

NORTHWEST BANCORPORATION INC  
Form 10-Q  
August 13, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-Q**

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the quarterly period ended June 30, 2010.**

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

Commission file number 000-24151

**NORTHWEST BANCORPORATION, INC.**

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

The Registrant has a single class of common stock, of which there were 3,072,498 shares issued and outstanding as of July 31, 2010.

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**NORTHWEST BANCORPORATION, INC.**

**FORM 10-Q**

**For the three-month and six-month periods ended June 30, 2010**

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

(unaudited)

(dollars in thousands)

|  | <b>June 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|--------------------------|------------------------------|
| <b>ASSETS</b>  |                          |                              |
| Cash and due from banks  | \$ 11,820                | \$ 13,789                    |
| Interest bearing deposits at other financial institutions  | 36                       | 28                           |
| Federal funds sold   | 8,341                    | 4,302                        |
| <b>Total cash and cash equivalents</b>   | <b>20,197</b>            | <b>18,119</b>                |
| Securities available for sale  | 38,176                   | 24,808                       |
| Federal Home Loan Bank stock, at cost  | 1,261                    | 1,261                        |
| Loans receivable, net of allowance for loan losses \$7,251 on June 30, 2010 and \$7,082 on December 31, 2009 | 296,348                  | 314,153                      |
| Loans held for sale  | 1,667                    | 3,112                        |
| Premises and equipment, net  | 17,667                   | 18,098                       |
| Accrued interest receivable  | 1,478                    | 1,467                        |
| Foreclosed real estate and other repossessed assets  | 4,011                    | 3,672                        |
| Bank owned life insurance  | 3,731                    | 3,670                        |
| Other assets   | 3,920                    | 5,342                        |
| <b>TOTAL ASSETS</b>  | <b>\$ 388,456</b>        | <b>\$ 393,702</b>            |
| <b>LIABILITIES</b>   |                          |                              |
| Noninterest bearing demand deposits  | \$ 57,646                | \$ 63,850                    |
| Money market accounts  | 30,462                   | 23,005                       |
| NOW accounts   | 54,607                   | 35,507                       |
| Savings accounts   | 42,612                   | 42,321                       |
| Time certificates of deposit, \$100,000 and over   | 76,274                   | 75,983                       |
| Time certificates of deposit, under \$100,000  | 74,615                   | 97,111                       |
| <b>TOTAL DEPOSITS</b>  | <b>336,216</b>           | <b>337,777</b>               |
| Securities sold under agreements to repurchase   | 105                      | 291                          |
| Borrowed funds   | 8,476                    | 13,177                       |
| Capital lease liability  | 596                      | 599                          |
| Junior subordinated debentures   | 5,155                    | 5,155                        |
| Accrued interest payable   | 513                      | 658                          |
| Other liabilities  | 2,222                    | 2,239                        |
| <b>TOTAL LIABILITIES</b>   | <b>353,283</b>           | <b>359,896</b>               |

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| <b>SHAREHOLDERS EQUITY</b>  |                   |                   |
|---|-------------------|-------------------|
| Preferred stock - Series A Cumulative Perpetual; \$1,000 par value; \$1,000 liquidation value; 10,500 shares authorized and issued      | 10,072            | 10,012            |
| Preferred stock - Series B Cumulative Perpetual; \$0.01 par value; \$1,000 liquidation value; 525 shares authorized and issued          | 573               | 580               |
| Common stock, no par, 5,000,000 shares authorized; issued and outstanding 2,385,693 on June 30, 2010 and 2,380,793 on December 31, 2009 | 23,308            | 23,269            |
| Common stock subscribed   | 2,169             |                   |
| Retained earnings (accumulated deficit)   | 74                | (443)             |
| Accumulated other comprehensive income, net of tax effect of \$182 and \$199, respectively  | 354               | 388               |
| Less: stock subscription receivable   | (1,377)           |                   |
| <b>TOTAL SHAREHOLDERS EQUITY</b>  | <b>35,173</b>     | <b>33,806</b>     |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>  | <b>\$ 388,456</b> | <b>\$ 393,702</b> |

See accompanying notes.

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

(unaudited)

(dollars in thousands, except per share data)

|   | Three months ended June 30, |                 | Six months ended June 30, |                   |
|---|-----------------------------|-----------------|---------------------------|-------------------|
|   | 2010                        | 2009            | 2010                      | 2009              |
| <b>Interest income:</b>   |                             |                 |                           |                   |
| Loans, including fees   | \$ 4,788                    | \$ 5,316        | \$ 9,862                  | \$ 10,446         |
| Investment securities   | 380                         | 228             | 707                       | 474               |
| Federal funds sold and interest bearing deposits                  | 6                           | 1               | 13                        | 4                 |
| <b>Total interest income</b>                                      | <b>5,174</b>                | <b>5,545</b>    | <b>10,582</b>             | <b>10,924</b>     |
| <b>Interest expense:</b>  |                             |                 |                           |                   |
| Deposits  | 1,468                       | 1,780           | 3,032                     | 3,698             |
| Securities sold under agreements to repurchase                    |                             | 1               |                           | 7                 |
| Borrowed funds  | 170                         | 287             | 366                       | 599               |
| <b>Total interest expense</b>                                     | <b>1,638</b>                | <b>2,068</b>    | <b>3,398</b>              | <b>4,304</b>      |
| <b>Net interest income</b>  | <b>3,536</b>                | <b>3,477</b>    | <b>7,184</b>              | <b>6,620</b>      |
| Provision for loan losses   | 950                         | 1,815           | 1,450                     | 2,995             |
| <b>Net interest income after provision for loan losses</b>        | <b>2,586</b>                | <b>1,662</b>    | <b>5,734</b>              | <b>3,625</b>      |
| <b>Noninterest income:</b>  |                             |                 |                           |                   |
| Service charges on deposits                                       | 326                         | 400             | 633                       | 705               |
| Gain from sale of loans, net                                      | 152                         | 209             | 316                       | 366               |
| Gain from sale of securities                                      | 312                         | 8               | 318                       | 9                 |
| Gain from sale of foreclosed real estate and other property owned | 94                          | 33              | 119                       | 54                |
| Other noninterest income  | 254                         | 214             | 693                       | 555               |
| <b>Total noninterest income</b>                                   | <b>1,138</b>                | <b>864</b>      | <b>2,079</b>              | <b>1,689</b>      |
| <b>Noninterest expense:</b>                                       |                             |                 |                           |                   |
| Salaries and employee benefits                                    | 1,535                       | 1,670           | 3,100                     | 3,400             |
| Occupancy and equipment   | 302                         | 343             | 613                       | 664               |
| Depreciation and amortization                                     | 294                         | 249             | 570                       | 494               |
| Advertising and promotion   | 95                          | 111             | 162                       | 184               |
| Loss on foreclosed real estate and other property owned           | 218                         | 300             | 322                       | 300               |
| Other noninterest expenses  | 941                         | 1,203           | 1,859                     | 2,062             |
| <b>Total noninterest expense</b>                                  | <b>3,385</b>                | <b>3,876</b>    | <b>6,626</b>              | <b>7,104</b>      |
| <b>Income (loss) before income taxes</b>                          | <b>339</b>                  | <b>(1,350)</b>  | <b>1,187</b>              | <b>(1,790)</b>    |
| Income tax expense (benefit)                                      | 70                          | (504)           | 332                       | (688)             |
| <b>Net income (loss)</b>  | <b>\$ 269</b>               | <b>(\$ 846)</b> | <b>\$ 855</b>             | <b>(\$ 1,102)</b> |

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|   |           |            |           |            |
|---|-----------|------------|-----------|------------|
| Preferred stock dividends                     | 142       | 145        | 285       | 219        |
| Preferred stock discount accretion, net       | 27        | 26         | 53        | 39         |
| Net income (loss) applicable to common shares | \$ 100    | (\$ 1,017) | \$ 517    | (\$ 1,360) |
| Earnings (loss) per common share - basic      | \$ 0.04   | \$ (0.43)  | \$ 0.22   | \$ (0.57)  |
| Earnings (loss) per common share - diluted    | \$ 0.04   | \$ (0.43)  | \$ 0.22   | \$ (0.57)  |
| Weighted average shares outstanding - basic   | 2,384,078 | 2,370,732  | 2,382,444 | 2,368,998  |
| Weighted average shares outstanding - diluted | 2,385,963 | 2,370,732  | 2,383,716 | 2,368,998  |

See accompanying notes.

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

(unaudited)

(dollars in thousands)

|   | <b>Total</b> | <b>Preferred<br/>Stock</b> | <b>Common<br/>Stock</b> | <b>(Accumulated<br/>Deficit)<br/>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Comprehensive<br/>Income<br/>(Loss)</b> |
|---|--------------|----------------------------|-------------------------|--|---|--|
| Balance, December 31, 2008  | \$ 26,919    | \$                         | \$ 23,211               | \$ 3,429   | \$ 279  |  |
| Net loss  | (3,277)      |                            |                         | (3,277)  |   | (\$ 3,277)                                 |
| Stock issued to directors   | 22           |                            | 22                      |  |   |  |
| Issuance of preferred stock series A  | 9,909        | 9,909                      |                         |  |   |  |
| Issuance of preferred stock series B  | 591          | 591                        |                         |  |   |  |
| Cash dividends declared on preferred stock  | (503)        |                            |                         | (503)  |   |  |
| Accretion of preferred stock discount, net  |              | 92                         |                         | (92)   |   |  |
| Equity-based compensation expense, net  | 75           |                            | 75                      |  |   |  |
| Tax effect of vested stock grants   | (39)         |                            | (39)                    |  |   |  |
| Unrealized holding gain on securities transferred from held to maturity to available for sale, net of taxes | 224          |                            |                         |  | 224   | 224  |
| Net change in unrealized gain on securities available for sale, net of taxes                                | (115)        |                            |                         |  | (115)   | (115)                                      |
| Comprehensive loss  |              |                            |                         |  |   | (\$ 3,168)                                 |
| Balance December 31, 2009   | 33,806       | 10,592                     | 23,269                  | (443)  | 388   |  |
| Net income  | 855          |                            |                         | 855  |   | 855  |
| Stock issued to directors   | 22           |                            | 22                      |  |   |  |
| Common stock subscribed, less subscriptions receivable  | 792          |                            | 792                     |  |   |  |
| Cash dividends declared on preferred stock  | (285)        |                            |                         | (285)  |   |  |
| Accretion of preferred stock discount, net  |              | 53                         |                         | (53)   |   |  |
| Equity-based compensation expense, net  | 17           |                            | 17                      |  |   |  |
| Change in unrealized gain on securities available for sale, net of taxes                                    | (34)         |                            |                         |  | (34)  | (34)                                       |
| Comprehensive income  |              |                            |                         |  |   | \$ 821                                     |
| Balance, June 30, 2010  | \$ 35,173    | \$ 10,645                  | \$ 24,100               | \$ 74  | \$ 354  |  |
| Disclosure of 2010 reclassification amount:   |              |                            |                         |  |   |  |
| Net change in unrealized holding gains on available for sale securities                                     | (\$ 431)     |                            |                         |  |   |  |
| Reclassification adjustment for net gains realized in income  | 380          |                            |                         |  |   |  |
| Net change in unrealized gains  | (51)         |                            |                         |  |   |  |
| Tax effect  | 17           |                            |                         |  |   |  |

Net of tax amount

(\$ 34)

See accompanying notes.

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

(unaudited)

(dollars in thousands)

|  | Six months ended<br>June 30, |                |
|--|------------------------------|----------------|
|  | 2010                         | 2009           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                              |                |
| Net income (loss)  | \$ 855                       | (\$ 1,102)     |
| Adjustments to reconcile net income (loss) to cash provided by operating activities:   |                              |                |
| Amortization (accretion) of securities premiums and discounts, net                     | 2                            | (9)            |
| Gain on sale of securities, net  | (318)                        | (9)            |
| Amortization of deferred loan fees   | 120                          | 214            |
| Provision for loan losses  | 1,450                        | 2,995          |
| Originations of loans held for sale  | (15,921)                     | (26,243)       |
| Proceeds from sales of loans held for sale   | 17,682                       | 22,741         |
| Gain on sale of loans, net   | (316)                        | (366)          |
| Depreciation and amortization  | 570                          | 494            |
| Loss on sale of premises and equipment   |                              | 9              |
| Provision for losses and impairment of foreclosed real estate and other property owned | 300                          | 300            |
| Gain on sale of foreclosed real estate and other property owned, net                   | (97)                         | (54)           |
| Net increase in bank owned life insurance  | (61)                         | (64)           |
| Gain on redemption of bank owned life insurance  |                              | (145)          |
| Net (increase) decrease in deferred income taxes                                       | (28)                         | 288            |
| Equity-based compensation expense  | 17                           | 19             |
| Issuance of common stock under directors' compensation arrangements                    | 22                           | 22             |
| Change in assets and liabilities:  |                              |                |
| Accrued interest receivable  | (11)                         | 112            |
| Other assets   | 1,219                        | (441)          |
| Interest payable   | (145)                        | (66)           |
| Other liabilities  | (231)                        | 80             |
| <b>Net cash provided (used) by operating activities</b>                                | <b>5,109</b>                 | <b>(1,225)</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                              |                |
| Securities available for sale:   |                              |                |
| Purchases  | (22,715)                     | (2,998)        |
| Proceeds from maturities, calls and principal repayments                               | 4,329                        | 9,741          |
| Proceeds from sale   | 5,345                        |                |
| Securities held to maturity:   |                              |                |
| Purchases  |                              | (1,959)        |
| Purchases of FHLB stock  |                              | (155)          |
| Proceeds from sale of equity security  | 189                          |                |
| Net decrease (increase) in loans   | 14,439                       | (3,919)        |
| Purchase of premises and equipment   | (340)                        | (605)          |
| Proceeds from sale of premises and equipment   |                              | 4              |
| Proceeds from sale of foreclosed real estate and other repossessed assets              | 1,453                        | 425            |
| Proceeds from redemption of bank owned life insurance                                  |                              | 291            |
| <b>Net cash provided by investing activities</b>                                       | <b>2,700</b>                 | <b>825</b>     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                              |                |

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|   |              |              |
|---|--------------|--------------|
| Net (decrease) increase in deposits                           | (1,561)      | 14,015       |
| Net decrease in securities sold under agreement to repurchase | (186)        | (21,485)     |
| Net decrease in federal funds purchased                       |              | (3,465)      |
| Proceeds from borrowed funds                                  |              | 5,000        |
| Repayment of borrowed funds                                   | (4,704)      | (4,507)      |
| Proceeds from issuance of preferred stock                     |              | 10,500       |
| Proceeds from common stock subscription                       | 792          |              |
| Cash dividend paid  | (72)         | (146)        |
| Net cash (used) provided by financing activities              | (5,731)      | (88)         |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                | <b>2,078</b> | <b>(488)</b> |
| Cash and cash equivalents, beginning of period                | 18,119       | 11,413       |
| Cash and cash equivalents, end of period                      | \$ 20,197    | \$ 10,925    |

SUPPLEMENTAL DISCLOSURES

|                                |          |          |
|--------------------------------|----------|----------|
| Cash paid during the year for: |          |          |
| Interest                       | \$ 3,543 | \$ 4,371 |
| Income taxes                   | \$ 405   | \$       |

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

|  |          |          |
|--|----------|----------|
| Net change in fair value of securities available for sale                      | \$ (34)  | \$ (42)  |
| Acquisition of real estate and other repossessed assets in settlement of loans | \$ 1,895 | \$ 3,510 |
| Foreclosed real estate financed in-house                                       | \$ 99    | \$ 409   |
| Preferred stock dividend accrued and paid in subsequent period                 | \$ 215   | \$ 73    |

See accompanying notes.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2009. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented. The results of operations for the three-month and six-month periods ended June 30, 2010 and 2009 are not necessarily indicative of the operating results for the full year. Certain prior year balances have been reclassified to conform to the current year presentation. These reclassifications had no effect on retained earnings or net income as previously presented.

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

The Company has evaluated events and transactions for potential recognition and disclosure through the day the financial statements were issued.

**NOTE 2. New Accounting Pronouncements**

In December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-16, *Transfers and Servicing (Topic 860) Accounting for Transfers of Financial Assets*. ASU 2009-16 codifies SFAS No. 166, *Accounting for Transfers of Financial Assets - an Amendment of FASB Statement No. 140*, which was previously issued by FASB in June 2009 but was not included in the original codification. ASU 2009-16 eliminates the concept of a qualifying special-purpose entity, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, clarifies other sale-accounting criteria, and changes the initial measurement of a transferor's interest in transferred financial assets. This statement is effective for annual reporting periods beginning after November 15, 2009, and for interim periods therein. This standard will primarily impact the Company's accounting and reporting of transfers representing a portion of a financial asset for which the Company has a continuing involvement. In order to recognize the transfer of a portion of a financial asset as a sale, the transferred portion and any portion that continues to be held by the transferor must represent a participating interest, and the transfer of the participating interest must meet the conditions for surrender of control. To qualify as a participating interest, (i) the portions of a financial asset must represent a proportionate ownership interest in an entire financial asset, (ii) from the date of transfer, all cash flows received from the entire financial asset must be divided proportionately among the participating interest holders in an amount equal to their share of ownership, (iii) involve no recourse (other than standard representation and warranties) to, or subordination by, any participating interest holder, and (iv) no party has the right to pledge or exchange the entire financial asset. If the participating interest or surrender of control criteria

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are not met, the transfer is not accounted for as a sale and derecognition of the asset is not appropriate. Rather, the transaction is accounted for as a secured borrowing arrangement. The impact of certain participations being reported as secured borrowings rather than derecognizing a portion of a financial asset would increase total assets, liabilities and their respective interest income and expense. An increase in total assets also increases regulatory risk-weighted assets and could negatively impact our capital ratios. The adoption of this amendment had no impact on the Company's consolidated financial statements.

In April 2010, the FASB issued ASU 2010-13, *Stock Compensation; Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades*. ASU 2010-13 clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the underlying entity's security trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. This amendment was effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The adoption of this amendment had no impact on the Company's consolidated financial statements.

In April 2010, the FASB issued ASU 2010-18, *Receivables; Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset*. ASU 2010-18 specifies that modifications of loans that are accounted for within a pool under Subtopic 310-30 do not result in the removal of those loans from the pool even if the modification of those loans would otherwise be considered a troubled debt restructuring. An entity will continue to be required to consider whether the pool of assets in which the loan is included is impaired if expected cash flows for the pool change. The amendments in this Update do not affect the accounting for loans under the scope of Subtopic 310-30 that are not accounted for within pools. This amendment was effective for modifications of loans accounted for within pools occurring in the first interim or annual period ending on or after July 15, 2010. The amendments are to be applied prospectively, and upon initial adoption of the guidance in this update, an entity may make a one-time election to terminate accounting for loans as a pool, on a pool-by-pool basis. The adoption of this amendment is not expected to have any impact on the Company's consolidated financial statements.

In July 2010, the FASB issues ASU 2010-20, *Receivables; Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. ASU 2010-20 requires an entity to provide disclosures that facilitate financial statement users' evaluation of the nature of credit risk inherent in the entity's portfolio of financing receivables; how that risk is analyzed and assessed in arriving at the allowance for credit losses; and the changes and reasons for those changes in the allowance for credit losses. To achieve these objectives, an entity should provide disclosures that are disaggregated by portfolio segment and class of financing receivables. Existing disclosures are amended to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis: 1) a rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method; 2) for each disaggregated ending balance in item (1) above, the related recorded investment in financing receivables; 3) the nonaccrual status of financing receivables by class of financing receivables; 4) impaired financing receivables by class of financing receivables. The amendments in this Update require an entity to provide the following additional disclosures about its financing receivables: 1) credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables; 2) the aging of past due financing receivables at the end of the reporting period by class of financing receivables; 3) the nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses; 4) the nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses; 5) significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The adoption of this amendment will increase the Company's loan-related disclosures to provide for greater transparency about the Company's allowance for credit losses and the credit quality of its loans receivable.

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The Company is managed by legal entity and not by lines of business. The Bank's primary business is that of a traditional banking institution, gathering deposits and originating loans for its portfolio in its respective primary market areas. The Bank offers a wide variety of deposit products to its consumer and commercial customers. Lending activities include the origination of real estate, commercial/agriculture business and consumer loans. Inland Northwest Bank is also an active participant in the secondary market, originating residential loans for sale on a servicing released basis. In addition to interest income on loans and investment securities, the Bank receives other income from deposit service charges, loan servicing fees and from the sale of loans and investments.

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 stockholders. The Company has determined that its current business and operations consist of a single business segment.

**NOTE 4. Stock-Based Compensation**

On May 15, 2006, shareholders approved the Inland Northwest Bank 2006 Share Incentive Plan (the "Plan") and the issuance of shares of common stock of the Company pursuant to the Plan. This Plan is an amendment and restatement of the Inland Northwest Bank Non-Qualified Stock Option Plan originally effective July 21, 1992, as revised December 21, 1993, December 21, 1999 and April 16, 2002. The Plan allows the Board of Directors of Inland Northwest Bank to grant stock options and restricted stock awards to key employees of the Bank. Since the adoption of the amendments to the Plan in May 2006, stock options are, for the most part, expected to be granted during the process of recruiting new employees to the Bank. The maximum number of stock options and restricted shares that may be granted under the Plan, as adjusted for stock dividends, is 384,912. At June 30, 2010, 221,224 shares and/or options were available for grant to employees.

Additional information regarding stock options and restricted stock outstanding at December 31, 2009 is detailed in Note 14 "Stock Based Compensation" in the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2009. Note 14 also provides additional details on the method of accounting for stock-based compensation expense and the Black-Scholes model assumptions utilized to calculate that expense. Stock based compensation expense of \$7 thousand and \$19 thousand was recorded for the three-month period ended June 30, 2010 and 2009. Stock based compensation expense of \$17 thousand and \$39 thousand was recorded for the six-month period ended June 30, 2010 and 2009. At June 30, 2010, compensation costs not yet recognized for non-vested stock options and restricted stock awards was \$76 thousand.

Stock options are subject to a graded five-year vesting period and expire ten years from the date of the grant. The exercise price of each option equals the fair market value of the Company's stock on the date of the grant. The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model. No stock options were granted during the three-month and six-month periods ended June 30, 2010 and 2009. Stock options outstanding and exercisable as of June 30, 2010 are as follows:

|  | Number of<br>shares | Weighted-<br>average<br>exercise price | Intrinsic<br>Value |
|--|---------------------|--|--------------------|
| Outstanding options, December 31, 2009 | 87,003              | \$ 9.67                                | \$ 0.00            |
| Granted                                |                     |  |                    |
| Exercised                              |                     |  |                    |
| Forfeited                              | (2,205)             | 16.73                                  |                    |
| Outstanding options, June 30, 2010     | 84,798              | 9.49                                   |                    |
| Options exercisable, June 30, 2010     | 79,876              | 9.02                                   |                    |

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Restricted stock awards cliff vest after either a three-year or five-year period depending on the individual grant with the exception of awards issued in 2009 to two executive officers, which cliff-vest in five years or upon the redemption of the Company's outstanding preferred stock, whichever is later. The fair value of these awards is recognized ratably over the vesting period as compensation expense. Restricted stock-award activity is summarized as follows:

|                                | Number of<br>shares | Weighted<br>average<br>fair value |
|--------------------------------|---------------------|-----------------------------------|
| Outstanding, December 31, 2009 | 21,351              | \$ 5.98                           |
| Granted                        |                     |                                   |
| Vested                         |                     |                                   |
| Forfeited                      |                     |                                   |
| Outstanding, June 30, 2010     | 21,351              | \$ 5.98                           |

**NOTE 5. Securities**

All securities held by the Bank at June 30, 2010 are classified as available for sale and are stated at fair value with unrealized holding gains and losses, net of related deferred taxes, reported as a separate component of shareholders' equity. Realized gains or losses on sales of available for sale securities are reported as part of noninterest income based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are recognized in interest income using the effective method over the period to maturity unless the security is called prior to maturity. When a security is called prior to maturity, any remaining premium or discount is reported as noninterest income. Nine securities were sold in the six-month period ended June 30, 2010, resulting in a net gain of \$318 thousand included in other noninterest income. There were no securities sold in the six-month period ended June 30, 2009.

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The amortized cost of securities available for sale and their approximate fair values at June 30, 2010 and December 31, 2009 were as follows:

|                                   | June 30, 2010  |                        |                         | Fair Value |
|-----------------------------------|----------------|------------------------|-------------------------|------------|
|                                   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses |            |
|                                   |                | (\$ in thousands)      |                         |            |
| U.S. government agency securities | \$ 24,022      | \$ 132                 | \$ 0                    | \$ 24,154  |
| Corporate debt obligations        | 1,888          | 28                     | 16                      | 1,900      |
| State and municipal securities    | 11,270         | 400                    | 57                      | 11,613     |
| Mortgage backed securities        | 460            | 49                     |                         | 509        |
|                                   | \$ 37,640      | \$ 609                 | \$ 73                   | \$ 38,176  |

|                                   | December 31, 2009 |                        |                         | Fair Value |
|-----------------------------------|-------------------|------------------------|-------------------------|------------|
|                                   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses |            |
|                                   |                   | (\$ in thousands)      |                         |            |
| U.S. government agency securities | \$ 8,102          | \$ 47                  | \$ 135                  | \$ 8,014   |
| Corporate debt obligations        | 1,541             |                        | 22                      | 1,519      |
| State and municipal securities    | 9,615             | 391                    | 28                      | 9,978      |
| Mortgage backed securities        | 4,963             | 334                    |                         | 5,297      |
|                                   | \$ 24,221         | \$ 772                 | \$ 185                  | \$ 24,808  |

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

|                                | <b>June 30, 2010</b>                |                          |                                   |                          |                   |                          |
|--------------------------------|-------------------------------------|--------------------------|-----------------------------------|--------------------------|-------------------|--------------------------|
|                                | <b>Impaired Less Than 12 Months</b> |                          | <b>Impaired 12 Months or More</b> |                          | <b>Total</b>      |                          |
|                                | <b>Fair Value</b>                   | <b>Unrealized Losses</b> | <b>Fair Value</b>                 | <b>Unrealized Losses</b> | <b>Fair Value</b> | <b>Unrealized Losses</b> |
|                                | <i>(\$ in thousands)</i>            |                          |                                   |                          |                   |                          |
| Corporate debt obligations     | \$ 334                              | \$ 16                    | \$                                | \$                       | \$ 334            | \$ 16                    |
| State and municipal securities | 2,413                               | 57                       |                                   |                          | 2,413             | 57                       |
|                                | <b>\$ 2,747</b>                     | <b>\$ 73</b>             | <b>\$</b>                         | <b>\$</b>                | <b>\$ 2,747</b>   | <b>\$ 73</b>             |

|                                   | <b>December 31, 2009</b>            |                          |                                   |                          |                   |                          |
|-----------------------------------|-------------------------------------|--------------------------|-----------------------------------|--------------------------|-------------------|--------------------------|
|                                   | <b>Impaired Less Than 12 Months</b> |                          | <b>Impaired 12 Months or More</b> |                          | <b>Total</b>      |                          |
|                                   | <b>Fair Value</b>                   | <b>Unrealized Losses</b> | <b>Fair Value</b>                 | <b>Unrealized Losses</b> | <b>Fair Value</b> | <b>Unrealized Losses</b> |
|                                   | <i>(\$ in thousands)</i>            |                          |                                   |                          |                   |                          |
| U.S. government agency securities | \$ 6,465                            | \$ 135                   | \$                                | \$                       | \$ 6,465          | \$ 135                   |
| Corporate debt obligations        | 1,021                               | 20                       | 499                               | 2                        | 1,520             | 22                       |
| State and municipal securities    | 905                                 | 28                       |                                   |                          | 905               | 28                       |
|                                   | <b>\$ 8,391</b>                     | <b>\$ 183</b>            | <b>\$ 499</b>                     | <b>\$ 2</b>              | <b>\$ 8,890</b>   | <b>\$ 185</b>            |

Management has evaluated the above securities and does not believe that any individual unrealized loss as of June 30, 2010, represents an other-than-temporary impairment ( OTTI ). The decline in fair market value of these securities is generally due to changes in interest rates since purchase and is not related to any known decline in the creditworthiness of the issuer. 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 Bank'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. At June 30, 2010, 10 securities had unrealized losses. At December 31, 2009, 16 securities had unrealized losses.

Management reviews investment securities on an ongoing basis for the presence of OTTI or permanent impairment, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether we intend to sell a security or if it is likely that we will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity, and other factors. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a

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security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ( OCI ). Impairment losses related to all other factors are presented as separate categories within OCI. For investment securities held to maturity, this amount is accreted over the remaining life of the debt security prospectively based on the amount and timing of future estimated cash flows. The accretion of the OTTI amount recorded in OCI will increase the carrying value of the investment, and would not affect earnings. If there is an indication of additional credit losses the security is re-evaluated accordingly to the procedures described above.

The unrealized losses on investments in U.S. government agency securities were caused by interest rate increases subsequent to the purchase of these securities. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. Because the Bank does not intend to sell the securities in this class and it is not likely that the Bank will be required to sell these securities before recovery of their amortized cost bases, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered other-than-temporarily impaired.

The unrealized losses on obligations of states and municipalities were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities. Management monitors published credit ratings of these securities and no adverse ratings changes have occurred since the date of purchase of obligations of political subdivisions which are in an unrealized loss position as of June 30, 2010. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because the Bank does not intend to sell the securities in this class and it is not likely that Bank will be required to sell these securities before recovery of their amortized cost bases, which may include holding each security until maturity, the unrealized losses on these investments are not considered other-than-temporarily impaired.

At June 30, 2010, the Bank owned \$1.3 million of stock of the Federal Home Loan Bank of Seattle ( FHLB ). As a condition of membership in the FHLB, the Bank is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. FHLB stock has a par value of \$100 per share, is carried at cost, and is subject to impairment testing per Accounting Standards Codification ( ASC ) 320-10-35. The FHLB recently announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency ( FHFA ), its primary regulator, and that it would suspend future dividends and the repurchase and redemption of outstanding capital stock. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB s private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in the FHLB s balance sheet. As a result, an OTTI has not been recorded for the Bank s investment in FHLB stock. However, continued deterioration in the FHLB s financial position may result in impairment in the value of those securities. Management will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of the Bank s investment.

Scheduled maturities of securities available for sale at June 30, 2010, are as follows:

|                                 | Amortized<br>Cost | Fair<br>Value |
|---------------------------------|-------------------|---------------|
|                                 | (\$ in thousands) |               |
| Due in one year or less         | \$ 312            | \$ 314        |
| Due from one year to five years | 7,959             | 8,138         |
| Due from five to ten years      | 10,231            | 10,464        |
| Due after ten years             | 18,678            | 18,751        |
| Mortgage backed securities      | 460               | 509           |
|                                 | \$ 37,640         | \$ 38,176     |

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At June 30, 2010 and December 31, 2009, securities with an amortized cost of \$11.3 million and \$16.4 million, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required or permitted by law. The market value for these securities was \$11.3 million and \$17.1 million at June 30, 2010 and December 31, 2009, respectively.

**NOTE 6. Loans**

Loan detail by category is as follows:

|   | June 30,<br>2010  | December 31,<br>2009 |
|---|-------------------|----------------------|
|   | (\$ in thousands) |                      |
| 1-4 family and multi-family real estate | \$ 51,172         | \$ 48,365            |
| Commercial real estate                  | 148,114           | 137,225              |
| Commercial construction                 | 12,425            | 34,217               |
| Commercial non-real estate              | 50,797            | 55,071               |
| Land and land development               | 32,567            | 36,833               |
| Consumer                                | 9,160             | 10,167               |
|   | 304,235           | 321,878              |
| Allowance for loan losses               | (7,251)           | (7,082)              |
| Net deferred loan fees                  | (636)             | (643)                |
|   | \$ 296,348        | \$ 314,153           |

The amount of impaired loans, net of any charge-offs recorded as a result of specific impairment analysis, and the related allocated reserve for loan losses were as follows:

|                         | June 30, 2010     |                  | December 31, 2009 |                  |
|-------------------------|-------------------|------------------|-------------------|------------------|
|                         | Loan Amount       | Specific Reserve | Loan Amount       | Specific Reserve |
|                         | (\$ in thousands) |                  |                   |                  |
| Impaired Loans:         |                   |                  |                   |                  |
| Loans on nonaccrual     | \$ 11,371         | \$ 1,814         | \$ 11,676         | \$ 1,191         |
| Loans on accrual status | 21,744            | 1,942            | 15,979            | 1,436            |
| Total impaired loans    | \$ 33,115         | \$ 3,756         | \$ 27,655         | \$ 2,627         |

**Table of Contents****NOTE 7. Allowance for Loan Losses**

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

|                              | Three months ended |           | Six months ended  |           |
|------------------------------|--------------------|-----------|-------------------|-----------|
|                              | 6/30/2010          | 6/30/2009 | 6/30/2010         | 6/30/2009 |
|                              | (\$ in thousands)  |           | (\$ in thousands) |           |
| Balance, beginning of period | \$ 7,175           | \$ 5,453  | \$ 7,082          | \$ 4,737  |
| Provision for loan losses    | 950                | 1,815     | 1,450             | 2,995     |
| Loan charge-offs             | (912)              | (2,849)   | (1,325)           | (3,316)   |
| Loan recoveries              | 38                 | 6         | 44                | 9         |
| Balance, end of period       | \$ 7,251           | \$ 4,425  | \$ 7,251          | \$ 4,425  |

**NOTE 8. Borrowed Funds**

Borrowed funds consist of FHLB term loan advances at June 30, 2010 and December 31, 2009.

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

|                            | June 30, 2010     |                     | December 31, 2009 |                     |
|----------------------------|-------------------|---------------------|-------------------|---------------------|
|                            | Line Amount       | Outstanding Balance | Line Amount       | Outstanding Balance |
|                            | (\$ in thousands) |                     |                   |                     |
| Federal Home Loan Bank     | \$ 51,129         | \$                  | \$ 53,753         | \$                  |
| Pacific Coast Bankers Bank | 10,000            |                     | 10,000            |                     |
| Zions Bank                 | 5,000             |                     | 5,000             |                     |

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### **NOTE 9. Capital Lease Liability**

The capital lease liability outstanding on June 30, 2010 and December 31, 2009 is related to a ground lease, with a purchase option, that the Bank entered into in early 2005 (a copy of the ground lease was filed as an Exhibit to the Company's annual report on Form 10-KSB filed with the SEC on March 24, 2005). As a capitalized lease, the value of the property is included as an asset on the consolidated statement of financial condition in Premises and equipment, net, and the net present value of future payments is included as a liability in Capital lease liability.

### **NOTE 10. Material Contracts**

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

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

### **NOTE 11. Junior Subordinated Debentures**

In June 2005, the Company issued junior subordinated debentures with an aggregate value of \$5.16 million to Northwest Bancorporation Capital Trust I (the Trust ), with interest fixed at 5.95% through June 30, 2010, thereafter re-pricing quarterly at three-month LIBOR plus 1.70%. The Trust issued \$155 thousand of common securities to the Company and capital securities with an aggregate liquidation amount of \$5 million to third-party investors. The common securities are included in Other assets on the consolidated statement of financial condition; the subordinated debentures are detailed individually in this report and are included in Borrowed funds in the consolidated financial statements included in the annual report on Form 10-K for the year ended December 31, 2009. The subordinated debentures are includable as Tier I capital for regulatory purposes. The subordinated debentures and the capital securities pay interest and dividends, respectively, on a quarterly basis, which are included in interest expense. The subordinated debentures will mature on June 30, 2035, at which time the capital securities must be redeemed. The subordinated debentures and capital securities can be redeemed prior to maturity, at the Company's discretion, in whole or in part, beginning June 30, 2010, at par value. The Company has provided a full and unconditional guarantee of the obligations of the Trust under the capital securities in the event of default. The Trust is not consolidated in these financial statements, pursuant to ASC 810, *Consolidation*. The Company reports the junior subordinated debentures within the liabilities section of the consolidated statements of financial condition.

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The following table presents a summary of the Company's outstanding trust preferred securities at June 30, 2010 and December 31, 2009:

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

On June 4, 2010, the Company gave written notice to the holders of its outstanding junior subordinated debentures that regularly scheduled interest payments would be deferred. Under the terms of the related trust documents, the Company is allowed to defer payments of interest for up to 20 consecutive quarterly periods without default. During the deferral period, the respective trust will likewise suspend the declaration and payment of dividends on the trust preferred securities. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Fixed Rate Cumulative Perpetual Preferred Stock, Series A and Series B, issued by the Company under the U.S. Department of the Treasury's Capital Purchase Program. In addition, the Company will be restricted from making any payment on outstanding debt obligations that rank equally with, or junior to, the junior subordinated notes.

**NOTE 12. Common and Preferred Stock****Common Stock:**

No cash dividends were declared during the three-month and six-month periods ended June 30, 2010 and 2009.

**Preferred Stock:**

On February 14, 2009, as part of the Troubled Asset Relief Capital Purchase Program (the CPP) of the U.S. Department of the Treasury (Treasury), the Company entered into a Letter Agreement incorporating an attached Securities Purchase Agreement Standard Terms (collectively, the Purchase Agreement) with the Treasury. Under the Purchase Agreement, the Company agreed to issue and sell to the Treasury (i) 10,500 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock), having no par value per share, and (ii) a warrant (the Warrant) to purchase 525,00525 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B (the Series B Preferred Stock), having no par value per share, for an aggregate purchase price of \$10,500,000. The Treasury immediately exercised the warrant.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series B Preferred Stock pays a cumulative dividend of 9% per year. The Series A Preferred Stock and the Series B Preferred Stock (together, the Preferred Stock) may not be redeemed by the Company during the first three years following the investment by the Treasury, except with the proceeds from a Qualified Equity Offering (as defined in the Company's Articles of Amendment). After three years, the Company may, at its option, redeem the Preferred Stock at the issue price, plus accrued and unpaid dividends. The Preferred Stock is generally non-voting and will qualify as Tier 1 capital.

As a result of the Company's participation in the CPP, the Company is restricted from paying any dividend on its common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock. During the three year period from February 13, 2009, payment of dividends on common stock by the Company may not exceed the last annual cash dividend of \$0.20 per share. Prior consent of the Treasury will be required after February 13, 2012 until February 13, 2019, for any annual increase of 3% or more in aggregate common dividends per share. After February 13, 2019, the Company will be prohibited from paying any common dividends or repurchasing any equity securities or trust preferred securities until all of the Preferred Stock has been redeemed in whole or the Treasury has transferred all of the Preferred Stock to third parties.

During the six months ended June 30, 2010 and 2009, the Company declared preferred stock dividends totaling approximately \$285,000 and \$219,000. Subsequent to the payment made on February 16, 2010, the Company began deferring payment of dividends on its preferred stock but continues to accrue the liability for the dividends.



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As of June 30, 2010, dividend payments in arrears on preferred stock were \$214,594. As of December 31, 2009, accrued and unpaid dividends totaled \$71,531 and no dividend payments on the preferred stock were in arrears.

**NOTE 13. Fair Value Measurements**

The Company determines the fair market value of its financial instruments based on the fair value hierarchy established in ASC 820 Fair Value Measurements and Disclosures. The Standard provides enhanced guidance for measuring assets and liabilities using fair value and applies to situations where other standards require or permit assets or liabilities to be measured at fair value. ASC 820 also requires expanded disclosure of items that are measured at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings.

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

|  | June 30, 2010   |                      | December 31, 2009 |                      |
|--|-----------------|----------------------|-------------------|----------------------|
|  | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| <i>(\$ in thousands)</i>   |                 |                      |                   |                      |
| <b>Financial Assets:</b>   |                 |                      |                   |                      |
| Cash and due from banks  | \$ 11,820       | \$ 11,820            | \$ 13,789         | \$ 13,789            |
| Federal funds sold/interest bearing balances at other financial institutions | 8,377           | 8,377                | 4,330             | 4,330                |
| Securities available for sale  | 38,176          | 38,176               | 24,808            | 24,808               |
| Federal Home Loan Bank stock   | 1,261           | 1,261                | 1,261             | 1,261                |
| Loans receivable, net  | 296,348         | 302,770              | 314,153           | 319,036              |
| Loans held for sale  | 1,667           | 1,667                | 3,112             | 3,112                |
| Bank owned life insurance  | 3,731           | 3,731                | 3,670             | 3,670                |
| <b>Financial Liabilities:</b>  |                 |                      |                   |                      |
| Deposits   | 336,216         | 337,492              | 337,777           | 339,544              |
| Securities sold under agreements to repurchase                               | 105             | 105                  | 291               | 291                  |
| Borrowed funds   | 8,476           | 8,615                | 13,177            | 13,419               |
| Junior subordinated debentures   | 5,155           | 2,551                | 5,155             | 5,056                |

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

| Description of Financial Instrument  | Fair Value | Fair Value at June 30, 2010 |           |         |
|--------------------------------------|------------|-----------------------------|-----------|---------|
|                                      |            | Level 1                     | Level 2   | Level 3 |
| <i>(\$ in thousands)</i>             |            |                             |           |         |
| <b>Securities available for sale</b> |            |                             |           |         |
| U.S. government agency securities    | \$ 24,154  | \$                          | \$ 24,154 | \$      |
| Corporate debt obligations           | 1,900      |                             | 1,900     |         |
| State and municipal securities       | 11,613     |                             | 11,613    |         |
| Mortgage backed securities           | 509        |                             | 509       |         |

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| Description of Financial Instrument | Fair Value | Fair Value at December 31, 2009 |          |         |
|-------------------------------------|------------|---------------------------------|----------|---------|
|                                     |            | Level 1                         | Level 2  | Level 3 |
|                                     |            | (\$ in thousands)               |          |         |
| Securities available for sale       |            |                                 |          |         |
| U.S. government agency securities   | \$ 8,014   | \$                              | \$ 8,014 | \$      |
| Corporate debt obligations          | 1,519      |                                 | 1,519    |         |
| State and municipal securities      | 9,978      |                                 | 9,978    |         |
| Mortgage backed securities          | 5,297      |                                 | 5,297    |         |

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

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

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

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

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

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

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

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

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

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Certain financial assets are measured at fair value on a nonrecurring basis from application of lower of cost or market accounting or write-downs of individual assets due to impairment. The following table summarizes the Company's financial instruments that were measured at fair value on a nonrecurring basis:

| Description of Financial Instrument                 | Fair Value | Fair Value at June 30, 2010 |         |           |
|---|------------|-----------------------------|---------|-----------|
|   |            | Level 1                     | Level 2 | Level 3   |
|   |            | (\$ in thousands)           |         |           |
| Loans   | \$ 14,976  | \$                          | \$      | \$ 14,976 |
| Foreclosed real estate and other repossessed assets | 4,011      |                             |         | 4,011     |

  

| Description of Financial Instrument                 | Fair Value | Fair Value at December 31, 2009 |         |          |
|---|------------|---------------------------------|---------|----------|
|   |            | Level 1                         | Level 2 | Level 3  |
|   |            | (\$ in thousands)               |         |          |
| Loans   | \$ 9,079   | \$                              | \$      | \$ 9,079 |
| Foreclosed real estate and other repossessed assets | 3,672      |                                 |         | 3,672    |

*Loans.* Loans measured at fair value on a nonrecurring basis are impaired loans, and are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or market value. Market value is measured based on the value of the collateral securing these loans. The value of real estate collateral is determined based on an independent appraisal. The value of business equipment, inventory and accounts receivable collateral is typically based on the net book value on the business' financial statements, but in some cases an appraisal is obtained for equipment and inventory. Appraised and reported values may be discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the customer and the customer's business. The impaired loans included in the table above are reported net of their specific reserve, which is management's best estimate of fair value. The specific reserve is established by recording provision expense in the Consolidated Statements of Operations.

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

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

**NOTE 14. Income Taxes**

The effective tax rates presented for the six-month period ended June 30, 2010 are not consistent with the six-month period ended June 30, 2009 or the Company's historical effective tax rates. Our normal, expected statutory income tax rate is 36.0%, representing a blend of the statutory federal income tax rate of 34.0% and apportioned effects of the Idaho income tax rate of 7.6%. Our effective tax rates have historically been lower than statutory

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tax rates due to permanent differences arising primarily from nontaxable interest income on state and municipal securities and nontaxable gains in bank owned life insurance. The effect of these permanent differences combined with a loss before income taxes for the six-month period ended June 30, 2009, and adjustments related to certain state deferred tax benefits, has resulted in a higher effective tax benefit percentage in the six months ended June 30, 2009 as compared to the same period ended in 2010.

As of June 30, 2010 and December 31, 2009, the Company had recorded net deferred income tax assets of approximately \$387 thousand and \$291 thousand, respectively; in addition, the Company had recorded an income tax receivable of \$4 thousand and \$1.0 million as of June 30, 2010 and December 31, 2009, respectively. These balances were included in other assets in the accompanying consolidated statements of financial condition.

The Company currently has a valuation allowance totaling \$742 thousand recorded against a portion of its deferred tax assets, because taxable income in the next calendar year may not be sufficient to realize the benefits of temporary deductible differences that cannot be realized through carry-back to prior years or through the reversal of future temporary taxable differences. This valuation allowance will be reduced or eliminated as future taxable income is earned.

The Company follows the provisions of ASC 740, *Income Taxes*. The Company had no unrecognized tax benefits at June 30, 2010 or December 31, 2009. The Company recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the periods ended June 30, 2010 and December 31, 2009 the Company recognized no interest and penalties.

**NOTE 15. Subsequent Event    Capital Raising Activities**

On July 15, 2010, the Company concluded a rights offering to the holders of its common stock, raising \$2,747,220 in exchange for 686,805 shares of the Company's common stock. Costs totaling \$141,384 were netted with capital.

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

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

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

From time to time, the Company and its senior managers have made and will make forward-looking statements that are not historical facts and that are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, but are not limited to, statements about the Company's plans, objectives, expectations and intentions and other statements contained in this release that are not historical facts and pertain to the Company's future operating results. When used in this report, the words expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions are generally intended to identify forward-looking statements. The Company and its senior managers have made and will make forward-looking statements regarding projected sources of funds, use of proceeds, availability of acquisition and growth opportunities, ability to repay government funds, payment of dividends, adequacy of the allowance for loan losses and provision for loan losses, the real estate portfolio and subsequent charge-offs. Such statements may be contained in this report and in other documents that the Company files with the Securities and Exchange Commission (the SEC). Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others.

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

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

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

further deterioration in economic conditions that could result in increased loan and lease losses;

applicable laws and regulations and legislative or regulatory changes;

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

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

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

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

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

technological and management changes;

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growth and acquisition strategies;

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

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

changes in consumer spending and saving habits;

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

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

This list of factors is not complete and additional information about risks of the Company achieving results suggested by any forward-looking statements may be found under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K, as updated regularly in the Company's filings with the SEC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in the Company's 2009 Annual Report on Form 10-K.*

## **Summary of Critical Accounting Policies**

The SEC defines "critical accounting policies" as those that require the application of management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. The accounting policies that the Company's management have identified as critical to understanding the Company's financial statements and operating results are described in Note 1 of the Notes to Consolidated Financial Statements in the Company's annual report on Form 10-K for the year ended December 31, 2009. There have been no significant changes in our application of accounting policies since December 31, 2009.

## **Results of Operations**

### *Summary*

The Company reported net income applicable to common shares of \$100 thousand and \$517 thousand for the three-month and six-month periods ended June 30, 2010, compared to a net loss applicable to common shares of approximately \$1.0 million and \$1.4 million for the comparable periods in 2009. The improvement in operating results compared to the first six months of 2009 is largely attributable to increased net interest income, a lower provision for loan losses, a reduction in non-interest expenses, and increased noninterest income.

During the first six months of 2010, total assets decreased \$5.2 million, or 1.3%. Total gross loans decreased \$17.6 million, or 5.5%, and deposits decreased \$1.6 million, or 0.5%, during the same period. Despite these decreases, the Company showed an improvement in operating results because a lower loan loss provision was required, and the Company's net interest margin improved. The shift from time certificates of deposit to core deposits, coupled with the decline in interest rates, resulted in a notable reduction of interest expense. In addition, we have been proactive in identifying and charging off problem loans, and as we work through resolving these loan issues, there has been a lesser need for provision expense.

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The table below summarizes the Company's financial performance for the three-month and six-month periods ended June 30, 2010 and 2009:

**Financial Highlights**

(\$ in thousands, except per share data)

|   | Three months ended June 30, |            |             | Six months ended June 30, |            |             |
|---|-----------------------------|------------|-------------|---------------------------|------------|-------------|
|   | 2010                        | 2009       | %<br>Change | 2010                      | 2009       | %<br>Change |
| <b>Results of Operations:</b>                       |                             |            |             |                           |            |             |
| Interest income                                     | \$ 5,174                    | \$ 5,545   | -6.7%       | \$ 10,582                 | \$ 10,924  | -3.1%       |
| Interest expense                                    | 1,638                       | 2,068      | -20.8%      | 3,398                     | 4,304      | -21.1%      |
| Net interest income                                 | 3,536                       | 3,477      | 1.7%        | 7,184                     | 6,620      | 8.5%        |
| Provision for loan losses                           | 950                         | 1,815      | -47.7%      | 1,450                     | 2,995      | -51.6%      |
| Net interest income after provision for loan losses | 2,586                       | 1,662      | 55.6%       | 5,734                     | 3,625      | 58.2%       |
| Noninterest income                                  | 1,138                       | 864        | 31.7%       | 2,079                     | 1,689      | 23.1%       |
| Noninterest expense                                 | 3,385                       | 3,876      | -12.7%      | 6,626                     | 7,104      | -6.7%       |
| Income (loss) before income taxes                   | 339                         | (1,350)    | 125.1%      | 1,187                     | (1,790)    | 166.3%      |
| Income tax expense (benefit)                        | 70                          | (504)      | 113.9%      | 332                       | (688)      | 148.3%      |
| Net income (loss)                                   | 269                         | (846)      | 131.8%      | 855                       | (1,102)    | 177.6%      |
| Preferred stock dividends and discount accretion    | 169                         | 171        | -1.2%       | 338                       | 258        | 31.0%       |
| Net income (loss) applicable to common shares       | \$ 100                      | \$ (1,017) | 109.8%      | \$ 517                    | \$ (1,360) | 138.0%      |
| <b>Share Data:</b>                                  |                             |            |             |                           |            |             |
| Basic earnings (loss) per common share              | \$ 0.04                     | \$ (0.43)  |             | \$ 0.22                   | \$ (0.57)  |             |
| Diluted earnings (loss) per common share            | \$ 0.04                     | \$ (0.43)  |             | \$ 0.22                   | \$ (0.57)  |             |
| <b>Selected Ratios:</b>                             |                             |            |             |                           |            |             |
| Return on average assets                            | 0.10%                       | -1.02%     |             | 0.26%                     | -0.55%     |             |
| Return on average equity                            | 1.15%                       | -11.12%    |             | 3.00%                     | -7.00%     |             |
| Net interest income to average earning assets       | 3.85%                       | 3.77%      |             | 3.92%                     | 3.59%      |             |
| Efficiency ratio                                    | 72.42%                      | 89.29%     |             | 71.53%                    | 86.64%     |             |
| Noninterest income to average assets                | 1.13%                       | 0.87%      |             | 1.04%                     | 0.85%      |             |
| Noninterest expense to average assets               | 3.37%                       | 3.90%      |             | 3.31%                     | 3.57%      |             |
| Ending shareholders' equity to average assets       | 8.76%                       | 9.07%      |             | 8.77%                     | 9.06%      |             |
| Nonperforming loans to gross loans                  | 3.74%                       | 4.50%      |             | 3.74%                     | 4.50%      |             |
| Allowance for loan losses to gross loans            | 2.38%                       | 1.31%      |             | 2.39%                     | 1.31%      |             |

*Net Interest Income*

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

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*Average Balances, Rates, and Interest Income and Expenses.* The following table presents an analysis of the Company's net interest income and net interest margin for the three-month period ended June 30, 2010 and 2009:

|   | Three months ended June 30, |                                 |                       |                 |                                 |                       |
|---|-----------------------------|---------------------------------|-----------------------|-----------------|---------------------------------|-----------------------|
|   | Average Balance             | 2010 Interest Income or Expense | Average Yield or Cost | Average Balance | 2009 Interest Income or Expense | Average Yield or Cost |
| <b>ASSETS</b>   |                             |                                 |                       |                 |                                 |                       |
| Loans, gross <sup>1,2</sup>                               | \$ 317,469                  | \$ 4,788                        | 6.03%                 | \$ 341,891      | \$ 5,316                        | 6.22%                 |
| Taxable investments                                       | 28,137                      | 270                             | 3.84%                 | 14,372          | 139                             | 3.87%                 |
| Nontaxable investments <sup>3</sup>                       | 11,170                      | 110                             | 3.94%                 | 8,740           | 89                              | 4.07%                 |
| FHLB stock  | 1,261                       |                                 | 0.00%                 | 1,140           |                                 | 0.00%                 |
| Federal funds sold & interest-bearing deposits with banks | 8,970                       | 6                               | 0.27%                 | 3,013           | 1                               | 0.13%                 |
| Total interest earning assets                             | 367,007                     | 5,174                           | 5.64%                 | 369,156         | 5,545                           | 6.01%                 |
| Less allowance for loan losses                            | (7,440)                     |                                 |                       | (5,227)         |                                 |                       |
| Cash and due from banks                                   | 11,051                      |                                 |                       | 8,085           |                                 |                       |
| Other non-earning assets                                  | 30,700                      |                                 |                       | 25,819          |                                 |                       |
| Total assets  | \$ 401,318                  |                                 |                       | \$ 397,833      |                                 |                       |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>               |                             |                                 |                       |                 |                                 |                       |
| NOW accounts  | 49,040                      | 203                             | 1.66%                 | 14,719          | 15                              | 0.41%                 |
| Money market accounts                                     | 30,248                      | 79                              | 1.04%                 | 26,736          | 59                              | 0.88%                 |
| Savings accounts  | 45,374                      | 103                             | 0.91%                 | 42,798          | 138                             | 1.29%                 |
| Time certificates of deposit                              | 156,207                     | 1,083                           | 2.77%                 | 178,483         | 1,568                           | 3.51%                 |
| Total interest bearing deposits                           | 280,869                     | 1,468                           | 2.09%                 | 262,736         | 1,780                           | 2.71%                 |
| Securities sold under repurchase agreements               | 174                         |                                 | 0.00%                 | 691             | 1                               | 0.58%                 |
| Borrowed funds  | 9,710                       | 92                              | 3.79%                 | 25,268          | 210                             | 3.32%                 |
| Junior subordinated note <sup>4</sup>                     | 5,155                       | 78                              | 6.05%                 | 5,155           | 77                              | 5.97%                 |
| Total borrowed funds                                      | 15,039                      | 170                             | 4.52%                 | 31,114          | 288                             | 3.70%                 |
| Total interest bearing liabilities                        | 295,908                     | 1,638                           | 2.21%                 | 293,850         | 2,068                           | 2.82%                 |
| Demand deposits   | 62,261                      |                                 |                       | 65,687          |                                 |                       |
| Other liabilities   | 8,460                       |                                 |                       | 1,713           |                                 |                       |
| Shareholders' equity                                      | 34,689                      |                                 |                       | 36,583          |                                 |                       |
| Total liabilities and shareholders' equity                | \$ 401,318                  |                                 |                       | \$ 397,833      |                                 |                       |
| Net interest income                                       |                             | \$ 3,536                        |                       |                 | \$ 3,477                        |                       |
| Net interest spread                                       |                             |                                 | 3.43%                 |                 |                                 | 3.19%                 |
| Net interest income to average earning assets (margin)    |                             |                                 | 3.85%                 |                 |                                 | 3.77%                 |

**Comments:**

1. Nonaccrual loan balances are included in average loan balances; however, no interest income is imputed to nonaccrual loans.

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2. Loan fee income in the amount of \$96 thousand and \$165 thousand is included in loan interest income for 2010 and 2009, respectively.
  3. Yields have not been adjusted on tax-exempt investments to determine a tax-equivalent yield.
  4. Junior subordinated note interest is fixed at 5.95%. Interest is computed using 360/365, which results in a higher annual percentage rate.
- The following table presents an analysis of the Company's net interest income and net interest margin for the six-month period ended June 30, 2010 and 2009:

|   | Six months ended June 30, |  |                             |                    | 2009<br>Interest<br>Income or<br>Expense | Average<br>Yield or<br>Cost |
|---|---------------------------|--|-----------------------------|--------------------|--|-----------------------------|
|   | Average<br>Balance        | 2010<br>Interest<br>Income or<br>Expense | Average<br>Yield or<br>Cost | Average<br>Balance |  |                             |
| (\$ in thousands)   |                           |  |                             |                    |  |                             |
| <b>ASSETS</b>   |                           |  |                             |                    |  |                             |
| Loans, gross <sup>1,2</sup>                               | \$ 320,664                | \$ 9,862                                 | 6.15%                       | \$ 341,891         | \$ 10,446                                | 6.11%                       |
| Taxable investments                                       | 23,445                    | 503                                      | 4.29%                       | 14,372             | 310                                      | 4.31%                       |
| Nontaxable investments <sup>3</sup>                       | 10,502                    | 204                                      | 3.88%                       | 8,740              | 164                                      | 3.75%                       |
| FHLB stock  | 1,261                     |  | 0.00%                       | 1,140              |  | 0.00%                       |
| Federal funds sold & interest-bearing deposits with banks | 10,651                    | 13                                       | 0.24%                       | 3,013              | 4  | 0.27%                       |
| <b>Total interest earning assets</b>                      | <b>366,523</b>            | <b>10,582</b>                            | <b>5.77%</b>                | <b>369,156</b>     | <b>10,924</b>                            | <b>5.92%</b>                |
| Less allowance for loan losses                            | (7,385)                   |  |                             | (5,227)            |  |                             |
| Cash and due from banks                                   | 10,516                    |  |                             | 8,085              |  |                             |
| Other non-earning assets                                  | 31,228                    |  |                             | 26,412             |  |                             |
| <b>Total assets</b>                                       | <b>\$ 400,882</b>         |  |                             | <b>\$ 398,426</b>  |  |                             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>               |                           |  |                             |                    |  |                             |
| NOW accounts  | 43,738                    | 326                                      | 1.49%                       | 14,380             | 31                                       | 0.43%                       |
| Money market accounts                                     | 28,333                    | 147                                      | 1.04%                       | 29,583             | 122                                      | 0.82%                       |
| Savings accounts  | 45,749                    | 240                                      | 1.05%                       | 41,550             | 270                                      | 1.30%                       |
| Time certificates of deposit                              | 161,953                   | 2,319                                    | 2.86%                       | 182,992            | 3,275                                    | 3.58%                       |
| <b>Total interest bearing deposits</b>                    | <b>279,773</b>            | <b>3,032</b>                             | <b>2.17%</b>                | <b>268,505</b>     | <b>3,698</b>                             | <b>2.75%</b>                |
| Securities sold under repurchase agreements               | 250                       |  | 0.00%                       | 4,840              | 7  | 0.29%                       |
| Borrowed funds  | 11,291                    | 211                                      | 3.74%                       | 22,666             | 444                                      | 3.92%                       |
| Junior subordinated note <sup>4</sup>                     | 5,155                     | 155                                      | 6.01%                       | 5,155              | 155                                      | 6.01%                       |
| <b>Total borrowed funds</b>                               | <b>16,696</b>             | <b>366</b>                               | <b>4.38%</b>                | <b>32,661</b>      | <b>606</b>                               | <b>3.71%</b>                |
| <b>Total interest bearing liabilities</b>                 | <b>296,469</b>            | <b>3,398</b>                             | <b>2.29%</b>                | <b>301,166</b>     | <b>4,304</b>                             | <b>2.86%</b>                |
| Demand deposits   | 61,516                    |  |                             | 60,375             |  |                             |
| Other liabilities   | 8,407                     |  |                             | 5,377              |  |                             |
| Shareholders' equity                                      | 34,490                    |  |                             | 31,508             |  |                             |
| <b>Total liabilities and shareholders' equity</b>         | <b>\$ 400,882</b>         |  |                             | <b>\$ 398,426</b>  |  |                             |
| <b>Net interest income</b>                                |                           | <b>\$ 7,184</b>                          |                             |                    | <b>\$ 6,620</b>                          |                             |
| Net interest spread                                       |                           |  | 3.48%                       |                    |  | 3.06%                       |
| Net interest income to average earning assets (margin)    |                           |  | 3.92%                       |                    |  | 3.59%                       |

**Comments:**

1. Nonaccrual loan balances are included in average loan balances; however, no interest income is imputed to nonaccrual loans.

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2. Loan fee income in the amount of \$205 thousand and \$314 thousand is included in loan interest income for 2010 and 2009, respectively.
3. Yields have not been adjusted on tax-exempt investments to determine a tax-equivalent yield.
4. Junior subordinated note interest is fixed at 5.95%. Interest is computed using 360/365, which results in a higher annual percentage rate. During the six months ended June 30, 2010 and 2009, the net interest margin improved 33 basis points from 3.59% to 3.92%. This improvement resulted from interest expense declining at a faster rate than interest income.

Interest income for the six months ended June 30, 2010 was \$10.6 million, representing a decrease of \$342 thousand, or 3.13%, compared to the same period in 2009. The decrease in interest income is related to a decrease of \$2.6 million in average interest earning assets combined with a change in the mix of interest earning assets, but was offset by an increase in the yields on loans and nontaxable investments. Loans, the highest yielding component of earning assets, represented 87.5% of average earning assets during the first six months of 2010, compared to 92.6% during the first six months of 2009. The average yield on loans improved 4 basis points to 6.15% for the first six months of 2010 from 6.11% for the comparable period in 2009.

Interest expense for the six months ended June 30, 2010 was \$3.4 million, representing a decrease of \$906 thousand, or 21.1%, compared to \$4.3 million for the same period in 2009. This improvement in interest expense is a result of the reductions in and re-pricing of time certificates of deposit along with the paydown of higher costing borrowed funds. The Bank expects to continue to see reductions in interest expense in the near-term as time certificates of deposit re-price to the lower rates that are currently being offered. The decrease was offset by an increase during the quarter in interest expense for NOW and money market accounts because the Bank offered higher than market rates on these accounts to increase core deposits.

The percentage of average interest earning assets funded by average interest bearing liabilities decreased to 80.9% for the first six months of 2010, compared to 81.6% for the same period in 2009. Deposits represented 94.4% of average interest bearing liabilities at June 30, 2010, compared to 89.2% at June 30, 2009. The cost of interest bearing funds for the first six months of 2010 decreased 57 basis points to 2.29%, from 2.86% during the same period last year.

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*Rate/Volume Analysis.* Net interest income can be analyzed in terms of the impact of varying rates and volumes. The following table sets forth the effects that different levels of interest earning assets and interest bearing liabilities and that applicable rates have had on net interest income for the periods presented:

|   | Three months ended June 30            |               |                 |              | Six months ended June 30              |               |                 |               |
|---|---------------------------------------|---------------|-----------------|--------------|---------------------------------------|---------------|-----------------|---------------|
|   | 2010 over 2009                        |               |                 |              | 2010 over 2009                        |               |                 |               |
|   | Increase (Decrease) Due to Changes in |               |                 |              | Increase (Decrease) Due to Changes in |               |                 |               |
|   | Volume                                | Rate          | Volume          | Total        | Volume                                | Rate          | Volume          | Total         |
|   | (\$ in thousands)                     |               |                 |              |                                       |               |                 |               |
| <b>Interest earning assets</b>                          |                                       |               |                 |              |                                       |               |                 |               |
| Loans   | \$ (380)                              | \$ (162)      | \$ 14           | \$ (528)     | \$ (648)                              | \$ 68         | \$ (4)          | \$ (584)      |
| Securities  | 153                                   | (1)           |                 | 152          | 214                                   | 13            | 6               | 233           |
| Fed funds sold/interest-bearing balances                | 2                                     | 1             | 2               | 5            | 10                                    |               | (1)             | 9             |
| <b>Total interest earning assets</b>                    | <b>(225)</b>                          | <b>(162)</b>  | <b>16</b>       | <b>(371)</b> | <b>(424)</b>                          | <b>81</b>     | <b>1</b>        | <b>(342)</b>  |
| <b>Interest bearing liabilities</b>                     |                                       |               |                 |              |                                       |               |                 |               |
| NOW accounts  | 35                                    | 46            | 106             | 187          | 63                                    | 76            | 156             | 295           |
| Money market accounts                                   | 8                                     | 11            | 1               | 20           | (5)                                   | 33            | (3)             | 25            |
| Savings accounts  | 8                                     | (41)          | (2)             | (35)         | 27                                    | (52)          | (5)             | (30)          |
| Time certificates of deposit                            | (195)                                 | (330)         | 44              | (481)        | (377)                                 | (659)         | 80              | (956)         |
| Securities sold under repurchase agreements             | (1)                                   | (1)           | 1               | (1)          | (7)                                   | (7)           | 7               | (7)           |
| Borrowed funds  | (129)                                 | 30            | (18)            | (117)        | (223)                                 | (20)          | 10              | (233)         |
| Junior subordinated debentures                          |                                       | 1             |                 | 1            |                                       |               |                 |               |
| <b>Total interest bearing liabilities</b>               | <b>(274)</b>                          | <b>(284)</b>  | <b>132</b>      | <b>(426)</b> | <b>(522)</b>                          | <b>(629)</b>  | <b>245</b>      | <b>(906)</b>  |
| <b>Total increase (decrease) in net interest income</b> | <b>\$ 49</b>                          | <b>\$ 122</b> | <b>\$ (116)</b> | <b>\$ 55</b> | <b>\$ 98</b>                          | <b>\$ 710</b> | <b>\$ (244)</b> | <b>\$ 564</b> |

Net interest income improved \$564 thousand for the six months ended June 30, 2010 compared to June 30, 2009; this improvement in earnings stemmed primarily from lower interest rates paid on time certificates of deposit, a lower volume of time certificates of deposit, higher loan rates, and paydowns on borrowed funds. The Company has benefited from a lower volume of certificates of deposit because they bear a higher rate of interest than other forms of deposit.

*Interest Rate Risk.* The Bank seeks to reduce fluctuations in its net interest margin and to optimize net interest income with acceptable levels of risk through periods of changing interest rates. Accordingly, the Bank's interest rate sensitivity is monitored by its Asset and Liability Committee (ALCO) on an ongoing basis. The ALCO establishes risk measures, limits and policy guidelines for managing the amount of interest rate risk and its effect on net interest income and capital. An interest rate simulation model is used as a quantitative tool to monitor the impact of changing interest rates on net interest income and the economic value of equity. To evaluate changes in net interest income, the model uses various assumptions

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and considers the maturity and re-pricing characteristics of interest bearing assets and liabilities, as well as the relative sensitivities of these balance sheet components over a range of interest rate scenarios. The simulation model captures the impact of interest rate changes on the net value of future cash flows, which is the economic value of equity ( EVE ). Net interest income simulation measures exposure over a relatively short time period of 12 months and the EVE simulation measures exposure over the estimated remaining life of all balance sheet positions. Notwithstanding the Bank's interest rate risk management activities, the potential for changing interest rates is an uncertainty that can have an adverse effect on net income.

Presented below are the results of the simulation performed on the Bank's financial information as of June 30, 2010 and 2009. Immediate rate increases of 100, 200 and 300 basis points were modeled, while a rate decrease of just 25 basis points was modeled since the Fed Funds Target Discount Rate is 0.25% and cannot go lower than 0%. These rate changes assume an instantaneous and uniform change in market interest rates at the earliest re-pricing opportunity.

| Projected<br>Interest<br>Rate | % Change in<br>Net Interest Income |       | % Change in<br>Economic Value of Equity |        |
|-------------------------------|------------------------------------|-------|---|--------|
|                               | 2010                               | 2009  | 2010                                    | 2009   |
| +300                          | -17.9%                             | 12.1% | -38.2%                                  | -29.2% |
| +200                          | -12.1%                             | 4.9%  | -26.0%                                  | -22.3% |
| +100                          | -5.6%                              | 0.2%  | -13.3%                                  | -12.6% |
| -25                           | 0.6%                               | -0.1% | 4.2%                                    | 3.3%   |

As noted above, computation of the prospective effect of hypothetical interest rate changes is based on a number of assumptions and results could vary significantly if different assumptions were used. The assumptions relied upon in making these calculations include the level of market interest rates, the shape of the yield curve, the degree to which certain assets and liabilities with similar maturities or periods to re-pricing react to changes in market interest rates, the degree to which non-maturity deposits (i.e. demand deposits) react to changes in market rates, expected prepayment rates, the degree to which early withdrawals occur on certificates of deposit and the volume of other deposit flows. In addition, the analysis does not reflect future actions that the Bank's ALCO might take in responding to or anticipating changes in interest rates. Accordingly, although the above table provides an indication of the Bank's sensitivity to interest rate changes at a point in time, these estimates are not intended to, and do not provide, a precise forecast of the effect of changes in market interest rates on the Bank's net interest income or economic value of equity.

*Provision for Loan Losses*

The provision for loan losses represents an expense against income that allows the Bank to establish an appropriate allowance for loan losses. Charges to the provision for loan losses result from our ongoing analysis of probable losses in our loan portfolio. Our methodology for analyzing probable loan losses is consistent with that at December 31, 2009; the calculation has been adjusted in the first and second quarters of 2010 for changes in leading indicators such as unemployment and trends in the real estate market, as well as changes in the weighted average risk rating of loans in our portfolio.

The provision for loan losses during the six-month period ended June 30, 2010 was \$1.45 million, which was a substantial decrease of \$1.55 million, or 51.6%, compared to the \$3.00 million added to the provision for the same period in 2009. Over the course of 2009, the Bank increased the allowance for loan losses dramatically to address higher levels of charged-off loans and indications of probable losses. During the first six months of 2010, charge-offs were lower than anticipated, so even in light of a slight increase in the allowance for loan losses, the required provision was much lower than in the same period last year.

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Net charge-offs for the first six months of 2010 were \$1.3 million compared to net charge-offs of \$3.3 million for the first six months of 2009. Annualized net charge-offs were 0.80% and 1.93% of average gross loans for the six-month periods ended June 30, 2010 and 2009, respectively; this measurement for the current period is slightly less than the five-year average of 0.44% through the year ended December 31, 2009. The majority of net charge-offs during the first six months of 2010 were due to losses on real estate secured loans, which comprised 79.9% of total net charge-offs, while net charge-offs for the same period of 2009 resulted from both real estate secured loans, which comprised 50.7% of total net charge-offs, and commercial loans, which comprised 48.9% of total net charge-offs. The significant decrease in the dollar amount of charge-offs between the first six months of 2010 and the same period of 2009, combined with the shift in the source of charge-offs away from commercial purpose loans, is the result of the Bank addressing specific commercial loan relationships that were troubled in 2009. These loans have either been charged-off or the credit quality issues have been resolved and have not recurred.

Management is committed to maintaining an adequate allowance for loan losses relative to our level of problem loans. See the *Loans* and *Allowance for Loan Losses* sections below for additional discussion on the Bank's loan portfolio and the adequacy of the allowance for loan losses.

*Noninterest Income*

For the six months ended June 30, 2010, noninterest income was \$2.1 million, an increase of \$390 thousand, or 23.1%, from the same period in 2009. The increase in noninterest income was attributable to a \$119 thousand gain on the sale of foreclosed real estate and other property owned, a \$318 thousand gain on the sale of securities, and a \$224 thousand B&O tax refund, offset by a decrease in service charges on deposits and a lower level of gains on the sale of mortgage loans; noninterest income in 2009 included \$145 thousand in nonrecurring life insurance proceeds.

*Noninterest Expense*

Noninterest expense for the six-month period ended June 30, 2010 was \$6.6 million, a decrease of \$478 thousand or 6.7%, from the same period in 2009.

Salaries and employee benefits for the first six months of 2010 decreased \$300 thousand, or 8.8%, compared to the same period in 2009. Contributing to the overall decrease were cost cutting measures taken to reduce staffing levels and reductions in the amount of incentive compensation paid to loan officers for commercial loan production. Full-time employee equivalents ( FTEs ) declined from 107 FTEs as of June 30, 2009 to 106 FTEs as of June 30, 2010.

During the first six months of 2010, depreciation and amortization expense was \$76 thousand higher than the same period in 2009. The increased expense is primarily due to higher depreciation costs for a Bank branch that was moved from inside a grocery store to a free-standing facility in February 2010.

The Company's loss on foreclosed real estate and other property owned included losses on sales of foreclosed real estate of \$22 thousand, a valuation allowance for foreclosed real estate held by the Company at period end of \$100 thousand, and an impairment charge of \$200 thousand for land included in the balance sheet under the caption *Premises and equipment, net*. For the same period in 2009, this category consisted of a valuation allowance for foreclosed real estate held by the Company at period end of \$300 thousand. In total, these expenses were \$22 thousand higher for the six months ended June 30, 2010 than in the same period in 2009.

Other noninterest expenses for the first six months of 2010 decreased \$203 thousand, or 9.8%, compared to the same period in 2009. This decrease in expenses was largely caused by overall cost cutting measures in several other operating expense categories including: outside professional fees, advertising and promotion costs, and stationery and supplies expenses. The decrease was offset by an increase in costs related to maintaining or selling real estate securing nonperforming assets, which increased \$72 thousand year over year.

**Table of Contents****Financial Condition***Securities*

As of June 30, 2010, the Bank had \$38.2 million of securities, which is an increase of \$13.4 million from December 31, 2009. This increase is a result of a combination of declining loan demand and a conscious effort by management to increase on-balance sheet liquidity in light of the current economy. With the exception of corporate bonds with a fair value of \$1.9 million, all securities at June 30, 2010, are obligations of the Treasury Department, U.S. agencies, and state or municipal governments. As of June 30, 2010, the securities portfolio included a net unrealized gain of \$536 thousand.

*Loans*

At June 30, 2010, the Bank reported \$304 million in gross loans, a decrease of \$17.6 million, or 5.5%, compared to December 31, 2009. This decrease is primarily attributable to a \$21.8 million, or 63.7%, reduction in commercial construction loans and a \$4.3 million, or 11.6%, reduction in land and land acquisition loans; these decreases were partially offset by an increase of \$10.9 million, or 7.9%, in commercial real estate loans. Management plans to further reduce loan balances as part of a strategy to re-balance assets and liabilities and focus closely upon asset quality. As part of this strategy, the Bank has implemented more stringent lending practices, has discontinued purchasing participation loans from other banks, and is limiting new loans for land development, speculative construction and non-owner occupied commercial real estate.

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

The demand for loans in our local markets has been adversely influenced by macroeconomic forces that have disrupted local and national economies. Specifically, real estate and related activities have slowed significantly, local unemployment rates have increased substantially, and real estate and other asset prices have declined appreciably. Despite overall weaknesses in the marketplace, management sees evidence that its workout efforts are making progress. Several foreclosed properties have been sold without unreasonable discounts.

Nonperforming assets increased \$34 thousand, or 0.2%, from \$15.3 million at December 31, 2009 to \$15.4 million at June 30, 2010. Nonperforming assets as a percentage of total assets were 4.0% as of June 30, 2010, and 3.9% as of December 31, 2009. The following table shows a summary of nonperforming assets for the periods covered in this report:

|  | June 30, 2010     | December 31, 2009 |
|--|-------------------|-------------------|
|  | (\$ in thousands) |                   |
| Loans accounted for on a nonaccrual basis                                | \$ 11,371         | \$ 11,676         |
| Loans contractually past due 90 days or more as to interest or principal |                   |                   |
| <b>Total nonperforming loans</b>   | <b>11,371</b>     | <b>11,676</b>     |
| Foreclosed real estate and other repossessed assets                      | 4,011             | 3,672             |
| <b>Total nonperforming assets</b>  | <b>\$ 15,382</b>  | <b>\$ 15,348</b>  |

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Nonperforming loans decreased \$305 thousand, or 2.6%, from \$11.7 million at December 31, 2009, to \$11.4 million at June 30, 2010. This decrease in nonperforming loans was offset by a \$339 thousand, or 9.2%, increase in foreclosed real estate and other repossessed assets. Of the \$11.4 million in nonaccrual loans, management believes \$4.0 million is well protected by collateral and is expected to be paid in full. The majority of the remaining \$7.4 million is supported by collateral but carries a risk of loss for a portion of the outstanding balance. When a risk of loss has been identified, an appropriate reserve for the loss is also established through an impairment analysis which considers estimated fair market value of collateral, net of selling costs. All nonaccrual loans are in the process of collection or under some form of a negotiated agreement for repayment of the debt.

Just over one-third of the nonaccrual balances are related to participation loans purchased from other banks. In most cases, there is either reasonable or strong collateral support. The Bank is aggressively working with the borrowers wherever possible so that these loans can be either repaid or restructured as performing assets.

One participation loan totaling \$2.8 million is secured by commercial real estate and the borrower has signed new tenants. These tenants may be able to restore positive cash flow for the borrower in the third quarter of 2010 and this loan is anticipated to return to accrual status before year end. Another local borrower, with approximately \$1.4 million outstanding, is participating in a workout plan, and is current on payments. With the establishment of a satisfactory pattern of payments it is possible that these loans could be returned to accrual status by year end.

A large parcel land development loan was foreclosed in June but is subject to redemption rights which will delay liquidation. There are about \$1 million in nonperforming assets with a reasonable opportunity for resolution by year end.

Foreclosed real estate and other repossessed assets increased by \$339 thousand from \$3.7 million at December 31, 2009, to \$4.0 million at June 30, 2010. The largest foreclosed real estate property consisted of 240 acres of land in Silver Valley, Washington. Another significant property consists of 13 lots for sale in southwest Washington; one lot has been sold since the property was foreclosed in November 2009. The third largest property consists of 33 lots north of Spokane, Washington; 3 lots from this property have been sold as of June 30, 2010. Most of the properties are listed for sale under marketing plans intended to liquidate properties in a responsible and timely manner.

Restructured notes increased significantly from \$5.5 million at December 31, 2009 to \$22.3 million at June 30, 2010. This is primarily the result of continuing negotiations related to troubled loans and identification of workout plans that are documented with forbearance or other agreements specifying the terms of those plans. Many of these agreements grant a period of interest-only payments without imposing other significant consequences. The intention of such agreements is always to improve or protect the Bank's opportunity for successful liquidation of the asset. An increase in restructured notes was expected by management as a result of the Bank's collection efforts in response to the current economic environment. Below is a summary of restructured loans for the periods covered in this report:

|   | <b>June 30, 2010</b>     | <b>December 31, 2009</b> |
|---|--------------------------|--------------------------|
|   | <i>(\$ in thousands)</i> |                          |
| Restructured notes included in nonaccrual loans | \$ 7,169                 | \$ 5,315                 |
| Performing restructured notes                   | 15,113                   | 202                      |
| <b>Total restructured notes</b>                 | <b>\$ 22,282</b>         | <b>\$ 5,517</b>          |

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Most of the restructured loans that are still accruing interest were contractually current as of June 30, 2010. Those that were delinquent are still expected to perform and were suffering only minor delinquencies. The large increase in troubled debt restructure totals is partly due to the Bank adding a full time loan workout specialist to the credit administration department. Significant progress has been made in working with borrowers to develop viable and mutually acceptable plans for repayment, and management believes the renegotiated terms for these loans create a realistic opportunity for the Bank to be paid in full.

*Allowance for Loan Losses*

The allowance for loan losses is a valuation allowance for probable losses inherent in the loan portfolio. Management evaluates the need to establish allowances against losses on loans on a monthly basis. When additional allowances are deemed necessary, a provision for loan losses is charged to earnings. In estimating the allowance for loan losses, management considers a number of factors, including: review of specific impaired loans; historical loan loss experience; quality, mix and size of loan portfolio; type and value of collateral; current and anticipated economic conditions; and other relevant factors. When there is clear evidence of an economic downturn, higher levels of reserves may be warranted. Since loan losses have significantly increased over the last 18 months, management has shifted from using a five-year weighted average historical loss experience to a two-year weighted average.

As of June 30, 2010, the allowance for loan losses was \$7.3 million, an increase of \$169 thousand, or 2.4%, over December 31, 2009, and an increase of \$2.8 million, or 63.9%, over June 30, 2009. These allowance balances represented 2.3%, 2.2%, and 1.3% of gross loans outstanding as of June 30, 2010, December 31, 2009, and June 30, 2009, respectively. The increase in the allowance for loan losses over the past six quarters was driven primarily by a higher level of estimated required reserves as a result of ongoing depressed economic conditions in our market areas. Net charge-offs were significantly lower in the most recent six months than in the same period of 2009, therefore management determined that a lower provision expense was required in order to maintain the allowance for loan losses at an appropriate level. Below is a summary of activity in the allowance for loan losses for the current quarter and the first six months of 2010 and 2009, respectively:

|   | Three months ended |           | Six months ended  |           |
|---|--------------------|-----------|-------------------|-----------|
|   | 6/30/2010          | 6/30/2009 | 6/30/2010         | 6/30/2009 |
|   | (\$ in thousands)  |           | (\$ in thousands) |           |
| Allowance for loan losses, beginning of period    | \$ 7,175           | \$ 5,453  | \$ 7,082          | \$ 4,737  |
| Loan charge-offs:                                 |                    |           |                   |           |
| Commercial  | 20                 | 1,602     | 160               | 1,619     |
| Real estate                                       | 811                | 1,242     | 1,056             | 1,684     |
| Installment and credit card                       | 81                 | 5         | 109               | 13        |
| Total charge-offs                                 | 912                | 2,849     | 1,325             | 3,316     |
| Recoveries of loans previously charged-off:       |                    |           |                   |           |
| Commercial  | 10                 | 1         | 10                | 1         |
| Real estate                                       | 27                 | 4         | 32                | 7         |
| Installment and credit card                       | 1                  | 1         | 2                 | 1         |
| Total recoveries                                  | 38                 | 6         | 44                | 9         |
| Net charge-offs                                   | 874                | 2,843     | 1,281             | 3,307     |
| Provision charged to expense                      | 950                | 1,815     | 1,450             | 2,995     |
| Allowance for loan losses, end of period          | \$ 7,251           | \$ 4,425  | \$ 7,251          | \$ 4,425  |
| Annualized net charge-offs to average gross loans | 1.09%              | 3.33%     | 0.80%             | 1.93%     |

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The table below sets forth the allowance for loan losses by category of loan and summarizes the percentage of allowance for loan losses in each category to total loans as of June 30, 2010 and December 31, 2009:

|   | June 30, 2010            |                  | December 31, 2009 |                  |
|---|--------------------------|------------------|-------------------|------------------|
|   | Amount                   | Percent of Loans | Amount            | Percent of Loans |
|   | <i>(\$ in thousands)</i> |                  |                   |                  |
| Construction and land development                 | \$ 1,099                 | 0.36%            | \$ 1,801          | 0.55%            |
| Secured by farmland                               | 4                        | 0.00%            | 3                 | 0.00%            |
| Home equity loans                                 | 1,051                    | 0.35%            | 483               | 0.14%            |
| Revolving loans secured by 1-4 family residential | 167                      | 0.05%            | 122               | 0.04%            |
| Secured by multi-family residential               | 275                      | 0.09%            | 23                | 0.01%            |
| Secured by non-farm, non-residential real estate  | 2,089                    | 0.69%            | 1,244             | 0.38%            |
| Commercial and industrial loans                   | 2,101                    | 0.69%            | 2,659             | 0.82%            |
| Loans to individuals                              | 105                      | 0.03%            | 115               | 0.04%            |
| Credit card loans                                 | 47                       | 0.02%            | 18                | 0.01%            |
| All other loans and leases                        |                          | 0.00%            |                   | 0.00%            |
| Mortgage loans held for sale                      |                          | 0.00%            |                   | 0.00%            |
| Supplementary allowance/non-specific factors      | 313                      | 0.10%            | 614               | 0.19%            |
|   | \$ 7,251                 | 2.38%            | \$ 7,082          | 2.18%            |

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### *Deferred Tax Asset*

At June 30, 2010, the Company had a net deferred tax asset of \$386 thousand, which compared to a net deferred tax asset of \$291 thousand at December 31, 2009.

During the fourth quarter of 2009, the Company recorded a valuation allowance of \$742 thousand against its net deferred tax asset due to uncertainty about the Company's ability to generate taxable income in the near term; the valuation allowance of \$742 thousand had the effect of increasing the provision for income taxes in 2009. There was no prior valuation allowance recorded. The Company will not be able to recognize the tax benefits on future losses until it can show that it is more likely than not that it will generate enough taxable income in future periods to realize the benefits of its deferred tax asset and loss carryforwards.

### *Deposits*

As of June 30, 2010, the Bank reported \$336.2 million in deposits, which represents a decrease of \$1.6 million over total deposits reported as of December 31, 2009. Time certificates of deposits declined \$22.2 million while other interest bearing deposits increased \$26.8 million; noninterest bearing demand deposits decreased \$6.2 million. Core deposits, which exclude time certificates of deposit, provide a relatively stable funding source. Core deposits increased \$20.6 million, or 12.5%, during the first six months of 2010 and represented 55.1% and 48.8% of total deposits as of June 30, 2010 and December 31, 2009, respectively.

Deposit growth continues to be positively affected by general adverse economic conditions that have encouraged consumers to become more defensive by saving a greater percentage of their income, as well as spreading their deposit balances to multiple financial institutions to ensure their balances are insured by the FDIC.

Competition for deposits in the Bank's primary market area has made it difficult to significantly reduce the rates that the Bank pays to customers on their deposits. Part of this competitive pressure is caused by larger financial institutions that have an increased need for liquidity, particularly those institutions that have responded to marketplace demand for refinancing and originating significant volumes of mortgage loans. In order to retain existing deposits, and to attract new deposits, the Bank has strived to remain competitive on deposit rates. Compared to the first six months of last year, the Bank has been successful in decreasing deposit rates and has reduced the Bank's average cost of funds by 57 basis points since June 30, 2009.

### *Junior Subordinated Debentures*

The Company had \$5.2 million in junior subordinated debentures at June 30, 2010; most of the proceeds have been invested in the Bank and have been primarily used by the Bank for branch expansion and relocation. The junior subordinated debentures bear interest at a rate of 5.95% that is fixed through June 30, 2010, after which time the rate decreases to 3-month LIBOR plus 1.7%. As of June 30, 2010, the entire balance of the junior subordinated debentures qualified as Tier 1 capital under regulatory capital guidelines. Additional information regarding the terms of the junior subordinated debentures, including maturity, re-pricing dates and interest rate, is included in Note 8 of the Notes to Consolidated Financial Statements in the Company's 2009 annual report on Form 10-K.

### *Capital Resources*

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

Banking regulations require the Bank to maintain minimum levels of capital. The Bank manages its capital to maintain a well-capitalized designation (the FDIC's highest rating). A well-capitalized rating from the FDIC requires that the Bank maintain or exceed capital levels of 10% of total risk-based assets. At June 30, 2010, the Bank's total capital to risk weighted assets was 12.91% compared to 11.94% reported as of December 31, 2009. The improved capital ratio reflects the Bank's net income for the first quarter of 2010 combined with a change in the mix of risk-based assets.

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Historically, the Board of Directors has scheduled its dividend considerations so that annual cash dividends on its common stock, when and if declared by the Company, would be paid in mid-June of each year. The Company paid its first cash dividend in 2003, in the amount of \$0.10 per share. In each of the subsequent years through 2008, the Board of Directors increased the amount of the cash dividend paid per common share by \$0.02. No dividends on common stock were declared in 2009 or 2010, and dividends are not expected to resume until the Company has returned to sustained profitability.

In April 2010, the Bank agreed with the FDIC and the WDFI that the Bank would, among other things, achieve and maintain a minimum leverage ratio of 10%, compared to its current minimum required regulatory ratio of 5%. As of June 30, 2010, the Bank's leverage ratio was 9.79%. The Bank also agreed that it would obtain written approval from the FDIC prior to paying dividends or any other form of payment or distribution representing a reduction of Bank capital.

The Company also agreed with the Federal Reserve Bank that the Company would, among other things, support the Bank's compliance with the Bank's obligations to the FDIC and WDFI by not receiving dividends or any other form of payment or distribution representing a reduction of capital from the Bank without the prior written approval of the Federal Reserve Bank. The Company also agreed that it would obtain written approval from the Federal Reserve Bank prior to the Company: (a) declaring or paying dividends, (b) making payments on trust preferred securities, or (c) making any other capital distributions.

In May 2010, the Board of Directors approved a rights offering for the purpose of raising up to \$4 million in new capital for the following purposes:

to increase the bank's leverage ratio to 10%;

to position the Company to take advantage of opportunities that might present themselves as a result of the turmoil in the banking industry; and

to retain the remaining net proceeds at the Company for general corporate purposes.

The rights offering concluded on July 15, 2010. The Company raised \$2.7 million in capital. A portion of the net proceeds will be invested into the Bank during the third quarter of 2010.

### *Off-Balance Sheet Arrangements and Commitments*

In the normal course of operations, the Bank engages in a variety of financial transactions that, in accordance with U.S. generally accepted accounting principles, are not recorded in our consolidated financial statements. These transactions are used primarily to manage customers requests for funding and take the form of commitments to extend credit and standby letters of credit. The Bank uses the same credit policies in making commitments to lend funds and conditional obligations as it does for other credit products. In the event of nonperformance by the customer, the Bank's exposure to credit loss is represented by the contractual amount of the instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established by the contract. Since some commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As of June 30, 2010, commitments to extend credit totaled \$53.7 million, and letters of credit totaled \$1.7 million.

### *Liquidity*

Liquidity is the term used to refer to the Bank's ability to meet its cash requirements. The Bank maintains sufficient liquidity to ensure that funds are available for both lending needs and the withdrawal of deposit funds. The Bank derives liquidity primarily through deposit growth, including core deposits, the maturity of investment securities, cash from operations and loan payments received. Additional liquidity is provided through sales of

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loans, sales of securities, and access to alternative funding sources. National time deposits, including brokered deposits, public deposits, and deposits available through various national listing programs are traditionally considered to be more volatile than core deposits; however, more recently, the volatility has been associated with pricing rather than with availability. FHLB borrowings and unsecured overnight Federal Reserve funds are referred to as alternative funding sources.

The primary ongoing funding needs of the Company, separate from the Bank, include debt service on junior subordinated debentures and dividends on preferred stock. Liquidity needs of the Company have historically been met through dividends from the Bank. The Bank has historically relied upon the generation of local deposits to fund its investment in loans, securities and other assets. On occasion, the Bank generates funds by advertising its certificate of deposit rates on a national listing service. Public funds are another source of deposits and are typically received from the states of either Washington or Idaho. Public funds are stable and are generally deposited with the Bank for as long as the Bank is willing to pay the required rate of interest on such funds and pledge securities equal to 100% of the uninsured balance for Washington public funds.

Concerns over deposit fluctuations with respect to the overall banking industry were addressed by the FDIC in September and October 2008. The FDIC increased the amount of deposit insurance available on individual accounts from \$100,000 per account to \$250,000 per account through December 31, 2013. The FDIC also implemented the Transaction Account Guarantee Program, which provides for full FDIC coverage for noninterest bearing transaction accounts and certain low-interest rate transaction accounts, regardless of dollar amounts. The Bank elected to participate in this program, which is set to expire on December 31, 2010. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law, which, in part, permanently raised the current standard maximum deposit insurance amount to \$250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

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

When the level of liquid assets (our primary liquidity) does not meet our liquidity needs, other available sources of liquid assets (our secondary liquidity) include: the purchase of federal funds, sales of securities under agreements to repurchase, purchase of brokered certificates of deposit, liquidation of unpledged securities, and sales of loans. Our lines of credit with the FHLB and other correspondent banks are also available to meet current and anticipated liquidity needs. At June 30, 2010, the Company had approximately \$51.1 million of funds available on its FHLB line and \$15 million of funds available on its federal funds lines with correspondent banks.

As a member of the CDARS® program, the Company can purchase certificates of deposit through the program. At June 30, 2010, the Company was eligible to purchase certificates of deposit of up to five percent of its total assets through CDARS®. These sources provide significant secondary liquidity to the Company to service its customers' needs.

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

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Not applicable because the Company is a smaller reporting company.

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**Item 4. Controls and Procedures.**

*Evaluation of Disclosure Controls and Procedures*

The Company's Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of disclosure controls and procedures (as defined in Exchange Act Rules 240.13a-14(c) and 15d-14(c)) as of June 30, 2010, the date of this quarterly report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's current disclosure controls and procedures are effective and timely, providing them with material information relating to the Company required to be disclosed in the reports that are filed or submitted under the Exchange Act.

*Changes in Internal Controls*

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

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

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

**Item 1A. Risk Factors.**

An investment in our common stock is subject to risks inherent to our business. Before making an investment decision, you should carefully consider the risks and uncertainties described both in this report and in our annual report on Form 10-K for the fiscal year ended December 31, 2009, as updated by our filings with the SEC. These are not the only risks and uncertainties we face. Additional risks and uncertainties that management is not currently aware of or focused on or that management currently deems immaterial may also impair our business operations. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially affected.

The following risk factor updates, and should be read together, with the risk factors set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, as updated by our filings with the SEC.

***The financial services industry is subject to extensive regulation.***

The financial services industry is subject to extensive regulation, which is undergoing major changes. The Dodd-Frank Act, signed into law on July 21, 2010, significantly revises and expands the rulemaking, supervisory and enforcement authority of federal bank regulators. Although the statute will have a greater impact on larger institutions than regional bank holding companies such as the Company, many of its provisions will apply to us. Among other things, the Dodd-Frank Act:

in changing the capital requirements for bank holding companies would permanently grandfather our existing trust preferred, but would require less favorable capital treatment for future issuances of trust preferred;

grants the FDIC back-up supervisory authority with respect to depository institution holding companies that engage in conduct that poses a foreseeable and material risk to the Deposit Insurance Fund, and heightens the Federal Reserve's authority to examine, prescribe regulations and take action with respect to all subsidiaries of a bank holding company;

prohibits insured state-chartered banks from engaging in derivatives transactions unless the chartering state's lending limit laws take into consideration credit exposure to derivative transactions;

specifies that a bank holding company may acquire control of a bank only if it is well capitalized and well managed, and does not allow interstate merger transactions unless the resulting bank would be well capitalized and well managed after the transaction;

changes how the FDIC calculates deposit insurance assessments and effectively requires increases in deposit insurance fees that will be borne primarily by institutions with assets of greater than \$10 billion;

subjects both large and small financial institutions to data and information gathering by a newly created Office of Financial Research;



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requires retention of 5% of the credit risk in assets transferred, sold or conveyed through issuances of asset-backed securities, with the risk-retention obligation spread between securitizers and originators;

creates a new Consumer Bureau given rulemaking, examination and enforcement authority over consumer protection matters, imposes limits on debit card interchange fees that may be charged by card issuers with \$10 billion or more in assets and contains provisions on mortgage-related matters such as steering incentives, determinations as to a borrowers ability to repay and prepayment penalties; and

mandates and allows certain changes regarding corporate governance and executive compensation such as shareholder proxy access for publicly-traded banks director nominations, clawback of incentive-based compensation from executive officers and increased disclosure on compensation arrangements.

Some of these changes are effective immediately, though most will be phased in gradually. In addition, the statute in many instances calls for future rulemaking to implement its provisions, so the precise contours of the law and its effects on us cannot yet be fully understood. The provisions of the Dodd-Frank Act and the subsequent exercise by regulators of their revised and expanded powers thereunder could materially impact the profitability of our business, the value of assets we hold or the collateral available for our loans, require changes to business practices or force us to discontinue businesses and expose us to additional costs, taxes, liabilities, enforcement actions and reputational risk. Legislators and regulators are also considering a wide range of proposals beyond the Dodd-Frank Act that, if enacted, could result in major changes to the way banking operations are regulated.

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

Not applicable.

**Item 3. Defaults upon Senior Securities.**

Not applicable.

**Item 4. Reserved.**

**Item 5. Other Information.**

Not applicable.

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**Item 6. Exhibits.**

- Exhibit 3.1 Restated Articles of Incorporation of the Company. Filed as Exhibit 3.1 to the Company's annual report on Form 10-K, filed with the SEC on March 27, 2009 and incorporated by reference herein.
- Exhibit 3.2 Amended and restated bylaws of the Company. Filed as Exhibit 3.1 to the Company's current report on form 8-K, filed with the SEC on January 25, 2010 and incorporated by reference herein.
- Exhibit 4.1 Reference is made to Exhibits 3.1 and 3.2 as well as Exhibits 4.2, 4.3 and 4.4 below.
- Exhibit 4.2 Form of Certificate for Series A Preferred Stock. Filed as Exhibit 4.1 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 4.3 Form of Certificate for Series B Preferred Stock. Filed as Exhibit 4.2 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 4.4 Warrant to purchase shares of the Company's Series B Preferred Stock, dated February 13, 2009 and issued to the United States Department of the Treasury. Filed as Exhibit 4.3 to the Company's current report on Form 8-K, filed with the SEC on February 17, 2009 and incorporated by reference herein.
- Exhibit 31.1 Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. Filed herewith.
- Exhibit 31.2 Certification of Holly A. Poquette, Chief Financial Officer, pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934. Filed herewith.
- Exhibit 32.1 Certification of Randall L. Fewel, President and Chief Executive Officer, pursuant to 18 U.S.C. 1350. Filed herewith.
- Exhibit 32.2 Certification of Holly A. Poquette, Chief Financial Officer, pursuant to 18 U.S.C. 1350. Filed herewith.

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**SIGNATURES**

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

NORTHWEST BANCORPORATION, INC.  
(Registrant)

Dated: August 13, 2010

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

Dated: August 13, 2010

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

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