions at a variable annual rate, with a current interest rate of 6.7375%, reset quarterly equal to three month LIBOR plus 1.38%.

Proposed Acquisition of NCW Community Bank: On June 28, 2007, Banner announced the signing of a definitive merger agreement with NCW Community Bank, Wenatchee, Washington, in a transaction valued at approximately $18.5 million in cash and common stock for all of the outstanding common shares and stock options of NCW Community Bank. According to the terms of the definitive agreement and assuming all outstanding NCW Community Bank options are exercised, NCW Community Bank shareholders will receive 0.7425 shares of Banner

Corporation common stock and $14.19 in cash for each NCW Community Bank share. The acquisition, which has been approved by the Boards of Directors of both companies, is subject to, among other contingencies, approval by regulators and NCW Community Bank shareholders. Founded in 1999, NCW Community Bank is a state chartered commercial community bank with $101 million in assets, $88 million in loans, $91 million in deposits and shareholders equity of $9 million as of June 30, 2007. NCW Community Bank operates one branch in Wenatchee, Washington and has another branch under construction in East Wenatchee. NCW Community Bank will merge into Banner Bank in connection with this transaction, which is expected to close during the fourth quarter of 2007 subject to regulatory and shareholder approval. The merger will significantly add to Banner s customer base and market share in the North Central Washington area.

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

Upon adoption of SFAS No. 159, we selected fair value measurement for all of our available for sale investment securities, Federal Home Loan Bank advances and junior subordinated debentures, which had fair values of approximately $226.2 million, $176.8 million and $124.4 million, respectively, on January 1, 2007. The initial fair value measurement of these instruments resulted in a $3.5 million adjustment for the cumulative effect, net of tax, as a result of the change in accounting, which was recorded as a reduction in retained earnings as of January 1, 2007, and which under SFAS No. 159 has not been recognized in current earnings. While the adjustment to retained earnings is permanent, approximately $2.6 million of the amount was previously reported as accumulated other comprehensive loss at December 31, 2006, so the reduction in total stockholders equity was $897,000 on January 1, 2007. Following the initial election, changes in the value of financial instruments recorded at fair value are recognized as gains or losses in subsequent financial reporting periods. As a result of the adoption of SFAS No. 159 and changes in the fair value measurement of the financial assets and liabilities noted above, we recorded a net gain of $1.2 million ($755,000 after tax) in the quarter ended March 31, 2007 and a net loss of $1.9 million ($1.2 million after tax) in the quarter ended June 30, 2007, resulting in a cumulative loss of $697,000 ($446,000 after tax) for the six months ended June 30, 2007. (For further information, see Note 6 of the Selected Notes to the Consolidated Financial Statements.)

Early redemption of $25 million of Trust Preferred Securities: Effective April 22, 2007, we repaid $26 million of junior subordinated debentures (debentures) issued in connection with Banner Capital Trust I as provided for under the early redemption provisions of the governing indenture at a price of 100% of the outstanding principal balance. Prior to repayment, the interest rate on the debentures supporting Banner Capital Trust I was 9.09% during the quarter ended June 30, 2007. The adjustable rate provisions of these debentures provided for changes in the interest rate every six months such that the rate would be equal to six month LIBOR plus 3.70%. The cash required to redeem these debentures came from our general operating funds.

Sale of $25 Million of Trust Preferred Securities: In December 2006, we completed the issuance of $25.8 million of junior subordinated debentures (debentures) in connection with a private placement of pooled trust preferred securities. The trust preferred securities were issued by Banner Capital Trust VI, a special purpose business trust formed by Banner Corporation. The debentures have been recorded as a liability on the Consolidated Statement of Financial Condition and, subject to limitation under current Federal Reserve guidelines, a portion of the trust preferred securities qualify as Tier 1 capital for regulatory capital purposes. The proceeds from this offering were retained by us to provide future flexibility with respect to regulatory capital requirements. Under the terms of the transaction, the trust preferred securities and debentures have a maturity of 30 years and are redeemable after five years, with certain exceptions. The holders of the trust preferred securities and debentures are entitled to receive cumulative cash distributions at a variable annual rate. The interest rate is fixed at 6.56% until March 1, 2012 and subsequent to that date will reset quarterly to equal the three month London Interbank Offered Rate Index (LIBOR) plus 1.62%. Our previously issued trust preferred securities have similar reset provisions but carry different spreads to LIBOR and interest rates than this issuance. At June 30, 2007, the interest rates on the other trust preferred securities ranged from 6.94% to 8.71%. In accordance with Financial Interpretation No. (FIN) 46, the trusts are not consolidated with our financial statements. Effective January 1, 2007, our junior subordinated debentures are being recorded at fair value.

Issuance of Shares through Dividend Reinvestment and Direct Stock Purchase and Sale Plan and Exercise of Options: During the six months ended June 30, 2007, we added to our capital structure by issuing 727,260 new shares of our common stock at an average net price of $40.38 through our Dividend Reinvestment and Direct Stock Purchase and Sale Plan. In addition, we issued a net 46,345 shares in connection with the exercise of vested stock options. This combined stock issuance provided $29.9 million in capital during the six months ended June 30. 2007. The additional capital will be available to support our continued growth initiatives and the acquisitions of F&M Bank, San Juan Financial Holding Company and NCW Community Bank.

Branch Expansion: Over the past four years, we have invested significantly in expanding Banner Bank s branch and distribution systems with a primary emphasis on the greater Boise, Idaho and Portland, Oregon markets, the Puget Sound region of Washington and, more recently, with the acquisition of F&M Bank, Spokane, Washington. This branch expansion is a significant element in our strategy to grow loans, deposits and customer relationships. This emphasis on growth has resulted in an elevated level of operating expenses; however, management believes that over time these new branches should help improve profitability by providing low cost core deposits which will allow Banner Bank to proportionately reduce higher cost borrowings as a source of funds. Since July 2003, Banner Bank has opened 23 new branch offices, relocated 7 additional branch offices and significantly refurbished its main office in Walla Walla. We have also added 16 branches through the acquisitions of F&M Bank and Islanders Bank as explained in other sections of this report.

Long-Term Incentive Plan: In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan (Plan) effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is indirectly related to changes in the value of Banner Corporation stock and changes in Banner Bank s average earnings rate. The primary objective of the Plan is for key employees who remain with the Company or the Bank for a sufficient period of time to share in the increases in the value of our stock. Although the Plan benefits are tied to the value of Banner Corporation stock, the Plan benefit is paid in cash rather than shares of our stock. Detailed information with respect to the plan was disclosed on a Form 8-K filed with SEC on July 19, 2006. We recorded $49,000 of compensation cost relating to this Plan for the six months ended June 30, 2007. There was no expense related to this plan for the six months ended June 30, 2006.

Recently Issued Accounting Pronouncements: We elected early adoption of Statement of Financial Accounting Standards (SFAS) No. 159*, The Fair Value Option for Financial Assets and Financial Liabilities*, and SFAS No. 157*, Fair Value Measurements*, effective January 1, 2007. (See the earlier discussion above and Note 6 of the Selected Notes to the Consolidated Financial Statements for further information.)

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

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, we adopted FIN 48. Currently, we are subject to U.S. federal income tax and income tax of the States of Idaho and Oregon. The years 2003 through 2005 remain open to examination for federal income taxes, and years 2003 through 2006 remain open for State examination. As of January 1, 2007 and June 30, 2007, we had insignificant unrecognized tax benefits or uncertain tax positions. In addition, we have no material accrued interest or penalties as of January 1, 2007 or June 30, 2007. It is our policy to record interest and penalties as a component of income tax expense. The amount of interest and penalties for the six months ended June 30, 2007 was immaterial. The adoption of this accounting standard did not have a material impact on our Consolidated Financial Statements.

Note 3: Acquisitions of F&M Bank and San Juan Financial Holding Company

On May 1, 2007, we completed the acquisition of F&M Bank (F&M) Spokane, Washington, in a stock and cash transaction valued at approximately $98.1 million with $20.1 million of cash and 1,773,402 shares of Banner common stock for 100% of the outstanding common shares of F&M Bank. F&M Bank was merged into Banner Bank and the results of its operations are included in those of Banner Bank starting in the quarter ended June 30, 2007. The purchase of F&M Bank allowed us to immediately expand Banner Bank s franchise in the Spokane, Washington area, the fourth largest metropolitan market in the Pacific Northwest, by the addition of 13 branches and one loan office.

The acquisition was accounted for as a purchase in accordance with SFAS 141. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the acquisition date as summarized in the following table:

	May 1, 2007 (in thousands)	
Cash paid to F&M s shareholders	$ 19,404	
Total value of the Banner s common stock exchanged with F&M s Shareholders	78,030	
Transaction closing costs	665	
Total purchase price		$ 98,099
Allocation of purchase price:		
F&M shareholders equity	$ 33,379	
Estimated adjustments to adjust assets and liabilities to fair value		
Loans	(195)	
Premises and equipment	3,315	
Core deposit intangible	10,867	
Deposits	(336)	
Deferred taxes-net	(4,916)	
Estimated fair value of net assets acquired		42,114
Goodwill resulting from acquisition		$ 55,985

Additional adjustments to the purchase price allocation may be required, specifically related to other assets and taxes. The core deposit intangible asset shown in the table above represents the value ascribed to the long-term deposit relationships acquired. This intangible asset is being amortized on a straight-line basis over an estimated useful life of eight years. The core deposit intangible asset is not estimated to have a significant residual value. Goodwill represents the excess of the total purchase price paid for F&M Bank over the fair values of the assets acquired, net of the fair values of the liabilities assumed. Goodwill is not amortized, but is evaluated for possible impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. No impairment losses were recognized in connection with core deposit intangible or goodwill assets during the period from acquisition on May 1, 2007 to the end of the current reporting period.

		May 1, 2007
The fair value of the assets and liabilities of F&M Bank at the date of acquisition		
Cash	$	12,056
Securities available for sale		6,768
Federal funds sold		137
Loans-net of allowance for loan losses of $4,528		389,137
Premises and equipment-net		12,466
Bank-owned life insurance (BOLI)		8,662
Other assets		18,112
Goodwill		55,985
Total assets acquired		503,323
Deposits		(348,822)
Advances from Federal Home Loan Bank		(20,000)
Federal funds purchased and other borrowings		(19,625)
Other liabilities		(16,777)
Total liabilities assumed		(405,224)
Net assets acquired	$	98,099

On May 1, 2007, we also completed the acquisition of San Juan Financial Holding Company (SJFHC), the parent company of Islanders Bank, Friday Harbor, Washington, in a stock and cash transaction valued at approximately $41.6 million in $6.4 million of cash and 819,209 shares of Banner common stock for 100% of the outstanding common shares of SJFHC. SJFHC was merged into Banner Corporation and Islanders Bank has continued to operate as a separate subsidiary of Banner Corporation. The results of its operations are included in Banner s consolidated operations beginning in the quarter ended June 30, 2007. The acquisition of Islanders Bank, with its three branches located in the San Juan Islands, added to Banner Corporation s presence in the North Puget Sound region.

The acquisition was accounted for as a purchase in accordance with SFAS 141. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the acquisition date as summarized in the following table.

		May 1, 2007 (in thousands)		
Cash paid to SJFHC shareholders	$	6,159		
Total value of the Banner s common stock exchanged with SJFHC shareholders		35,177		
Closing costs		253		
Total purchase price			$	41,589
Allocation of purchase price				
SJFHC shareholders equity	$	16,782		
Estimated adjustments to adjust assets and liabilities to fair value				
Loans		(604)		
Premises and equipment		1,800		
Core deposit intangible-net increase		6,147		
Deposits		37		
Deferred taxes-net		(2,659)		

Estimated fair value of net assets acquired		21,503
Goodwill resulting from acquisition	$	20,086

Additional adjustments to the purchase price allocation may be required, specifically related to other assets and taxes. The core deposit intangible asset shown in the table above represents the value ascribed to the long-term deposit relationships acquired. This intangible asset is being amortized on a straight-line basis over an estimated useful life of eight years. The core deposit intangible asset is not estimated to have a significant residual value. Goodwill represents the excess of the total purchase price paid for SJFHC over the fair values of the assets acquired, net of the fair values of the liabilities assumed. Goodwill is not amortized, but is evaluated for possible impairment at least annually and more frequently if events and circumstances indicate that the asset might be impaired. No impairment losses were recognized in connection with core deposit intangible or goodwill assets during the period from acquisition on May 1, 2007 to the end of the current reporting period.

		May 1, 2007
The fair value of the assets and liabilities of SJFHC at the date of acquisition		
Cash	$	7,449
Securities available for sale		26,263
Loans-net of allowance for loan losses of $1,429		116,999
Premises and equipment-net		5,756
BOLI		2,315
Other assets		8,380
Goodwill		20,086
Total assets acquired		187,248
Deposits		(124,264)
Advances from Federal Home Loan Bank		(15,726)
Other liabilities		(5,669)
Total liabilities assumed		(145,659)
Net assets acquired	$	41,589

The following tables present unaudited pro forma condensed results of operations for the quarters and six months ended June 30, 2007 and 2006 prepared as if the acquisitions of F&M Bank and SJFHC had occurred on January 1, 2006. Any cost savings realized as a result of the acquisitions are not reflected in the pro forma condensed statements of income as no assurance can be given with respect to the final amount of such cost savings. The pro forma results have been prepared for comparison purposes only and are not necessarily indicative of the results that would have been obtained had the acquisitions actually occurred on January 1, 2006.

Pro Forma Financial Information Unaudited
(in thousands except per share data)

	Quarter Ended June 30, 2007					
		One Month Ended April 30, 2007				
	Banner	F&M	SJFHC	F&M Pro Forma Adjustments	SJFHC Pro Forma Adjustments	Pro Forma Consolidated
Net interest income before provision for loan losses	$ 38,110	$ 1,498	$ 439	$ 87(A)	$ 44(A)	$ 40,178
Provision for loan losses	1,400	853	5			2,258
Other operating income	4,986	600	290		(22) (B)	5,854
Other operating expense	31,299	9,649	1,880	(6,905) (C)	(1,207) (D)	34,716
Income before provision for income taxes	10,397	(8,404)	(1,156)	6,992	1,229	9,058
Provision for income taxes (benefits)	3,286	(2,963)	75	2,517(E)	443(E)	3,558
Net income	$ 7,111	$ (5,441)	$ (1,231)	$ 4,475	$ 786	$ 5,700
Basic earnings per share	$ 0.49					$ 0.37
Diluted earning per share	$ 0.48					$ 0.36
Basic weighted average shares outstanding	14,520	687	120	584(F)	270(F)	15,374
Diluted weighted average shares outstanding	14,791	687	120	584(F)	270(F)	15,645

(A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M and SJFHC assuming acquired January 1, 2006.
(B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition
(C) Reversal of merger related expenses of $7.0 million, offset by additional core deposit amortization of $113,000 assuming acquired January 1, 2006.
(D) Reversal of merger related expenses of $1.3 million, offset by additional core deposit amortization of $50,000 assuming acquired January 1, 2006.
(E) Income tax effect of pro forma adjustments at 36%
(F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M and 2.2503 to 1 for SJFHC

	Six Months Ended June 30, 2007					
		Four Months Ended April 30, 2007				
	Banner	F&M	SJFHC	F&M Pro Forma Adjustments	SJFHC Pro Forma Adjustments	Pro Forma Consolidated
Net interest income before provision for loan losses	$ 70,287	$ 5,803	$ 2,074	$ 33(A)	$ (10) (A)	$ 78,187
Provision for loan losses	2,400	1,028	20			3,448
Other operating income	11,320	1,375	599		(22) (B)	13,272
Other operating expense	57,370	13,425	3,109	(6,610) (C)	(1,026) (D)	66,268
Income before provision for income taxes	21,837	(7,275)	(456)	6,643	994	21,743
Provision for income taxes (benefits)	6,913	(2,612)	270	2,391(E)	358(E)	7,320
Net income	$ 14,924	$ (4,663)	$ (726)	$ 4,252	$ 636	$ 14,423
Basic earnings per share	$ 1.11					$ 0.95
Diluted earning per share	$ 1.09					$ 0.93
Basic weighted average shares outstanding	13,427	1,383	241	1,176(F)	542(F)	15,145
Diluted weighted average shares outstanding	13,728	1,383	241	1,176(F)	542(F)	15,446

(A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M and SJFHC assuming acquired January 1, 2006.
(B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition
(C) Reversal of merger related expenses of $7.1 million, offset by additional core deposit amortization of $453,000 assuming acquired January 1, 2006.
(D) Reversal of merger related expenses of $1.3 million, offset by additional core deposit amortization of $231,000 assuming acquired January 1, 2006
(E) Income tax effect of pro forma adjustments at 36%
(F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M and 2.2503 to 1 for SJFHC

Pro Forma Financial Information Unaudited
(in thousands except per share data)

	Quarter Ended June 30, 2006					
	Banner	F&M	SJFHC	F&M Pro Forma Adjustments	SJFHC Pro Forma Adjustments	Pro Forma Consolidated
Net interest income before provision for loan losses	$ 31,225	$ 4,065	$ 1,724	$ (52) (A)	$ (23) (A)	$ 36,939
Provision for loan losses	2,300	112	6			2,418
Other operating income	5,000	1,197	394		(44) (B)	6,547
Other operating expense	20,011	3,567	1,289	339 (C)	181 (D)	25,387
Income before provision for income taxes	13,914	1,583	823	(391)	(248)	15,681
Provision for income taxes (benefits)	4,555	478	275	(141) (E)	(89) (E)	5,078
Net income	$ 9,359	$ 1,105	$ 548	$ (250)	$ (159)	$ 10,603
Basic earnings per share	$ 0.79					$ 0.74
Diluted earning per share	$ 0.77					$ 0.72
Basic weighted average shares outstanding	11,882	2,026	364	1,722(F)	819(F)	14,423
Diluted weighted average shares outstanding	12,196	2,134	364	1,814(F)	819(F)	14,829

(A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M and SJFHC assuming acquired January 1, 2006.
(B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition
(C) Core deposit amortization assuming acquired January 1, 2006.
(D) Additional core deposit amortization assuming acquired January 1, 2006
(E) Income tax effect of pro forma adjustments at 36%
(F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M and 2.2503 to 1 for SJFHC

	Six Months Ended June 30, 2006					
	Banner	F&M	SJFHC	F&M Pro Forma Adjustments	SJFHC Pro Forma Adjustments	Pro Forma Consolidated
Net interest income before provision for loan losses	$ 61,129	$ 7,944	$ 3,436	$ (202) (A)	$ (124) (A)	$ 72,183
Provision for loan losses	3,500	315	12			3,827
Other operating income	9,502	2,240	745		(73) (B)	12,414
Other operating expense	43,209	7,288	2,569	679(C)	362 (D)	54,107
Income before provision for income taxes	23,922	2,581	1,600	(881)	(559)	26,663
Provision for income taxes (benefits)	7,775	779	522	(317) (E)	(201) (E)	8,558
Net income	$ 16,147	$ 1,802	$ 1,078	$ (564)	$ (358)	$ 18,105
Basic earnings per share	$ 1.36					$ 1.26
Diluted earning per share	$ 1.33					$ 1.23
Basic weighted average shares outstanding	11,836	2,029	364	1,725 (F)	819 (F)	14,380
Diluted weighted average shares outstanding	12,161	2,077	364	1,765 (F)	819 (F)	14,745

(A) Consists of net accretion of fair value adjustments related to the acquisitions of F&M and SJFHC assuming acquired January 1, 2006.
(B) Reversal of effects of equity in earnings of San Juan Title Company not acquired in acquisition
(C) Core deposit amortization assuming acquired January 1, 2006.
(D) Core deposit amortization assuming acquired January 1, 2006

(E) Income tax effect of pro forma adjustments at 36%

(F) Additional shares issued at an exchange rate of 0.85 to 1 for F&M and 2.2503 to 1 for SJFHC

Note 4: Business Segments

We are managed by legal entity and not by lines of business; however, both of our primary subsidiaries are engaged in the same line of business, commercial banking. Banner Bank and Islanders Bank (together the Banks) are community oriented commercial banks chartered in the State of Washington. The Banks primary business is that of traditional banking institutions, gathering deposits and originating loans for their portfolios in their primary market areas. The Banks offer a wide variety of deposit products to their consumer and commercial customers. Lending activities include the origination of real estate, commercial and agricultural business and consumer loans. The Banks do not engage and have not engaged in any sub-prime lending programs. Banner Bank is also an active participant in the secondary market, originating residential loans for sale on both a servicing released and servicing retained basis. In addition to interest income on loans and investment securities, the Banks receive other income from deposit service charges, loan servicing fees and from the sale of loans and investments. The performance of the Banks is reviewed by Banner Corporation s executive management and Board of Directors on a monthly basis. All of the executive officers of Banner Corporation are members of the Banner Bank executive management team and one director of Banner Corporation and one executive officer of Banner Bank are members of the Board of Directors of Islanders Bank. None of the officers of Islanders Bank are officers or directors of Banner Corporation.

Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements and require reporting of selected information about operating segments in interim reports to shareholders. We have determined that our current business and operations consist of a single business segment.

Note 5: Additional Information Regarding Interest-Bearing Deposits and Securities

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

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

	June 30 2007	December 31 2006	June 30 2006
Interest-bearing deposits included in Cash and due from banks	$ 25,437	$ 5,068	$ 32,547
Mortgage-backed securities	116,873	150,166	160,733
Other securities taxable	63,677	77,332	82,365
Other securities tax exempt	48,102	42,817	43,609
Equity securities with dividends	2,513	3,710	3,439
Total securities	231,165	274,025	290,146
FHLB stock	37,291	35,844	35,844
	$ 293,893	$ 314,937	$ 358,537

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

	Quarters Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Mortgage-backed securities interest	$ 1,535	$ 2,011	$ 3,310	$ 4,094
Taxable interest income	1,244	1,285	2,546	2,553
Tax-exempt interest income	503	488	968	981
Other stock dividend income	27	61	67	78
FHLB stock dividends	55		91	
	1,829	1,834	3,672	3,612

	$ 3,364	$ 3,845	$ 6,982	$ 7,706

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Note 6: Fair Value Accounting and Measurement

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

The following table details the financial instruments carried at fair value to the dates indicated (in thousands)

	Cumulative Adjustment on Adoption of SFAS 159 January 1, 2007					June 30, 2007		
	Amortized Cost	Fair Market Valuation Adjustment	Fair Value	Related Taxes	Cumulative Effect of Adoption	Amortized Cost	Fair Market Valuation Adjustment	Fair Value
Assets:								
Securities available for sale reclassified to fair value	$ 230,189	$ (4,036)	$ 226,153	$ 1,413	$ (2,623)	$ 186,625	$ (3,656)	$ 182,969
Liabilities:								
Advances from FHLB	$ 177,430	$ (678)	$ 176,752	$ 244	$ 434	$ 34,170	$ (344)	$ 33,826
Junior subordinated debentures, net of unamortized deferred origination costs	122,287	2,079	124,366	(748)	(1,331)	97,092	1,327	98,419
	$ 299,717	$ 1,401	$ 301,118	$ (504)	$ (897)	$ 131,262	$ 983	$ 132,245
Total adjustment					$ (3,520)			
Less transfer from accumulated other comprehensive loss to retained earnings					(2,623)			
Cumulative reduction of opening stockholders equity at January 1, 2007 upon adoption of SFAS No. 159					$ (897)			

Note 6: Fair Value Accounting and Measurement (continued)

SFAS No. 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS No. 157, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

We hold fixed and variable rate interest bearing securities, investments in marketable equity securities and certain other financial instruments, which are carried at fair value. Fair value is determined based upon quoted prices when available or through the use of alternative approaches, such as matrix or model pricing, when market quotes are not readily accessible or available.

We also carry our FHLB advances and junior subordinated debentures at fair value. In determining the fair value of our obligations, various factors are considered including: price activity for equivalent or similar instruments, discounting the expected cash flows using market interest rates and our own credit standing.

These valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our own market assumptions. These two types of inputs create the following fair value hierarchy:

Level 1 - Quoted prices for identical instruments in active markets
Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.
Level 3 - Instruments whose significant value drivers are unobservable.

Fair values are determined as follows:

Securities at fair value are priced using matrix pricing based on the securities relationship to other benchmark quoted prices and under the provisions of SFAS No. 157 are considered a Level 2 input method.
Advances from FHLB are priced using discounted cash flows to the date of maturity based on the FHLB of Seattle s current rate sheet for member bank advances on the date of valuation and is considered a Level 2 input method.
Junior subordinated debentures are priced using discounted cash flows to the next available redemption date on the date of valuation based on recent issuances or quotes from brokers for comparable bank holding companies and are considered a Level 2 input method.

The following table outlines the net change in fair values recorded at the dates indicated (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Assets:				
Securities available for sale reclassified as carried at fair value	$ (1,619)	$	$ (533)	$
Liabilities				
Advances from FHLB	(155)		(334)	
Junior subordinated debentures net of unamortized deferred issuance costs	(103)		170	
Net change in fair value	$ (1,877)	$	$ (697)	$

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

Note 7: Calculation of Weighted Average Shares Outstanding for Earnings Per Share (EPS)

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

	Quarters Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Basic weighted average shares outstanding	14,520	11,882	13,427	11,836
Plus unvested MRP and stock option incremental shares considered outstanding for diluted EPS calculations	271	314	301	325
Diluted weighted average shares outstanding	14,791	12,196	13,728	12,161

Note 8: Stock Based Compensation Plans

Banner Corporation operates the following stock-based compensation plans as approved by the shareholders: the 1996 Management Recognition and Development Plan (MRP), a restricted stock plan; and the 1996 Stock Option Plan, the 1998 Stock Option Plan and the 2001 Stock Option Plan (collectively, SOPs).

MRP Stock Grants: Under the MRP, Banner was authorized to grant up to 528,075 shares of restricted stock to its directors, officers and employees. On July 26, 2006, this stock program expired with 522,660 shares having been granted and no additional shares eligible to be granted. Shares granted under the MRP vest ratably over a five-year period from the date of grant. The Consolidated Statements of Income for the quarters and six months ended June 30, 2007 and 2006 reflect accruals of $43,000 and $46,000, and $89,000 and $93,000, respectively, for these grant awards. The MRP stock grants fair value equals their intrinsic value on the date of grant.

A summary of unvested MRP share activity during the six months ended June 30, 2007 follows:

	Shares	Weighted-Average Grant-Date Fair Value
Unvested at December 31, 2006	19,360	$ 22.07
Granted		
Vested	8,020	20.29
Forfeited		
Unvested at June 30, 2007	11,340	$ 23.34

Stock Options: Under the SOPs, we reserved 2,284,186 shares for issuance pursuant to the exercise of stock options to be granted to directors and employees. Authority to grant additional options under the 1996 Stock Option Plan terminated on July 26, 2006. As of June 30, 2007, there were 53,747 options eligible for grants under the 1998 and 2001 plans. The exercise price of the stock options is set at 100% of the fair market value of the stock price on the date of grant. Such options have graded vesting of 20% per year from the date of grant and any unexercised incentive stock options will expire ten years after date of grant or 90 days after employment or service ends.

We did not grant any stock options during the six months ended June 30, 2007 and 2006. Also, there were no significant modifications made to any stock option grants during the period. The fair values of stock options granted are amortized as compensation expense on a straight-line basis over the vesting period of the grant.

Stock-based compensation costs related to the SOPs were $72,000 and $129,000, and $156,000 and $309,000 for the quarters and six months ended June 30, 2007 and 2006, respectively. The SOPs stock option grant compensation costs are generally based on the fair value calculated from the Black-Scholes option pricing on the date of the grant award. Assumptions used in the Black-Scholes model are an expected volatility based on the six-month historical volatility at the date of the grant. The expected term is based on the remaining contractual life of the vesting period. We base the estimate of risk-free interest rate on the U.S. Treasury Constant Maturities Indices in effect at the time of the grant. The dividend yield is based on the current quarterly dividend in effect at the time of the grant.

As part of the provisions of SFAS 123(R), *Share-Based Payment*, we are required to estimate potential forfeitures of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

A summary of our SOP stock compensation activity for the six months ended June 30, 2007 follows (in thousands, except shares and per share data):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term, In Years	Aggregate Intrinsic Value
Outstanding at December 31, 2006	713,460	$ 20.49		
Granted				
Exercised	(56,955)	17.40		$ 1,264
Forfeited	(600)	31.75		
Outstanding at June 30, 2007	655,905	$ 20.75	5.1	$ 8,729
Vested at June 30, 2007 and expected to vest	649,556	$ 20.70	5.1	$ 8,680
Exercisable at June 30, 2007	511,565	$ 19.25	4.6	$ 7,576

The intrinsic value of stock options is calculated as the amount by which the market price of our common stock exceeds the exercise price of the stock option.

A summary of our unvested stock option activity with respect to the six months ended June 30, 2007 follows:

	Shares	Weighted-Average Grant-Date Fair Value
Unvested at December 31, 2006	211,810	$ 7.57
Granted		
Vested	(66,870)	7.17
Forfeited	(600)	9.26
Unvested at June 30, 2007	144,340	$ 7.75

No options were granted during the six months ended June 30, 2007 and 2006. During the six months ended June 30, 2007 and 2006, the total intrinsic value of stock options exercised was $1.3 million and $5.3 million, respectively.

We had $313,000 of total unrecognized compensation expense related to stock options at June 30, 2007 that is expected to be recognized over a period of 2.8 years.

During the six months ended June 30, 2007, we received $991,000 from the exercise of stock options. Cash was not used to settle any equity instruments previously granted. Upon the exercise of stock options, we issue shares from authorized but unissued shares. We do not currently expect to repurchase shares from any source to satisfy our obligations under the SOPs.

The following are the stock-based compensation costs we recognized in our Condensed Consolidated Statements of Income (in thousands):

	Quarters Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Salary and employee benefits	$ 115	$ 175	$ 245	$ 402
Total decrease in income before income taxes	115	175	245	402

Decrease in provision for income taxes	(20)	(31)	(45)	(58)
Decrease in net income	$ 95	$ 144	$ 200	