

BANNER CORP
Form 10-K
February 29, 2016

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

FORM 10-K

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

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

Commission File Number 0-26584

BANNER CORPORATION

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of
incorporation
or organization)

91-1691604

(I.R.S. Employer

Identification Number)

10 South First Avenue, Walla Walla, Washington 99362

(Address of principal executive offices and zip code)

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

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

Common Stock, par value \$.01 per share

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

(Title of Each Class)

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

None.

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

Yes No

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

Act Yes No

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

X No

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

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

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

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

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

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

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

Common Stock – \$979,733,679

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

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

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

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

Documents Incorporated by Reference

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

BANNER CORPORATION AND SUBSIDIARIES

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Forward-Looking Statements

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

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

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

PART 1

Item 1 – Business

General

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recent Developments and Significant Events

Acquisition of AmericanWest Bank

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

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

Acquisition of Siuslaw Financial Group, Inc.

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

Acquisition of Six Sterling Savings Bank Branches

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

Lending Activities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our commercial business loans may be structured as term loans or as lines of credit. Commercial business term loans are generally made to finance the purchase of fixed assets and have maturities of five years or less. Commercial business lines of credit are typically made for the purpose of providing working capital and are usually approved with a term of one year. Adjustable- or floating-rate loans are primarily tied to various prime rate or LIBOR indices. At