NORTHWEST BANCORPORATION INC
Form 10-K
February 29, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to __________

Commission file number 000-24151

NORTHWEST BANCORPORATION, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1574174**
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)
421 W. Riverside Avenue, Spokane, WA	**99201-0403**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(509) 456-8888**

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

Title of each class

None

Name of each exchange on which registered

None

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

Common Stock (No Par Value Per Share)

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

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

Yes ¨ No x

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

Indicate by a check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this annual report on Form 10-K or any amendment to this annual report on Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 ¨	Smaller reporting company x

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

The aggregate market value of the common stock held by non-affiliates of the registrant computed by reference to the price at which the common equity was last sold as of the last business day of the registrant s most recently completed second fiscal quarter was $10,985,295.

The number of shares outstanding of the registrant s common stock, as of February 15, 2012, was 3,084,548.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the registrant s Annual Meeting of Shareholders to be held on May 14, 2012 (the 2012 Proxy Statement) have been incorporated by reference into Part III, Items 10, 11, 12, 13 and 14 of this annual report on Form 10-K.

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NORTHWEST BANCORPORATION, INC.

ANNUAL REPORT ON FORM 10-K

For the fiscal year ended December 31, 2011

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PART I

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For a discussion of the risks and uncertainties inherent in such statements, see Business Forward-Looking Statements and Risk Factors.

Item 1. ***Business*****.**

General

Northwest Bancorporation, Inc. (the Company), a Washington corporation incorporated in 1991, is a bank holding company registered with and supervised by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). In 1993, the Company became the bank holding company parent of Inland Northwest Bank (the Bank) by acquiring all the outstanding shares of common stock of the Bank in exchange for an equal number of shares of common stock of the Company. Since commencing operations, the Company s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been derived from the Bank. Although the Company s management continues to consider the possibility of other business opportunities, the Company currently has not established any independent business activity apart from acting as the parent company of the Bank. The Company also owns one-hundred percent of the common stock of Northwest Bancorporation Capital Trust I, a trust established in 2005 for the purpose of issuing trust preferred securities; proceeds received by the trust from the issuance of the trust preferred securities were funded to the Company.

The Bank commenced operations in 1989 as a Washington state-chartered commercial bank and is regulated by the Federal Deposit Insurance Corporation (the FDIC) and the Washington State Department of Financial Institutions (the DFI). The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium-sized businesses in eastern Washington and northern Idaho. The Bank operates seven branch offices in Washington and four branches in Idaho. In November 2011, the Bank formed a wholly-owned subsidiary, Northwest Property LLC, for the sole purpose of holding real estate acquired through foreclosure.

The Company and the Bank are managed as a single entity and not by departments or lines of business. Based on management s analysis, no department or line of business meets the criteria established in Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 280, *Segments Reporting*, for reporting of selected information about operating segments.

The primary asset of the Company is its investment in the common stock of the Bank. The Bank s operating results, financial position, and ability to provide dividends to the Company will directly and materially affect the operating results, financial position and liquidity of the Company. The Bank derives its income principally from interest charged on loans and, to a lesser extent, interest earned on investments and fees received in connection with the origination of loans and for other services. The Bank s principal expenses are interest expense on deposits and borrowings, operating expenses, and the provision for loan losses. Funds for activities of the Bank are provided principally by operating revenues, deposit growth and repayment of outstanding loans and investments. Specific information concerning the effect of these items upon the Bank s operating results for the fiscal years 2011 and 2010 is set forth in Part II, Item 7 of this annual report on Form 10-K. At such time as the Company decides to engage in any other business activities, the success or failure of any new business activities and the associated costs and expenses would be additional factors affecting the operating results, financial position and liquidity of the Company.

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Products and Services

The Bank promotes relationship-based products and services to meet the banking needs of its primary market area. The Bank strives to occupy a niche market wherein it specializes in the personalized delivery of depository, cash management, and lending services to individuals, professionals and small to medium-sized businesses.

A full range of deposit products is offered including noninterest bearing demand deposits, money market demand accounts, negotiable order of withdrawal (NOW) accounts, savings accounts, and time deposits. The flow of deposits is influenced significantly by general economic conditions, changes in prevailing interest rates, pricing of deposits and competition. Our deposits are primarily obtained from areas surrounding our banking offices. We rely on marketing, new products, service and long-standing relationships with customers to attract and retain these deposits. Occasionally, the Bank solicits time deposits through brokers. Broker deposits are placed by brokers acting as an administrator, custodian, agent or trustee for funds placed at financial institutions on behalf of a third-party. Deposits of the Bank are insured by the Deposit Insurance Fund administered by the FDIC up to the maximum amount allowed by law.

Other services offered to the Bank s depositors include: cash management services, wire transfers, ACH origination, merchant bankcard services, electronic bill payment, Internet banking, commercial remote deposit capture, ATM and debit cards, safe deposit boxes, and overdraft protection.

The Bank also engages in a full complement of commercial and consumer lending activities in its market area, with the main focus on commercial lending. The Bank primarily originates commercial real estate secured loans, which include loans secured by nonresidential real property. To a lesser extent, the Bank originates commercial loans not secured by real estate, construction and land development loans, one- to four-family and multifamily residential real estate loans, and other consumer loans. Commercial loans consist of business loans and lines of credit on a secured and unsecured basis. Consumer loans consist of loans for a consumer purpose that are secured by collateral other than real estate, such as automobiles, recreational vehicles and boats, however such loans may also be made on an unsecured basis. The Bank also originates first mortgage residential loans, a majority of which are sold to the secondary mortgage market.

Market Area and Competition

The Bank s primary market area is Spokane County, Washington, and Kootenai County, Idaho. Based on population estimates by the U.S. Census Bureau from data collected in the 2010 Census, the population of Spokane County is 471,221 and the population of Kootenai County is 138,494.

The Bank encounters vigorous competition in its primary market area for the attraction of retail deposits and the origination of loans. Our most direct competition for depositors has historically come from locally owned and out-of-state commercial banks, thrift institutions and credit unions operating in our primary market area. Our competition for loans also comes from banks, thrifts and credit unions in addition to mortgage bankers and brokers. With liberalization of interstate banking limitations and other financial institution regulations, increased competition and consolidation in the overall financial services industry, it is anticipated that competition will continue to increase in the future.

Regulation and Supervision

General. Bank holding companies and banks are extensively regulated under both federal and state law. The following information describes certain aspects of regulations applicable to the Company and the Bank, but does not purport to be complete and is qualified in its entirety by reference to the particular provisions of these regulations. In addition, federal and state regulations are subject to future changes that may have

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significant impact on the way in which bank holding companies and their subsidiaries (including banks) may conduct business. The likelihood and potential effects of such changes cannot be predicted. Legislation enacted in recent years has substantially increased the level of competition among commercial banks, savings banks, thrift institutions and non-banking companies, including insurance companies, securities brokerage firms, mutual funds, investment banks and major retailers. Recent legislation also has broadened the regulatory powers of the federal banking agencies in a number of areas.

The Company. As a bank holding company, the Company is subject to various regulations, including the following, some of which may have a material impact upon the Company s future financial performance.

Bank Holding Company Act. The Company is subject to the Bank Holding Company Act of 1956, as amended (the BHC Act), and related federal statutes, and is subject to supervision, regulation and inspection by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of San Francisco (collectively, the Federal Reserve). The Company is required to file with the Federal Reserve an annual report and any additional information that the Federal Reserve may require pursuant to the BHC Act. The Federal Reserve possesses cease and desist powers over bank holding companies and their non-bank subsidiaries if their actions represent unsafe or unsound practices.

Bank Acquisitions. With some limited exceptions, the BHC Act requires a bank holding company to obtain prior approval from the Federal Reserve if the Company proposes to: (1) acquire all or substantially all of the assets of any bank, (2) acquire direct or indirect ownership or control of more than 5% of the voting shares of any bank, or (3) merge or consolidate with any other bank holding company. The BHC Act currently permits bank holding companies from any state to acquire banks and bank holding companies located in any other state, subject to certain conditions, including certain nationwide and state-imposed concentration limits. The establishment of new interstate branches also will be possible in those states with laws that expressly permit it. Interstate branches will be subject to certain laws of the states in which they are located. Competition may increase further as banks branch across state lines and enter new markets.

Non-Bank Acquisitions. The BHC Act also prohibits a bank holding company, with certain exceptions, from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company, and from engaging in any activities other than those of banking, managing or controlling banks, or activities which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto.

Change in Bank Control Act. The acquisition of 10% or more of the Company s outstanding shares by any person or group of persons may, in certain circumstances, be subject to the provisions of the Change in Bank Control Act of 1978, as amended, and the acquisition of control of the Company by another company would be subject to regulatory approval under the BHC Act.

Source of Strength Policy. Under Federal Reserve policy, a bank holding company is expected to act as a source of financial strength to each of its subsidiary banks and to commit resources to support each such bank. Consistent with its source of strength policy for subsidiary banks, the Federal Reserve has stated that, as a matter of prudent banking, a bank holding company generally should not maintain a rate of cash dividends unless its net income available to common shareholders has been sufficient to fully fund the dividends, and the prospective rate of earnings retention appears to be consistent with the corporation s capital needs, asset quality and overall financial condition.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 requires the Company to comply with the internal controls and procedures for reporting companies established by Section 404.

Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Financial Modernization Act (the GLB) authorizes a bank holding company to apply to the Federal Reserve to become a financial holding company, and thereby engage (directly or through a subsidiary) in certain activities deemed financial in nature, such as securities brokerage, insurance underwriting, and merchant banking. The Company has not made this application and is not currently engaged in such activities.

Legislative Initiatives to Address Financial and Economic Crisis. In response to unprecedented market turmoil and the financial crises affecting the overall banking system and financial markets in the United States, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted in October 2008. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted, which among other things augmented certain provisions of EESA. EESA authorized the United States Department of Treasury (the Treasury) to establish the Troubled Asset Relief Program (TARP) to purchase troubled assets held by financial institutions.

In October 2008, the Treasury announced terms of the TARP Capital Purchase Program (the Capital Purchase Program), through which the Treasury has made capital investments in banking institutions by purchasing senior preferred shares. The purpose of this program is to restore confidence and stability to the financial markets and to encourage the flow of credit within the financial system. Only institutions determined to be eligible for the Capital Purchase Program by the Treasury and the financial institution s primary federal regulator were allowed to participate.

The Company elected to participate in the Capital Purchase Program and received $10.5 million through the issuance and sale of 10,500 shares of Series A preferred stock and 525 shares of Series B preferred stock to the Treasury. Terms of the Capital Purchase Program include: (1) dividends on the Series A preferred stock of 5% per year for the first five years, resetting to 9% per year after five years, and dividends on the Series B preferred stock of 9% per year; (2) common stock dividends cannot be increased for three years while the Treasury is an investor unless preferred stock is redeemed or consent from the Treasury is received; (3) after three years, the preferred shares may be redeemed by the Company at their issue price, plus all accrued and unpaid dividends, and, subject to approval by the Company s banking regulators, the preferred shares may also be redeemed at any time if the Company chooses to replace them with newly raised equity capital; (4) dividends on the Series A and Series B preferred stock must be paid before other dividends can be paid; and, (5) compliance with executive compensation standards and restrictions established by the Treasury and the ARRA. Additional disclosure regarding the details of this transaction, the agreements and other documents related to the transaction have been filed with the Securities and Exchange Commission (the SEC) and can be found on the SEC s website at www.sec.gov. Additional details regarding the Capital Purchase Program can be found on the Treasury s website at www.treas.gov/initiatives/financial-stability.

Securities and Exchange Commission. The Company is under the jurisdiction of the SEC and certain state securities commissions for matters relating to the offering and sale of our securities. The Company is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC.

The Bank. As a Washington state-chartered commercial bank, with deposits insured by the Deposit Insurance Fund of the FDIC, the Bank is subject to various regulations, including the following:

Bank Regulation. The Bank is subject to supervision, regulation and examination by the Divisions of Banking of the States of Washington and Idaho and by the FDIC. The Bank is subject to various requirements and restrictions under federal and state law, including (1) requirements to maintain reserves against deposits, (2) restrictions on the types, amount and terms and conditions of loans that may be granted, (3) limitations on the types of investments that may be made, the activities that may be engaged in, and the

types of services that may be offered, and (4) standards relating to asset quality, earnings, and employee compensation.

The approval of a Bank s primary regulator is required prior to any merger or consolidation or the establishment or relocation of any office. Various consumer laws and regulations also affect the operations of the Bank.

Affiliate Transactions. The Bank is subject to federal laws that limit the transactions by subsidiary banks with or on behalf of their parent company and with or on behalf of any non-bank subsidiaries. Such transactions by a subsidiary bank to its parent company or to any non-bank subsidiary are limited to 10% of a bank subsidiary s capital and surplus and, with respect to such parent company and all such non-bank subsidiaries, to an aggregate of 20% of such bank subsidiary s capital and surplus. Further, loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also prohibits banks from purchasing low quality assets from affiliates.

Deposit Insurance. The deposits of the Bank are insured up to prescribed limits for each depositor by the FDIC s Deposit Insurance Fund (DIF) and are subject to deposit insurance assessments to maintain the DIF. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the maximum deposit insurance amount has been permanently increased from $100,000 to $250,000 per depositor and temporary unlimited deposit insurance coverage on noninterest bearing transaction accounts was extended from December 31, 2010 through December 31, 2012. This temporary unlimited coverage is in addition to, and separate from, the coverage of at least $250,000 available to depositors under the FDIC s general deposit insurance rules.

The DIF is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are based upon several factors, including the level of regulatory capital and the results of regulatory examinations. The FDIC may adjust assessments if the insured institution s risk profile changes or if the size of the DIF declines in relation to the total amount of insured deposits. Since 2008, there have been higher levels of bank failures which has dramatically increased resolution costs of the FDIC and depleted the DIF. In order to maintain a strong funding position and restore reserve ratios of the DIF, the FDIC has increased assessment rates of insured institutions and may continue to do so in the future. In 2009, the FDIC instituted an additional special assessment totaling $180 thousand for the Bank. Also in 2009, the FDIC required institutions to prepay their assessments for 13 quarters, beginning with the fourth quarter of 2009 through the fourth quarter of 2012. The Bank paid $2.8 million for this prepaid assessment, which will be applied toward actual quarterly assessments until exhausted; any funds remaining after June 30, 2013 will be returned to the Bank.

The Dodd-Frank Act requires the FDIC to take future steps to increase the reserve ratio of the DIF from 1.15% to 1.35% of insured deposits by September 30, 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than $10 billion. The Dodd-Frank Act also broadens the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of the financial institution, whereas assessments were previously based on an institution s insured deposits.

In addition to the FDIC assessments, all FDIC-insured depository institutions must pay a quarterly assessment to the FDIC to fund interest payments on bonds issued by the Financing Corporation (FICO), an agency of the Federal government established to recapitalize the Federal Savings and Loan Insurance Corporation. These assessments will continue until the FICO bonds mature in 2017 through 2019.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional financial institution failures or if the FDIC otherwise determines, we may be required

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to pay even higher FDIC premiums than the recently increased levels. Any future increases in FDIC insurance premiums may have a material and adverse effect on our earnings.

In October 2008, the FDIC announced the Temporary Liquidity Guarantee Program (the TLGP) to strengthen confidence and encourage liquidity in the banking system. The TLGP consists of two components: a temporary guarantee of newly issued senior unsecured debt (the Debt Guarantee Program) and a temporary unlimited guarantee of funds in noninterest bearing transaction accounts at FDIC-insured institutions (the Transaction Account Guarantee Program or TAGP). The Company elected to participate in the TAGP, which is set to expire on December 31, 2012.

Capital Requirements. The FDIC has adopted risk-based capital guidelines to which the Bank is subject. The guidelines establish a systematic analytical framework that makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations. The Bank is required to maintain certain levels of regulatory capital in relation to regulatory risk-weighted assets. The ratio of such regulatory capital to regulatory risk-weighted assets is referred to as the risk-based capital ratio. Risk-based capital ratios are determined by allocating assets and specified off-balance sheet items to four risk-weighted categories ranging from 0% to 100%, with the higher levels of capital being required for the categories perceived as representing greater risk.

These guidelines divide a bank s capital into two tiers. The first tier (Tier 1) primarily includes common shareholders equity, retained earnings, and qualifying preferred stock, less goodwill and other disallowed intangibles. Supplementary (Tier 2) capital includes, among other items, partial recognition of increases in the market value of qualifying equity securities, certain cumulative and limited-life preferred stock, qualifying subordinated debt and the allowance for loan losses, subject to certain limitations, less required deductions as prescribed by regulation. Banks are required to maintain a total risk-based capital ratio of at least 8% and a Tier 1 risk-based capital ratio of at least 4%.

In addition, the FDIC has established regulations prescribing a minimum Tier 1 leverage ratio (Tier 1 capital to adjusted average assets as specified in the regulations). These regulations provide for a minimum Tier 1 leverage ratio of 3% for banks that meet certain specified criteria, including that such banks have the highest examination rating, the bank is not anticipating or experiencing significant growth and has well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings, and in general, a strong banking organization, and receiving the highest rating under the Uniform Financial Institutions Rating System established by the Federal Financial Institutions Examination Council. For all but the most highly rated institutions meeting the conditions set forth above, the minimum leverage capital ratio is 4%. The FDIC may, however, set higher capital requirements when particular circumstances warrant.

In December 2010, the Basel Committee on Banking Supervision (the Basel Committee) published new capital standards commonly referred to as Basel III. The standards will, when implemented, among other things, impose more restrictive eligibility requirements for Tier 1 and Tier 2 capital; increase the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduce a capital conservation buffer of an additional 2.5% of common equity to risk-weighted assets, raising the target minimum common equity ratio to 7%; increase the minimum Tier 1 capital ratio to 8.5% inclusive of the capital conservation buffer; increase the minimum total capital ratio to 10.5% inclusive of the capital buffer; and introduce a countercyclical capital buffer of up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards. U.S. banking regulators have not yet released proposed rules to implement the Basel III requirements, and it is uncertain at this time whether the proposed rules, when released, will apply Basel III s requirements to the Bank.

Under federal banking laws, failure to meet the minimum regulatory capital requirements could subject a bank to a variety of enforcement remedies available to federal bank regulatory agencies, including the termination of deposit insurance by the FDIC and seizure of the institution.

Prompt Corrective Action. Federal banking agencies possess broad powers to take corrective action as deemed appropriate for an insured depository institution and its holding company. The extent of these powers depends on whether the institution in question is considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized. The required Tier 1 capital t average assets ratio, Tier I capital to risk-weighted assets ratio and total capital to risk-weighted assets ratio for classification as adequately capitalized are 4.0%, 4.0% and 8.0%, respectively. The required Tier 1 capital to average assets ratio, Tier l capital to risk-weighted assets ratio and total capital to risk-weighted assets ratio for classification as well capitalized are 5.0%, 6.0% and 10.0%, respectively. As of December 31, 2011, the Bank exceeded the required Tier 1 capital to average assets ratio, Tier 1 capital to risk-weighted assets ratio and total capital to risk-weighted assets ratio for classification as well capitalized, with ratios of 10.2%, 12.2% and 13.4%, respectively.

Reserve Requirements. The Federal Reserve Board of Governors requires all depository institutions to maintain reserves against their net transaction deposit accounts. Within limits specified by law, the Board of Governors has sole authority over changes in reserve requirements. As of December 31, 2011, the Bank is required to maintain reserves of 3% against net transaction accounts greater than $11.5 million and up to $71.0 million, and reserves of 10% must be maintained against net transaction accounts in excess of $71.0 million.

Environmental Regulations. Our business is affected from time to time by federal and state laws and regulations relating to hazardous substances. Under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), owners and operators of properties containing hazardous substances may be liable for the costs of cleaning up the substances. CERCLA and similar state laws can affect us both as an owner of branches and other properties used in our business and as a lender holding a security interest in property found to contain hazardous substances. While CERCLA contains an exemption for holders of security interests, the exemption is not available if the holder participates in the management of a property, and some courts have broadly defined what constitutes participation in management of property. Moreover, CERCLA and similar state statutes can affect our decision as to whether or not to foreclose on a property. When appropriate, before foreclosing on commercial real estate, our general policy is to obtain an environmental report, thereby increasing the costs of foreclosure. In addition, the existence of hazardous substances on a property securing a troubled loan may cause us to elect not to foreclose on the property, thereby reducing our flexibility in handling the loan.

Gramm-Leach-Bliley Act. In addition to other consumer privacy provisions, the GLB Act restricts the use by financial institutions of customers nonpublic personal information. At the inception of the customer relationship and annually thereafter, the Bank is required to provide its customers with information regarding its policies and procedures with respect to handling of customers nonpublic personal information. The GLB Act generally prohibits a financial institution from providing a customer s nonpublic personal information to unaffiliated third parties without prior notice and approval by the customer.

U.S.A. Patriot Act. The U.S.A. Patriot Act (the Patriot Act) facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on financial institutions to establish and maintain anti-money laundering policies and procedures, including a customer identification program.

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The Company and the Bank. As a bank holding company and state-chartered bank, the Company and the Bank are also subject to the following further regulation:

Dodd-Frank Act. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. The Dodd-Frank Act is intended to effect a fundamental restructuring of federal banking regulation. Although the statute will have a greater impact on larger institutions than community institutions such as the Company, many of its provisions will apply to us. Among other things, the Dodd-Frank Act:

- centralizes responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau, responsible for implementing, examining and enforcing compliance with federal consumer financial laws;

- changes the capital requirements for bank holding companies and would require less favorable capital treatment for future issuances of trust preferred securities (although our existing trust preferred securities are grandfathered and therefore not subject to the new rules);

- permanently increases the maximum deposit insurance amount to $250,000 per depositor and extends unlimited deposit insurance to noninterest bearing transaction accounts through December 31, 2012;

- broadens the FDIC insurance assessment base to be calculated on the average consolidated total assets less tangible equity capital of a financial institution and increased the reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020;

- repeals the federal statutory prohibition on the payment of interest on demand deposits, thereby permitting financial institutions to pay interest on business and other accounts;

- raises prudential standards by requiring, for instance, annual internal stress testing and establishment of independent risk committees for banks with $10 billion or more in assets;

- 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 an out of state bank only if it is well capitalized and well managed, and does not allow interstate merger transactions unless the resulting and would be well capitalized and well managed after the transaction;

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

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;

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.

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Some aspects of the Dodd-Frank Act 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 the Company 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.

Incentive Compensation. In June 2010, the FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation practices of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization s incentive compensation arrangements should (1) provide incentives that do not encourage risk-taking beyond the organization s ability to effectively identify and manage risks, (2) be compatible with effective internal controls and risk management, and (3) be supported by strong corporate governance, including active and effective oversight by the organization s board of directors. As part of its regular, risk-focused examination process, the FDIC will review incentive compensation arrangements of banking organizations, such as the Company, that are not large, complex banking organizations. The FDIC s findings will be incorporated into the organization s supervisory ratings, which can affect an organization s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Restrictions on Dividends and Other Capital Distributions. Federal and state banking regulations place restrictions on dividends paid by the Bank and by the Company. In April 2010, the Bank agreed with the FDIC and the DFI, its primary regulators, that the Bank 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. In April 2010, the Company also agreed with the Federal Reserve Bank, the Company s primary regulator, that the Company 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.

Under terms of the Capital Purchase Program, for so long as any preferred stock issued by the Company under the Capital Purchase Program remains outstanding, the Company is prohibited from increasing dividends on its common stock for three years while the Treasury is an investor unless preferred stock is redeemed or consent from the Treasury is received. The terms of our preferred stock and junior subordinated debentures also limit our ability to pay dividends on our common stock. If we are not current in our payment of dividends on our preferred stock or in our payment of interest on our junior subordinated debentures, we may not pay dividends on our common stock.

Consumer Protection Regulations. Retail activities of banks are subject to a variety of statutes and regulations designed to protect consumers. The Dodd-Frank Act established the Consumer Financial Protection Bureau (the CFPB) that, together with the statute s changes to consumer protection laws such as limits on debit card interchange fees and provisions on mortgage-related matters, will likely increase the compliance costs of consumer banking operations. Interest and other charges collected or contracted for by banks are subject to state usury laws and federal laws concerning interest rates. In January 2012, a director

was appointed to lead the CFPB and the CFPB began exercising its full range of powers. The CFPB has exclusive authority to require reports and conduct examinations, for purposes of ensuring compliance with federal consumer financial laws and related matters, of insured depository institutions with more than $10 billion of assets. For insured depository institutions with assets of $10 billion or less, the CFPB can require reports and conduct examinations on a sample basis.

Community Reinvestment Act. Bank holding companies and their subsidiary banks are also subject to the provisions of the Community Reinvestment Act of 1977, as amended (the CRA). Under the terms of the CRA, a bank s record in meeting the credit needs of the community served by the bank, including low-income and moderate-income neighborhoods, is assessed by the bank s primary federal regulator. When a bank holding company applies for approval to acquire a bank or other bank holding company, the Federal Reserve will review the assessment of each subsidiary bank of the applicant bank holding company, and such records may be the basis for denying the application. As of December 31, 2011, the Bank was rated Satisfactory with respect to compliance with the CRA.

Other Regulations. The policies of regulatory authorities, including the Federal Reserve and the FDIC, have had a significant effect on the operating results of financial institutions in the past and are expected to do so in the future. An important function of the Federal Reserve is to regulate aggregate national credit and money supply through such means as open market dealings in securities, establishment of the discount rate on bank borrowings and changes in reserve requirements against bank deposits. Policies of these agencies may be influenced by many factors, including inflation, unemployment, short-term and long-term changes in the international trade balance and fiscal policies of the United States government. Supervision, regulation or examination of the Company by these regulatory agencies is not intended for the protection of the Company s shareholders.

Employees

The Bank employed 125 employees, representing 114 full-time equivalent positions as of December 31, 2011. The Company, separate from the Bank, does not have any compensated employees; however, the Company reimburses the Bank for time that Bank employees spend on Company business. In 2011, the Company reimbursed the Bank $87,084 for work performed by Bank employees. None of the Bank s employees are represented by a union or covered under a collective bargaining agreement. Management of the Bank considers their employee relations to be excellent.

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, strategies and intentions and other statements contained in this report that are not historical facts and pertain to the Company s future operating results and capital position. When used in this report, the words expects, anticipates, intends, plans, believes, seeks, estimates and simi expressions are generally intended to identify forward-looking statements. Management may 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 Company s allowance for loan losses and provision for loan losses, the Company s 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 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.

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Actual results may differ materially from the results discussed in these forward-looking statements, because such statements are inherently subject to significant assumptions, risks and uncertainties, many of which are difficult to predict and are generally beyond the Company s control. These include but are not limited to:

- the inflation, interest rate levels and market and monetary fluctuations;
- trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;
- applicable laws and regulations and legislative or regulatory changes;
- the timely development and acceptance of new products and services of the Company;
- the willingness of customers to substitute competitors products and services for the Company s products and services;
- the financial condition of the Company s borrowers and lenders;
- the Company s success in gaining regulatory approvals, when required;
- technological and management changes;
- growth and acquisition strategies;
- the Company s critical accounting policies and the implementation of such policies;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- changes in consumer spending and saving habits;
- the strength of the United States economy in general and the strength of the local economies in which the Company conducts its operations; and
- the Company s success at managing the risks involved in the foregoing.

Other factors that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements may be found under the headings Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations below, as updated periodically in the Company s filings with the SEC. Unless legally required, the Company disclaims any obligation to update any forward-looking statements. You should consider any forward-looking statements in light of this explanation, and we caution you about relying on forward-looking statements.

Available Information

The Company files reports with the SEC. The public may read and copy any materials the Company files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-732-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC Internet site is www.sec.gov. The Company maintains a corporate website at www.inb.com, and electronic copies of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports can be found at http://investors.inb.com. We will also provide printed copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports at no charge upon written request. Requests should be made to Northwest Bancorporation, Inc., 421 W. Riverside Ave., Suite 113, Spokane, WA 99201, Attention: Lisa Sanborn, Corporate Secretary.

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

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks or uncertainties actually occur, our financial condition, results of operations or cash flows could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

We incurred significant losses over the last three quarters, and may continue do so in the future, and we are unable to estimate when we will be profitable.

Cumulatively, since the second quarter of 2011, we have incurred a net loss available to common shareholders of $1.3 million, or a loss of $0.60 per common share, primarily due to increased provision for loan losses. In light of the current economic environment, significant additional provisions for loan losses may be necessary to supplement the allowance for loan losses in the future. As a result, we may incur significant loan costs throughout 2012, which would continue to have an adverse impact on our financial condition and results of operations and the value of our common stock. Additional loan losses or impairment charges could cause us to incur a net loss in the future and could adversely affect the price of, and market for, our common stock.

Our business has been adversely affected by conditions in the local economies where we operate as well as by the national economy and financial markets.

Our success significantly depends upon the growth in population, income levels, deposits and housing starts in our primary and secondary markets as well as economic and political conditions at the local and national level. If the communities in which we operate do not grow or if prevailing economic conditions locally or nationally continue to be unfavorable, our business may not succeed. We are currently experiencing adverse economic conditions in some of our market areas, which affect the ability of our customers to repay their loans to us and generally negatively affect our financial condition and results of operations. We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies and are thus disproportionately impacted. Conditions such as inflation, recession, unemployment, changes in interest rates, money supply and other factors beyond our control may adversely affect our asset quality, deposit levels and loan demand and, therefore, our earnings.

Capital and credit markets have experienced unprecedented levels of volatility and disruption for more than two years. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial strength. In addition, the market value of the real estate securing our loans as collateral has been adversely affected by the weak economy and unfavorable economic conditions in our market areas and could be further adversely affected in the future. As of December 31, 2011, approximately 78% of our loans receivable were secured by real estate. Any sustained period of increased payment delinquencies, foreclosures or losses caused by the adverse market and economic conditions, including the downturn in the real estate market in Eastern Washington and Northern Idaho, will adversely affect the value of our assets, our revenues, results of

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operations and financial condition. Currently, our market is experiencing such an economic downturn, and if market conditions continue to worsen, they would likely have adverse effects on us and other financial institutions. In particular, we may face the following risks in connection with these events:

The processes we use to estimate inherent losses may no longer be reliable, because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation.

Our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage, and underwrite our customers become less predictive of future charge-offs.

The values of our real estate collateral supporting many construction, land acquisition, multifamily and commercial loans and home mortgages have declined and may continue to decline.

Our ability to borrow from other financial institutions or to engage in securitization funding transactions on favorable terms or at all could be adversely affected by further disruptions in the capital markets or other events, including actions by rating agencies and deteriorating investor expectations.

We may be required to pay significantly higher FDIC premiums, because market developments have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits.

Competition in our industry for deposits and quality loans has increased significantly and could intensify as a result of the increasing consolidation of financial services companies in connection with current market conditions.

We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs, limit our ability to pursue business opportunities, and increase compliance challenges.

Market developments may affect consumer confidence levels and may cause declines in credit use and adverse changes in payment patterns, causing increases in delinquencies and default rates.

We remain subject to certain agreements entered into with our regulators and are uncertain when they will be lifted.

In April 2010, the Company executed a memorandum of understanding (MOU) with the Federal Reserve Bank of San Francisco (the Reserve Bank). The MOU is an informal administrative agreement pursuant to which the Company has agreed to take various actions and comply with certain requirements to facilitate improvement in its financial condition. In accordance with the MOU, the Company agreed, among other things, to (a) utilize financial and managerial resources to function in a safe and sound manner; (b) obtain prior written approval from the Reserve Bank before receiving dividends or any other form of payment or distribution from the Bank; (c) refrain from paying any dividends, payments on trust preferred securities or make other capital distributions without prior regulatory approval; (d) refrain from incurring, increasing, renewing or guaranteeing any existing debt, or issuing any trust preferred securities without prior regulatory approval; (e) refrain from purchasing, redeeming or otherwise acquiring any of its stock without prior regulatory approval; (f) refrain from appointing any new director or senior executive officer or changing the responsibilities of any senior officer without prior regulatory approval; (g) comply with restrictions on indemnification and severance payments; (h) submit written progress reports detailing the Company s compliance with the MOU within 30 days after the end of each quarter.

In addition, during April 2010, the Bank executed an MOU with the FDIC and the DFI pursuant to which the Bank has agreed, among other things, to (a) provide prior notice to, and receive prior approval from, the

FDIC and the DFI prior to appointing any new director or senior executive officer or changing the responsibilities of any senior officer; (b) eliminate or correct all violations of law and contraventions and take steps to ensure future compliance with all applicable laws and regulations; (c) have and maintain its Tier 1 capital equal to or above 10% of the Bank s adjusted total assets and maintain capital ratios above well capitalized thresholds without causing a deduction from the Bank s allowance for loan losses; (d) maintain a fully funded allowance for loan losses; (e) refrain from paying dividends or otherwise reducing the Bank s capital without prior regulatory approval; (f) refrain from engaging in any transactions, without prior regulatory approval, that would materially change the balance sheet composition, including growth in total assets of five percent or more or significant changes in funding sources; (g) formulate and implement a written three-year profit plan that includes goals and strategies for improving and sustaining the earnings of the Bank; (h) eliminate by charge-off or collection, all assets classified as Loss ; (i) reduce the dollar amount of assets classified as Substandard ; (j) develop a written plan to reduce the amount of loans for acquisitions, development, construction and commercial real estate; (k) develop and implement a written policy to improve guidance and control over the Bank s lending management function; (l) revise and implement a written liquidity and funds management policy; and (m) submit written progress reports detailing the Bank s compliance with the MOU within 30 days after the end of each quarter.

The MOUs will remain in effect until modified or terminated by the Reserve Bank, the FDIC and the DFI. We cannot assure you whether or when the MOUs will be lifted or terminated. Even if lifted or terminated, we may still be subject to other agreements with regulators that restrict our activities. The requirements and restrictions of the MOUs are judicially enforceable and the failure of the Company or the Bank to comply with such requirements and restrictions may subject the Company and the Bank to additional regulatory restrictions including: the imposition of civil monetary penalties; the issuance of directives to increase capital or enter into a strategic transaction, whether by merger or otherwise, with a third party; the appointment of a conservator or receiver for the Bank; the termination of insurance of deposits; the issuance of removal and prohibition orders against institution-affiliated parties; and the enforcement of such actions through injunctions or restraining orders.

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

Liquidity is essential to our business. An inability to raise funds through traditional deposits, brokered deposits, borrowings, the sale of securities or loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets.

We rely on commercial and retail deposits, brokered deposits, advances from the Federal Home Loan Bank of Seattle (FHLB) and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, we might not be able to replace such funds in the future if, among other things, our results of operations or financial condition or the results of operations or financial condition of the FHLB or market conditions were to change. In addition, if we fall below the FDIC s thresholds to be considered well capitalized, we will be unable to continue with uninterrupted access to brokered funds markets.

Although we consider these sources of funds adequate for our liquidity needs, we may be compelled or elect to seek additional sources of financing in the future. Likewise, we may seek additional debt in the future to

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achieve our business objectives, in connection with future acquisitions or for other reasons. Additional borrowings, if sought, may not be available to us or, if available, may not be on reasonable terms. Bank and holding company stock prices have been negatively affected by the recent adverse economic trend, as has the ability of banks and holding companies to raise capital or borrow in the debt markets. If additional financing sources are unavailable or not available on reasonable terms, our financial condition, results of operations and future prospects could be materially adversely affected.

We actively monitor the depository institutions that hold our federal funds sold and due from banks cash balances. However, access to our cash equivalents and federal funds sold may be impacted by adverse conditions in the financial markets. Our emphasis is primarily on safety of principal, and we diversify our cash due from banks and federal funds sold among counterparties to minimize exposure to any one of these entities. The financials of the counterparties are routinely reviewed as part of our asset/liability management process. Balances in our accounts with financial institutions in the United States may exceed the FDIC insurance limits. While we monitor and adjust the balances in our accounts as appropriate, these balances could be impacted if the financial institutions fail and could be subject to other adverse conditions in the financial markets.

We are subject to credit risk.

There are inherent risks associated with our lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets where we operate as well as those across the United States and abroad. Increases in interest rates and/or weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. We are also subject to various laws and regulations that affect our lending activities. Failure to comply with applicable laws and regulations could subject us to regulatory enforcement action that could result in the assessment of significant civil money penalties against us.

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses. Due to recent economic conditions affecting the real estate market, many lending institutions, including us, have experienced substantial declines in the performance of their loans, including commercial real estate, construction, land development and land loans. The value of real estate collateral supporting many construction and land development loans and commercial loans have declined and may continue to decline. Recent negative developments in the financial industry and credit markets may continue to adversely impact our financial condition and results of operations.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease.

Our success depends to a significant extent upon the quality of our assets, particularly loans. In originating loans, there is a substantial likelihood that credit losses will be experienced. The risk of loss will vary with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the quality of the collateral for the loan.

Our loan customers may not repay their loans according to the terms of these loans, and the collateral securing the payment of these loans may be insufficient to assure repayment. As a result, we may experience significant loan losses, which could have a material adverse effect on our operating results. Management makes various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We maintain an allowance for loan losses in an attempt to cover any loan

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losses that may occur. In determining the size of the allowance, we rely on an analysis of our loan portfolio based on historical loss experience, volume and types of loans, trends in classification, volume and trends in delinquencies and nonaccruals, national and local economic conditions and other pertinent information. Our determination of the size of the allowance could be understated due to deviations in one or more of these factors.

If our assumptions are wrong, our current allowance may not be sufficient to cover future loan losses, and adjustments may be necessary to allow for different economic conditions or adverse developments in our loan portfolio. Material additions to our allowance would materially decrease our net income, and our allowance may not be adequate to cover future loan losses given current and future market conditions.

In addition, federal and state regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs, based on judgments different from those of our management. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a negative effect on our operating results.

We have made and hold in our portfolio a significant number of land acquisition and development and construction loans, which pose more credit risk than other types of loans typically made by financial institutions.

Historically, we have offered land acquisition and development and construction loans for builders and developers. As of December 31, 2011, these loans totaled $31 million, or 12%, of our loan portfolio. These land acquisition and development and construction loans are considered more risky than other types of real estate loans. The primary credit risks associated with land acquisition and development and construction lending are underwriting, project risks and market risks. Project risks include cost overruns, borrower credit risk, project completion risk, general contractor credit risk, and environmental and other hazard risks. Market risks are risks associated with the sale of the completed projects. They include affordability risk, which means the risk of affordability of financing by borrowers, product design risk, and risks posed by competing projects. While we believe we have established adequate reserves on our financial statements to cover the credit risk of our land acquisition and development and construction loan portfolio, our losses may exceed our reserves, which could adversely impact our earnings. Given the current environment, we expect that loans in our loan portfolio could result in a material level of charge-offs, which will negatively impact our capital and earnings.

Further deterioration in the housing market may lead to increased losses, delinquencies and nonperforming assets in our loan portfolios. Consequently, our results of operations may be adversely impacted.

There has been substantial industry concern and publicity over asset quality among financial institutions due in large part to issues related to subprime mortgage lending, declining real estate values and general economic concerns. At December 31, 2011, the Bank s nonperforming assets were $12.8 million, representing 3.3% of total assets. Furthermore, housing and residential mortgage markets have experienced a variety of difficulties and changed economic conditions. If market conditions continue to deteriorate, they may lead to additional valuation adjustments on our loan portfolios and real estate owned as we continue to reassess the market value of our loan portfolio, the losses associated with the loans in default and the net realizable value of real estate owned.

The homebuilding industry has experienced a significant and sustained decline in demand for new homes and an oversupply of new and existing homes available for sale in various markets, including some of the markets in which we lend. Our customers who are builders and developers face greater difficulty in selling their homes in markets where these trends are more pronounced. Consequently, we are facing increased

delinquencies and nonperforming assets as these builders and developers are forced to default on their loans with us. We do not anticipate that the housing market will improve in the near-term, and accordingly, additional downgrades, provisions for loan losses and charge-offs related to our loan portfolio may occur. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature. We anticipate that further declines in the real estate markets in our primary market area would affect our business.

We face regulatory risks related to our commercial real estate loan concentrations.

Commercial real estate is cyclical and poses risks of possible loss due to concentration levels and similar risks of the asset class. As of December 31, 2011, approximately 54% of our loan portfolio consisted of commercial real estate loans. Banking regulators have begun giving commercial real estate lending greater scrutiny and may require banks with higher levels of commercial real estate loans to implement more conservative underwriting, internal controls, risk management policies and portfolio stress testing, as well as possibly requiring higher levels of allowances for possible loan losses and capital levels as a result of commercial real estate lending growth and exposures.

Our loan portfolio has commercial and industrial loans that include risks that may be greater than the risks related to residential loans.

Our commercial and industrial loan portfolio was $53 million at December 31, 2011, comprising 20% of loans receivable. Commercial and industrial loans generally carry larger loan balances and involve a greater degree of financial and credit risk than home equity loans or residential mortgage loans. Any significant failure to pay on time by our customers would hurt our earnings. The increased financial and credit risk associated with these types of loans is a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the size of loan balances, the effects of general economic conditions on income-producing properties and the increased difficulty of evaluating and monitoring these types of loans. In addition, when underwriting a commercial or industrial loan, we may take a security interest in commercial real estate, and, in some instances upon a default by the borrower, we may foreclose on and take title to the property, which may lead to potential financial risk for us under applicable environmental laws. If hazardous substances were discovered on any of these properties, we may be liable to governmental entities or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination.

Furthermore, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate or commercial project. If the cash flow from the project is reduced, a borrower s ability to repay the loan may be impaired. This cash flow shortage may result in the failure to make loan payments. In such cases, we may be compelled to modify the terms of the loan. In addition, the nature of these loans is such that they are generally less predictable and more difficult to evaluate and monitor. As a result, repayment of these loans may, to a greater extent than residential loans, be subject to adverse conditions in the real estate market or economy.

Our net interest income could be negatively affected by interest rates adjustments by the Federal Reserve, as well as by competition in our primary market area.

As a financial institution, our earnings are significantly dependent upon our net interest income, which is the difference between the interest income that we earn on interest earning assets, such as investment securities and loans, and the interest expense that we pay on interest bearing liabilities, such as deposits and

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borrowings. Therefore, any change in general market interest rates, including changes resulting from changes in the Federal Reserve s fiscal and monetary policies, affects us more than non-financial institutions and can have a significant effect on our net interest income and total income. Our assets and liabilities may react differently to changes in overall market rates or conditions, because there may be mismatches between the re-pricing or maturity characteristics of the assets and liabilities. As a result, an increase or decrease in market interest rates could have material adverse effects on our net interest margin and results of operations.

Our deposit insurance premiums could be substantially higher in the future, which could have a material adverse effect on our future earnings.

The FDIC insures deposits at the Bank and at other financial institutions. The FDIC charges insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. Current economic conditions have caused bank failures and expectations for additional bank failures, in which case the FDIC, through the Deposit Insurance Fund, ensures payments of customer deposits at failed banks up to insured limits. In addition, deposit insurance limits on customer deposit accounts have generally increased to $250,000 from $100,000, and the FDIC adopted the TLGP for noninterest bearing transaction deposit accounts. These developments will cause the premiums assessed by the FDIC to increase and may increase our noninterest expense. An increase in the risk category of the Bank would also cause our premiums to increase. Whether through adjustments to base deposit insurance assessment rates, significant special assessments or emergency assessments under the TLGP, increased deposit insurance premiums could have a material adverse effect on our earnings.

The price of our common stock could decline.

The market price of our common stock could decline in response to numerous factors, some of which are beyond our control. These factors include, among other things, actual or anticipated variations in our costs of doing business, operating results and cash flow, the nature and content of our earnings releases and our competitors earnings releases, changes in financial estimates by securities analysts, business conditions in our markets and the general state of the securities markets and the market for other financial stocks, changes in capital markets that affect the perceived availability of capital to companies in our industry, governmental legislation or regulation, currency and exchange rate fluctuations, as well as general economic and market conditions, such as downturns in our economy and recessions.

We may need to raise additional capital in the future, but that capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In addition, we may elect to raise additional capital to support our business or to finance acquisitions, if any, or we may otherwise elect to raise additional capital. In that regard, a number of financial institutions have recently raised considerable amounts of capital as a result of deterioration in their results of operations and financial condition arising from the turmoil in the mortgage loan market, deteriorating economic conditions, declines in real estate values and other factors. Should we be required by regulatory authorities to raise additional capital, we may seek to do so through the issuance of, among other things, our common stock or preferred stock, which could dilute current shareholders ownership interest in the Company.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside our control, and on our financial performance. Accordingly, we may not be able to raise additional capital if needed or on terms acceptable to us. If we cannot raise additional capital when needed, it may have a material adverse effect on our financial condition, results of operations and prospects.

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We may be subject to more stringent capital requirements.

As discussed above, the Dodd-Frank Act would require the federal banking agencies to establish stricter risk-based capital requirements and leverage limits to apply to banks and bank holding companies. In addition, the Basel III standards recently announced by the Basel Committee, if adopted, could lead to significantly higher capital requirements, higher capital charges and more restrictive leverage and liquidity ratios. The standards would, among other things, impose more restrictive eligibility requirements for Tier 1 and Tier 2 capital; increase the minimum Tier 1 common equity ratio to 4.5%, net of regulatory deductions, and introduce a capital conservation buffer of an additional 2.5% of common equity to risk-weighted assets, raising the target minimum common equity ratio to 7%; increase the minimum Tier 1 capital ratio to 8.5% inclusive of the capital conservation buffer; increase minimum total capital ratio to 10.5% inclusive of the capital buffer; and introduce a countercyclical capital buffer up to 2.5% of common equity or other fully loss absorbing capital for periods of excess credit growth. Basel III also introduces a non-risk adjusted Tier 1 leverage ratio of 3%, based on a measure of total exposure rather than total assets, and new liquidity standards. The new Basel III capital standards are expected to be phased in from January 1, 2013 until January 1, 2019, and it is not yet known how these standards will be implemented by U.S. regulators generally or how they will be applied to community banks of our size. Implementation of these standards, or any other new regulations, may adversely affect our ability to pay dividends, or require us to reduce business levels or raise capital, including in ways that may adversely affect our results of operations or financial condition.

Because of our participation in the Treasury s Capital Purchase Program, we are subject to several restrictions including restrictions on our ability to declare or pay dividends and repurchase our shares.

The terms of the preferred stock the Company issued under the Treasury s Capital Purchase Program could reduce investment returns to the Company s common shareholders by restricting dividends and restricting capital management practices.

Without the prior consent of the Treasury, the Company is prohibited from increasing the Company s common stock dividends for the first three years while the Treasury holds the preferred stock. Also, the Company is required to make quarterly dividend payments on the preferred stock until such time as the stock is redeemed by the Company. Payment of these dividends will decrease funds the Company may otherwise have available to pay dividends on the Company s common stock and to use for general corporate purposes, including working capital. The Company is prohibited from continuing to pay dividends on its common stock unless the Company has fully paid all required dividends on the preferred stock issued to the Treasury. In addition, our ability to repurchase our shares is restricted; the Treasury s consent generally is required for us to make any stock repurchase until the third anniversary of the investment by the Treasury.

Recent changes have created regulatory uncertainty.

Regulation of the financial services industry 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 community institutions such as the Company, many of its provisions will apply to us. Among other things, the Dodd-Frank Act:

- is changing the capital requirements for bank holding companies and would require less favorable capital treatment for future issuances of trust preferred (although our existing trust preferred are grandfathered and therefore not subject to the new rules);

- raises prudential standards by requiring, for instance, annual internal stress testing and establishment of independent risk committees for banks with $10 billion or more in assets;

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- 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 an out of state 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;

- 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.

We could be materially and adversely affected if we or any of our officers or directors fail to comply with bank and other laws and regulations.

The Company and the Bank are subject to laws, regulations, administrative actions and policies that govern financial institutions in each location in which we operate. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Such changes could subject

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the Company to additional costs, limit the types of financial services and products the Company may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with applicable laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Company s business, financial condition and results of operations.

Our profitability depends significantly on economic conditions in the Pacific Northwest.

Our success depends primarily on the general economic conditions in the areas in which we conduct business. Unlike larger banks that are more geographically diversified, we provide banking and financial services to customers primarily in the Inland Northwest. The local economic conditions in our market area have a significant impact on the demand for our products and services as well as the ability of our customers to repay loans, the value of collateral securing loans and the stability of our deposit funding sources. Adverse economic conditions unique to the Pacific Northwest could have a material adverse effect on our financial condition and results of operations. Further, a significant decline in general economic conditions caused by inflation, natural disasters, recession, unemployment or other factors beyond our control could affect our local economic conditions and could adversely affect our financial condition and results of operations.

The value of our investment securities portfolio may be negatively affected by interest rate changes or disruptions in securities markets, including the municipal bond markets and we may realize losses on our investment securities in future periods.

The market for some of the investment securities held in our portfolio experienced extreme volatility over the past two years. Volatile market conditions may detrimentally affect the value of these securities, such as through reduced valuations due to the perception of heightened credit and liquidity risks. Declines in market value associated with these disruptions may result in other-than-temporary or permanent impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income, capital levels and liquidity.

In addition, we held $25 million of municipal bonds as of December 31, 2011. The current economic downturn has impacted the credit worthiness of a number of municipalities and some municipalities are struggling to meet financial obligations. We have certain municipal investment securities that are subject to credit risk if the municipalities are unable to meet their obligations. A continued or further decline in the economy could result in credit ratings downgrades for the municipalities that have issued the bonds held by us, which could negatively impact the value of the bonds. Although we believe the municipalities will be able to meet their obligations, there can be no certainty in this regard, and a significant decline in the value of these securities could have a material adverse effect on the Company s results of operations.

A decline in the value of our FHLB common stock may occur, resulting in an other-than-temporary impairment charge that would cause our earnings and shareholders equity to decrease.

We own common stock of the FHLB in order to qualify for membership in the FHLB system, which enables us to borrow funds under the FHLB advance program. The carrying value of our FHLB common stock was approximately $1.3 million as of December 31, 2011. The FHLB has experienced losses from credit-related charges associated with projected losses on its investments in private-label mortgage-backed securities, and is currently unable to repurchase or redeem capital stock or to pay dividends. Consequently, for this and other reasons, there is a risk that our investment in the common stock of the FHLB could be deemed other-than-temporarily impaired at some time in the future, which would adversely affect our earnings, our shareholders equity and the value of our common stock.

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The Bank may be required to repurchase mortgage loans in some circumstances, which could harm our liquidity, results of operations and financial condition.

When the Bank sells mortgage loans, we are required to make certain representations and warranties to the purchaser about the loans and the manner in which they were originated. Our sales agreements require us to repurchase mortgage loans in the event we breach any of these representations or warranties. In addition, we may be required to repurchase mortgage loans as a result of borrower fraud or in the event of early payment default of the borrower on a mortgage loan. If repurchase and indemnity demands increase, our liquidity, results of operations and financial condition will be adversely affected.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual funds, and other institutional clients. As a result, defaults by, or even rumors or questions about, one or more financial services companies, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of direct and indirect competitors, some of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the market areas we serve. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Additionally, we expect competition to intensify among financial services companies due to the recent consolidation of certain competing financial institutions and the conversion of certain investment banks to bank holding companies. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic funds transfer and automatic payment systems. Some of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, some competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services.

Our cost of funds may increase as a result of a change in one or more variables.

Our cost of funds may remain higher than prevailing interest rates because of general economic conditions, unfavorable conditions in the capital markets, interest rates and competitive pressures. The Bank has traditionally obtained funds principally through deposits and borrowings. As a general matter, deposits are a cheaper source of funds than borrowings, because interest rates paid for deposits are typically less than interest rates charged for borrowings. If, as a result of general economic conditions, market interest rates, competitive pressures, or other factors, our level of deposits decreases relative to our overall banking operation, we may have to rely more heavily on borrowings as a source of funds in the future, which may

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negatively impact net interest margin. Additional borrowings, if sought, may not be available to us or, if available, may not be on favorable terms. If additional borrowing sources are unavailable or not available on reasonable terms, our financial condition, results of operations and future prospects could be materially adversely affected.

We rely on dividends from our banking subsidiary for most of our revenue.

Because we are a holding company with no significant assets other than the Bank, we depend upon dividends from the Bank for a substantial portion of our revenues. Our ability to pay dividends on our common stock or to make payments on our other obligations will, therefore, continue to depend in large part upon our receipt of dividends or other capital distributions from the Bank. The ability of the Bank to pay dividends or make other capital distributions to the Company is subject to its ability to earn net income and to the regulatory authority of the Federal Reserve Board, the FDIC and the DFI.

Our common stock is equity and holders of our preferred stock and trust preferred securities have rights that are senior to those of our common shareholders.

Shares of our common stock are equity interests in the Company, do not constitute indebtedness and, therefore, are not insured against loss by the FDIC or by any other public or private entity. We have supported our growth through the issuance of trust preferred securities from a special purpose trust and accompanying junior subordinated debentures. Payments of the principal and interest on the trust preferred securities of this special purpose trust are conditionally guaranteed by the Company. Further, the accompanying junior subordinated debentures issued to the special purpose trust are senior to our shares of common stock. We have also issued shares of preferred stock to the Treasury in connection with our participation in the Capital Purchase Program. As a result, we must make payments on the junior subordinated debentures and preferred stock before any dividends can be paid on our common stock and, in the event of our bankruptcy, dissolution or liquidation, the holders of the junior subordinated debentures and preferred stock must be satisfied before any distributions can be made on our common stock. We have the right to defer distributions on our junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time no dividends may be paid on our common stock. In addition, shares of our common stock would rank junior to any indebtedness and to other non-equity claims against us and our assets available to satisfy such claims, including in liquidation.

Because of our participation in Treasury s Capital Purchase Program, we are subject to restrictions on compensation paid to our executives.

Pursuant to the terms of the Capital Purchase Program, we have adopted certain standards for executive compensation and corporate governance for the period during which the Treasury holds an investment in our Company. These standards generally apply to our most highly compensated senior executive officers, including our Chief Executive Officer and Chief Financial Officer, and certain of these restrictions also apply to our other senior executives. The standards include, among other things:

- ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution;
- a required clawback of any bonus or incentive compensation paid to a senior executive officer or one of the next twenty most highly compensated employees based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate;
- a prohibition on making golden parachute payments to senior executive officers;

- an agreement not to deduct for tax purposes annual compensation in excess of $500,000 for each senior executive officer; and

- limitations on bonuses and incentive compensation.

In particular, the change to the deductibility limit on executive compensation may increase the overall cost of our compensation programs in future periods and may make it more difficult to attract suitable candidates to serve as executive officers.

We are dependent on key personnel and the loss of one or more of those key personnel could harm our business.

As a community bank, our success depends greatly on the continued services of our senior management. Failure to attract, retain and motivate key employees could have an adverse effect on our results of operations, financial condition and prospects. In connection with the Company s sale of preferred stock to the Treasury as part of its participation in the Capital Purchase Program, we agreed to abide by certain limitations on the compensation of certain executive officers. More stringent restrictions on executive compensation were imposed by Congress on Capital Purchase Program participants in February 2009 as part of the ARRA, and these restrictions apply retroactively. Congress may impose additional restrictions in the future that may also apply retroactively. These restrictions may have an adverse affect on our ability to attract and retain executive talent.

Our controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations, cash flows and financial condition.

Our information systems may experience an interruption or breach in security.

We rely heavily on communications and information systems to conduct our business, including systems provided by third-party service providers. Specifically, we receive core systems processing, essential web hosting and other Internet systems and deposit and other transaction processing services from third-party service providers. If these third-party service providers experience difficulties or terminate their services, and we are unable to replace them with other service providers, our operations could be interrupted. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, such failures, interruptions or security breaches may occur and, if they do occur, they may not be adequately addressed. The occurrence of any failures, interruptions or security breaches of information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition, results of operations and cash flows.

We are exposed to the risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may own or foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or

to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, cash flows, liquidity and results of operations could be materially and adversely affected.

Item 1B. ***Unresolved Staff Comments.***

None.

Item 2. ***Properties.***

The Company historically has not owned or leased real or personal property apart from the premises and equipment of the Bank. In 2008, the Company purchased undeveloped property located in Airway Heights, Washington for $1.3 million and divided it into two parcels, one of which was used to construct a new branch for the Bank as a replacement for the branch located in a grocery store in Airway Heights. The ground on which the branch was built was transferred to the Bank in 2008. The Company retained ownership of the remaining parcel and currently has it listed for sale.

The Bank leases its principal office and main branch, which is located in downtown Spokane. The Company s registered office is also at this location. The Company pays no rent or other form of consideration for the use of the Bank s main office as its principal executive offices.

The Bank also owns the real property for the Northpointe, Ruby and Valley branches located in Spokane, Washington. In Idaho, the Bank owns the real property for the Coeur d Alene, Post Falls, Hayden and Spirit Lake branches. The Bank owns the buildings for the Francis and South Hill branches, which are located on leased property.

The Bank owns property that was being held for future development located on East Sprague Avenue in Spokane. During 2008, the Bank identified and purchased an alternative site on East Sprague Avenue that the Bank deemed to be more suitable to replace the existing Spokane Valley grocery store branch, which the Bank leased. The original property is listed for sale. In February 2010, the Bank s new Spokane Valley branch opened and the nearby grocery store branch was permanently closed.

We consider our facilities to be suitable and adequate for our current and immediate future purposes. As of December 31, 2011, the total net book value of the Company s premises and equipment was $16.4 million.

Item 3. ***Legal Proceedings.***

Other than routine litigation incidental to the business of the Bank, there are no pending legal proceedings in which the Company or the Bank is a party or any of their respective properties is subject. There are no pending legal proceedings to which any director, officer or affiliate of the Company, any owner of record or beneficiary of more than 5% of the common stock of the Company, or any security holder of the Company is a party adverse to the Company or the Bank or has a material interest adverse to the Company or the Bank.

Item 4. **Mine Safety Disclosures.**

Not applicable.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.***
Market Price of and Dividends on Issuer s Common Equity

Common shares of Northwest Bancorporation, Inc. are traded over-the-counter under the symbol NBCT. At the close of business on December 31, 2011, there were 3,084,548 shares of common stock outstanding, held by approximately 584 shareholders of record, including shares held by 180 known beneficial shareholders by 26 nonaffiliated depositories. The Company has relied upon information received from those depositories in determining the number of beneficial holders.

There is no established public trading market for the Company s shares of common stock. Quotations may be obtained by researching the stock symbol NBCT. Various Internet quotation services detail information about daily transaction volume and price. One such service is the OTC Markets (www.otcmarkets.com) where a list of market makers is also detailed. The high and low range of actual transactions using the daily ending price, by quarter, for the Company s last two fiscal years is set forth below.

	2011		2010	
	High	Low	High	Low
First quarter	$4.90	$3.68	$3.90	$2.90
Second quarter	$5.00	$4.00	$6.00	$3.55
Third quarter	$4.65	$4.30	$4.25	$3.95
Fourth quarter	$5.00	$4.00	$4.90	$3.50

The above quotations may not reflect inter-dealer prices and should not be considered over-the-counter market quotations as that term is customarily used.

In order to conserve capital in the current uncertain economic environment, the Company s Board of Directors determined that it was in the best interest of the Company and its shareholders not to declare a dividend on its common stock during 2010 and 2011 and not to declare the dividends payable during 2010 and 2011 on its Series A and Series B Preferred Stock. In addition, the Company has given notice of its intention to defer interest payments on the junior subordinated debentures underlying its trust preferred securities as permitted by the related indentures. During the period during which the Company defers payments on its junior subordinated debentures, it is prohibited under the indentures from declaring or paying dividends on its capital stock. The Company is prohibited from declaring or paying dividends on its common stock while dividends on its Series A and Series B Preferred Stock are in arrears. No determination has been made as to whether or when the Company will resume the payment of dividends on its common or preferred stock or interest payments on its junior subordinated debentures. As a bank holding company that has no significant assets other than its equity interest in the Bank, the Company s ability to declare dividends depends primarily upon dividends it receives from the Bank. Future dividend payments are at the discretion of the Board of Directors and will depend on a variety of factors including, but not limited to, results of operations, general business and economic conditions, financial condition, capital adequacy, liquidity, statutory and regulatory limitations and other factors deemed relevant. In April 2010, the Bank agreed with the FDIC and the DFI that the Bank 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. Also in April 2010, the Company agreed with the Federal Reserve Bank that the Company 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.

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Equity Compensation Plan Information

Information regarding stock-based compensation awards outstanding and available for future grant as of December 31, 2011, is presented in the table below.

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	34,224	$ 11.16	193,897
Equity compensation plans not approved by security holders	-	-	-
	34,224	$ 11.16	193,897

Recent Sales of Unregistered securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Occasionally, the Company will repurchase shares of its common stock from employees, former employees, or other shareholders who own less than 100 shares; the price that the Company pays for such shares is reflective of the last several trades reported on various Internet quotation services, such as www.otcmarkets.com. During the fourth-quarter, the Company did not repurchase any shares.

Item 6. ***Selected Financial Data*****.**
Not applicable because the Company is a smaller reporting company.

Item 7. ***Management*** **s Discussion and Analysis of Financial Condition and Results of Operations.**
This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For a discussion of the risks and uncertainties inherent in such statements, see Business Forward-Looking Statements and Risk Factors.

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. Significant accounting policies are also described in the notes to consolidated financial statements included in Item 8 of this Form 10-K. Management believes that the following policies would be considered critical under the SEC s definition:

Allowance for Loan Losses

The allowance for losses on outstanding loans is classified as a contra-asset account offsetting outstanding loans on the consolidated statements of financial condition. The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses for outstanding loans is maintained at an amount that management believes will be adequate to absorb known and inherent losses in the loan portfolio. The allowance is evaluated on a regular basis by management and is based upon management s periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may

affect the borrower s ability to repay,

estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Revisions to these estimates and assumptions typically occur on a regular basis and may have a material impact on the Company s consolidated financial statements or results of operations.

Foreclosed Real Estate

Foreclosed real estate is recorded at the lower of estimated fair value, less costs to sell, or the carrying value of the defaulted loan on the acquisition date. Estimated fair value is based upon many subjective factors, including location and condition of the property and current economic conditions, among other things. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Because the calculation of fair value relies on estimates and judgments relating to inherently uncertain events, the amounts ultimately recovered from property sales may differ substantially from the carrying value of the assets.

Fair Value Measurements

FASB ASC 820, *Fair Value Measurements*, establishes a hierarchical disclosure framework associated with the level of pricing observability utilized in measuring financial instruments at fair value. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of pricing observability and a lesser degree of judgment utilized in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have little or no pricing observability and a higher degree of judgment utilized in measuring fair value. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. See the notes to consolidated financial statements included in Item 8 of this Form 10-K for additional information about the level of pricing transparency associated with financial instruments carried at fair value.

Income Taxes

Deferred income tax assets and liabilities are determined using the liability method. Under this method, the net deferred tax asset or liability is recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as net operating and capital loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. To the extent that current available evidence about the future raises doubt about the likelihood of a deferred tax asset being realized, a valuation allowance is established. The judgment about the level of future taxable income, including that which is considered capital, is inherently subjective and is reviewed on a continual basis as regulatory and business factors change.

Overview and Financial Highlights

We are a bank holding company providing banking and other financial services throughout Eastern Washington and Northern Idaho to consumers and to small- and medium-sized businesses, including the owners and employees of those businesses. We offer an array of banking products and services to the communities we serve, including accepting time and demand deposits and originating real estate loans, commercial loans and consumer loans. We derive our income primarily from interest received on loans and,

to a lesser extent, interest on investment securities, and fees received in connection with servicing loans and deposit accounts. Our major operating expenses are the interest we pay on deposits and borrowings and general operating expenses. We rely primarily on locally generated deposits to provide us with funds for making loans, but we have also used brokered time deposits and time deposits obtained through a national listing service to fund loan demand.

We are subject to competition from other financial institutions and our operating results, like those of other financial institutions operating exclusively or primarily in the Pacific Northwest, are significantly influenced by economic conditions in Washington and Idaho, including the strength of the real estate market. In addition, both the fiscal and regulatory policies of the federal government and regulatory authorities that govern financial institutions and market interest rates also impact our financial condition, results of operations and cash flows.

The following discussion contains a review of Northwest Bancorporation, Inc. s and its wholly-owned subsidiary, Inland Northwest Bank s, consolidated operating results and financial condition for the year ended December 31, 2011. When warranted, comparisons are made to the same period in 2010. The discussion should be read in conjunction with the consolidated financial statements and related notes included in Item 8 of this Form 10-K. All numbers, except per share data, are expressed in thousands of dollars, unless otherwise noted.

The following summary financial information is derived from the consolidated financial statements and other data of the Company for the years ended December 31, 2011 and 2010:

	Year Ended December 31,	
	2011	2010
	($ in thousands, except per share data)	
Results of Operations:		
Interest income	$ 19,370	$ 20,802
Interest expense	4,123	6,164
Net interest income	15,247	14,638
Provision for loan losses	6,874	2,950
Net interest income after provision for loan losses	8,373	11,688
Noninterest income	4,053	4,032
Noninterest expense	13,965	14,555
(Loss) income before income taxes	(1,539)	1,165
Income tax (benefit) expense	(793)	221
Net (loss) income	(746)	944
Preferred stock dividends and discount accretion, net	677	677
Net (loss) income applicable to common shares	$ (1,423)	$ 267
Per Common Share Data:		
Basic (loss) earnings	$ (0.46)	$ 0.10
Diluted (loss) earnings	$ (0.46)	$ 0.10
Book value	$ 8.30	$ 8.12
Selected Ratios:		
Return on average assets	-0.36%	0.07%
Return on average equity	-3.89%	0.76%
Net interest margin	4.29%	4.07%
Efficiency ratio	72.36%	77.96%
Noninterest income to average assets	1.03%	1.02%
Noninterest expense to average assets	3.57%	3.68%
Ending shareholders equity to average assets	9.29%	9.03%
Nonperforming loans to gross loans	3.64%	4.51%

Allowance for loan losses to gross loans	2.56%	2.45%

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Results of Operations

Earnings

The Company recognized a net loss applicable to common shares of $1.4 million for the year ended December 31, 2011, compared to net income applicable to common shares of $267 thousand in 2010. Earnings during 2011 were adversely affected by increases to the provision for loan losses due to higher levels of net charge-offs and loan delinquencies. The return on average assets during 2011 was -0.36% compared to 0.07% in 2010, and the return on average equity during 2011 was -3.89% compared to 0.76% in 2010. The decrease in earnings for 2011 was primarily a result of an increased level of charge-offs on impaired loans compared to the prior year. Details of the changes in the various components of earnings are further discussed below.

Net Interest Income

The principal component of the Company s earnings is its net interest income. Net interest income is the difference between the income earned on assets and the interest paid on deposits and on borrowings used to support such assets. Net interest income is determined by the yields earned on the Company s interest earning assets and the rates paid on its interest bearing liabilities, the relative amounts of interest earning assets and interest bearing liabilities, and the degree of mismatch and the maturity and re-pricing characteristics of its interest earning assets and interest bearing liabilities. The Company s net interest rate spread is determined based upon the total interest earning assets yield, less the total interest bearing liabilities rate.

Average Balances, Rates, and Interest Income and Expense. The following table sets forth certain information related to the Company s average balance sheet and its average yields on assets and average costs of liabilities. Such yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities.

	Year Ended December 31,					
	2011			2010		
	Average Balance	Interest Income or Expense [1]	Average Yield or Rate	Average Balance	Interest Income or Expense [1]	Average Yield or Rate
	($ in thousands)					
ASSETS						
Loans receivable, gross [2] [3]	$ 277,571	$ 17,071	6.15%	$ 308,031	$ 19,294	6.26%
Investment securities	69,218	2,282	3.30%	38,315	1,480	3.86%
FHLB stock	1,261	-	0.00%	1,261	-	0.00%
Federal funds sold and interest bearing deposits	7,250	17	0.23%	12,070	28	0.23%
Total interest earning assets	355,300	19,370	5.45%	359,677	20,802	5.78%
Noninterest earning assets	36,361			35,550		
Total assets	$ 391,661			$ 395,227		
LIABILITIES AND SHAREHOLDERS EQUITY						
Money market accounts	39,820	214	0.54%	32,180	306	0.95%
NOW accounts	60,403	1,038	1.72%	52,310	906	1.73%
Savings accounts	53,825	343	0.64%	45,064	414	0.92%
Time deposits	115,236	2,185	1.90%	150,038	3,978	2.65%
Total interest bearing deposits	269,284	3,780	1.40%	279,592	5,604	2.00%
Securities sold under repurchase agreements	13	-	0.00%	219	-	0.00%
Borrowed funds	6,490	234	3.61%	8,946	349	3.90%
Junior subordinated debentures	5,155	109	2.11%	5,155	211	4.09%
Total borrowed funds	11,658	343	2.94%	14,320	560	3.91%
Total interest bearing liabilities	280,942	4,123	1.47%	293,912	6,164	2.10%
Noninterest bearing deposits	69,500			64,140		
Other noninterest bearing liabilities	4,637			1,882		
Shareholders equity	36,582			35,293		
Total liabilities and shareholders equity	$ 391,661			$ 395,227		
Net interest income		$ 15,247			$ 14,638	
Net interest spread			3.98%			3.68%
Net interest income to average earning assets (margin)			4.29%			4.07%

Comments:

(1) There are no tax equivalency adjustments.
(2) Nonaccrual loans and loans held for sale are included in average loan balances.
(3) Loan fee income in the amount of $426 thousand and $434 thousand is included in loan interest income for 2011 and 2010, respectively.

During the years ended December 31, 2011 and 2010, net interest income was $15.2 million and $14.6 million, respectively. This increase in net interest income of $609 thousand, or 4.2%, resulted from interest expense declining at a faster rate than interest income as well as from a change in the mix of interest earning assets and interest bearing liabilities. The net interest margin improved 22 basis points from 4.07% to 4.29% for the years ended December 31, 2010 and 2011, respectively.

Interest income fell $1.4 million, or 6.9%, during 2011 ending the year at $19.4 million compared to $20.8 million for 2010. The decrease in interest income is related to a change in the mix of interest earning assets and a decrease in yield on loans and investments. Loans, the highest yielding component of earning assets, represented 78.1% of average earning assets in 2011, compared to 85.6% in 2010. The average yield on loans fell 11 basis points to 6.15% in 2011 from 6.26% in 2010. The reduction in loan yield combined with a $30.5 million, or 9.9%, decrease in average loan balances resulted in interest income on loans decreasing $2.2 million, or 11.5%. The Bank did not introduce any new loan products during the year and did not change

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its loan pricing strategy. However, in the second half of 2008 and continuing through 2011, the Bank significantly cut back lending for land acquisition and development, construction, and non-owner occupied commercial real estate. The Bank redirected resources to focus more on commercial and industrial lending and the collection and workout of problem credits. Average investment securities increased $30.9 million, or 80.7%, during 2011 as a result of a reduction in average loans outstanding. The yield on securities decreased 56 basis points from 3.86% in 2010 to 3.30% in 2011. The increase in investment securities combined with the decrease in yield on securities resulted in an improvement in investment income of $802 thousand, or 54.2%.

Interest expense was $4.1 million in 2011, representing a decrease of $2.1 million, or 33.1%, from the $6.2 million in interest expense for 2010. This improvement in interest expense was impacted by reductions in time deposit balances and reductions in rates paid on all interest bearing liabilities, and was partially offset by increased balances in non-maturity deposit accounts and borrowed funds. The Bank expects to continue to see reductions in interest expense in the near-term as time deposits continue to re-price to the lower rates currently offered by the Bank. Overall, the average cost of interest bearing deposits improved 60 basis points from 2.00% in 2010 to 1.40% in 2011. Interest expense on junior subordinated debentures decreased $102 thousand, or 48.3%, during 2011 compared to 2010, because the interest rate, which had been fixed at 5.95% through June 30, 2010, now re-prices quarterly at the 3-month LIBOR rate plus 170 basis points, which was 2.26% as of December 31, 2011.

Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The rate/volume column shows the effects attributable to changes in both rate and volume (changes in rate multiplied by changes in volume).

	2011 over 2010 Increase (Decrease) Due to Changes in				2010 over 2009 Increase (Decrease) Due to Changes in			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
	($ in thousands)							
Interest income:								
Loans receivable	$ (1,907)	$ (339)	$ 23	$ (2,223)	$ (1,768)	$ 59	$ 7	$ (1,702)
Investment securities	1,156	(199)	(155)	802	258	205	56	519
Federal funds sold and interest bearing deposits	(11)	-	-	(11)	13	(1)	(1)	11
Total interest income	(762)	(538)	(132)	(1,432)	(1,497)	263	62	(1,172)
Interest expense:								
Money market accounts	73	(132)	(33)	(92)	44	14	2	60
NOW accounts	140	(5)	(3)	132	182	218	409	809
Savings accounts	81	(126)	(26)	(71)	37	(147)	(10)	(120)
Time deposits	(922)	(1,125)	254	(1,793)	(1,032)	(1,462)	244	(2,250)
Securities sold under repurchase agreements	-	-	-	-	(6)	(7)	6	(7)
Borrowed funds	(96)	(26)	7	(115)	(470)	39	(23)	(454)
Junior subordinated debentures	-	(102)	-	(102)	-	(100)	-	(100)
Total interest expense	(724)	(1,516)	199	(2,041)	(1,245)	(1,445)	628	(2,062)
Net interest income	$ (38)	$ 978	$ (331)	$ 609	$ (252)	$ 1,708	$ (566)	$ 890

During 2011, the decrease in interest income was primarily attributable to decreases in yields on loans and investments and changes in the mix of interest earning assets with loan volume down and investment volume up. The decreases in interest income were more than offset by reductions in rates paid on interest bearing liabilities and decreases in time deposit balances.

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. 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 earnings simulation model is used as a quantitative tool to measure the impact of changing interest rates on net interest income. The model quantifies the effects of various interest rate scenarios on projected net interest income over the next 12 months and uses various assumptions regarding the maturity and re-pricing characteristics of interest bearing assets and liabilities, as well as the relative sensitivities of these balance sheet components. The model assumes instantaneous and uniform changes in market interest rates at the earliest re-pricing opportunity. 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.

At December 31, 2011, the simulation model projected that immediate rate increases of 100, 200 and 300 basis points would result in decreases to net interest income of 2.2%, 3.5% and 5.3%, respectively, relative to the base case, over the next 12 months. Conversely, the simulation model projected that an immediate rate decrease of 25 basis points would result in an increase to net interest income of 1.2% relative to the base case, over the next 12 months. The likelihood of a decrease in interest rates beyond 25 basis points as of December 31, 2011, was considered remote given prevailing interest rate levels.

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 react to changes in market rates, expected prepayment rates, the degree to which early withdrawals occur on time deposits 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.

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 management s ongoing analysis of probable losses in the loan portfolio. See Allowance for Loan Losses caption below for further analysis of the provision for loan losses.

The 2011 provision for loan losses was $6.9 million, a substantial increase from the $3.0 million expensed in 2010. The higher provision for loan losses is attributable to increases in net charge-offs during the year as well as deteriorating collateral values on impaired loans. During 2011, one large land development loan became impaired, which resulted in a $2.5 million provision for loan losses; this amount was also charged-off in 2011. The provision for loan losses as a percentage of average outstanding loans was 2.5% and 1.0% in 2011 and 2010, respectively.

Net charge-offs in 2011 were $7.0 million, compared to net charge-offs of $3.1 million reported in 2010. Net charge-offs represented 2.5% and 1.0% of average loans outstanding in 2011 and 2010, respectively. The majority of net loan charge-offs in 2011 were due to losses related to real estate loans, which accounted for 94% of net charge-offs; commercial and industrial loans accounted for 4% of net charge-offs. In 2010, real estate loans accounted for 81% of net charge-offs, and commercial and industrial loans accounted for 13% of net charge-offs.

Noninterest Income

Noninterest income in 2011 was $4.1 million, an increase of $21 thousand, or 0.5%, from 2010.

Service charge income on deposits increased $53 thousand, or 3.7%, in 2011 compared to 2010. Included in service charge income are fees for overdraft and nonsufficient funds collected under the Bank s overdraft privilege program, which increased $74 thousand, or 6.0%, in 2011. However, the Bank experienced reduced service charge income during 2011 of $28 thousand, or 14.2%, as a result of increasing the earnings crediting rate for commercial depositors that offsets their service charges and as a result of consumers moving deposits from fee-based accounts to a non fee-based checking product.

Net gains from sale of loans totaled $897 thousand in 2011, representing a decrease of $89 thousand, or 9.0%, from 2010. Gains from the sale of loans represent income from the origination and sale of residential mortgage loans, which are typically sold in the secondary mortgage market. This mortgage loan income decreased, because the volume of mortgage loan originations declined 12% in 2011 compared to 2010. Competition for mortgage loans is high, and many consumers have already refinanced their loans to take advantage of lower loan rates and to obtain access to available equity in their homes.

During 2011, the Company reported net gains on sales of securities totaling $264 thousand compared to $375 thousand in 2010.

Other noninterest income was $1.4 million in 2011, compared to $1.2 million in 2010, representing an increase of $168 thousand, or 13.6%. This increase is primarily attributable to higher debit and credit card income totaling $298 thousand in addition to income generated from foreclosed real estate properties totaling $92 thousand. Other noninterest income in 2010 included a $224 thousand B&O tax refund.

Noninterest Expense

Noninterest expense decreased from $14.6 million for 2010 to $14.0 million for 2011, representing a decrease of $590 thousand, or 4.1%.

Salaries and employee benefits in 2011 increased 2.2%, or $142 thousand, compared to 2010. Salaries increased $277 thousand primarily due to the addition of four new loan officers as well as small increases in staffing at several branch offices. Full-time employee equivalents (FTEs) climbed from 109 FTEs at the end of 2010 to 114 FTEs at the end of 2011. Payroll taxes, employee benefits and stock compensation costs also increased during the year. However, these increases were partially offset by an increase of $232 thousand in loan origination fee salary credits.

Occupancy and equipment expense was $73 thousand, or 5.8%, higher in 2011 compared to 2010. The increase is attributable to higher property taxes at the Bank s newer facilities and for equipment purchased in addition to higher operating and maintenance costs associated with these facilities and equipment.

Depreciation and amortization expense increased $36 thousand, or 3.1%, during 2011. The increase is primarily related to higher depreciation costs for a Bank branch that was moved from inside a grocery store to a free-standing facility in 2010 and for various new technology-related purchases.

Advertising and promotion expense for 2011 increased $26 thousand, or 9.4%, compared to 2010 as a result of increased donations for community service organizations and higher business development costs associated with hiring four new loan officers.

Net losses on foreclosed real estate and other property owned were $355 thousand in 2011, compared to $1.5 million in 2010. During 2011, the net loss on foreclosed real estate and other property owned included net gains from sales of property of $391 thousand, offset by valuation allowance provisions of $646 thousand on foreclosed real estate and $100 thousand on other property owned. During 2010, the net loss on foreclosed real estate included net gains from sales of property of $162 thousand, offset by valuation allowance provisions of $1.5 million on foreclosed real estate and $200 thousand on other property owned.

FDIC assessments decreased $244 thousand, or 29.6%, in 2011 compared to 2010. This reduction in assessments was the result of the FDIC changing its assessment method from a deposit-based assessment to an asset-based assessment in April 2011, the FDIC s discontinuance of its Transaction Account Guarantee Program premium in January 2011, and the Bank s total assets decreasing $8.3 million during 2011.

Other noninterest expense increased $520 thousand, or 16.2%, in 2011 compared to 2010. Significant year-over-year cost increases in other noninterest expense included: costs related to maintaining or selling foreclosed real estate or for properties securing nonperforming loans, which increased $213 thousand; costs associated with debit and credit card processing, which increased $162 thousand; and fees and costs related to deposit account programs including Reward Checking and Savings accounts and the overdraft privilege program, which increased $122 thousand. These increases in other noninterest expense were partially offset by a decrease of $66 thousand in software licenses and fees.

Income Taxes

For the year ended December 31, 2011, the Company recorded an income tax benefit of $793 thousand compared to income tax expense of $221 thousand in 2010.

The Company s normal, expected statutory income tax rate is 36.2%, 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%. The ratio of tax expense (benefit) to the net income (loss) before tax (referred to as the effective tax rate) differs substantially from statutory tax rates due to permanent differences arising primarily from nontaxable interest income on state and municipal securities and nontaxable increases in the value of bank owned life insurance. The differences between tax expense (benefit) at the statutory rates and actual tax expense (benefit) were as follows for the years ended December 31, 2011 and 2010:

	December 31,	
	2011	2010
	($ in thousands)	
Federal income tax at statutory rate	$ (528)	$ 396
Effect of tax-exempt interest income	(246)	(219)
Effect of nondeductible interest expense	13	16
Effect of other nondeductible expenses	14	13
Effect of state income taxes	(34)	14
Other	(12)	1
Income tax (benefit) expense	$ (793)	$ 221

Preferred Stock Dividends and Discount Accretion

In connection with preferred stock issued to the Treasury under the Capital Purchase Program in February 2009, the Company accrued preferred stock dividends and accreted the related net discount in the amount of $677 thousand during both years ending December 31, 2011 and 2010, respectively.

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Financial Condition

Total assets at December 31, 2011, were $385.7 million, a decrease of $8.8 million, or 2.2%, when compared to total assets of $394.6 million at December 31, 2010. Total earning assets, which are comprised of loans, investment securities, FHLB stock, federal funds sold and other interest bearing deposits, averaged $355.3 million in 2011, compared to $359.7 million in 2010. Earning assets serve as the primary revenue source for the Company.

Securities

In addition to generating revenue, the Bank maintains its investment securities portfolio to manage interest rate risk, provide liquidity, provide collateral for borrowings, and to diversify the credit risk of earning assets. The securities portfolio is classified as available for sale and consists primarily of U.S. government agency securities, municipal securities, corporate debt obligations, and mortgage-backed and other asset-backed securities. The following table sets forth the amortized cost and fair values of the securities portfolio:

	December 31, 2011		December 31, 2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	($ in thousands)			
U.S. government agency securities	$ 6,735	$ 6,802	$ 30,787	$ 30,124
State and municipal securities	23,529	25,054	23,332	22,999
Corporate debt obligations	11,909	11,751	11,060	10,798
SBA guaranteed loan pools	8,756	8,950	3,243	3,378
Mortgage backed securities	4,284	4,397	2,146	2,165
Collateralized mortgage obligations	9,201	9,296	269	266
	$ 64,414	$ 66,250	$ 70,837	$ 69,730

As of December 31, 2011, the Bank had $66.3 million in securities classified as available for sale, which represents a decrease of $3.5 million, or 5.0%, from December 31, 2010. Activity in the securities portfolio during 2011 included $30.5 million in purchases, $27.1 million in called and matured securities, $8.1 million in securities sold, principal paydowns of $1.2 million, and amortization of net purchase price premiums of $523 thousand. As of December 31, 2011, the securities portfolio included a net unrealized gain of $1.8 million, representing an improvement of $2.9 million from December 31, 2010. All of the Bank s securities as of December 31, 2011, are obligations of either U.S. government agencies or government-sponsored enterprises or state or municipal governments, except for the Bank s corporate debt obligations valued at $11.8 million. At December 31, 2011, there were no securities issued by a single issuer (other than U.S. government or government-sponsored enterprise securities) that had an aggregate book value in excess of 10% of our shareholders equity.

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The following table sets forth the distribution of contractual maturities, excluding periodic principal payments, and the weighted average yields of available for sale securities, based on amortized cost, at December 31, 2011. Actual maturities will differ from contractual maturities, because issuers may have the right to call or prepay obligations. Weighted average yields are not presented on a tax equivalent basis.

	Within one year		After one but within five years		After five but within ten years		After ten years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
					($ in thousands)					
U.S. government agency securities	$ -	0.00%	$ 1,000	1.80%	$ 3,229	3.65%	$ 2,506	4.35%	$ 6,735	3.64%
State and municipal securities	556	3.64%	5,340	3.31%	9,927	3.79%	7,706	4.79%	23,529	4.01%
Corporate debt obligations	-	0.00%	7,257	3.94%	4,163	4.46%	489	4.64%	11,909	4.15%
SBA guaranteed loan pools	-	0.00%	-	0.00%	-	0.00%	8,756	3.50%	8,756	3.50%
Mortgage backed securities	-	0.00%	-	0.00%	1,052	2.25%	3,232	3.33%	4,284	3.06%
Collateralized mortgage obligations	-	0.00%	-	0.00%	-	0.00%	9,201	2.00%	9,201	2.00%
	$ 556	3.64%	$ 13,597	3.53%	$ 18,371	3.83%	$ 31,890	3.45%	$ 64,414	3.58%

Loans

At December 31, 2011, the Bank reported $265.8 million in gross loans receivable, a decrease of $16.1 million, or 5.7%, compared to December 31, 2010. This decrease is a result of transfers to foreclosed real estate totaling $2.8 million, charge-offs totaling $7.0 million, and net loan attrition of $6.3 million. The Bank experienced weak loan demand in 2010 and 2011 despite efforts to pursue lending relationships with creditworthy customers in our market place. Loan demand has been adversely influenced by economic forces that have disrupted local and national economies. Specifically, real estate and related activities have slowed significantly, local unemployment rates remain very high, and real estate and other asset prices have declined appreciably.

The following table presents the composition of the loan portfolio for the periods indicated:

	December 31,									
	2011		2010		2009		2008		2007	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
					($ in thousands)					
Real estate:										
Commercial	$ 142,465	53.6%	$ 150,373	53.4%	$ 149,970	46.6%	$ 159,839	47.0%	$ 115,733	41.6%
Construction and land development	31,381	11.8%	40,145	14.2%	72,076	22.4%	72,815	21.4%	66,158	23.8%
Residential	32,180	12.1%	35,061	12.4%	33,227	10.3%	29,853	8.8%	27,673	9.9%
Commercial and industrial	53,224	20.0%	47,345	16.8%	55,917	17.4%	65,590	19.3%	58,601	21.1%
Consumer	6,553	2.5%	9,026	3.2%	10,688	3.3%	11,891	3.5%	9,903	3.6%
Total gross loans	265,803	100.0%	281,950	100.0%	321,878	100.0%	339,988	100.0%	278,068	100.0%
Allowance for loan losses	(6,816)		(6,918)		(7,082)		(4,737)		(2,711)	
Net deferred loan fees	(401)		(616)		(643)		(946)		(644)	
Total loans, net	$ 258,586		$ 274,416		$ 314,153		$ 334,305		$ 274,713	

Loan Origination/Risk Management. The Bank has lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, nonperforming loans and other potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions. See the notes to consolidated financial statements included in Item 8 of this Form 10-K for further details of the Bank s policies and procedures related to loan origination and risk management.

Real Estate Loans. Real estate loans are generally collateralized by real property located within the Bank s market area and are made primarily for the purpose of purchasing, refinancing and constructing 1-4 family,

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multifamily and commercial properties, and for the acquisition and development of land for the purpose of providing residential and commercial lots for sale. Real estate loans also include home equity lines of credit. Because a significant portion of real estate loans are secured by properties located in Spokane County, Washington and Kootenai County, Idaho, declines in these local economies and in real estate values have had a significant effect on the collectability of our real estate loans and on the level of allowance for loan losses determined to be necessary.

Total real estate loans decreased $19.6 million, or 8.7%, during 2011 and comprise 77.5% of the loan portfolio. Included in real estate loans are construction and land development loans, which decreased $8.8 million (21.8%), commercial real estate loans, which decreased $7.9 million (5.3%), and residential real estate loans, which decreased $2.9 million (8.2%). In response to the continuing weak economy, the Bank has implemented more stringent lending practices and is limiting new loans for land development, speculative construction and non-owner occupied commercial real estate. The Bank s primary focus for the commercial real estate portfolio has been growth in loans secured by owner occupied properties. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Consequently, these loans must undergo a similar analysis and underwriting process as that of a commercial and industrial loan, in addition to a real estate analysis.

The Bank also originates long-term conventional residential real estate loans which typically conform to secondary market requirements and are originated with a commitment from a correspondent financial institution to purchase the loan within 30 days of closing. Such loans are classified as loans held for sale in the Company s consolidated financial statements. At December 31, 2011 and 2010, loans held for sale totaled $2.7 million and $2.4 million, respectively.

Commercial and Industrial Loans. The commercial and industrial loan segment comprised 20.0% of the loan portfolio at December 31, 2011, representing an increase of $5.9 million, or 12.4%, during the year. Commercial and industrial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. The Bank also makes term commercial loans secured by real estate, which are categorized as real estate loans. Lending decisions are based on an evaluation of the financial strength, management and credit history of the borrower, and the quality of the collateral securing the loan. The Bank normally requires personal guarantees and secondary sources of repayment. Commercial loans are a major focus of the Bank s lending activities as they have lower historical net charge-off ratios and generally provide greater yields and re-price more frequently than other types of loans.

Consumer. The consumer loan segment accounted for 2.5% of the loan portfolio at December 31, 2011, representing a decrease of $2.5 million, or 27.4%, during the year. Consumer loans include automobile loans, boat and other recreational vehicle financing, and miscellaneous secured and unsecured personal loans and lines of credit. Consumer loans generally carry greater risk than other loans, because the collateral often consists of rapidly depreciating assets such as automobiles and equipment. Repossessed collateral securing a defaulted loan may not provide an adequate source of repayment of the loan. Consumer delinquencies are sensitive to job loss, illness and other personal factors. The Bank attempts to manage the risks inherent in consumer lending by following established credit guidelines and underwriting practices designed to minimize risk of loss.

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Maturities and Sensitivities of Loans to Changes in Interest Rates. The table below presents the maturity distribution and interest rate structure for loans outstanding as of December 31, 2011. The dollar amounts of loans maturing are based on their contractual terms to maturity and do not include scheduled payments or potential prepayments.

	Within one year	One to five years	Over five years	Total
By loan type:		*($ in thousands)*		
Commercial real estate	$ 15,851	$ 49,179	$ 77,435	$ 142,465
Construction and land development	25,697	3,106	2,578	31,381
Residential real estate	5,761	11,275	15,144	32,180
Commercial and industrial	27,928	16,141	9,155	53,224
Consumer	1,986	1,515	3,052	6,553
	$ 77,223	$ 81,216	$ 107,364	$ 265,803
By interest rate structure:				
Fixed rate loans	$ 28,877	$ 57,596	$ 11,156	$ 97,629
Variable rate loans	48,346	23,620	96,208	168,174
	$ 77,223	$ 81,216	$ 107,364	$ 265,803

Nonperforming Assets. Nonperforming assets include nonaccrual loans, loans that are 90 or more days past due, and foreclosed real estate. The following table shows a summary of nonperforming assets:

			December 31,		
	2011	2010	2009	2008	2007
			($ in thousands)		
Nonaccrual loans:					
Commercial real estate	$ 3,870	$ 8,661	$ 3,191	$ 2,570	$ -
Construction and land development	3,953	2,613	7,845	10,493	542
Residential real estate	1,758	1,362	190	876	-
Commercial and industrial	50	21	434	2,048	-
Consumer	43	56	16	43	5
Loans past due 90 days or more and accruing interest	-	-	-	1,081	-
Total nonperforming loans	9,674	12,713	11,676	17,111	547
Foreclosed real estate	4,459	3,963	3,672	1,702	6
Total nonperforming assets	$ 14,133	$ 16,676	$ 15,348	$ 18,813	$ 553
Ratio of nonperforming assets to:					
Total loans and foreclosed assets	5.2%	5.8%	4.7%	5.5%	0.2%
Total assets	3.7%	4.2%	3.9%	4.7%	0.2%

At December 31, 2011, nonperforming assets were $14.1 million, representing a decrease of $2.5 million, or 15.2%, from December 31, 2010. Nonperforming assets as a percentage of total assets were 3.7% and 4.2% at December 31, 2011 and 2010, respectively. In general, the level of nonperforming assets in recent years is reflective of the weaker economic conditions, which began in the latter part of 2008.

Loans are generally placed on nonaccrual status when payment in full of principal and interest is not reasonably expected, or when principal or interest due on the loan is 90 days or more past due. A rare exception to the 90-day nonaccrual policy may be allowed if the loan is both well secured and in the process of collection. When loans are placed on nonaccrual status, future interest accruals are discontinued and all unpaid

accrued interest is reversed against interest income. Loans may be returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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At December 31, 2011, the Bank had eighteen nonaccrual loans totaling $9.7 million compared to thirty-one nonaccrual loans totaling $12.7 million at December 31, 2010, representing a decrease of $3.0 million, or 23.9%. This decrease was mainly comprised of $4.8 million in commercial real estate loans and was partially offset by an increase of $1.3 million in construction and land development loans and an increase of $396 thousand in residential real estate loans.

All of the Bank s nonaccrual loans are in the process of collection or under some form of a negotiated agreement for repayment of the debt and are supported by liens on collateral that mitigates the risk of loss. Whenever management determines that a collateral position is weak or insufficient to reasonably protect the Bank from loss, the loan balance is written down with a partial charge-off to a level where collateral protection is deemed adequate. If the customer has identifiable sources of repayment and is working on a repayment plan, a partial charge-off may be deferred and the amount of the exposure set aside in a specific reserve. If nonaccrual loans had performed in accordance with their original contract terms, additional interest income of $413 thousand in 2011 and $571 thousand in 2010 would have been recognized.

Twelve of the nonaccrual loans totaling $7.7 million, or 79% of total nonaccrual loans, are under a formal workout, forbearance agreement or approved bankruptcy plan. All of these loans include negotiated repayment schedules which are current at this time. As these borrowers perform under the terms of their agreement for a period of at least six months, and if they can establish a reliable source of future repayment, they will be considered for return to accrual. In several cases, the repayment plan includes the liquidation of all or a portion of the collateral supporting the loan. In such cases, the loan has also been written down to a balance that management believes can be supported by the collateral value. The other six nonaccrual loans totaling $2.0 million are either in the process of foreclosure or expected to soon be in the process of foreclosure.

Foreclosed real estate represents real property acquired as the result of borrower defaults on loans and is recorded at estimated fair value, less estimated selling costs, at the time of foreclosure. Write-downs occurring at foreclosure are charged against the allowance for loan losses. Foreclosed properties are appraised as deemed necessary due to market fluctuations or as required by applicable regulations. Write-downs for declines in value subsequent to foreclosure are included in other noninterest expense along with other expenses related to maintaining the properties. Foreclosed real estate totaled $4.5 million at December 31, 2011, representing an increase of $496 thousand, or 12.5%, from the amount reported at December 31, 2010. The largest foreclosed real estate property balances consist of a motel, business park, developed residential lots and undeveloped land located in Clark, Kootenai, Spokane and Shoshone counties. The remaining foreclosed real estate properties consist of eight residential lots all in the Bank s primary market area. Most of the properties are listed for sale under a marketing plan intended to liquidate properties in a responsible and timely manner.

Impaired Loans. At December 31, 2011 and 2010, the Bank had $30.4 million and $37.2 million in impaired loans having valuation allowances of $2.6 million and $4.2 million, respectively. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan. Impaired loans are generally measured based upon the present value of future cash flows discounted at the historical effective interest rate, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral.

Restructured Loans. Restructured loans, also known as troubled debt restructurings, are those for which, due to a borrower s financial difficulties, the Bank grants a concession in loan terms or conditions that it would not otherwise consider or that would not otherwise be available to the borrower. Restructured loans are included in impaired loans until such time as the restructured loan bears a market rate of interest and

performs according to the new terms for an acceptable duration, typically one year or longer depending on the circumstances specific to each loan. Restructured loans performing in accordance with their new terms are not included in nonaccrual loans unless there is uncertainty as to the ultimate collection of principal or interest. The following table presents a summary of restructured loans:

	December 31, 2011			December 31, 2010		
	Accruing Restructured Loans	Restructured Loans Included in Nonaccrual Loans	Total	Accruing Restructured Loans	Restructured Loans Included in Nonaccrual Loans	Total
Real estate:			($ in thousands)			
Commercial	$ 9,684	$ 1,939	$ 11,623	$ -	$ 3,972	$ 3,972
Construction and land development	-	2,957	2,957	-	-	-
Residential	-	815	815	-	705	705
Commercial and industrial	535	-	535	397	-	397
	$ 10,219	$ 5,711	$ 15,930	$ 397	$ 4,677	$ 5,074

Restructured loans increased substantially from $5.1 million at December 31, 2010, to $15.9 million at December 31, 2011. Many of these agreements grant a period of interest-only payments without imposing other significant consequences. The intention of the workout agreement is always to improve or protect the Bank s opportunity for successful liquidation of the asset. As of December 31, 2011, ten of the thirteen restructured loans, with an aggregate value of $12.2 million, were current according to the restructured loan terms. Two of the three restructured loans that were not current as of December 31, 2011, were in active negotiations that were satisfactorily concluded in January 2012. Both of these loans are now, subsequent to year end, considered to be current under the terms of their respective agreements. Only one loan for $300 thousand remains in default and management has initiated appropriate legal action. Any failure of a borrower with a restructured loan to make timely payments according to the terms of their agreement is subject to aggressive collection efforts or legal action and will be placed on nonaccrual if future payment is deemed to be in jeopardy.

Included in total restructured loans are A/B notes totaling $2.1 million and $1.6 million as of December 31, 2011 and 2010, respectively. In A/B note restructurings, the original note is split into two notes where the A note represents the portion of the original loan which allows for an acceptable loan-to-value and debt service coverage and is expected to be collected in full. The B note is fully charged off and represents the portion of the original loan where there is a shortfall in collateral support. The A/B note balances as of December 31, 2011 and 2010, are comprised of A note balances only.

Potential Problem Loans. Management has identified potential problem loans totaling $30.3 million as of December 31, 2011, compared to $30.8 million as of December 31, 2010. These loans have been internally classified as special mention or substandard, yet are not currently impaired or on nonaccrual status. Management has identified potential credit problems with these loans, which, in the future, may result in a borrower s noncompliance with current loan repayment terms. Management believes the allowance for loan losses is adequate to cover probable credit losses in the loan portfolio.

Allowance for Loan Losses

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense. The allowance for loan losses represents management s best estimate of probable losses within the existing portfolio of loans. The allowance is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Bank s methodology for establishing the allowance for loan losses is based upon guidance from ASC Topic 310, *Receivables*, and ASC Topic 450, *Contingencies*. Accordingly, the methodology is based on historical loss experience, internal risk grade, specific homogeneous risk pools and

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specific loss allocations, with adjustments for current events and conditions. The Bank s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects not only the necessary increases in the allowance for loan losses related to newly identified classified loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools. See the notes to consolidated financial statements included in Item 8 on this Form 10-K for additional details about the Bank s methodology for estimating the appropriate level of the allowance for loan losses.

As of December 31, 2011, the allowance for loan losses was $6.8 million, a decrease of $102 thousand, or 1.5%, from December 31, 2010. The allowance for loan losses decreased slightly, because net charge-offs exceeded the provision for loan losses during 2011. The provision was lower than net charge-offs primarily due to a $16.1 million, or 5.7%, reduction in gross loans outstanding. While the allowance for loan losses decreased in 2011, the allowance as a percentage of gross loans outstanding increased slightly from 2.5% at December 31, 2010, to 2.6% at December 31, 2011.

The following table provides a summary of activity in the allowance for loan losses and an analysis of losses by loan type during each of the last five years:

	2011	2010	2009	2008	2007
			($ in thousands)		
Balance of allowance for loan losses, beginning of year	$ 6,918	$ 7,082	$ 4,737	$ 2,711	$ 2,586
Loan charge-offs:					
Real estate	(6,609)	(2,616)	(3,061)	(1,465)	(125)
Commercial and industrial	(315)	(433)	(2,038)	(361)	(34)
Consumer	(97)	(174)	(86)	(131)	(90)
Total charge-offs	(7,021)	(3,223)	(5,185)	(1,957)	(249)
Recoveries of previous loan losses:					
Real estate	26	65	13	21	17
Commercial and industrial	15	27	165	-	3
Consumer	4	17	5	7	2
Total recoveries	45	109	183	28	22
Net charge-offs	(6,976)	(3,114)	(5,002)	(1,929)	(227)
Provision for loan losses	6,874	2,950	7,347	3,955	352
Balance of allowance for loan losses, end of year	$ 6,816	$ 6,918	$ 7,082	$ 4,737	$ 2,711
Ratios at end of year:					
Net charge-offs to average gross loans	2.51%	1.01%	1.49%	0.61%	0.09%
Allowance for loan losses to gross loans	2.56%	2.45%	2.20%	1.39%	0.97%
Allowance for loan losses to nonperforming loans	70.46%	54.42%	60.65%	27.68%	495.61%

A majority of loan charge-offs in 2011 and 2010 were from real estate secured loans and commercial and industrial loans and are primarily attributable to the depressed real estate market and general economy. Charge-offs of real estate loans are detailed as follows for the years ended December 31:

	2011	2010
	($ in thousands)	
Commercial real estate	$ 2,546	$ 375
Construction and land development	3,282	1,652
Residential real estate	781	589

	$ 6,609	$ 2,616

One large real estate secured land development loan became impaired in 2011, and the Bank charged off $2.5 million of the loan balance. This charge-off accounted for 76.8% of total construction and land development loan

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charge-offs in 2011. The remaining real estate loan charge-offs of $4.1 million were related to twenty-five different borrowers. Total real estate loan charge-offs of $2.6 million in 2010 were related to twenty-six different borrowers.

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

	2011		2010		2009		2008		2007	
	Amount	Percent of Loans	Amount	Percent of Loans	Amount	Percent of Loans	Amount	Percent of Loans	Amount	Percent of Loans
Real estate:					*($ in thousands)*					
Commercial	$ 3,135	53.6%	$ 2,779	53.4%	$ 1,269	46.6%	$ 1,437	46.6%	$ 955	46.6%
Construction and land development	1,304	11.8%	1,341	14.2%	1,761	22.4%	1,293	22.4%	380	22.4%