COLUMBIA BANKING SYSTEM INC
Form 10-Q
August 08, 2011
Table of Contents

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, 2011.

¨ **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 0-20288

COLUMBIA BANKING SYSTEM, INC.

(Exact name of issuer as specified in its charter)

Washington	**91-1422237**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
1301 A Street	
Tacoma, Washington	**98402-2156**
(Address of principal executive offices)	**(Zip Code)**

(253) 305-1900

(Issuer s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 x No ¨

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

Large accelerated filer	x	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 Exchange Act). Yes ¨ No x

The number of shares of common stock outstanding at July 31, 2011 was 39,496,663.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

CONSOLIDATED CONDENSED STATEMENTS OF INCOME

Columbia Banking System, Inc.

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands except per share)	**2011**	**2010**	**2011**	**2010**
Interest Income				
Loans	$ 44,362	$ 38,940	$ 91,791	$ 75,887
Taxable securities	6,247	4,708	10,664	9,453
Tax-exempt securities	2,516	2,290	4,983	4,736
Federal funds sold and deposits in banks	184	210	482	359
Total interest income	53,309	46,148	107,920	90,435
Interest Expense				
Deposits	2,848	4,334	5,927	9,275
Federal Home Loan Bank advances	714	710	1,408	1,415
Long-term obligations	253	254	504	503
Other borrowings	119	118	257	236
Total interest expense	3,934	5,416	8,096	11,429
Net Interest Income	49,375	40,732	99,824	79,006
Provision for loan and lease losses	2,150	13,500	2,150	28,500
Provision for losses on covered loans	2,301	0	1,879	0
Net interest income after provision for loan and lease losses	44,924	27,232	95,795	50,506
Noninterest Income (Loss)				
Service charges and other fees	6,467	6,442	12,755	11,866
Gain on bank acquisitions	0	0	0	9,818
Merchant services fees	1,808	1,913	3,441	3,652
Gain on sale of investment securities, net	0	0	0	58
Bank owned life insurance	528	516	1,033	1,020
Change in FDIC loss sharing asset	(6,419)	3,399	(21,193)	3,399
Other	1,158	967	2,087	1,897
Total noninterest income (loss)	3,542	13,237	(1,877)	31,710
Noninterest Expense				
Compensation and employee benefits	19,459	17,497	38,380	34,483
Occupancy	4,388	4,307	8,785	8,276
Merchant processing	905	1,227	1,788	2,327
Advertising and promotion	1,012	785	1,913	1,623
Data processing and communications	1,913	2,567	3,837	4,446
Legal and professional fees	1,498	1,477	2,911	2,975
Taxes, licenses and fees	907	688	1,772	1,252
Regulatory premiums	1,279	1,462	2,979	2,918

Net cost of operation of other real estate owned	214	(672)	(228)	640
Amortization of intangibles	955	1,055	1,939	1,842
FDIC clawback liability	448	0	2,148	0
Other	4,186	4,352	8,286	7,860
Total noninterest expense	37,164	34,745	74,510	68,642
Income before income taxes	11,302	5,724	19,408	13,574
Income tax provision	2,670	668	4,997	602
Net Income	$ 8,632	$ 5,056	$ 14,411	$ 12,972
Net Income Applicable to Common Shareholders	$ 8,632	$ 3,946	$ 14,411	$ 10,755
Earnings per common share				
Basic	$ 0.22	$ 0.11	$ 0.37	$ 0.34
Diluted	$ 0.22	$ 0.11	$ 0.36	$ 0.34
Dividends paid per common share	$ 0.05	$ 0.01	$ 0.08	$ 0.02
Weighted average number of common shares outstanding	39,107	34,829	39,073	31,376
Weighted average number of diluted common shares outstanding	39,166	35,077	39,159	31,607

See accompanying notes to unaudited consolidated condensed financial statements.

1

Table of Contents

CONSOLIDATED CONDENSED BALANCE SHEETS

Columbia Banking System, Inc.

(Unaudited)

(in thousands)	June 30, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 89,926	$ 55,492
Interest-earning deposits with banks	179,573	458,638
Total cash and cash equivalents	269,499	514,130
Securities available for sale at fair value (amortized cost of $956,125 and $743,928, respectively)	989,768	763,866
Federal Home Loan Bank stock at cost	18,791	17,908
Loans held for sale	655	754
Loans, excluding covered loans, net of deferred loan fees of ($3,454) and ($3,490), respectively	1,987,474	1,915,754
Less: allowance for loan and lease losses	54,057	60,993
Loans, excluding covered loans, net	1,933,417	1,854,761
Covered loans, net of allowance for loan losses of ($7,948) and ($6,055), respectively	607,310	517,061
Total loans, net	2,540,727	2,371,822
FDIC loss sharing asset	206,238	205,991
Interest receivable	14,010	11,164
Premises and equipment, net	99,439	93,108
Other real estate owned ($24,239 and $14,443 covered by FDIC loss share, respectively)	46,979	45,434
Goodwill	119,343	109,639
Core deposit intangible, net	18,602	18,696
Other assets	105,092	103,851
Total Assets	$ 4,429,143	$ 4,256,363
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing	$ 923,031	$ 895,671
Interest-bearing	2,552,136	2,431,598
Total deposits	3,475,167	3,327,269
Federal Home Loan Bank advances	120,681	119,405
Securities sold under agreements to repurchase	25,000	25,000
Other borrowings	0	642
Long-term subordinated debt	25,768	25,735
Other liabilities	54,847	51,434
Total liabilities	3,701,463	3,549,485
Commitments and contingent liabilities		
Shareholders equity:		

	June 30, 2011	December 31, 2010		
Common Stock (no par value)				
Authorized shares	63,033	63,033		
Issued and outstanding	39,475	39,338	578,046	576,905
Retained earnings			128,949	117,692
Accumulated other comprehensive income			20,685	12,281
Total shareholders equity			727,680	706,878
Total Liabilities and Shareholders Equity			$ 4,429,143	$ 4,256,363

See accompanying notes to unaudited consolidated condensed financial statements.

Table of Contents

CONSOLIDATED CONDENSED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

Columbia Banking System, Inc.

(Unaudited)

	Preferred Stock		Common Stock			Accumulated Other Comprehensive Income	Total Shareholders Equity
(in thousands)	**Number of Shares**	**Amount**	**Number of Shares**	**Amount**	**Retained Earnings**		
Balance at January 1, 2010	77	$ 74,301	28,129	$ 348,706	$ 93,316	$ 11,816	$ 528,139
Comprehensive income:							
Net income					12,972		12,972
Other comprehensive income, net of tax:							
Net unrealized gain from securities, net of reclassification adjustments						7,128	7,128
Net change in cash flow hedging instruments						(727)	(727)
Net pension plan liability adjustment						37	37
Other comprehensive income							6,438
Comprehensive income							19,410
Accretion of preferred stock discount		294			(294)		0
Issuance of common stock, net of offering costs			11,040	229,129			229,129
Issuance of common stock - stock option and other plans			42	521			521
Issuance of common stock - restricted stock awards, net of cancelled awards			93	705			705
Tax benefit deficiency associated with share-based compensation				(12)			(12)
Preferred dividends					(1,922)		(1,922)
Cash dividends paid on common stock					(675)		(675)
Balance at June 30, 2010	77	$ 74,595	39,304	$ 579,049	$ 103,397	$ 18,254	$ 775,295
Balance at January 1, 2011	0	$ 0	39,338	$ 576,905	$ 117,692	$ 12,281	$ 706,878
Comprehensive income:							
Net income					14,411		14,411
Other comprehensive income, net of tax:							
Net unrealized gain from securities, net of reclassification adjustments						8,780	8,780
Net change in cash flow hedging instruments						(143)	(143)
Net pension plan liability adjustment						(233)	(233)
Other comprehensive income							8,404
Comprehensive income							22,815
Issuance of common stock - stock option and other plans			25	410			410
			114	763			763

Issuance of common stock - restricted stock awards, net of cancelled awards							
Repurchase of shares			(2)	(32)			(32)
Cash dividends paid on common stock					(3,154)		(3,154)
Balance at June 30, 2011	0	$ 0	39,475	$ 578,046	$ 128,949	$ 20,685	$ 727,680

See accompanying notes to unaudited consolidated condensed financial statements.

3

Table of Contents

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

Columbia Banking System, Inc.

(Unaudited)

(in thousands)	Six Months Ended June 30, 2011	2010
Cash Flows From Operating Activities		
Net Income	$ 14,411	$ 12,972
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan and lease losses and losses on covered loans	4,029	28,500
Stock-based compensation expense	763	705
Depreciation, amortization and accretion	6,900	6,084
Net realized gain on FDIC assisted bank acquisitions	0	(9,818)
Net realized gain on sale of securities	0	(58)
Net realized gain on sale of other assets	(3)	(14)
Net realized gain on sale of other real estate owned	(5,455)	(1,644)
Gain on termination of cash flow hedging instruments	(222)	(1,128)
Write-down on other real estate owned	4,559	1,793
Deferred income tax benefit	0	142
Net change in:		
FDIC loss-sharing asset, net of cash received	20,139	(16,340)
Loans held for sale	99	0
Interest receivable	(1,940)	469
Interest payable	(1)	(459)
Other assets	1,287	5,651
Other liabilities	(2,045)	11,327
Net cash provided by operating activities	42,521	38,182
Cash Flows From Investing Activities		
Loans originated and acquired, net of principal collected	(27,829)	97,279
Purchases of:		
Securities available for sale	(269,966)	(64,054)
Premises and equipment	(2,388)	(1,054)
Proceeds from:		
FDIC reimbursement on loss-sharing asset	44,892	0
Sales of securities available for sale	0	69,328
Principal repayments and maturities of securities available for sale	60,247	42,790
Disposal of premises and equipment	20	60
Sales of covered other real estate owned	11,081	9,347
Sales of other real estate and other personal property owned	7,874	3,190
Capital improvements on other real estate properties	(468)	(579)
Decrease in Small Business Administration secured borrowings	(642)	0
Net cash acquired in business combinations	39,010	145,534
Net cash (used in) provided by investing activities	(138,169)	301,841
Cash Flows From Financing Activities		
Net decrease in deposits	(134,906)	(345,080)
Proceeds from:		
Issuance of common stock	0	229,129
Exercise of stock options	410	509
Federal Home Loan Bank advances	100	0
Federal Reserve Bank borrowings	100	0
Payment for:		

Repayment of Federal Home Loan Bank advances	(11,401)	(30,197)
Repayment of Federal Reserve Bank borrowings	(100)	0
Preferred stock dividends	0	(1,922)
Common stock dividends	(3,154)	(675)
Repurchase of common stock	(32)	0
Net decrease in other borrowings	0	87
Net cash used in financing activities	(148,983)	(148,149)
(Decrease) Increase in cash and cash equivalents	(244,631)	191,874
Cash and cash equivalents at beginning of period	514,130	305,074
Cash and cash equivalents at end of period	$ 269,499	$ 496,948
Supplemental Information:		
Cash paid during the year for:		
Cash paid for interest	$ 8,097	$ 11,888
Non-cash investing activities		
Assets acquired in FDIC assisted acquisitions (excluding cash and cash equivalents)	$ 257,104	$ 1,075,166
Liabilities assumed in FDIC assisted acquisitions	$ 296,114	$ 1,210,882
Loans transferred to other real estate owned	$ 8,240	$ 15,019

See accompanying notes to unaudited consolidated condensed financial statements.

4

NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

Columbia Banking System, Inc.

1. Basis of Presentation and Significant Accounting Policies

Basis of Presentation

The interim unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for condensed interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain financial information and footnotes have been omitted or condensed. The consolidated condensed financial statements include the accounts of the Company, and its wholly owned banking subsidiary Columbia Bank (the Bank). All intercompany transactions and accounts have been eliminated in consolidation. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of the results for the interim periods presented have been included. The results of operations for the six months ended June 30, 2011 are not necessarily indicative of results to be anticipated for the year ending December 31, 2011. The accompanying interim unaudited consolidated condensed financial statements should be read in conjunction with the financial statements and related notes contained in the Company s 2010 Annual Report on Form 10-K.

Significant Accounting Policies

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2010 Annual Report on Form 10-K. There have not been any changes in our significant accounting policies compared to those contained in our 2010 10-K disclosure for the year ended December 31, 2010.

2. Accounting Pronouncements Recently Issued

In April 2011, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) 2011-02, *A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring* (Topic 310). ASU 2011-02 clarifies the criteria for a restructuring to be classified as a Troubled Debt Restructuring. The effective date of ASU 2011-02 will be the first interim or annual period beginning after June 15, 2011 and should be applied retrospectively to the beginning of the annual period of adoption. The Company is evaluating the impact this ASU will have on its financial condition and results of operations.

In April 2011, the FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements* (Topic 860). ASU 2011-03 attempts to improve the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before maturity. The effective date of ASU 2011-03 will be the first interim or annual period beginning after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is evaluating the impact this ASU will have on its financial condition and results of operations.

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. Generally Accepted Accounting Principles* (GAAP) *and International Financial Reporting Standards* (IFRS) (Topic 820). ASU 2011-04 developed common requirements between GAAP and IFRS for measuring fair value and for disclosing information about fair value measurements. The effective date of ASU 2011-04 will be during interim or annual period beginning after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company is evaluating the impact this ASU will have on its financial condition and results of operations.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income* (Topic 220). ASU 2011-05 attempts to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The effective date of ASU 2011-05 will be the first interim or fiscal period beginning after December 15, 2011 and should be applied retrospectively. Early adoption is permitted. The Company will apply the disclosure requirements of ASU 2011-05 for its first interim period beginning after December 15, 2011.

Table of Contents

3. Earnings per Common Share

Basic Earnings per Share (EPS) is computed by dividing income applicable to common shareholders by the weighted average number of common shares outstanding for the period. Common shares outstanding include common stock and vested restricted stock awards where recipients have satisfied the vesting terms. Diluted EPS reflects the assumed conversion of all dilutive securities, applying the treasury stock method. The Company calculates earnings per share using the two-class method as described in the Earnings per Share topic of the FASB Accounting Standards Codification (ASC). The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2011 and 2010:

(in thousands except per share)	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Basic EPS:				
Net income	$ 8,632	$ 5,056	$ 14,411	$ 12,972
Less: Preferred dividends and accretion of issuance discount for preferred stock	0	(1,110)	0	(2,217)
Net income applicable to common shareholders	$ 8,632	$ 3,946	$ 14,411	$ 10,755
Less: Earnings allocated to participating securities	(82)	(38)	(135)	(109)
Earnings allocated to common shareholders	$ 8,550	$ 3,908	$ 14,276	$ 10,646
Weighted average common shares outstanding	39,107	34,829	39,073	31,376
Basic earnings per common share	$ 0.22	$ 0.11	$ 0.37	$ 0.34
Diluted EPS:				
Earnings allocated to common shareholders	$ 8,550	$ 3,908	$ 14,276	$ 10,646
Weighted average common shares outstanding	39,107	34,829	39,073	31,376
Dilutive effect of equity awards and warrants	59	248	86	231
Weighted average diluted common shares outstanding	39,166	35,077	39,159	31,607
Diluted earnings per common share	$ 0.22	$ 0.11	$ 0.36	$ 0.34
Potentially dilutive share options that were not included in the computation of diluted EPS because to do so would be anti-dilutive.	62	54	54	54

4. Business Combinations

Summit Bank

On May 20, 2011 the Bank acquired certain assets and assumed certain liabilities of Summit Bank from the Federal Deposit Insurance Corporation (FDIC) in an FDIC-assisted transaction. As part of the Purchase and Assumption Agreement, the Bank and the FDIC entered into loss-sharing agreements (each, a loss-sharing agreement and collectively, the loss-sharing agreements), whereby the FDIC will cover a substantial portion of any future losses on loans (and related unfunded commitments), OREO and certain accrued interest on loans for up to 90 days. We refer to the acquired loans and OREO subject to the loss-sharing agreements collectively as covered assets. Under the terms of the loss-sharing agreements, the FDIC will absorb 80% of losses and share in 80% of loss recoveries. The loss-sharing provisions of the agreements for commercial and single family residential mortgage loans are in effect for five years and ten years, respectively, from the May 20, 2011 acquisition date and the loss recovery provisions for such loans are in effect for eight years and ten years, respectively, from the acquisition date.

Summit Bank was a full service community bank headquartered in Burlington, Washington that operated three branch locations in Skagit County. We entered into this transaction to assist us with filling in our geographic footprint between Seattle and Bellingham, Washington and to support our recently expanded Bellingham banking team. We believe participating with the FDIC in this assisted transaction was, from an economical standpoint, advantageous to expansion through de novo branching.

The assets acquired and liabilities assumed have been accounted for under the acquisition method of accounting (formerly the purchase method). The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the May 20, 2011 acquisition date. Initial accounting for acquired loans and the related indemnification asset for the Summit Bank acquisition was incomplete as of June 30, 2011. The amounts currently recognized in the financial statements have been determined provisionally as we are completing a fair value analysis of those assets utilizing an income approach. The application of the acquisition method of accounting resulted in the recognition of $3.8 million of goodwill and a core deposit intangible of $509 thousand. The goodwill represents the excess of the estimated fair value of the liabilities assumed over the estimated fair value of the assets acquired and is influenced significantly by the FDIC-assisted transaction process. All of the goodwill and core deposit intangible assets recognized are deductible for income tax purposes.

Table of Contents

The operating results of the Company include the operating results produced by the acquired assets and assumed liabilities for the period May 21, 2011 to June 30, 2011. Due primarily to the significant amount of fair value adjustments and the FDIC loss-sharing agreements put in place, historical results of Summit Bank are not meaningful to the Company s results and thus no pro forma information is presented.

The table below displays the amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed:

	May 20, 2011 *(in thousands)*
Assets	
Cash and due from banks	$ 1,837
Interest-earning deposits with banks and federal funds sold	14,198
Investment securities	871
Federal Home Loan Bank stock	406
Acquired loans	71,452
Accrued interest receivable	429
Premises and equipment	42
FDIC receivable	6,984
Other real estate owned covered by loss sharing	2,671
Goodwill	3,770
Core deposit intangible	509
FDIC indemnification asset	27,174
Other assets	786
Total assets acquired	$ 131,129
Liabilities	
Deposits	$ 123,279
Federal Home Loan Bank advances	7,772
Accrued interest payable	71
Other liabilities	7
Total liabilities assumed	$ 131,129

First Heritage Bank

On May 27, 2011 the Bank acquired certain assets and assumed certain liabilities of First Heritage Bank from the FDIC in an FDIC-assisted transaction. As part of the Purchase and Assumption Agreement, the Bank and the FDIC entered into loss-sharing agreements (each, a loss-sharing agreement and collectively, the loss-sharing agreements), whereby the FDIC will cover a substantial portion of any future losses on loans (and related unfunded commitments), OREO and certain accrued interest on loans for up to 90 days. We refer to the acquired loans and OREO subject to the loss-sharing agreements collectively as covered assets. Under the terms of the loss-sharing agreements, the FDIC will absorb 80% of losses and share in 80% of loss recoveries. The loss-sharing provisions of the agreements for commercial and single family residential mortgage loans are in effect for five years and ten years, respectively, from the May 27, 2011 acquisition date and the loss recovery provisions for such loans are in effect for eight years and ten years, respectively, from the acquisition date.

First Heritage Bank was a full service community bank headquartered in Snohomish, Washington that operated five branch locations in King and Snohomish Counties. We entered into this transaction to assist us with filling in our geographic footprint between Seattle and Bellingham, Washington and to support our recently expanded Bellingham banking team. We believe participating with the FDIC in this assisted transaction was, from an economical standpoint, advantageous to expansion through de novo branching.

The assets acquired and liabilities assumed have been accounted for under the acquisition method of accounting (formerly the purchase method). The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the May 27, 2011 acquisition date. The initial accounting for acquired loan s and the related indemnification asset for the First Heritage Bank acquisition was incomplete as of June 30, 2011. The amounts currently recognized in the financial statements have been determined provisionally as we are completing a fair value analysis of those assets utilizing an income approach. The application of the acquisition method of accounting resulted in the recognition in $5.9 million of goodwill and a core deposit intangible of $1.3 million. The goodwill represents the excess of the estimated fair value of the liabilities assumed over the estimated fair value of the assets acquired and is influenced significantly by the FDIC-assisted transaction process. All of the goodwill and core deposit intangible assets recognized are deductible for income tax purposes.

Table of Contents

The operating results of the Company include the operating results produced by the acquired assets and assumed liabilities for the period May 28, 2011 to June 30, 2011. Due primarily to the significant amount of fair value adjustments and the FDIC loss-sharing agreements put in place, historical results of First Heritage Bank are not meaningful to the Company s results and thus no pro forma information is presented.

The table below displays the amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed:

	May 27, 2011 *(in thousands)*
Assets	
Cash and due from banks	$ 4,688
Interest-earning deposits with banks	6,689
Investment securities	5,303
Federal Home Loan Bank stock	477
Acquired loans	81,857
Accrued interest receivable	476
Premises and equipment	5,339
FDIC receivable	4,751
Other real estate owned covered by loss sharing	8,286
Goodwill	5,934
Core deposit intangible	1,337
FDIC indemnification asset	38,104
Other assets	1,743
Total assets acquired	$ 164,984
Liabilities	
Deposits	$ 159,525
Federal Home Loan Bank advances	5,003
Accrued interest payable	421
Other liabilities	35
Total liabilities assumed	$ 164,984

Table of Contents

5. Securities

The following table summarizes the amortized cost, gross unrealized gains and losses and the resulting fair value of securities available for sale:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2011:				
U.S. government agency and government-sponsored enterprise mortgage-backed securities and collateralized mortgage obligations	$ 671,342	$ 22,154	($ 84)	$ 693,412
State and municipal securities	250,336	12,161	(858)	261,639
U.S. government agency securities	30,054	224	0	30,278
Other securities	4,393	77	(31)	4,439
Total	$ 956,125	$ 34,616	($ 973)	$ 989,768
December 31, 2010:				
U.S. government agency and government-sponsored enterprise mortgage-backed securities and collateralized mortgage obligations	$ 491,530	$ 16,139	($ 1,027)	$ 506,642
State and municipal securities	249,117	7,247	(2,383)	253,981
Other securities	3,281	0	(38)	3,243
Total	$ 743,928	$ 23,386	($ 3,448)	$ 763,866

The scheduled contractual maturities of investment securities available for sale at June 30, 2011 are presented as follows:

	June 30, 2011	
	Amortized Cost	Fair Value
	(in thousands)	
Due within one year	$ 29,452	$ 29,790
Due after one year through five years	93,873	96,310
Due after five years through ten years	169,886	177,458
Due after ten years	659,633	682,942
Total investment securities available-for-sale	$ 952,844	$ 986,500

The following table summarizes the carrying value of securities pledged as collateral at June 30, 2011:

(in thousands)	Carrying Amount
Washington and Oregon State public deposits	$ 220,540
Federal Home Loan Bank advances	92,418
Federal Reserve Bank borrowings	51,657
Repurchase agreement	27,556
Interest rate contracts	13,336
Other	1,429
Total securities pledged as collateral	$ 406,936

Table of Contents

The following tables show the gross unrealized losses and fair value of the Company s investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011 and December 31, 2010:

June 30, 2011

	Less than 12 Months		12 Months or More		Total	
(in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government agency and government-sponsored enterprise mortgage-backed securities and collateralized mortgage obligations	$ 26,028	($ 83)	$ 347	($ 1)	$ 26,375	($ 84)
State and municipal securities	27,944	(636)	2,829	(222)	30,773	(858)
Other securities	0	0	969	(31)	969	(31)
Total	$ 53,972	($ 719)	$ 4,145	($ 254)	$ 58,117	($ 973)

December 31, 2010

	Less than 12 Months		12 Months or More		Total	
(in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government agency and government-sponsored enterprise mortgage-backed securities and collateralized mortgage obligations	$ 86,529	($ 1,025)	$ 588	($ 2)	$ 87,117	($ 1,027)
State and municipal securities	74,755	(2,099)	2,792	(284)	77,547	(2,383)
Other securities	2,275	(6)	968	(32)	3,243	(38)
Total	$ 163,559	($ 3,130)	$ 4,348	($ 318)	$ 167,907	($ 3,448)

The unrealized losses on the above securities are primarily attributable to increases in market interest rates subsequent to their purchase by the Company. Management does not intend to sell any impaired securities nor does available evidence suggest it is more likely than not that management will be required to sell any impaired securities. The Company s securities portfolio does not include any private label mortgage backed securities or investments in trust preferred securities. Management believes the nature of securities in the Company s investment portfolio present a very high probability of collecting all contractual amounts due, as the majority of the securities held are backed by government agencies or government-sponsored enterprises. However, this recovery in value may not occur for some time, perhaps greater than the one-year time horizon or perhaps even at maturity.

Table of Contents

6. Noncovered Loans

The following is an analysis of the noncovered loan portfolio by major types of loans (net of deferred loan fees):

(in thousands)	June 30, 2011	December 31, 2010
Noncovered loans:		
Commercial business	$ 836,745	$ 795,369
Real Estate:		
One-to-four family residential	51,077	49,383
Commercial and five or more family residential properties	843,288	794,329
Total real estate	894,365	843,712
Real estate construction:		
One-to-four family residential	52,368	67,961
Commercial and five or more family residential properties	29,886	30,185
Total real estate construction	82,254	98,146
Consumer	177,564	182,017
Less: deferred loan fees	(3,454)	(3,490)
Total noncovered loans, net of deferred fees	1,987,474	1,915,754
Less: Allowance for loan and lease losses	(54,057)	(60,993)
Total loans, net	$ 1,933,417	$ 1,854,761
Loans held for sale	$ 655	$ 754

At June 30, 2011 and December 31, 2010, the Company had no loans to foreign domiciled businesses or foreign countries, or loans related to highly leveraged transactions. Substantially all of the Company s loans and unfunded commitments are geographically concentrated in its service areas within the states of Washington and Oregon.

The Company and its banking subsidiary have granted loans to officers and directors of the Company and related interests. These loans are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectability. The aggregate dollar amount of these loans was $9.8 million and $12.9 million at June 30, 2011 and December 31, 2010, respectively. During the first six months of 2011, advances on related party loans were $3.1 million and repayments totaled $6.2 million.

At June 30, 2011 and December 31, 2010, $366.1 million and $426.6 million of commercial and residential real estate loans were pledged as collateral on Federal Home Loan Bank borrowings.

Table of Contents

The following is an analysis of noncovered, nonaccrual loans as of June 30, 2011 and December 31, 2010:

	June 30, 2011		December 31, 2010	
(in thousands)	Recorded Investment (1) Nonaccrual Loans	Unpaid Principal Balance Nonaccrual Loans	Recorded Investment (1) Nonaccrual Loans	Unpaid Principal Balance Nonaccrual Loans
Commercial Business				
Secured	$ 11,506	$ 17,798	$ 32,368	$ 44,316
Unsecured	204	814	0	327
Real Estate 1-4 Family				
Residential RE Perm	2,748	3,197	2,999	3,353
Real Estate Commercial & Multifamily				
Commercial RE Land	3,962	7,382	4,093	6,279
Income Property Multifamily Perm	8,611	10,724	11,716	12,737
Owner Occupied RE Perm	10,256	11,134	7,407	8,990
Construction 1-4 Family				
Land & Acquisition	7,823	18,168	11,608	21,344
Residential Construction	2,307	4,593	6,503	11,547
Construction Commercial & Multifamily				
Income Property Multifamily Construction	5,977	12,873	7,585	12,916
Owner Occupied RE Construction	0	0	0	0
Consumer	6,076	6,620	5,022	5,192
Total	$ 59,470	$ 93,303	$ 89,301	$ 127,001

(1) Recorded investment includes unpaid principal balance, net of charge-offs, unamortized deferred loan fees or costs, unamortized premiums or discounts and accrued interest.

Table of Contents

The following is an analysis of the aged loan portfolio as of June 30, 2011 and December 31, 2010:

(in thousands)	Current Loans	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Nonaccrual Loans	Total Loans
June 30, 2011							
Commercial Business							
Secured	$ 782,661	$ 446	$ 969	$ 0	1,415	$ 11,380	$ 795,456
Unsecured	40,921	0	59	0	59	310	41,290
Real Estate 1-4 Family							
Residential RE Perm	48,331	0	0	0	0	2,746	51,077
Real Estate Commercial & Multifamily							
Commercial RE Land	21,525	211	0	0	211	3,957	25,693
Income Property Multifamily Perm	472,606	45	0	0	45	8,601	481,252
Owner Occupied RE Perm	333,095	301	460	0	761	10,252	344,108
Construction 1-4 Family							
Land & Acquisition	22,233	0	0	0	0	7,819	30,052
Residential Construction	18,084	1,942	0	0	1,942	2,289	22,315
Construction Commercial & Multifamily							
Income Property Multifamily							
Construction	2,938	0	0	0	0	5,976	8,914
Owner Occupied RE Construction	13,208	0	0	0	0	0	13,208
Consumer	168,317	663	2,509	0	3,172	6,074	177,563
Total	$ 1,923,919	$ 3,608	$ 3,997	$ 0	$ 7,605	$ 59,404	$ 1,990,928

(in thousands)	Current Loans	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Nonaccrual Loans	Total Loans
December 31, 2010							
Commercial Business							
Secured	$ 720,926	$ 919	$ 692	$ 1	$ 1,612	$ 31,919	$ 754,457
Unsecured	40,455	9	0	0	9	448	40,912
Real Estate 1-4 Family							
Residential RE Perm	46,167	220	0	0	220	2,996	49,383
Real Estate Commercial & Multifamily							
Commercial RE Land	18,979	0	1,752	0	1,752	4,091	24,822
Income Property Multifamily Perm	426,320	1,208	121	0	1,329	10,745	438,394
Owner Occupied RE Perm	318,508	497	3,752	0	4,249	8,356	331,113
Construction 1-4 Family							
Land & Acquisition	24,883	214	205	0	419	11,604	36,906
Residential Construction	24,655	0	0	0	0	6,400	31,055
Construction Commercial & Multifamily							
Income Property Multifamily							
Construction	10,666	0	0	0	0	7,584	18,250
Owner Occupied RE Construction	11,935	0	0	0	0	0	11,935
Consumer	176,005	397	595	0	992	5,020	182,017
Total	$ 1,819,499	$ 3,464	$ 7,117	$ 1	$ 10,582	$ 89,163	$ 1,919,244

13

Table of Contents

The following is an analysis of impaired loans as of June 30, 2011 and December 31, 2010:

(in thousands)	Balance of Loans Collectively Measured for Contingency Provision	Balance of Loans Individually Measured for Specific Impairment	Impaired Loans With Recorded Allowance: Recorded Investment (1)	Impaired Loans With Recorded Allowance: Unpaid Principal Balance	Impaired Loans With Recorded Allowance: Related Allowance	Impaired Loans Without Recorded Allowance: Recorded Investment (1)	Impaired Loans Without Recorded Allowance: Unpaid Principal Balance	Average Recorded Investment Impaired Loans (1)	Interest Recognized on Impaired Loans
June 30, 2011									
Commercial Business									
Secured	$ 786,252	$ 9,204	$ 1,593	$ 1,592	$ 331	$ 7,617	$ 7,612	$ 20,471	$ 52
Unsecured	41,189	100	71	71	71	29	29	102	1
Real Estate 1-4 Family									
Residential RE Perm	48,652	2,425	0	0	0	2,428	2,425	2,649	0
Real Estate Commercial & Multifamily									
Commercial RE Land	21,933	3,760	0	0	0	3,763	3,760	4,567	0
Income Property Multifamily Perm	473,138	8,113	2,340	2,339	301	5,782	5,774	10,330	442
Owner Occupied RE Perm	327,962	16,146	1,466	1,465	286	14,717	14,681	15,431	64
Construction 1-4 Family									
Land & Acquisition	22,078	7,974	1,190	1,190	148	6,787	6,784	9,681	138
Residential Construction	20,027	2,289	0	0	0	2,311	2,289	4,158	0
Construction Commercial & Multifamily									
Income Property Multifamily Construction	2,939	5,976	0	0	0	5,977	5,976	6,878	0
Owner Occupied RE Construction	13,207	0	0	0	0	0	0	0	0
Consumer	172,409	5,155	106	106	11	5,050	5,049	4,871	1
Total	$ 1,929,786	$ 61,142	$ 6,766	$ 6,763	$ 1,148	$ 54,461	$ 54,379	$ 79,138	$ 698

(in thousands)	Balance of Loans Collectively Measured for Contingency Provision	Balance of Loans Individually Measured for Specific Impairment	Impaired Loans With Recorded Allowance: Recorded Investment (1)	Impaired Loans With Recorded Allowance: Unpaid Principal Balance	Impaired Loans With Recorded Allowance: Related Allowance	Impaired Loans Without Recorded Allowance: Recorded Investment (1)	Impaired Loans Without Recorded Allowance: Unpaid Principal Balance
December 31, 2010							
Commercial Business							
Secured	$ 724,665	$ 29,793	$ 2,717	$ 2,758	$ 600	$ 27,081	$ 26,913
Unsecured	40,808	104	75	75	75	29	30
Real Estate 1-4 Family							
Residential RE Perm	46,728	2,655	0	0	0	2,658	2,949
Real Estate Commercial & Multifamily							

Commercial RE Land	20,959	3,863	3,062	5,225	0	804	826
Income Property Multifamily Perm	427,799	10,595	3,094	3,139	59	10,292	12,253
Owner Occupied RE Perm	317,010	14,103	0	0	0	14,152	17,099
Construction 1-4 Family							
Land & Acquisition	25,362	11,543	533	549	3	11,013	20,718
Residential Construction	24,655	6,400	915	1,723	62	5,585	9,824
Construction Commercial & Multifamily							
Income Property Multifamily Construction	10,666	7,584	6,792	10,515	175	792	2,401
Owner Occupied RE Construction	11,935	0	0	0	0	0	0
Consumer	177,484	4,533	0	0	0	4,533	4,691
Total	$ 1,828,071	$ 91,173	$ 17,188	$ 23,984	$ 974	$ 76,939	$ 97,704

(1) Recorded investment includes unpaid principal balance, net of charge-offs, unamortized deferred loan fees or costs, unamortized premiums or discounts and accrued interest.

7. Allowance for Loan and Lease Losses and Unfunded Commitments and Letters of Credit

We maintain an allowance for loan and lease losses (ALLL) to absorb losses inherent in the loan portfolio. The size of the ALLL is determined through quarterly assessments of the probable estimated losses in the loan portfolio. Our methodology for making such assessments and determining the adequacy of the ALLL includes the following key elements:

1. General valuation allowance consistent with the Contingencies topic of the FASB ASC.

2. Classified loss reserves on specific relationships. Specific allowances for identified problem loans are determined in accordance with the Receivables topic of the FASB ASC.

3. The unallocated allowance provides for other factors inherent in our loan portfolio that may not have been contemplated in the general and specific components of the allowance. This unallocated amount generally comprises less than 5% of the allowance. The unallocated amount is reviewed quarterly based on trends in credit losses, the results of credit reviews and overall economic trends.

The general valuation allowance is systematically calculated quarterly using quantitative and qualitative information about specific loan classes. The minimum required level in which an entity develops a systematic methodology to determine its allowance for loan and lease losses is at the segment level. However, the Company s systematic methodology in determining its allowance for loan and lease losses is prepared at the class level, which is more detailed than the segment level. The quantitative information uses historical losses from a specific loan class and incorporates the loan s risk rating migration from origination to the point of loss. A loan s risk rating is primarily determined based upon the borrower s ability to fulfill its debt obligation from a cash flow perspective. In the event there is financial deterioration of the borrower, the borrower s other sources of income or repayment are also considered, including recent appraisal values for collateral dependent loans. The qualitative information takes into account general economic and business conditions affecting our market place, seasoning of the loan portfolio, duration of the business cycle, etc. to ensure our methodologies reflect the current economic environment and other factors as using historical loss information exclusively may not give an accurate estimate of inherent losses within the Company s loan portfolio.

Table of Contents

The specific valuation allowance is a reserve for each loan determined to be impaired and the value of the impaired loan is less than its recorded investment. The Company measures the impairment based on the discounted expected future cash flows, observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependant or if foreclosure is probable. The specific reserve for each loan is equal to the difference between the recorded investment in the loan and its determined impairment value.

The ALLL is increased by provisions for loan and lease losses (provision) charged to expense, and is reduced by loans charged off, net of recoveries. While the Company s management believes the best information available is used to determine the ALLL, changes in market conditions could result in adjustments to the ALLL, affecting net income, if circumstances differ from the assumptions used in determining the ALLL.

We have used the same methodology for ALLL calculations during the three and six months ended June 30, 2011 and 2010. Adjustments to the percentages of the ALLL allocated to loan categories are made based on trends with respect to delinquencies and problem loans within each pool of loans. The Company reviews the ALLL quantitative and qualitative methodology on a quarterly basis and makes adjustments when appropriate. The Company continues to strive towards maintaining a conservative approach to credit quality and will continue to prudently add to our ALLL as necessary in order to maintain adequate reserves. The Company carefully monitors the loan portfolio and continues to emphasize the importance of credit quality while continuously strengthening loan monitoring systems and controls.

Table of Contents

The following table shows a detailed analysis of the allowance for loan and lease losses for noncovered loans as of the three and six months ended June 30, 2011:

(in thousands)	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance	Specific Reserve	General Allocation
Three months ended June 30, 2011							
Commercial Business							
Secured	$ 22,307	($ 834)	$ 233	$ 614	$ 22,320	$ 330	$ 21,990
Unsecured	618	0	359	(404)	573	72	501
Real Estate 1-4 Family							
Residential RE Perm	1,100	(216)	0	(37)	847	0	847
Real Estate Commercial & Multifamily							
Commercial RE Land	555	(656)	0	995	894	0	894
Income Property Multifamily Perm	12,297	(275)	13	2,674	14,709	301	14,408
Owner Occupied RE Perm	10,412	(623)	0	(3,310)	6,479	286	6,193
Construction 1-4 Family							
Land & Acquisition	3,295	(410)	700	(733)	2,852	148	2,704
Residential Construction	2,118	(395)	0	(19)	1,704	0	1,704
Construction Commercial & Multifamily							
Income Property Multifamily Construction	127	(1,078)	0	994	43	0	43
Owner Occupied RE Construction	68	0	0	(34)	34	0	34
Consumer	2,418	(271)	45	556	2,748	161	2,587
Unallocated	0	0	0	854	854	0	854
Total	$ 55,315	($ 4,758)	$ 1,350	$ 2,150	$ 54,057	$ 1,298	$ 52,759

(in thousands)	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance	Specific Reserve	General Allocation
Six months ended June 30, 2011							
Commercial Business							
Secured	$ 21,811	($ 4,121)	$ 329	$ 4,301	$ 22,320	$ 330	$ 21,990
Unsecured	738	(84)	368	(449)	573	72	501
Real Estate 1-4 Family							
Residential RE Perm	1,100	(664)	0	411	847	0	847
Real Estate Commercial & Multifamily							
Commercial RE Land	634	(656)	0	916	894	0	894
Income Property Multifamily Perm	15,210	(640)	55	84	14,709	301	14,408
Owner Occupied RE Perm	9,692	(623)	31	(2,621)	6,479	286	6,193
Construction 1-4 Family							
Land & Acquisition	3,769	(1,178)	1,768	(1,507)	2,852	148	2,704
Residential Construction	2,292	(1,054)	36	430	1,704	0	1,704
Construction Commercial & Multifamily							
Income Property Multifamily Construction	274	(1,565)	0	1,334	43	0	43
Owner Occupied RE Construction	70	0	0	(36)	34	0	34
Consumer	2,120	(1,196)	108	1,716	2,748	161	2,587
Unallocated	3,283	0	0	(2,429)	854	0	854
Total	$ 60,993	($ 11,781)	$ 2,695	$ 2,150	$ 54,057	$ 1,298	$ 52,759

Table of Contents

The three and six months changes as of June 30, 2011 and 2010 are summarized as follows:

(in thousands)	Three Months Ended June 30, 2011	Six Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2010
Beginning balance	$ 55,315	$ 60,993	$ 56,981	$ 53,478
Provision charged to expense	2,150	2,150	13,500	28,500
Loans charged off	(4,758)	(11,781)	(11,073)	(23,926)
Recoveries	1,350	2,695	340	1,696
Ending balance	$ 54,057	$ 54,057	$ 59,748	$ 59,748

Changes in the allowance for unfunded commitments and letters of credit are summarized as follows:

(in thousands)	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Beginning balance	$ 1,660	$ 815	$ 1,165	$ 775
Net changes in the allowance for unfunded commitments and letters of credit	(200)	0	295	40
Ending balance	$ 1,460	$ 815	$ 1,460	$ 815

Risk Elements

The extension of credit in the form of loans to individuals and businesses is one of our principal commerce activities. Our policies and applicable laws and regulations require risk analysis as well as ongoing portfolio and credit management. We manage our credit risk through lending limit constraints, credit review, approval policies and extensive, ongoing internal monitoring. We also manage credit risk through diversification of the loan portfolio by type of loan, type of industry, type of borrower and by limiting the aggregation of debt to a single borrower.

The monitoring process for the loan portfolio includes periodic reviews of individual loans with risk ratings assigned to each loan. Based on the analysis, loans are given a risk rating of 1-10 based on the following criteria:

1) ratings of 1-3 indicate minimal to low credit risk,

2) ratings of 4-5 indicate an average to above average credit risk with adequate repayment capacity when prolonged periods of adversity do not exist,

3) ratings of 6-7 indicate potential weaknesses and higher credit risk requiring greater attention by bank personnel and management to help prevent further deterioration,

4) rating of 8 indicates a loss is possible if loan weaknesses are not corrected,

5) rating of 9 indicates loss is highly probable; however, the amount of loss has not yet been determined,

6) and a rating of 10 indicates the loan is uncollectable, and when identified is charged-off.

Loans with a risk rating of 1-6 are considered Pass loans and loans with risk ratings of 7, 8, 9 and 10 are considered Special Mention, Substandard, Doubtful and Loss, respectively. Loans with a risk rating of Substandard or worse are reported as classified loans in our allowance for loan and lease losses analysis. We review these loans to assess the ability of our borrowers to service all interest and principal obligations and, as a result, the risk rating may be adjusted accordingly. Risk ratings are reviewed and updated whenever appropriate, with more periodic reviews as the risk and dollar value of loss on the loan increases. In the event full collection of principal and interest is not reasonably assured, the loan is appropriately downgraded and, if warranted, placed on non-accrual status even though the loan may be current as to principal and interest payments. Additionally, we assess whether an impairment of a loan warrants specific reserves or a write-down of the loan.

Table of Contents

The following is an analysis of the credit quality of our noncovered loan portfolio as of June 30, 2011 and December 31, 2010:

	June 30, 2011		December 31, 2010	
(dollars in thousands)	Weighted-Average Risk Rating	Recorded Investment Noncovered Loans (1)	Weighted-Average Risk Rating	Recorded Investment Noncovered Loans (1)
Commercial Business				
Secured	4.94	$ 799,676	4.96	$ 757,372
Unsecured	4.27	41,568	4.23	41,175
Real Estate 1-4 Family				
Residential RE Perm	4.94	51,259	4.96	49,436
Real Estate Commercial & Multifamily				
Commercial RE Land	5.79	25,899	5.75	24,956
Income Property Multifamily Perm	5.05	483,465	5.07	406,711
Owner Occupied RE Perm	5.12	345,811	5.12	366,284
Construction 1-4 Family				
Land & Acquisition	6.66	30,164	6.79	37,054
Residential Construction	6.49	22,529	6.63	31,293
Construction Commercial & Multifamily				
Income Property Multifamily Construction	5.94	8,932	6.38	18,296
Owner Occupied RE Construction	4.81	13,266	4.93	11,990
Consumer	4.39	178,560	4.31	182,624
Total recorded investment of noncovered loans		$ 2,001,129		$ 1,927,191

(1) Recorded investment includes unpaid principal balance, net of charge-offs, unamortized deferred loan fees or costs, unamortized premiums or discounts and accrued interest.

Table of Contents

8. Covered Assets and FDIC Loss-sharing Asset

Covered Assets

Covered assets consist of loans and OREO acquired in FDIC assisted acquisitions during 2010 and 2011, for which the Bank entered into loss-sharing agreements, whereby the FDIC will cover a substantial portion of any future losses on loans (and related unfunded loan commitments), OREO and certain accrued interest on loans. Under the terms of the loss-sharing agreements, the FDIC will absorb 80% of losses and share in 80% of loss recoveries up to specified amounts and, with respect to loss-sharing agreements for two acquisitions completed in 2010, will absorb 95% of losses and share in 95% of loss recoveries thereafter. The loss-sharing provisions of the agreements for commercial and single-family mortgage loans are in effect for five and ten years, respectively, from the acquisition dates and the loss recovery provisions are in effect for eight and ten years, respectively, from the acquisition dates.

Ten years and forty-five days after the acquisition dates, the Bank shall pay to the FDIC a clawback in the event the losses from the acquisitions fail to reach stated levels. This clawback shall be in the amount of 50% of the excess, if any, of 20% of the stated threshold amounts, less the sum of 25% of the asset premium (discount), 20% or 25% of the cumulative loss-sharing payments (depending on the particular agreement), and the cumulative servicing amount. As of June 30, 2011, the net present value of the Bank s estimated clawback liability is $2.1 million, which is included in other liabilities on the consolidated condensed financial statements.

The following is an analysis of our covered loans, net of related allowance for losses on covered loans as of June 30, 2011 and December 31, 2010:

	$241,391	$241,391	$241,391
(dollars in thousands)	Covered Loans June 30, 2011	Weighted-Average Risk Rating	Allowance for Loan Losses
Commercial Business	$ 241,391	5.82	$ 3,156
Real Estate 1-4 Family	84,568	4.68	508
Real Estate Commercial & Multifamily	365,099	5.72	3,861
Construction 1-4 Family	57,638	7.44	0
Construction Commercial & Multifamily	32,203	6.65	382
Consumer	65,936	4.60	41
Subtotal of covered loans	846,835		$ 7,948
Less:			
Valuation discount resulting from acquisition accounting	231,577		
Allowance for loan losses	7,948		
Covered loans, net of allowance for loan losses	$ 607,310		

(dollars in thousands)	Covered Loans December 31, 2010	Weighted-Average Risk Rating	Allowance for Loan Losses
Commercial Business	$ 165,255	5.74	$ 2,903
Real Estate 1-4 Family	68,700	4.77	1,013
Real Estate Commercial & Multifamily	341,063	5.70	821
Construction 1-4 Family	39,754	7.29	98
Construction Commercial & Multifamily	41,624	6.79	469
Consumer	58,337	4.49	751
Subtotal of covered loans	714,733		$ 6,055
Less:			

Valuation discount resulting from acquisition accounting		191,617
Allowance for loan losses		6,055
Covered loans, net of allowance for loan losses	$	517,061

Acquired loans are accounted for under ASC 310-30 and initially measured at fair value based on expected future cash flows over the life of the loans or market-based information for comparable loans. Management monitors and estimates expected future cash flows of acquired loans on a quarterly basis. Acquired loans are also subject to the Company s internal and external credit review and are risk rated using the same criteria as loans originated by the Company. However, risk ratings are not a clear indicator of losses on acquired loans as a majority of the losses are recoverable from the FDIC under the loss-sharing agreements.

Table of Contents

Draws on acquired loans, advanced subsequent to the loan acquisition date, are accounted for under ASC 450-20 and those amounts are also subject to the Company s internal and external credit review. An allowance for loan losses is estimated in a similar manner as the originated loan portfolio, and a provision for loan losses is charged to earnings as necessary.

During the six months ended June 30, 2011, the Company recorded a provision expense for losses on covered loans of $1.9 million. Of this amount, $2.3 million was impairment expense calculated in accordance with ASC 310-30 and $462 thousand was a negative provision to adjust the allowance for loss calculated under ASC 450-20 for draws on acquired loans. The impact to earnings of the $1.9 million of provision expense for covered loans was partially offset through noninterest income by a $1.5 million increase in the FDIC loss-sharing asset.

The following table shows the changes in accretable yield for acquired loans for three and six months ended June 30, 2011. Due to the provisional measurement of loans acquired from Summit Bank and First Heritage Bank acquisitions, the table below does not include accretable yield arising from those two acquisitions:

(in thousands)	**Three months ended June 30, 2011**	**Six months ended June 30, 2011**
Balance at beginning of period	$ 217,351	$ 256,572
Accretion	(15,458)	(36,761)
Cash receipts, disposals and change in cash flows	52,629	34,711
Balance at end of period	$ 254,522	$ 254,522

The excess of cash flows expected to be collected over the initial fair value of acquired loans is referred to as the accretable yield and is accreted into interest income over the estimated life of the acquired loans using the effective yield method. Other adjustments to the accretable yield include changes in the estimated remaining life of the acquired loans, changes in expected cash flows and changes of indices for acquired loans with variable interest rates.

The following table sets forth activity in covered OREO at carrying value for the three and six months ended June 30, 2011:

(in thousands)	**Three Months Ended June 30, 2011**	**Six Months Ended June 30, 2011**
Covered OREO:		
Balance, beginning of period	$ 13,527	$ 14,443
Established through acquisitions	10,896	10,896
Transfers in, net of write-downs ($23 and $441, respectively)	1,668	5,092
OREO improvements	0	0
Additional OREO write-downs	(99)	(113)
Proceeds from sale of OREO property	(4,122)	(11,081)
Gain on sale of OREO	2,369	5,002
Total covered OREO, end of period	$ 24,239	$ 24,239

The covered OREO is covered by loss-sharing agreements with the FDIC in which the FDIC will assume 80% of additional write-downs and losses on covered OREO sales, or 95%, if applicable, of additional write-downs and losses on covered OREO sales if the minimum loss share thresholds are met.

FDIC Loss-sharing Asset

The FDIC loss-sharing asset as of June 30, 2011 is comprised of a $199.3 million FDIC indemnification asset and a $6.9 million FDIC receivable. The indemnification is the present value of the cash flows the Company expects to collect from the FDIC under the loss-sharing agreements and the FDIC receivable represents 80% of reimbursable amounts from the FDIC that have not yet been received.

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2011	2010	2011	2010
Balance at beginning of period	$ 193,053	$ 210,405	$ 205,991	$ 0
Adjustments not reflected in income				
Established through acquistions	65,278	0	65,278	210,405
Cash received from the FDIC	(44,892)	0	(44,892)	0
FDIC share of additional estimated losses	991	13,947	2,295	13,947
Other	(1,773)	(1,006)	(1,241)	(1,006)
Adjustments reflected in income				
(Amortization) accretion	(6,638)	3,952	(15,641)	3,952
Loan loss provision	1,841	0	1,503	0
Other	(1,622)	(553)	(7,055)	(553)