INTERMOUNTAIN COMMUNITY BANCORP
Form 10-K
March 08, 2013
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K
(Mark One)

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the year ended December 31, 2012

OR

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

COMMISSION FILE NUMBER 000-50667
INTERMOUNTAIN COMMUNITY BANCORP
(Exact name of registrant as specified in its charter)

Idaho	82-0499463
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

414 Church Street, Sandpoint, ID 83864
(Address of principal executive offices) (Zip code)
Registrant's telephone number, including area code:
(208) 263-0505
Securities registered pursuant to Section 12(b) of the Act:

None	None
(Title of each class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:
Common Stock (no par value)
(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 o No þ

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 o No þ

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 þ No o

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation 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. þ

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

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Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company þ
(Do not check if a smaller reporting company)

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

As of June 30, 2012, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported on the OTC Bulletin Board, was $41,849,548.

As of March 4, 2013, the number of shares outstanding of the registrant's Voting Common Stock, no par value per share, was 2,603,606 and the number of shares outstanding of Non Voting Common Stock, no par value, was 3,839,688.

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PART I — Financial Information

Forward-Looking Statements

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about our plans, objectives, expectations and intentions that are not historical facts, such as the statements in this report regarding expected or projected growth, asset quality and losses, other income and operating expenses, and other statements identified by words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “will likely," “should,” “projects,” “seeks,” “estimates” similar meaning. These forward-looking statements are based on current beliefs and expectations of management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. In addition to the factors set forth in the sections titled “Risk Factors,” “Business” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, as applicable, in this report, the following factors, among others, could cause actual results to differ materially from the anticipated results:

- deterioration in economic conditions that could result in increased loan and lease losses;
- inflation and interest rate levels, and market and monetary fluctuations;
- changes in market interest rates and spreads, which could adversely affect our net interest income and profitability;
- trade, monetary and fiscal policies and laws, including interest rate and income tax policies of the federal government;
- growth and acquisition strategies;
- applicable laws and regulations and legislative or regulatory changes, including the ultimate financial and operational burden of financial regulatory reform legislation and related regulations and the restrictions imposed on participants in the Troubled Asset Relief Program (“TARP”) Capital Purchase Program, including the impact of executive compensation restrictions, which may affect our ability to retain and recruit executives in competition with other firms who do not operate under those restrictions;
- our ability to attract new deposits and loans and leases;
- competitive market pricing factors;
- our ability to comply with informal regulatory actions issued to us;
- the effects of any further adverse regulatory action;
- our ability to raise capital or incur debt on reasonable terms;
- the risks associated with lending and potential adverse changes in credit quality;
- risks associated with concentrations in real estate-related loans;
- declines in real estate values supporting loan collateral;
- increased loan delinquency rates;
- the timely development and acceptance of our new products and services;
- the willingness of customers to substitute competitors’ products and services for our products and services;
- technological and management changes;
- our ability to recruit and retain key management and staff;
- changes in estimates and assumptions used in financial accounting;
- our critical accounting policies and the implementation of such policies;
- potential interruption or breach in security of our systems;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- changes in consumer spending, saving and borrowing habits;

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- the strength of the United States economy in general and the strength of the local economies in which Intermountain conducts its operations;
- stability of funding sources and continued availability of borrowings;
- our success in gaining regulatory approvals, when required;
- results of regulatory examinations that could restrict growth; and
- our success at managing the risks involved in the foregoing.

Please take into account that forward-looking statements speak only as of the date of this report. We do not undertake any obligation to publicly correct or update any forward-looking statement whether as a result of new information, future events or otherwise.

Item 1. BUSINESS

General

Overview & History

Intermountain Community Bancorp ("Intermountain" or the "Company") is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was formed as Panhandle Bancorp in October 1997 under the laws of the State of Idaho in connection with a holding company reorganization of Panhandle State Bank (the "Bank") that was approved by the shareholders on November 19, 1997 and became effective on January 27, 1998. In June 2000, Panhandle Bancorp changed its name to Intermountain Community Bancorp.

Panhandle State Bank, a wholly owned subsidiary of the Company, was first opened in 1981 to serve the local banking needs of Bonner County, Idaho. Panhandle State Bank is regulated by the Idaho Department of Finance, the State of Washington Department of Financial Institutions, the Oregon Division of Finance and Corporate Securities and by the Federal Deposit Insurance Corporation ("FDIC"), its primary federal regulator and the insurer of its deposits. Since opening in 1981, the Bank has continued to grow by opening additional branch offices throughout Idaho and has also expanded into the states of Oregon and Washington. During 1999, the Bank opened its first branch under the name of Intermountain Community Bank, a division of Panhandle State Bank, in Payette, Idaho. Over the next several years, the Bank continued to open branches under both the Intermountain Community Bank and Panhandle State Bank names. In January 2003, the Bank acquired a branch office from Household Bank F.S.B. located in Ontario, Oregon, which is now operating under the Intermountain Community Bank name. In 2004, Intermountain acquired Snake River Bancorp, Inc. ("Snake River") and its subsidiary bank, Magic Valley Bank, and the Bank now operates three branches under the Magic Valley Bank name in south central Idaho. In 2005 and 2006, the Company continued to open branches in Idaho and eastern Washington.

In 2006, Intermountain also opened a Trust & Wealth Management division, and purchased a small investment company, Premier Alliance, which now operates under the name, Intermountain Community Investments. The acquisition and development of these services improves the Company's ability to provide a full-range of financial services to its targeted customers.

Intermountain offers banking and financial services that fit the needs of the communities it serves. Lending activities include consumer, commercial, commercial real estate, residential construction, mortgage and agricultural loans. A full range of deposit services are available including checking, savings and money market accounts as well as various types of certificates of deposit. Trust and wealth management services, investment and insurance services, and business cash management solutions round out the Company's product offerings.

The Company's equity investments include Panhandle State Bank, as previously noted, and Intermountain Statutory Trust I and Intermountain Statutory Trust II, financing subsidiaries formed in January 2003 and March 2004, respectively. Each Trust has issued $8 million in preferred securities, the purchasers of which are entitled to receive cumulative cash dividends from the Trusts. The Company has issued junior subordinated debentures to the Trusts, and payments from these debentures are used to make the cash dividends to the holders of the Trusts' preferred securities.

In 2012, the Company successfully completed two capital raises for a net addition of $50.3 million, and completed a 10-for-1 reverse stock split. In early 2013, the Company's voting common stock moved from the "Over the Counter" exchange to the NASDAQ Capital Markets Exchange.

Business Strategy & Opportunities

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Intermountain seeks to differentiate itself by attracting, retaining and motivating highly experienced employees who are local market leaders, and supporting them with advanced technology, training and compensation systems. This approach allows the Bank to provide local marketing and decision-making to respond quickly to customer opportunities and build leadership in its communities. Simultaneously, the Bank has focused on standardizing and centralizing administrative and operational functions to improve risk management, efficiency and the ability of the branches to serve customers effectively.

Intermountain has resolved many of the challenges created by the financial crisis and subsequent economic downturn of 2008-2011, and is now positioning itself to succeed in the economy and markets of the future. Its strengths provide the foundation for future growth and profitability, and lower risk exposure, and include the following:

- A strong, loyal and low-cost deposit franchise with proven growth capabilities: 76% of Intermountain's deposits at December 31, 2012 are in low-cost transaction accounts, resulting in a cost of funds that has consistently been below its peer group. Intermountain has maintained this low-cost deposit focus while growing since 1999 from the 8th ranked bank by deposit market share to the 3rd in the core markets it serves (Source: FDIC Deposit Market Share and Federal Financial Institutions Examination Council ("FFIEC") Uniform Bank Performance Report ("UBPR") data).
- A sophisticated, and increasingly effective, risk management system and overall much lower risk exposure: Tempered by its experiences during the current downturn, Intermountain has developed a refined credit loss forecasting system, an integrated approach to credit, liquidity, capital and other risk factors, and a well-seasoned credit administration function. Its current non-performing asset (NPA) to total asset ratio ranks below many of its peers, and solvency and liquidity risk exposure is relatively low, especially given the addition of $50 million in new common equity raised in 2012.
- An operational and compliance infrastructure built for future profitable growth: During the past several years, Intermountain has focused on upgrading talent, technology and operational processes to facilitate further balance sheet growth while simultaneously reducing the expenses associated with these upgrades. Operating expenses are down significantly from prior years and should continue to decrease as additional initiatives are implemented.
- A young, but highly experienced, management team: The executive and senior management team averages under 50 years old, but still generally exceeds 20 years in banking experience, most of which has been in the Company's defined core and growth markets.

Management believes that the economic and financial crises of the past several years have fundamentally changed the future landscape for community banks. In a slower growth, more conservative environment, further consolidation of the industry is inevitable. Those banks and management teams with strong market positions, solid infrastructure, and staying power will be able to capitalize on growth opportunities created by this changing environment, including potential acquisitions. Management has defined potential opportunities in terms of prospects within the Company's core markets of north, southwest rural, and south central Idaho, and within its growth markets of Spokane, Boise, and contiguous eastern Washington and northern Idaho counties. While the Company cannot guarantee that it will pursue, or be successful in pursuing opportunities in this new environment, it believes it is increasingly well-positioned to succeed in the changing landscape.

Lending conditions are improving but still challenging, with moderate borrowing demand, keen competition for quality borrowers, historically low rates, and challenging appraisal conditions. Management is responding by diversifying its current portfolio and positioning for prudent growth opportunities. It believes these prospects will include pursuing attractive commercial credits in its markets, originating commercial real estate loans to strong borrowers at lower real estate prices, expanding and diversifying its agricultural portfolio, and expanding its already strong government-guaranteed loan marketing efforts. Compressed loan rates are likely to continue until either market rates increase or some market consolidation occurs. These conditions will be difficult for all financial institutions. However, management believes it is better positioned than many of its peers, given its low-cost of funds, strong market position and high levels of capital and liquidity.

We believe local deposit growth and pricing will continue to be a cornerstone of the Company's success. As demonstrated by its past successes, the growth of low-cost core deposits has always been a focus. Management will continue this core focus, while pursuing opportunities to gain additional market share from larger banks and smaller, more stressed competitors in its defined core and growth markets. In the current constrained environment, management has taken strong steps to reduce its current deposit and borrowing rates, which will continue to produce lower interest expense in future periods. There is some additional opportunity to decrease the Company's cost of funds and interest expense by continuing to reprice down maturing CDs, and paying off or replacing higher rate wholesale funding vehicles.

Management continues to undertake significant efforts to improve its efficiency, with successful results demonstrated in its financial statements again in 2012. Management believes that it can continue to lower operating expenses in 2013 while maintaining the infrastructure that has been built for future Company expansion.

Non-interest revenue growth will remain challenged by new regulatory restrictions. However, management continues to take steps to expand and diversify its revenue sources. These include expanding its trust and investment service opportunities to

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both new and existing customers, increasing debit and credit card accounts and usage, and restructuring and enhancing its deposit and cash management service fees.

In addition to the above, management believes that disruption and consolidation in the market may lead to other opportunities as well. Subject to regulatory and capital constraints, we believe that attractive acquisition opportunities within our footprint will soon appear and that Intermountain could be in a unique position to capitalize on them. Intermountain is one of the largest publicly traded bank holding companies headquartered in Idaho, with branches located throughout the state and has strong capital and liquidity positions, which may help facilitate future transactions. Even if these opportunities are not available, large disruptions create potential opportunities to attract strong new employees and customers.

Primary Market Area

The Company conducts its primary banking business through its bank subsidiary, Panhandle State Bank. The Bank maintains its main office in Sandpoint, Idaho and has 18 other branches. In addition to the main office, seven branch offices operate under the name of Panhandle State Bank. Eight branches are operated under the name Intermountain Community Bank, a division of Panhandle State Bank, and three branches operate under the name Magic Valley Bank, a division of Panhandle State Bank. Sixteen of the Company's branches are located in northern, southwestern and south central Idaho, two branches are located in Spokane, Washington, and one branch is located in eastern Oregon. The Company focuses its banking and other services on individuals, professionals, and small to medium-sized businesses throughout its market area.

After several challenging years, the Idaho economy continued to recover in 2012. The percentage increase in population in the state was the 4th fastest of any state over the period from 2000 to 2010, increasing by 21 percent during this time period. Although growth slowed in the 2010-2012 period, the 1.8% estimated growth rate still exceeded the national average for this time period. Population growth slowed in 2009 through 2011, with total 2011 growth estimated at 0.9% (Source: US Census Bureau). Based on U.S. Census Bureau estimates, the State is projected to sustain future population growth rates in excess of the national average for the next 10 years. Idaho experienced rapid employment growth during the period of 2000 to 2008 (14% versus U.S. 8%), sustained net job losses in 2009, and rebounded in the period from 2010 to 2012 (Source: Idaho Department of Labor). The unemployment rate at the end of 2012 was 6.6% down from 8.4% at the end of the prior year and below the national average of 7.8%. The Idaho Department of Labor forecasts employment rising between 14% and 16% between now and 2018. These prospects are based on a diverse economic base, including agriculture, health care, technology, light manufacturing, retirement, tourism, education and professional services segments, a low-cost of living and doing business, favorable state government policies, and a strong quality of life. The Oregon, Washington and California governments have all recently enacted unfriendly business policies, which should increase the attractiveness of doing business in Idaho. While Idaho has faced difficult state budget issues as well, the conservative legislature has balanced the budget without increasing taxes or creating new burdensome business regulations, and experienced an increase in tax revenues in both 2011 and 2012.

During the downturn, real estate valuations throughout the state demonstrated considerable variability, based on specific geographical location and type of property. During the period 2009-2011, Idaho experienced higher than average foreclosure rates and large declines in both residential and commercial real estate values. Conditions stabilized throughout the Company's market area in 2012, and residential and commercial real estate values are anticipated to increase moderately in 2013.

The Bank's primary service area covers four distinct geographical regions. The north Idaho and eastern Washington region encompasses the four northernmost counties in Idaho, including Boundary County, Bonner County, Shoshone County and Kootenai County and Spokane County in eastern Washington. Bonner and Boundary Counties are heavily forested and contain numerous lakes. As such, the economies of these counties are primarily based on tourism, real estate development and natural resources, including logging, mining and agriculture. Bonner County has also experienced expansion in the areas of light industrial, commercial, retirement and retail development over the past ten years, and management believes both counties are likely to continue benefiting from Canadian spending and investment as the dollar has weakened against the Canadian currency. Shoshone County continues to experience expansion in the areas of residential and tourism development relating to the outdoor recreation industry in the area and has seen a resurgence in mining activity as mineral prices have rebounded. Kootenai County is more diverse than the other northern Idaho counties, with light industrial, high-tech, commercial, retail, medical, tourism and real estate development all contributing to the economic base. It, along with Spokane County in Washington, should also benefit from additional Canadian investment.

In general, the northern Idaho and eastern Washington economy lagged the rest of the country and state in terms of feeling the impacts of the recession. In 2010 and 2011, however, the recession caught up with the area. Unemployment rates exceeded 10% in both 2010 and 2011, but have improved markedly in 2012 to a region average of 8.1%. Diversification, strengthening mining prices, favorable business cost structures, continuing tourism activity and Canadian investment are all projected to have a continued positive impact on these local economies. Although Spokane weathered the jobs downturn a little better, it has not rebounded as quickly, with an unemployment rate of 8.6% in December 2012 (Washington State Employment Security Department Labor Market & Economic Analysis). Strength in health care, agri-business, private education, technology and transportation have offset losses in real estate, government and tourism-related industries. A large Caterpillar operation recently opened in Spokane, and there are several other promising biotechnology, health care and aerospace developments.

Data on real estate activity is limited for much of this region, but it generally appears that residential home prices declined 15% to 35% from their peak during the downturn, while lot prices fell 40% to 60% based on type of home and location. Prices for both homes and lots stabilized in 2012 and are now generally increasing at a moderate pace. Commercial real estate activity and pricing has softened, although there is not a significant overhang of commercial properties in this region. Intermountain holds 57% of its loans and 50% of its deposits in this region.

The second region served by the Bank encompasses two counties in southwestern Idaho (Payette, and Washington) and one county in southeastern Oregon (Malheur). The economies of these counties are primarily based on agriculture and related or supporting businesses. A variety of crops are grown in the area including beans, onions, corn, apples, peaches, cherries and sugar beets. Livestock, including cattle, sheep and pigs, are also raised. Agriculture has been strong over the past several years, cushioning the impact of the national downturn on these counties. Unemployment is historically high in this area, and stood at 8.4% in December 2012, but real estate values have held up much better, given the predominance of agricultural land in the region. Commercial real estate property is relatively limited and has not grown significantly. The Company holds 20% of its loans and 23% of its deposits in this region.

The third region, known as the greater Boise area, is comprised of two counties, Ada and Canyon. The cities of Boise, Nampa and Caldwell were hit hard earlier in the recession because of excessive residential and commercial real estate development, volatility in the area’s high-tech industries, and reductions in other corporate and state and local government activity. The local economy stabilized in 2011 and is now improving, as private sector hiring has picked up, government employment has stopped declining and much of the excess real estate inventory has been absorbed. Unemployment in the Boise Metropolitan Statistical area was 6.2% in December 2012, down from 9.9% in December 2010. After steep declines early in the recession, home prices stabilized in 2011 and increased moderately in 2012. There is still excess supply of commercial real estate, particularly office and retail, which will slow improvement in this sector. 11% of the Company’s loans and 10% of its deposits are in this region.

The fourth region served by the Bank encompasses two counties in south central Idaho (Twin Falls and Gooding), also known as the Magic Valley region. The economies of these counties are primarily based on agriculture and related or supporting businesses. A variety of crops are grown in the area including beans, peas, corn, hay, sugar beets and potatoes. Fish farms, dairies and beef cattle are also contributors to the local economy. The area is also experiencing growth in light manufacturing and retail development, including the opening of a significant new yogurt plant which is expected to add up to 1,000 direct jobs to the region after additional expansion.

Twin Falls’ strong agricultural base, along with its status as the commercial, medical, retail, retirement and services hub for the area has cushioned it somewhat from the impacts of the recession, resulting in a December 2012 unemployment rate of 5.9%. In addition, the region maintains a conservative character with little evidence of significant overbuilding or excess inventory. Residential valuation declines were relatively moderate, in the 5% to 20% range for homes and 20% to 50% range for development land, during the downturn and values are now increasing. The Company has 5% of its loans and 9% of its deposits in the Magic Valley region.

As demonstrated by the loan and deposit totals in each market, Intermountain pursues a long-term strategy of balancing loan and deposit balances in each of its regions. As it enters new markets, it may lead with either a heavier emphasis on loans or deposits depending on specific market opportunities. Over the long-term, however, management believes that both Intermountain and the local markets are well-served by pursuing a balanced strategy and the discipline this requires.

Intermountain has also segmented its market area into core and growth markets to facilitate future planning activities. The Company defines its core market as including the four counties of northern Idaho listed above, Canyon, Payette and Washington Counties in southwestern Idaho, Malheur County in eastern Oregon, and Gooding and Magic Valley Counties in Southwest Idaho. Deposits in this market totaled $6.2 billion, of which Intermountain held $700 million or 11.2% (Source: FDIC Survey of Banking Institutions). The Company’s growth markets consist of Spokane County in Washington, and Ada County in Idaho (where Boise is located), as well as counties contiguous to its existing markets in north Idaho and eastern Washington. Deposits in Ada and Spokane County totaled $12.6 billion at June 30, 2012 and Intermountain held a combined total of $39 million or 0.3% of deposits in these markets. The Company believes that it has significant future opportunities in these growth markets because of an established brand presence, strong market contacts in other banking institutions, and the presence of distressed competitors.

Competition

The Company competes with a number of international banking groups, out-of-state banking companies, state-wide banking organizations, and several local community banks, as well as savings banks, savings and loans, credit unions and other non-bank competitors throughout its market area. Banks and similar financial institutions compete based on a number of factors, including price, customer service, convenience, technology, local market knowledge, operational efficiency, advertising and promotion, and reputation. In competing against other institutions, the Company focuses on delivering highly personalized customer service with an emphasis on local involvement and empowerment. It recruits, retains and motivates seasoned, knowledgeable bankers who have worked in the Company's market areas for extended periods of time and supports them with current technology. Product offerings, pricing and location convenience are generally competitive with other community banks in its market areas. The Company seeks to differentiate itself based on the high skill levels and local knowledge of its staff, combined with sophisticated relationship management and profit systems that pinpoint marketing and service opportunities.

The Company has employed these competitive tools to grow market share over the past twelve years, since it began expanding beyond its Sandpoint, Idaho base. During this time period, the Company has grown from eighth overall in market share in its defined core markets to third, with a consolidated market share of 11.2%. As noted previously, the Spokane and Boise market areas represent potential future growth markets for the Company, as total market deposits in these two counties exceed by a two-to-one margin the total market deposits in the Company's core markets. The Company has a relatively small, but growing presence in Spokane County with strong local market talent. The Company does not have any branches in Ada County, which includes Boise, but has a number of key managers who came from or worked in the Boise area. The Company also sees opportunities in the Idaho and eastern Washington counties contiguous to its current service area, as they contain a number of smaller struggling competitors, and management is familiar with many of the bankers and customers in these markets.

As discussed above, the Company's principal market area is divided into four separate regions based upon population and the presence of banking offices. In northern Idaho/eastern Washington, the primary competitors include US Bank, Wells Fargo, Washington Trust Bank, Sterling Bank, Banner Bank and Bank of America, all large international or regional banks, and Idaho Independent Bank and Mountain West Bank, both community banks.

Primary competitors in the Company's other regions in southwestern and south central Idaho and eastern Oregon include international or regional banks, US Bank, Wells Fargo, Key Bank, Bank of America, Banner Bank and Zions Bank, and community banks, Bank of the Cascades, Idaho Independent Bank, DL Evans Bank, First Federal Savings Bank and Farmers National Bank.

The severe economic downturn and additional regulatory changes are altering Intermountain's competitive landscape. Many non-FDIC insured competitors, including residential mortgage brokers, commercial finance operations, and commercial real estate mortgage brokers have exited the market, while larger regional credit unions have aggressively expanded. Significant consolidation of the banking industry is forecast over the next few years, as smaller community banks face a constrained revenue environment and increasing costs and capital requirements. These events will likely present both opportunities and challenges to Intermountain. Previous sections have highlighted various opportunities that may arise, such as additional growth through attracting strong employees and customers from disaffected institutions, and potential acquisition opportunities. Potential challenges include stronger remaining competitors, additional regulatory constraints, and continuing low interest rates.

Services Provided

Lending Activities

The Bank offers and encourages applications for a variety of secured and unsecured loans to help meet the needs of its communities. While specific credit programs may vary from time to time, based on Bank policies and market conditions, the Bank makes every effort to encourage applications for the following credit services throughout its communities.

Commercial Loans. The Bank offers a wide range of loans and open-end credit arrangements to businesses of small and moderate size, from small sole proprietorships to larger corporate entities, with purposes ranging from working capital and inventory acquisition to equipment purchases and business expansion. The Bank also participates in the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") financing programs. Operating loans or lines of credit typically carry annual maturities. Straight maturity notes are also available, in which the maturities match the anticipated receipt of specifically identified repayment sources. Term loans for purposes such as equipment purchases, expansion, term working capital, and other purposes generally carry terms that match the borrower's cash flow capacity and/or collateral life, typically with maturities of three years or longer. Risk is controlled by applying sound, consistent underwriting guidelines, concentrating on relationship loans as opposed to transaction type loans, and requiring sound alternative repayment sources, such as collateral or strong guarantor support. While underwriting guidelines vary depending on the type of loan, in general businesses are required to maintain a minimum 1.25 debt service coverage ratio (“DSC”). Loan-to-value (“LTV”) guidelines generally range from a low of 40% on illiquid equipment and inventory to a high of 75% of liquidation value on easily convertible accounts receivable, inventory or equipment. Government guaranty programs are also utilized when appropriate.

The Bank also offers loans for agricultural and ranching purposes. These include expansion loans, short-term working capital loans, equipment loans, cattle or livestock loans, and real estate loans on a limited basis. Terms are generally up to one year for operating loans or lines of credit and up to seven years for term loans. As with other business loans, sound underwriting is applied by a staff of lending and credit personnel seasoned in this line of lending. Underwriting guidelines for agricultural credit lines depend on the type of loan and collateral, but generally require a minimum DSC of 1.25, and hard collateral coverage (collateral other than the crops being grown) of greater than 50% of peak borrowing. Term equipment loans generally require a minimum 1.25 DSC and maximum 75% liquidation LTV. Government guaranteed programs are utilized whenever appropriate and available. Agricultural real estate loans are considered for financially sound borrowers with strong financial and management histories. Many of the Company's agricultural customers are third or fourth generation family farmers with strong real estate equity and limited real estate debt.

Real Estate Loans. For consumers, the Bank offers first mortgage loans to purchase or refinance homes, home improvement loans and home equity loans and credit lines. Conforming first mortgage loans are offered with up to 30-year maturities, while typical maturities for second mortgages (home improvement and home equity loans and lines) are as stated below under "Consumer Loans." First mortgage loans are underwritten with the intention to sell the loans on the secondary market, so guidelines generally reflect secondary market standards. Lot acquisition and construction loans are also offered to consumer customers with typical terms up to 36 months (interest only loans are also available) and up to 12 months (with six months' extension), respectively, and are underwritten to both secondary market standards and with a solid take-out mortgage loan approval required.

Loans for purchase, construction, rehabilitation or repurchase of commercial and industrial properties are also available through the Bank. The Bank makes commercial real estate loans for both owner and non-owner occupied properties, but favors owner-occupied loans. Non-owner occupied commercial real estate loans are restricted to projects with high occupancy and low loan-to-value ratios, and/or borrowers with established track records and the ability to fund potential project cash flow shortfalls from other income sources or liquid assets. Project due diligence is conducted by the Bank, to help provide for adequate contingencies, collateral and/or government guaranties. General underwriting requirements are dependent upon the type of property being taken as collateral and the occupancy status. For desirable property types, a minimum DSC of 1.25 and maximum LTV of 75% is required. With current housing market conditions, the Bank has drastically curtailed residential land acquisition, development or builder loans, and has significantly reduced its concentrations of these types of loans.

Consumer Loans. The Bank offers a variety of consumer loans, including personal loans, motor vehicle loans, boat loans, recreational vehicle loans, home improvement loans, home equity loans, open-end credit lines, both secured and unsecured, and overdraft protection credit lines. The Bank's terms and underwriting on these loans are consistent with what is offered by competing community banks and credit unions, which generally require sufficient verified and documented disposable income, solid credit histories, and equity in the collateral. Generally, underwriting guidelines include a maximum debt to income of 40%, credit scores exceeding 700, and maximum LTVs ranging from 80% on home equity loans and lines to 50% to 90% on other types of consumer collateral. Loans for the purchase of new autos typically range up to 60 months. Loans for the purchase of smaller RV's, pleasure crafts and used vehicles range up to 60 months. Loans for the purchase of larger RV's and larger pleasure crafts, mobile homes, and home equity loans range up to 120 months (180 months if credit factors and value warrant). Unsecured loans are usually limited to two years, except for credit lines, which may be open-ended but are reviewed by the Bank periodically. Relationship lending is emphasized, which, along with credit control practices, minimizes risk in this type of lending.

Municipal Financing. Operating and term loans and leases are available to municipal entities, many of which qualify for financing on a tax-exempt basis. Operating loans are generally restricted by law to the duration of one fiscal year. Term loans and leases, which under certain circumstances can extend beyond one year, typically range up to five years. Municipal financing is restricted to loans with sound purposes and with established tax bases or other revenue to adequately support repayment.

Deposit Services

The Bank offers the full range of retail deposit services typically available in most banks, including checking accounts, savings accounts, money market accounts and various types of certificates of deposit. The transaction accounts and certificates of deposit are tailored to the Bank's primary market area at rates competitive with those offered in the area. All deposit accounts are insured by the FDIC to the maximum amount permitted by law. The Bank also offers a number of business-oriented deposit accounts, including various types of FDIC-insured checking, savings, money market and time deposit accounts, and non-FDIC insured alternatives including reverse repurchase agreements and sweep accounts. Its deposit product offerings are generally competitive with both large and small direct competitors and provide opportunities for fee income generation through direct service charges, transaction fee income, and fees associated with related services (see “Other Services” below).

Investment Services

The Bank provides non-FDIC insured investment services through its Trust and Intermountain Community Investments divisions. Products offered to its customers include annuities, equity and fixed income securities, mutual funds, insurance products and brokerage services. The Bank offers these products in a manner consistent with the principles of prudent and safe banking and in compliance with applicable laws, rules, regulations and regulatory guidelines. The Bank earns fees for providing these services, either on a per-product basis or through a percentage of the balances invested.

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Trust & Wealth Management Services

The Bank provides trust and wealth management services to its higher net worth customers to assist them in investment, tax and estate planning and to serve as their trustee or other fiduciary. The Bank offers these services in a manner consistent with the principles of prudent and safe banking and in compliance with applicable laws, rules, regulations and regulatory guidelines. The Bank earns fees for managing client assets and providing trust services. The Company is one of the few smaller banking institutions in the northwest to offer in-house trust services, and activity and income from these services has increased continuously since its beginning in 2006. The Bank's Trust & Wealth Management Department operates under a Trust Charter through the FDIC and the Idaho Department of Finance. Due to the reciprocity arrangements with the states of Oregon and Washington applicable to the Bank's general banking business, the Bank is authorized to provide fiduciary services and to serve as a fiduciary in relationships located or sited in any of those three states. The Bank is also authorized to provide investment management services through the Trust & Wealth Management Department to clients in all fifty states.

Other Services

Other consumer-oriented services include automated teller machines ("ATMs"), debit cards, safe deposit boxes, internet and phone banking services, savings bonds, and VISA/MasterCard credit cards. The Bank is a member of the Star, Plus, Exchange, Interlink and Accell ATM networks. New consumer products and services introduced over the past several years include electronic statements, mobile-phone banking access, identity theft protection, and Certificate of Deposit Account Registry Service ("CDARS") certificates of deposit and money market accounts.

The Company also offers numerous business services that improve its customers' operations. Its online business product offerings allow companies to manage their financial operations efficiently from any location, including originating ACH entries for payroll, outgoing tax and other payments, and incoming collections. The system also allows transfers of funds to and from various accounts and operating credit lines. Credit card acceptance, remote deposit capture, night deposit and concentration account services make it more convenient for businesses to receive and deposit funds quickly, and the Company's Check Collect service assists them in collecting on returned checks. Intermountain's positive pay and credit card monitoring services help reduce fraud, and its employee benefits program enhances business customers' existing benefits programs by providing valuable banking services to their employees at a reduced cost. These services are generally competitive with those offered by larger institutions. They provide additional fee income to Intermountain, and management is continually evaluating and adjusting pricing on these services to enhance future revenue.

Loan Portfolio

The loan portfolio is the largest component of earning assets, and is comprised of net loans receivable and loans held for sale. In 2012, net loans receivable, which includes loans the Company generally intends to keep until repayment or maturity, increased by $18.5 million, or 3.7%. Increases in commercial, commercial real estate and agricultural loans offset reductions in land, land development and multifamily loans. Loans held for sale, primarily residential real estate loans originated for sale in the secondary market, decreased by $3.9 million over the prior year, as the Company sold several larger residential loan pools before year end.

In 2012, the Company continued to aggressively resolve problem loans through workouts with borrowers, refinances from other sources, and/or collateral liquidation, resulting in additional improvements in the quality of its credit portfolio. Negative external credit factors have also moderated, allowing the Company to shift its focus to the origination of new loans. In general, the Company's underwriting standards remain more restrictive than prior to the recession and are more similar to standards existing prior to 2000.

Overall demand for commercial and commercial real estate loans has improved moderately, but high quality borrowers are being targeted by all competitors. In this difficult economic climate, the Bank continues to pursue quality conventional loans using conservative underwriting and control practices, and is actively marketing SBA, USDA and other financing assistance programs to borrowers who are financially weaker. Residential activity continued at a strong pace in 2012, with particularly strong refinancing activity in the second half of the year. Higher levels of activity in this sector is projected to continue in the first half of 2013. Bank lending staff continues to utilize relationship pricing models and other techniques to manage interest rate risk and customer profitability.

The Company’s average loan yield decreased from 5.94% in 2011 to 5.43% in 2012 as Federal Reserve actions, ongoing economic concerns and strong competition for quality borrowers compressed yields. These trends are projected to continue at least through 2013 and likely into 2014, constraining revenue growth for financial institutions.

Loan Portfolio Concentrations

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The Bank continuously monitors concentrations of loan categories by industry, loan type, market area, borrower characteristics, collateral characteristics and other factors. Concentration guidelines are established and then approved by the Board of Directors at least annually, and are reviewed by management and the Board monthly. Circumstances affecting industries and market areas where concentrations exist are reviewed as to their current and potential impact, and appropriate strategies are implemented to mitigate potential risk.

Construction and Development Loans

Management has focused over the past several years on shifting the mix of the loan portfolio away from a relatively high concentration in residential construction, acquisition and development loans to a more balanced mix of commercial, agriculture, commercial real estate, and residential real estate loans. It has done this through a combination of more conservative underwriting practices on construction and land development lending, limited marketing, and aggressive resolution and disposal of loans in these categories. As a result, combined loan balances in the commercial construction, land and land development, and residential construction categories have declined by $11.5 million from December 31, 2011 to December 31, 2012 and by $34.6 million from December 31, 2010 to December 31, 2011.

After the aggressive reduction efforts of the last few years, the land development and construction loan components pose much lower concentration risk for the total loan portfolio. Management plans to continue resolving remaining problem loans in this sector and applying prudent underwriting standards to new loan requests.

Commercial Loans

Although the impacts of the economic downturn are still being felt in the Bank's commercial, and particularly SBA portfolio, management does not consider this portfolio to present a particular "concentration risk" at this time. Management believes there is adequate diversification by type, industry, and geography to mitigate excessive risk. The commercial portfolio includes a mix of term loan facilities and operating loans and lines made to a variety of different business types in the markets it serves. The Company utilizes SBA, USDA and other government-assisted or guaranteed financing programs whenever advantageous to further mitigate risk in this area. With the exception of the agricultural portfolio, there is no other significant concentration of industry types in its loan portfolio, and no dominant employer or industry across all the markets it serves. Underwriting focuses on the evaluation of potential future cash flows to cover debt requirements, sufficient collateral margins to buffer against devaluations, credit history of the business and its principals, and additional support from willing and capable guarantors.

Agricultural Loans

The agricultural portfolio represents a larger percentage of the loans in the Bank's southern Idaho region. At December 31, 2012, agricultural loans and agricultural real estate loans totaled $86.0 million or 16.3% of the total loan portfolio. The agricultural portfolio consists of loans secured by livestock, crops and real estate. To mitigate credit risk, specific underwriting is applied to retain only borrowers that have proven track records in the agricultural industry. Many of Intermountain's agricultural borrowers are third or fourth generation farmers and ranchers with limited real estate debt, which reduces overall debt coverage requirements and provides extra flexibility and collateral for equipment and operating borrowing needs. In addition, the Bank has hired senior lenders with significant experience in agricultural lending to administer these loans. Further mitigation is provided through frequent collateral inspections, adherence to farm operating budgets, and annual or more frequent review of financial performance. The Company has minimal exposure to the dairy industry, the one significant agricultural segment that has been under more pressure for the past few years.

Commercial Real Estate Loans

Difficult economic conditions and oversupply in certain segments continue to create risk in the commercial real estate portfolio, although this risk appears to have moderated in 2012 with moderate improvement in economic conditions and valuations. In comparison to peers, the Company has less overall exposure to commercial real estate and a stronger mix of owner-occupied (where the borrower occupies and operates in at least part of the building) versus non-owner occupied loans. The loans represented in this category are spread across the Company's footprint, and there are no significant concentrations by industry type or borrower. The most significant property types represented in the portfolio are office 23.2%, industrial 14.6%, retail 10.1%, and health care 12.0%. The other 40.1% is a mix of property types with smaller concentrations, including religious facilities, auto-related properties, restaurants, convenience stores, storage units, motels and commercial investment land.

While 66% of the Company’s commercial real estate portfolio is in its Northern Idaho/Eastern Washington region, this region is a large and diverse region with differing local economies and real estate markets. Given this diversity, and the diversity of property types and industries represented, management does not believe that this concentration represents a significant concentration risk.

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Non-owner occupied commercial real estate loans are made only in cases where project debt service coverage and loan to value ratios are very strong or to borrowers with established track records and the ability to fund potential project cash flow shortfalls from other income sources or liquid assets. Project due diligence is conducted by the Bank, to help provide for adequate contingencies, collateral and/or government guaranties. The Company has largely avoided speculative financing of investment properties, particularly of the types most vulnerable in the downturn, including investment office buildings and retail strip developments. Management believes geographic, borrower and property-type diversification, and prudent underwriting and monitoring standards applied by seasoned commercial lenders mitigate concentration risk in this segment.

Residential Real Estate and Consumer

Residential real estate and consumer loans comprise smaller segments of the loan portfolio. Management does not believe they represent significant concentration risk. While debt service ability and collateral values have declined in these segments, underwriting has generally been more conservative, with higher debt-to-income and equity requirements than found elsewhere in the financial industry.

Geographic Distribution

In terms of geographic distribution, 57% of the Company’s loans are in north Idaho and eastern Washington and 38% are in southern Idaho and eastern Oregon. The markets are relatively large geographically and represent a mix of agricultural, forested and metropolitan landscapes. While the Company has suffered and would suffer again from a broad national or regional recession, the relative diversity of its geography provides more protection than many of its community bank peers.

Classification of Loans

The Bank is required under applicable law and regulations to review its loans on a regular basis and to classify them as “satisfactory,” “special mention,” “substandard,” “doubtful” or “loss.” A loan which possesses no apparent weakness or deficiency is designated “satisfactory.” A loan which possesses weaknesses or deficiencies deserving close attention is designated as “special mention.” A loan is generally classified as “substandard” if it possesses a well-defined weakness and the Bank will likely sustain some loss if the weaknesses or deficiencies are not corrected. A loan is classified as “doubtful” if a probable loss of principal and/or interest exists but the amount of the loss, if any, is subject to the outcome of future events which are undeterminable at the time of classification. It is a transitional category, and once the amount of the loss is determined, this amount is charged off and the remaining balance of the loan would most likely be classified as “substandard.” The typical duration of a loan in the “doubtful” category would be one to two months. If a loan is classified as “loss,” the Bank either establishes a specific valuation allowance equal to the amount classified as loss or charges off such amount.

As of December 31, 2012, the risk grades range from cash equivalent secured loans (Risk Grade “1”) to “loss” (Risk Grade “8”). Risk Grades “3”, “5”, “6”, “7” and “8” closely reflect the FDIC’s definitions for “satisfactory,” “special mention,” “subst “doubtful” and “loss”, respectively. Risk Grade “4” is an internally designated “watch” category. At December 31, 2012, the Company had $0 in the special mention, $24.9 million in the substandard and $0 in the doubtful and loss loan categories. At December 31, 2011, the Company had $1.4 million in the special mention, $53.2 million in the substandard and $0 in the doubtful and loss loan categories.

Overall, classified loans (loans with risk grades 6, 7, or 8) decreased from $53.2 million at the end of 2011 to $24.9 million at the end of 2012. The significant decrease reflected aggressive workout and problem loan reduction efforts in 2012, resulting in a significant reduction in the overall loss exposure of the portfolio.

Non-accrual loans are those loans that have become delinquent for more than 90 days (unless well-secured and in the process of collection). Placement of loans on non-accrual status does not necessarily mean that the outstanding loan principal will not be collected, but rather that timely collection of principal and interest is in question. Total non-accrual loans decreased from $9.2 million at December 31, 2011 to $6.5 million at the end of 2012. When a loan is placed on non-accrual status, interest accrued but not received is reversed. The amount of interest income which was reversed from income in fiscal years 2012, 2011, 2010, 2009, and 2008 on non-accrual and other problem loans was approximately $440,000, $405,000, $794,000, $1.9 million, and $465,000, respectively. A non-accrual loan may be restored to accrual status if it is brought current and has performed in accordance with contractual terms for a reasonable period of time, and the collectability of the total contractual principal and interest is no longer in doubt.

Troubled debt restructure loans ("TDRs") are those loans that have been modified in response to distressed borrower conditions. TDRs totaled $6.7 million at year end 2012 versus $7.2 million at the end of the prior year.

Allowance for Loan Losses

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The allowance for loan losses is based upon management's assessment of various factors including, but not limited to, current and future economic trends, historical loan losses, delinquencies, and underlying collateral values, as well as current and potential risks identified in the loan portfolio. The allowance is evaluated on a monthly basis by management. The methodology for calculating the allowance is discussed in more detail below. An allocation is also included for unfunded loan commitments. However, this allocation is recorded as a liability, as required by bank regulatory guidance issued in early 2007.

Allocation of the Allowance for Loan Losses
and Non-Accrual Loans Detail
(Dollars in thousands)

	December 31, 2012				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	22.95	%	$121,307	$2,156	$ 4,042
Commercial real estate loans	35.35	%	186,844	2,762	1,716
Commercial construction loans	0.72	%	3,832	101	—
Land and land development loans	5.92	%	31,278	1,197	246
Agriculture loans	16.26	%	85,967	228	98
Multifamily loans	3.13	%	16,544	51	—
Residential real estate loans	11.35	%	60,020	1,144	423
Residential construction loans	0.18	%	940	24	—
Consumer loans	1.82	%	9,626	202	4
Municipal loans	2.32	%	12,267	78	—
Totals	100.00	%	$528,625	$7,943	$ 6,529
	December 31, 2011				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	21.45	%	$110,395	$2,817	$ 3,686
Commercial real estate loans	32.56	%	167,586	4,880	2,303
Commercial construction loans	1.23	%	6,335	500	46
Land and land development loans	7.48	%	38,499	2,273	2,652
Agriculture loans	15.80	%	81,316	172	187
Multifamily loans	5.06	%	26,038	91	—
Residential real estate loans	11.44	%	58,861	1,566	401
Residential construction loans	0.53	%	2,742	59	—
Consumer loans	2.30	%	11,847	295	17
Municipal loans	2.15	%	11,063	37	—
Totals	100.00	%	$514,682	$12,690	$ 9,292

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	December 31, 2010				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	21.31	%	$ 122,656	$ 2,925	$ 3,859
Commercial real estate loans	30.50	%	175,559	3,655	3,566
Commercial construction loans	3.12	%	17,951	540	71
Land and land development loans	10.59	%	60,962	2,408	1,910
Agriculture loans	15.18	%	87,364	779	582
Multifamily loans	4.59	%	26,417	83	—
Residential real estate loans	10.57	%	60,872	1,252	964
Residential construction loans	0.56	%	3,219	65	110
Consumer loans	2.45	%	14,095	613	389
Municipal loans	1.13	%	6,528	135	—
Totals	100.00	%	$ 575,623	$ 12,455	$ 11,451

	December 31, 2009				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	19.57	%	$ 131,562	$ 4,785	$ 2,653
Commercial real estate loans	25.69	%	172,726	3,827	3,209
Commercial construction loans	6.78	%	45,581	1,671	3,135
Land and land development loans	13.18	%	88,604	2,707	5,724
Agriculture loans	16.40	%	110,256	1,390	447
Multifamily loans	2.69	%	18,067	26	135
Residential real estate loans	9.75	%	65,544	1,412	2,872
Residential construction loans	2.47	%	16,626	170	205
Consumer loans	2.72	%	18,287	539	88
Municipal loans	0.75	%	5,061	81	—
Totals	100.00	%	$ 672,314	$ 16,608	$ 18,468

	December 31, 2008				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	82.81	%	$ 636,982	$ 14,277	$ 22,783
Residential loans	13.51	%	103,937	1,653	3,491
Consumer loans	3.02	%	23,245	452	91
Municipal loans	0.66	%	5,109	51	—
Totals	100.00	%	$ 769,273	$ 16,433	$ 26,365

In the table above, commercial loans for 2008 include commercial real estate loans, as well as residential land, subdivision acquisition and development, and builder loans, where the borrower is not a consumer.

The loan portfolio is segregated into loans for which a specific reserve is calculated by management, and loans for which a reserve is calculated using an allowance model. For loans with a specific reserve, management evaluates each loan and derives

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the reserve based on such factors as expected collectability, collateral value and guarantor support. For loans with reserves calculated by the model, the model mathematically derives a base reserve allocation for each loan using probability of default and loss given default rates based on both historical company and regional industry experience. This base reserve allocation is then modified by management considering factors such as the current economic environment, portfolio delinquency trends, collateral valuation trends, quality of underwriting and quality of collection activities. The reserves derived from the model are reviewed and modified by management, then added to the reserve for specifically identified loans to produce the total reserve. Management believes that this methodology provides a reasonable, reliable and verifiable reserve calculation and is in compliance with regulatory and accounting guidance. The Bank’s total allowance for loan losses was 1.50% of total loans at December, 31, 2012 and 2.47% of total loans at December 31, 2011. The decrease in the ratio reflects the substantial reduction in classified loans during the year and an overall reduction in both default and loss-given-default rates in the portfolio as a whole. Net chargeoffs totaled $9.1 million in 2012 compared to a loan loss provision of $4.3 million, as the Company resolved and charged off a number of loans that had previously been reserved for.

Management’s general policy is to charge off loans or portions of loans as soon as an identifiable loss amount can be determined from evidence obtained, such as updated appraisals or similar real estate evaluations, equipment, inventory or similar collateral evaluations, or accepted offers on loan sales or negotiated discounts. In situations where problem loans are dependent on collateral liquidation for repayment, management obtains updated independent valuations, generally no less frequently than once every six months and more frequently for larger or more troubled loans. In the time period between these independent valuations, it monitors market conditions for any significant event or events that would materially change the valuations, and updates them as appropriate.

Loan Maturity and Repricing Information

The following table details loan maturity and repricing information for fixed and variable rate loans.

Maturity and Repricing for the Bank’s
Loan Portfolio at December 31, 2012

Loan Repricing	Fixed Rate	Variable Rate	Total Loans
	(Dollars in thousands)		
0-90 days	$22,413	$150,747	$173,160
91-365 days	43,317	18,387	61,704
1 year-5 years	130,189	69,673	199,862
5 years or more	83,602	10,297	93,899
Total	$279,521	$249,104	$528,625

The Company has traditionally maintained a high level of variable rate loans as part of its overall balance sheet management approach. The significant unanticipated decrease in market rates experienced during the economic downturn and financial turmoil of the past several years impacted these loans negatively and created additional pressure on the Company’s asset yields and net interest margin. The imposition of floors had offset some of this negative impact, although these are now under pressure as well, given strong competition for quality borrowers.

Investments

The investment portfolio is the second largest earning asset category and is comprised mostly of securities categorized as available-for-sale. These securities are carried at fair value. Unrealized gains and losses that are considered temporary are recorded as a component of accumulated other comprehensive income or loss.

The carrying value of the available-for-sale securities portfolio increased 27.9% to $280.2 million at December 31, 2012 from $219.0 million at December 31, 2011, and now represents 28.9% of total assets. The carrying value of the held-to-maturity securities portfolio decreased 8.2% to $14.8 million at December 31, 2012 from $16.1 million at December 31, 2011. During 2012, the Company deployed funds from its successful capital raises and from deposit increases into the investment portfolio. Given continued challenging market conditions for fixed income securities in 2012, the Company focused on maintaining high credit quality and moderate duration. Opportunities to prudently pick up yield were limited in 2012, and the Company used a modified barbell strategy in which it balanced purchases of longer-term municipal and agency securities with shorter term and floating rate investments. The average duration of the available for sale and the held-to-maturity portfolios was approximately 3.6 years and 4.8 years, respectively on December 31, 2012, compared to 3.1 years and 5.6 years, respectively on December 31, 2011. The average duration differs from the investment's contractual maturity as average duration takes into account estimated

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prepayments. Reinvestment rates are substantially lower than a year ago and likely to remain low at least through 2013, which will place pressure on the Company's investment yield. In addition, record low mortgage rates are accelerating prepayment speeds on the Company's mortgage-backed holdings, resulting in accelerated premium amortization and lower reinvestment rates.

As noted above, available-for-sale securities are required by generally accepted accounting principles to be accounted for at fair value (See Note 20 “Fair Value of Financial Instruments” in the Company’s Consolidated Financial Statements for more information).

Market data and pricing on similar assets were used to value securities totaling $269.9 million classified as available for sale as of December 31, 2012. For these securities, the Company obtained fair value measurements from an independent pricing service and internally validated these measurements. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus, prepayment speeds, credit information and the bond’s terms and conditions, among other things.

The available for sale portfolio also includes $10.2 million in super senior or senior tranche collateralized mortgage obligations not backed by a government or other agency guarantee. These securities are collateralized by fixed rate prime or Alt A mortgages, are structured to provide credit support to the senior tranches, and are carefully analyzed and monitored by management. Because of disruptions in the current market for non-government agency guaranteed mortgage-backed securities and CMOs, a less active market existed for these securities at December 31, 2012. This is evidenced by a wider bid-ask spread for these types of securities and the smaller volume of actual trades made. As a result, less reliance can be placed on easily observable market data, such as pricing on transactions involving similar types of securities, in determining their current fair value. As such, significant adjustments were required to determine the fair value at the December 31, 2012 measurement date.

In valuing these securities, the Company utilized the same independent pricing service as for its other available-for-sale securities. In addition, it utilized Federal Home Loan Bank pricing indications to derive independent valuations and used this data to evaluate and adjust the values derived from the original independent pricing service. In addition to observable market-based input including dealer quotes, market spreads, live trading levels and execution data, both services also employed a present-value income model that considered the nature and timing of the cash flows and the relative risk of receiving the anticipated cash flows as agreed. The discount rates used were based on a risk-free rate, adjusted by a risk premium for each security. In accordance with accounting guidance, the Company has determined that the risk-adjusted discount rates utilized appropriately reflect the Company’s best estimate of the assumptions that market participants would use in pricing the assets in a current transaction to sell the asset at the measurement date. Risks include nonperformance risk (that is, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions). To the extent possible, the pricing services and the Company validated the results from these models with independently observable data.

The following table displays investment securities balances and repricing information for the total portfolio:

Investment Portfolio Detail

Carrying Value as of December 31,	2012 Amount	Percent Change Previous Year	2011 Amount	Percent Change Previous Year	2010 Amount
	(Dollars in thousands)				
U.S. treasury securities and obligations of government agencies	$—	— %	$—	(100.00)%	$3,894
Mortgage-backed securities & collateralized mortgage obligations (“CMOs”)	196,200	7.86 %	181,903	4.57 %	173,957
SBA Pools	20,320	— %	—	— %	—

State and municipal bonds	78,475	47.29 %	53,279	94.12 %	27,447
Total	$294,995	25.43 %	$235,182	14.56 %	$205,298
Available-for-Sale	280,169	27.91 %	219,039	19.64 %	183,081
Held-to-Maturity	14,826	(8.16)%	16,143	(27.34)%	22,217
Total	$294,995	25.43 %	$235,182	14.56 %	$205,298

Investments held as of December 31, 2012

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Mature as follows:

	One Year		One to Five Years		Five to Ten Years		Over Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
U.S. treasury securities and obligations of government agencies	$—	— %	$—	— %	$—	— %	$—	— %	$—	— %
Mortgage-backed securities & CMOs	—	— %	17,844	4.04 %	21,233	2.04 %	157,123	2.15 %	196,200	2.31 %
SBA Pools	—	— %	—	— %	—	— %	20,320	1.62 %	20,320	1.62 %
State and municipal bonds (tax — equivalent)	503	6.31 %	5,600	3.61 %	19,044	3.38 %	53,328	4.27 %	78,475	4.20 %
Total	$503	6.31 %	$23,444	3.94 %	$40,277	2.68 %	$230,771	2.59 %	$294,995	2.72 %

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Intermountain's investment portfolios are managed to provide and maintain liquidity; to maintain a balance of high quality, diversified investments to minimize risk; to offset other asset portfolio elements in managing interest rate risk; to provide collateral for pledging; and to maximize risk-adjusted returns. At December 31, 2012, the Company does not intend to sell any of its available-for-sale securities that have a loss position and it is not likely that it will be required to sell the available-for-sale securities before the anticipated recovery of their remaining amortized cost. However, unforeseen changes in credit risk or other types of portfolio risk could cause management to change its position and sell individual securities on a case-by-case basis.

See Note 20 "Fair Value of Financial Instruments" in the Company's Consolidated Financial Statements for more information on the calculation of fair or carrying value for the investment securities.

Fed Funds Sold & Cash Equivalents

The Bank held $53.4 million in interest-bearing cash equivalents at December 31, 2012, with the bulk of it deposited at the Federal Reserve. This compares to $82.2 million in interest-bearing cash equivalents at December 31, 2011, as funds were deployed into the loan and investment portfolios in 2012. In 2011 and 2012, excess funds were held at the Federal Reserve as opposed to Fed Funds Sold at a correspondent bank as there was a higher yield on the excess funds at the Federal Reserve.

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Deposits

Deposit Composition & Trends	December 31, 2012			December 31, 2011		
	Amount	%		Amount	%	
	(Dollars in thousands)					
Non-interest bearing demand accounts	$254,979	34.0	%	$190,074	26.1	%
Interest bearing demand accounts 0.0% to 1.15%	99,623	13.3	%	—	—	%
NOW accounts	—	—	%	107,476	14.7	%
Money market 0.0% to 4.07%	213,155	28.5	%	201,237	27.6	%
Savings and IRA 0.0% to 4.91%	75,788	10.1	%	73,493	10.1	%
Certificate of deposit accounts (CDs)	43,535	5.8	%	59,199	8.1	%
Jumbo CDs	56,228	7.5	%	56,177	7.7	%
Brokered CDs	5,200	0.7	%	37,000	5.1	%
CDARS CDs to local customers	426	0.1	%	4,717	0.6	%
Total deposits	$748,934	100.0	%	$729,373	100.0	%
Weighted average interest rate on certificates of deposit		1.28	%		1.23	%
Core Deposits as a percentage of total deposits (1)		91.7	%		86.2	%
Deposits generated from the Company’s market area as a % of total deposits		99.3	%		94.9	%

(1) Core deposits consist of non-interest bearing checking, interest-bearing checking, money market, and savings accounts, and retail certificate of deposit accounts of less than $100,000.

Deposits totaled $748.9 million, representing 87.3% of the Bank’s liabilities at December 31, 2012. Total deposits increased 2.7% in 2012, as increases in demand and money market balances offset reductions in higher-priced retail and brokered CDs. NOW account balances were transferred to interest-bearing demand deposits, as regulatory changes effective in 2012 eliminated the need to maintain NOW accounts, particularly for commercial customers. Given the high level of liquid assets, the Company continued to price down its deposit portfolio and allowed brokered, collateralized and single-service deposit accounts to run off or convert to non-FDIC insured investments. Non-interest bearing demand deposits increased, reflecting sustained growth in business and agriculture deposits, but also included approximately $30.1 million in temporary shifts in the Company's money market deposits and other customer investment funds used to pay taxes and dividends at year end. Total transaction account deposits (demand, NOW and money market) comprise 75.8% of total deposits, a percentage that exceeds peer group averages. The Company continues to emphasize growth in low-cost transaction account balances to minimize its cost of funding and enhance fee income and other cross-selling opportunities.

The Company’s strong local, core funding base, high percentage of checking, money market and savings balances and careful management of its brokered CD funding provide lower-cost, more reliable funding to the Company than most of its peers and add to the liquidity strength of the Bank. Maintaining the local funding base at a reasonable cost remains a critical priority for the Company’s management and production staff. The Company uses a combination of proactive branch staff efforts and community leadership to target and grow low-cost deposit balances. It emphasizes personalized service, local community involvement and targeted campaigns to generate deposits, rather than media campaigns or advertised rate specials.

The Company seeks long-term balance between loans and deposits in each of its regions, and has generally succeeded in achieving this balance, although when it enters new markets, it may emphasize one or the other depending on the specific market.

Business checking, money market and savings balances comprise about 47% of total non-maturity deposits, and consumer accounts about 53%. The Company emphasizes balanced growth of both business and consumer deposits in its markets to diversify its funding sources. Consumer deposit growth is largely driven by branch marketing efforts in the communities served. Intermountain also employs specialized staff who target the acquisition of business deposit accounts and other fee-related services. With the exception of the secured savings program noted below, the Company is not reliant on any one depositor or small group of depositors, with the largest single depositor making up less than 1% of overall company deposits.

The Company currently holds $13.4 million in deposits used to secure credit cards marketed and maintained by another bank under a contractual arrangement. The contractual arrangement terminated in November, 2009 and was replaced by a transitional contract allowing the provider sufficient time to migrate the credit cards into an unsecured status or move these deposits into its own organization. This movement is anticipated to occur in early 2013 resulting in the loss of these deposit balances.

The following table details re-pricing information for the Bank's time deposits with minimum balance of $100,000 at December 31, 2012 (in thousands):

Maturities/Repricing	
Less than three months	$13,786
Three to six months	9,348
Six to twelve months	8,654
Over twelve months	30,246
	$62,034

By repricing its portfolio, the Company succeeded in lowering the 2012 interest cost on its deposits by 0.17%. This resulted in overall liability interest costs to the Bank being 0.27% below the average of its peer group as of December 31, 2012 (Source: FFIEC Uniform Bank Performance Report ("UBPR") for December 31, 2012). Given the current compressed market rate environment, management believes that this improvement and its overall competitive standing positions the Company comparatively well for future periods.

Borrowings

As part of the Company's funds management and liquidity plan, the Bank has arranged to have short-term and long-term borrowing facilities available. The short-term and overnight facilities are federal funds purchasing lines as reciprocal arrangements to the federal funds selling agreements in place with various correspondent banks. At December 31, 2012, the Bank had overnight unsecured credit lines of $45.0 million available. For additional long and short-term funding needs, the Bank has credit available from the Federal Home Loan Bank of Seattle ("FHLB"), limited to a percentage of its total regulatory assets and subject to collateralization requirements and a blanket pledge agreement. It also has a "Borrower in Custody" line set up with the Federal Reserve Bank, subject to collateralization requirements.

At December 31, 2012 the Bank had a $4.0 million FHLB advance at 3.11% that matures in September 2014 and the ability to borrow an additional $107.3 million from the FHLB.

The Bank has the ability to borrow up to $17.9 million on a short term basis from the Federal Reserve Bank under the Borrower in Custody program, utilizing commercial loans as collateral. At December 31, 2012, the Bank had no borrowings outstanding under this line.

Securities sold under agreements to repurchase, which are classified as other secured borrowings, generally are short-term agreements. These agreements are treated as financing transactions and the obligations to repurchase securities sold are reflected as a liability in the consolidated financial statements. The dollar amount of securities underlying the agreements remains in the applicable asset account. All of the Company's current repurchase agreements are with municipal customers in its local markets and mature on a daily basis. These agreements had a weighted average interest rate of 0.32%, 0.33%, and 0.27%, at December 31, 2012, 2011, and 2010, respectively. The average balances of securities sold subject to repurchase agreements were $63.4 million, $81.4 million, and $87.2 million during the years ended December 31, 2012, 2011, and 2010, respectively. The maximum amount outstanding at any month end during these same periods was $77.5 million, $111.8 million, and $105.1 million, respectively. The decrease in the repurchase amounts during 2012 reflected generally lower municipal repurchase demand in 2012. At December 31, 2012, 2011, and 2010, the Company pledged as collateral certain investment securities with aggregate amortized costs of $76.5 million, $106.0 million, and $126.2 million, respectively. These investment securities had market values of $76.9 million, $108.9 million, and $128.7 million at December 31, 2012, 2011 and 2010, respectively.

In January 2003 the, Company issued $8.0 million of Trust Preferred securities through its subsidiary, Intermountain Statutory Trust I. Approximately $7.0 million was subsequently transferred to the capital account of Panhandle State Bank for capitalizing the Ontario branch acquisition. The debt associated with these securities bears interest on a variable basis tied to the 90-day LIBOR index plus 3.25% with interest payable quarterly. The debt was callable by the Company in March 2008 and matures in March 2033.

In March 2004, the Company issued $8.0 million of additional Trust Preferred securities through a second subsidiary, Intermountain Statutory Trust II. This debt was callable by the Company starting in April 2009, bears interest on a variable basis tied to the 90-day LIBOR index plus 2.8%, and matures in April 2034. In July of 2008, the Company entered into a cash flow swap transaction with Pacific Coast Bankers Bank, by which the Company effectively pays a fixed rate on these securities of 7.38% through October 2013 (see Note 19 in the Company's Consolidated Financial Statements for more information on this swap). Funds received from this borrowing were used to support planned expansion activities during 2004, including the Snake River Bancorp acquisition.

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During the third quarter of 2009, the Board of Directors of the Company approved the deferral of regularly scheduled interest payments on its outstanding Junior Subordinated Debentures related to its Trust Preferred Securities ("TRUPS Debentures"), beginning in December 2009. The Company is permitted to defer payments of interest on the TRUPS Debentures for up to 20 consecutive quarterly periods without default. During the deferral period, the Company may not pay any dividends or distributions on, or redeem, purchase or acquire, or make a liquidation payment with respect to the Company's capital stock, or make any payment of principal or interest on, or repay, repurchase or redeem any debt securities of the Company that rank equally or junior to the TRUPS Debentures. Deferred payments compound for the TRUPS Debentures. The Company repaid the deferred interest payments on its TRUPs debentures in December 2012 and January 2013 and intends to pay its interest payments as scheduled in the future.

Employees

The Company employed 270 full-time equivalent employees at December 31, 2012, down from 280 at the end of 2011 and 349 at the end of 2010. None of the employees are represented by a collective bargaining unit and the Company believes it has good relations with its employees. The Company reduced full-time equivalent employees during both 2012 and 2011 as part of an operating expense reduction strategy.

Supervision and Regulation

General

The following discussion provides an overview of certain elements of the extensive regulatory framework applicable to Intermountain Community Bancorp (the "Company") and Panhandle State Bank, which operates under the names Panhandle State Bank, Magic Valley Bank and Intermountain Community Bank (collectively referred to herein as the "Bank"). This regulatory framework is primarily designed for the protection of depositors, federal deposit insurance funds and the banking system as a whole, rather than specifically for the protection of shareholders. Due to the breadth and growth of this regulatory framework, our costs of compliance continue to increase in order to monitor and satisfy these requirements.

To the extent that this section describes statutory and regulatory provisions, it is qualified by reference to those provisions. These statutes and regulations, as well as related policies, are subject to change by Congress, state legislatures and federal and state regulators. Changes in statutes, regulations or regulatory policies applicable to us, including the interpretation or implementation thereof, could have a material effect on our business or operations. In light of the recent financial crisis, numerous changes to the statutes, regulations or regulatory policies applicable to us have been made or proposed. The full extent to which these changes will impact our business is not yet known. However, our continued efforts to monitor and comply with new regulatory requirements add to the complexity and cost of our business.

Federal Bank Holding Company Regulation

General. The Company is a bank holding company as defined in the Bank Holding Company Act of 1956, as amended ("BHCA"), and is therefore subject to regulation, supervision and examination by the Federal Reserve. In general, the BHCA limits the business of bank holding companies to owning or controlling banks and engaging in other activities closely related to banking. The Company must file reports with and provide the Federal Reserve such additional information as it may require. Under the Financial Services Modernization Act of 1999, a bank holding company may apply to the Federal Reserve to become a financial holding company, and thereby engage (directly or through a subsidiary) in certain expanded activities deemed financial in nature, such as securities and insurance underwriting.

Holding Company Bank Ownership. The BHCA requires every bank holding company to obtain the prior approval of the Federal Reserve before (i) acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares; (ii) acquiring all or substantially all of the assets of another bank or bank holding company; or (iii) merging or consolidating with another bank holding company.

Holding Company Control of Nonbanks. With some exceptions, the BHCA also prohibits a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than

those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities that, by statute or by Federal Reserve regulation or order, have been identified as activities closely related to the business of banking or of managing or controlling banks.
Transactions with Affiliates. Subsidiary banks of a bank holding company are subject to restrictions imposed by the Federal Reserve Act on extensions of credit to the holding company or its subsidiaries, on investments in their securities and on the use

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of their securities as collateral for loans to any borrower. These regulations and restrictions may limit the Company's ability to obtain funds from the Bank for its cash needs, including funds for payment of dividends, interest and operational expenses.

Tying Arrangements. The Company is prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services. For example, with certain exceptions, neither the Company nor its subsidiaries may condition an extension of credit to a customer on either (i) a requirement that the customer obtain additional services provided by us; or (ii) an agreement by the customer to refrain from obtaining other services from a competitor.

Support of Subsidiary Banks. Under Federal Reserve policy and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Company is expected to act as a source of financial and managerial strength to the Bank. This means that the Company is required to commit, as necessary, resources to support the Bank. Any capital loans a bank holding company makes to its subsidiary banks are subordinate to deposits and to certain other indebtedness of those subsidiary banks.

State Law Restrictions. As an Idaho corporation, the Company is subject to certain limitations and restrictions under applicable Idaho corporate law. For example, state law restrictions in Idaho include limitations and restrictions relating to indemnification of directors, distributions to shareholders, transactions involving directors, officers or interested shareholders, maintenance of books, records and minutes, and observance of certain corporate formalities.

Federal and State Regulation of the Bank

General. The Bank is an Idaho commercial bank operating in Idaho, with one branch in Oregon and two in Washington. Its deposits are insured by the FDIC. As a result, the Bank is subject to primary supervision and regulation by the Idaho Department of Finance and the FDIC. With respect to the Oregon and Washington branches, the Bank is also subject to supervision and regulation by, respectively, the Oregon Department of Consumer and Business Services and the Washington Department of Financial Institutions, as well as the FDIC. These agencies have the authority to prohibit banks from engaging in what they believe constitute unsafe or unsound banking practices.

Consumer Protection. The Bank is subject to a variety of federal and state consumer protection laws and regulations that govern its relationship with consumers including laws and regulations that impose certain disclosure requirements and regulate the manner in which the Bank takes deposits, makes and collects loans, and provides other services. Failure to comply with these laws and regulations may subject the Bank to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

Community Reinvestment. The Community Reinvestment Act of 1977 requires that, in connection with examinations of financial institutions within their jurisdiction, the Federal Reserve or the FDIC evaluate the record of the financial institution in meeting the credit needs of its local communities, including low and moderate-income neighborhoods, consistent with the safe and sound operation of the institution. A bank's community reinvestment record is also considered by the applicable banking agencies in evaluating mergers, acquisitions and applications to open a branch or facility.

Insider Credit Transactions. Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons. Extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, and follow credit underwriting procedures that are at least as stringent as those prevailing at the time for comparable transactions with persons not related to the lending bank; and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to insiders. A violation of these restrictions may result in the assessment of substantial civil monetary penalties, regulatory enforcement actions, and other regulatory sanctions.

Regulation of Management. Federal law (i) sets forth circumstances under which officers or directors of a bank may be removed by the institution's federal supervisory agency; (ii) places restraints on lending by a bank to its executive officers, directors, principal shareholders, and their related interests; and (iii) generally prohibits management personnel of a bank from serving as directors or in other management positions of another financial institution whose assets exceed a specified amount or which has an office within a specified geographic area.

Safety and Soundness Standards. Certain non-capital safety and soundness standards are also imposed upon banks. These standards cover internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, such other operational and managerial standards as the agency determines to be appropriate, and standards for asset quality, earnings and stock valuation. An institution that fails to meet these standards may be subject to regulatory sanctions.

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Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (“Interstate Act”) together with the Dodd-Frank Act relaxed prior interstate branching restrictions under federal law by permitting, subject to regulatory approval, state and federally chartered commercial banks to establish branches in states where the laws permit banks chartered in such states to establish branches. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area. Federal banking regulations prohibit banks from using their interstate branches primarily for deposit production and the federal bank regulatory agencies have implemented a loan-to-deposit ratio screen to ensure compliance with this prohibition.

Dividends

The principal source of the Company's cash is from dividends received from the Bank, which are subject to government regulation and limitations. Regulatory authorities may prohibit banks and bank holding companies from paying dividends in a manner that would constitute an unsafe or unsound banking practice or would reduce the amount of its capital below that necessary to meet minimum applicable regulatory capital requirements. Idaho law also limits a bank's ability to pay dividends subject to surplus reserve requirements. Additionally, current guidance from the Federal Reserve provides, among other things, that dividends per share on the Company's common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. The Company entered into an informal agreement with the Federal Reserve and the Idaho Department of Finance, which requires the Company to obtain advance approval from the Federal Reserve and the Idaho Department of Finance prior to paying any dividends. In addition, the Company is subject to contractual restrictions that limit our ability to pay dividends on our common stock, including those contained in the securities purchase agreement between us and the United States Department of the Treasury.

Capital Adequacy

Regulatory Capital Guidelines. Federal bank regulatory agencies use capital adequacy guidelines in the examination and regulation of bank holding companies and banks. The guidelines are “risk-based,” meaning that they are designed to make capital requirements more sensitive to differences in risk profiles among banks and bank holding companies.

Tier I and Tier II Capital. Under the guidelines, an institution's capital is divided into two broad categories, Tier I capital and Tier II capital. Tier I capital generally consists of common stockholders' equity (including surplus and undivided profits), qualifying non-cumulative perpetual preferred stock, and qualified minority interests in the equity accounts of consolidated subsidiaries. Tier II capital generally consists of the allowance for loan losses, hybrid capital instruments, and qualifying subordinated debt. The sum of Tier I capital and Tier II capital represents an institution's total regulatory capital. The guidelines require that at least 50% of an institution's total capital consist of Tier I capital.

Risk-based Capital Ratios. The adequacy of an institution's capital is determined primarily with reference to the institution's risk-weighted assets. The guidelines assign risk weightings to an institution's assets in an effort to quantify the relative risk of each asset and to determine the minimum capital required to support that risk. An institution's risk-weighted assets are then compared with its Tier I capital and total capital to arrive at a Tier I risk-based ratio and a total risk-based ratio, respectively. The guidelines provide that an institution must have a minimum Tier I risk-based ratio of 4% and a minimum total risk-based ratio of 8%.

Leverage Ratio. The guidelines also employ a leverage ratio, which is Tier I capital as a percentage of average total assets, less intangibles. The principal objective of the leverage ratio is to constrain the maximum degree to which a bank holding company may leverage its equity capital base. The minimum leverage ratio is 3%; however, for all but the most highly rated bank holding companies and for bank holding companies seeking to expand, regulators expect an additional cushion of at least 1% to 2%.

Prompt Corrective Action. Under the guidelines, an institution is assigned to one of five capital categories depending on its total risk-based capital ratio, Tier I risk-based capital ratio, and leverage ratio, together with certain subjective factors. The categories range from “well capitalized” to “critically undercapitalized.” Institutions that are “undercapitalized” or lower are subject to certain mandatory supervisory corrective actions. At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. During these challenging economic times, the federal banking regulators have actively enforced these provisions.

Regulatory Oversight and Examination

The Federal Reserve conducts periodic inspections of bank holding companies, which are performed both onsite and offsite. The supervisory objectives of the inspection program are to ascertain whether the financial strength of the bank holding company is being maintained on an ongoing basis and to determine the effects or consequences of transactions between a holding company or its non-banking subsidiaries and its subsidiary banks. For holding companies under $10 billion in assets, the inspection type and frequency varies depending on asset size, complexity of the organization, and the holding company's rating at its last inspection.

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Banks are subject to periodic examinations by their primary regulators. Bank examinations have evolved from reliance on transaction testing in assessing a bank's condition to a risk-focused approach. These examinations are extensive and cover the entire breadth of operations of the bank. Generally, safety and soundness examinations occur on an 18-month cycle for banks under $500 million in total assets that are well capitalized and without regulatory issues, and 12 months otherwise. Examinations alternate between the federal and state bank regulatory agency or may occur on a combined schedule. The frequency of consumer compliance and CRA examinations is linked to the size of the institution and its compliance and CRA ratings at its most recent examination. However, the examination authority of the Federal Reserve and the FDIC allows them to examine supervised banks as frequently as deemed necessary based on the condition of the bank or as a result of certain triggering events.

Corporate Governance and Accounting

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (the "Act") addresses, among other things, corporate governance, auditing and accounting, enhanced and timely disclosure of corporate information, and penalties for non-compliance. Generally, the Act (i) requires chief executive officers and chief financial officers to certify to the accuracy of periodic reports filed with the Securities and Exchange Commission (the "SEC"); (ii) imposes specific and enhanced corporate disclosure requirements; (iii) accelerates the time frame for reporting of insider transactions and periodic disclosures by public companies; (iv) requires companies to adopt and disclose information about corporate governance practices, including whether or not they have adopted a code of ethics for senior financial officers and whether the audit committee includes at least one "audit committee financial expert;" and (v) requires the SEC, based on certain enumerated factors, to regularly and systematically review corporate filings.

Anti-terrorism

USA Patriot Act of 2001. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, intended to combat terrorism, was renewed with certain amendments in 2006 (the "Patriot Act"). The Patriot Act, in relevant part, (i) prohibits banks from providing correspondent accounts directly to foreign shell banks; (ii) imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals; (iii) requires financial institutions to establish an anti-money-laundering compliance program; and (iv) eliminates civil liability for persons who file suspicious activity reports. The Act also includes provisions providing the government with power to investigate terrorism, including expanded government access to bank account records.

Financial Services Modernization

Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Financial Services Modernization