

NORTHWEST BANCORPORATION INC
Form 10-Q
November 13, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

- Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2009.**
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from _____ to _____.**

Commission file number 000-24151

NORTHWEST BANCORPORATION, INC.

(Exact name of registrant as specified in its charter)

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Washington
(State or other jurisdiction of

91-1574174
(I.R.S. Employer

incorporation or organization)

identification No.)

421 West Riverside, Spokane, WA 99201-0403

(Address of principal executive offices)

(509) 456-8888

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

The Registrant has a single class of common stock, of which there were 2,376,539 shares issued and outstanding as of November 2, 2009.

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NORTHWEST BANCORPORATION, INC.

FORM 10-Q

For the Three Months Ended September 30, 2009

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Financial Condition****(unaudited)****(dollars in thousands)**

	September 30, 2009	December 31, 2008
ASSETS		
Cash and due from banks	\$ 8,906	\$ 9,363
Federal funds sold/interest bearing balances at other financial institutions	8,820	2,050
Securities available for sale (amortized cost of \$22,787 and \$18,299, respectively)	23,671	18,722
Securities held to maturity (fair value of \$ and \$7,734, respectively)		7,512
Federal Home Loan Bank stock, at cost	1,261	1,106
Loans receivable, net of allowance for loan losses of \$6,334 and \$4,737, respectively	317,943	334,305
Loans held for sale	3,617	1,132
Accrued interest receivable	1,476	1,531
Foreclosed real estate and other repossessed assets	3,880	1,703
Premises and equipment, net	16,982	16,598
Bank owned life insurance	3,640	3,691
Other assets	3,222	2,518
TOTAL ASSETS	\$ 393,418	\$ 400,231
LIABILITIES		
Noninterest bearing demand deposits	\$ 64,789	\$ 46,900
Money market accounts	23,261	29,924
NOW accounts	21,089	14,278
Savings accounts	40,054	38,363
Time certificates of deposit, \$100,000 and over	77,618	86,145
Time certificates of deposit, under \$100,000	99,251	100,444
TOTAL DEPOSITS	326,062	316,054
Securities sold under agreement to repurchase	794	22,101
Federal funds purchased		3,465
Borrowed funds	22,526	23,382
Capital lease liability	599	599
Junior subordinated debentures issued in connection with trust preferred securities	5,155	5,155
Accrued interest payable	819	837
Other liabilities	1,783	1,719
TOTAL LIABILITIES	357,738	373,312
SHAREHOLDERS EQUITY		
Preferred stock - Series A Cumulative Perpetual; \$1,000 par value; \$1,000 liquidation value; 10,500 shares authorized and issued	9,983	

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Preferred stock - Series B Cumulative Perpetual; \$0.01 par value; \$1,000 liquidation value; 525 shares authorized and issued	583	
Common stock, no par, 5,000,000 shares authorized; issued and outstanding 2,376,539 on September 30, 2009 and 2,367,246 on December 31, 2008	23,266	23,211
Retained earnings	1,265	3,429
Accumulated other comprehensive income, net of tax effect of \$301 for 2009 and \$144 for 2008	583	279
TOTAL SHAREHOLDERS EQUITY	35,680	26,919
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 393,418	\$ 400,231

See accompanying notes.

Table of Contents**NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Operations****(unaudited)****(dollars in thousands, except per share data)**

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Interest income:				
Interest and fees on loans	\$ 5,272	\$ 5,583	\$ 15,718	\$ 16,302
Interest on securities	225	305	699	992
Interest on federal funds sold	8	13	12	103
Total interest income	5,505	5,901	16,429	17,397
Interest expense:				
Interest on deposits	1,758	2,254	5,456	6,763
Interest on securities sold under agreement to repurchase		57	7	205
Interest on borrowed funds	285	303	884	754
Total interest expense	2,043	2,614	6,347	7,722
Net interest income	3,462	3,287	10,082	9,675
Provision for loan losses	2,400	625	5,300	1,000
Net interest income after provision for loan losses	1,062	2,662	4,782	8,675
Noninterest income:				
Fees and service charges	395	344	1,100	898
Net gain from sale of loans	148	88	514	347
Other noninterest income	221	210	839	616
Total noninterest income	764	642	2,453	1,861
Noninterest expense:				
Salaries and employee benefits	1,555	1,679	4,955	5,023
Occupancy and equipment	346	278	1,010	845
Depreciation and amortization	247	220	741	569
Other operating	1,015	814	3,656	2,394
Total noninterest expense	3,163	2,991	10,362	8,831
(Loss) income before income taxes	(1,337)	313	(3,127)	1,705
Income tax (benefit) expense	(706)	110	(1,394)	564
Net (loss) income	(\$631)	\$ 203	(\$1,733)	\$ 1,141
Preferred stock dividends	146		365	
Preferred stock discount accretion, net	27		66	
Net (loss) income applicable to common shares	(\$804)	\$ 203	(\$2,164)	\$ 1,141
Earnings (loss) per common share - basic	\$ (0.34)	\$ 0.09	\$ (0.91)	\$ 0.48
Earnings (loss) per common share - diluted	\$ (0.34)	\$ 0.09	\$ (0.91)	\$ 0.48

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Weighted average shares outstanding - basic	2,376,539	2,367,246	2,371,540	2,364,817
Weighted average shares outstanding - diluted	2,376,539	2,377,526	2,371,540	2,382,624
Cumulative dividends declared per common share	\$	\$	\$ 0.20	\$ 0.20

See accompanying notes.

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

	Total	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Loss
Balance, December 31, 2007	\$ 27,346	\$	\$ 23,039	\$ 4,178	\$ 129	
Net loss	(275)			(275)		(\$275)
Stock issued to directors	69		69			
Equity-based compensation expense and related tax effects	103		103			
Cash dividend (\$0.20 per share)	(474)			(474)		
Change in unrealized gain on securities available for sale, net of taxes	150				150	150
Comprehensive loss						(\$125)
Balance December 31, 2008	26,919		23,211	3,429	279	
Net loss	(1,733)			(1,733)		(1,733)
Stock issued to directors	22		22			
Issuance of preferred stock series A	9,909	9,909				
Issuance of preferred stock series B	591	591				
Cash dividends declared on preferred stock	(365)			(365)		
Accretion of preferred stock discount, net		66		(66)		
Equity-based compensation expense and related tax effects	33		33			
Change in unrealized gain on securities available for sale, net of taxes	304				304	304
Comprehensive loss						(\$1,429)
Balance, September 30, 2009	\$ 35,680	\$ 10,566	\$ 23,266	\$ 1,265	\$ 583	
Disclosure of 2009 reclassification amount:						
Net change in unrealized holding gains on available for sale securities	\$ 112					
Reclassification adjustment for transfer of held to maturity securities	340					
Reclassification adjustment for net gains realized in income	9					
Net change in unrealized gains	461					
Tax effect	(157)					
Net of tax amount	\$ 304					

See accompanying notes.

Table of Contents**NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****Consolidated Statements of Cash Flows****(unaudited)****(dollars in thousands)**

	Nine months ended September 30,	
	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss) income	(\$1,733)	\$ 1,141
Adjustments to reconcile net (loss) income to cash provided by operating activities:		
Provision for loan losses	5,300	1,000
Depreciation and amortization	741	569
Net (increase) decrease in bank owned life insurance	51	(99)
Net (gain) loss on sale of foreclosed real estate and other repossessed assets	243	(293)
Equity-based compensation expense	33	77
Originations of loans held for sale	(36,045)	(23,318)
Proceeds from sales of loans held for sale	34,074	25,038
Gain on sale of loans	(514)	(347)
Change in assets and liabilities:		
Accrued interest receivable	55	(16)
Other assets	(861)	(348)
Interest payable	(18)	(294)
Other liabilities	(12)	(142)
Net cash provided by operating activities	1,314	2,968
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) decrease in federal funds sold/interest bearing balances at other financial institutions	(6,770)	3,119
Net decrease in investment securities	3,024	10,332
Purchases of FHLB stock	(155)	
Net (increase) decrease in loans	7,495	(57,825)
Purchase of premises and equipment, net of gain or loss on asset disposal	(1,125)	(5,671)
Proceeds from sale of foreclosed real estate and other repossessed assets	1,147	
Net cash (used) provided by investing activities	3,616	(50,045)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	10,008	37,372
Net decrease in securities sold under agreement to repurchase	(21,307)	(11,336)
Net increase (decrease) in federal funds purchased	(3,465)	8,910
Repayment of borrowed funds	(5,856)	
Proceeds from issuance of borrowed funds	5,000	10,738
Proceeds from issuance of preferred stock	10,500	
Proceeds from issuance of common stock	22	69
Cash dividend paid	(289)	(474)
Net cash (used) provided by financing activities	(5,387)	45,279
NET CHANGE IN CASH AND CASH EQUIVALENTS	(457)	(1,798)
Cash and cash equivalents, beginning of year	9,363	8,155
Cash and cash equivalents, end of period	\$ 8,906	\$ 6,357

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SUPPLEMENTAL DISCLOSURES

Cash paid during the year for:

Interest	\$ 6,365	\$ 8,016
Income taxes	\$	\$ 704

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

Net change in fair value of securities available for sale	\$ 304	\$ (46)
Acquisition of real estate and other repossessed assets in settlement of loans	\$ 3,567	\$ 299
Preferred stock dividend accrued and paid in subsequent period	\$ 76	\$

See accompanying notes.

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NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. Basis of Presentation and Consolidation

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

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2008. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented. The results of operations for the three-month and nine-month periods ended September 30, 2009 and 2008 are not necessarily indicative of the operating results for the full year. Certain prior year balances have been reclassified to conform to the current year presentation. These reclassifications had no effect on retained earnings or net income as previously presented.

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

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition and disclosure through November 13, 2009, the date the financial statements were issued. In management's opinion, all accounting adjustments necessary to accurately reflect the financial position and results of operations on the accompanying financial statements have been made.

NOTE 2. New Accounting Pronouncements

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification (ASC) and the Hierarchy of Generally Accepted Accounting Principles* a replacement of FASB Statement No. 162. The Standard established ASC 105 which establishes a single source of authoritative, nongovernmental U.S. GAAP, except for rules and interpretive releases of the SEC. The effective date of ASC 105 is for interim and annual reporting periods ending after September 15, 2009. ASC 105 does not have an impact on our company's financial position or results of operations as it does not change authoritative guidance.

In August 2009, the FASB issued ASU 2009-05, *Measuring Liabilities at Fair Value*. ASU 2009-05 is an amendment of ASC 820, *Fair Value Measurements and Disclosures*. ASU 2009-05 applies to all entities that measure liabilities at fair value within the scope of ASC 820, *Fair Value Measurements and Disclosures*. ASU 2009-05 provides guidance on measuring fair value of liabilities under circumstances in which a quoted price in an active market for the identical liability is not available. ASU 2009-05, which is effective for the first interim or annual reporting period beginning after August 28, 2009, will not have a material impact on our company's financial statements.

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NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In September 2009, the FASB issued ASU 2009-06, Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities. ASU 2009-06 is an amendment of ASC 740, *Income Taxes*. ASU 2009-06 provides guidance on accounting for uncertainty in income taxes and modifies certain disclosure requirements for nonpublic entities. ASU 2009-06, which is effective for the first interim or annual reporting period ending after September 15, 2009, did not have a material impact on the company's financial statements.

In September 2009, the FASB issued ASU 2009-08, Earnings Per Share. ASU 2009-08 is an amendment of ASC 260, *Earnings Per Share*. ASU 2009-08 provides technical corrections on computing earnings per share for a period that includes a redemption or an induced conversion of a portion of a class of preferred stock. ASU 2009-08 did not have a material impact on the company's financial statements.

In September 2009, the FASB issued ASU 2009-12, Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent). ASU 2009-12 provides guidance on estimating fair value of alternative investments when using the net asset value per share provided by the investment entity. The effective date of ASU 2009-12 is for interim and annual periods ending after December 15, 2009, with early adoption permitted. ASU 2009-12 will not have a material impact on our company's financial statements.

NOTE 3. Business Segments

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

Generally accepted accounting principles establish standards to report information about operating segments in annual financial statements and require reporting of selected information about operating segments in interim reports to stockholders. The Company has determined that its current business and operations consist of a single business segment.

NOTE 4. Stock-Based Compensation

On May 15, 2006, shareholders approved the Inland Northwest Bank 2006 Share Incentive Plan (the "Plan") and the issuance of shares of common stock of the Company pursuant to the Plan. This Plan is an amendment and restatement of the Inland Northwest Bank Non-Qualified Stock Option Plan originally effective July 21, 1992, as revised December 21, 1993, December 21, 1999 and April 16, 2002. Prior to 2006, the Plan allowed only for the award of stock options; with the approval of the amendment and restatement of the Plan in May 2006, the Company was also authorized to grant restricted stock awards to key employees of the Bank. Since the adoption of the amendments to the Plan in May 2006, stock options are, for the most part, expected to be awarded during the process of recruiting new employees to the Bank. The maximum number of stock options and restricted shares that may be awarded under the Plan, as adjusted for stock dividends, is 384,912. At September 30, 2009, 216,516 shares and/or options were available for award to employees.

Additional information regarding stock options and restricted stock outstanding at December 31, 2008 is detailed in Note 14 "Stock Based Compensation" in the audited consolidated financial statements and the accompanying notes included in the annual report on Form 10-K for the year ended December 31, 2008. Note 14 also provides additional details on the method of accounting for stock-based compensation expense and the Black-Scholes model assumptions utilized to calculate that expense. Stock based compensation expense of \$19,000 and \$25,000 was recorded for the three months ending September 30, 2009 and 2008. The Company recorded stock based

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compensation expense of \$58,000 and \$103,000 for the nine months ended September 30, 2009 and 2008, respectively. At September 30, 2009, compensation costs not yet recognized for non-vested stock grant and option awards is \$30,773.

Stock option awards are subject to a graded five-year vesting period and expire ten years from the date of the grant. The exercise price of each option equals the fair market value of the Company's stock on the date of the grant. The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. No stock options were awarded during 2008 or 2009. Stock options outstanding and exercisable as of September 30, 2009 are as follows:

	Number of shares	Weighted average fair value
Outstanding, December 31, 2008	14,973	15.84
Granted		
Forfeited	(2,275)	15.94
Exercised	(4,095)	16.98
Outstanding, September 30, 2009	8,603	15.28

Restricted stock awards cliff vest after three years with compensation expense recorded over the vesting period equal to the fair market value of the Company's stock on the date of the award. No restricted stock was awarded in 2008 or 2009. Shares issued during 2009 in connection with previously granted restricted stock-awards totaled 4,095. Restricted stock-awards outstanding as of September 30, 2009 are as follows:

	Number of shares	Weighted- average exercise price
Outstanding options, December 31, 2008	112,364	\$ 10.06
Granted		
Exercised		
Forfeited	5,858	13.26
Outstanding options, September 30, 2009	106,506	9.88
Options exercisable, September 30, 2009	98,966	

NOTE 5. Securities

All securities held by the Bank at September 30, 2009 are classified as available for sale and are stated at fair value with unrealized holding gains and losses, net of related deferred taxes, reported as a separate component of shareholders' equity. Realized gains or losses on sales of available for sale securities are reported as part of noninterest income based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are recognized in interest income using the effective method over the period to maturity unless the security is called prior to maturity. When a security is called prior to maturity, any remaining premium or discount is reported as noninterest income. There were no securities sold in the nine month periods ending September 30, 2009 and 2008; consequently, there were no gains or losses included in noninterest income due to the sale of securities. Some securities were called prior to maturity during the nine month period ended September 30, 2009 and 2008; remaining net discounts on those securities resulted in \$9 thousand and \$18 thousand in noninterest income for that period, respectively.

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Held to maturity securities with a carrying value of \$9.6 million and an unrealized gain of \$340 thousand were reclassified as available for sale during September 2009. Unrealized gains totaling \$224 thousand was recorded in Other Comprehensive Loss along with a \$116 thousand increase in deferred tax assets. The decision to reclassify held to maturity securities was based on changes in the Bank's liquidity management strategy. Management, as part of their liquidity management strategy, does not intend to classify investments as held-to-maturity in the near-term.

The amortized cost of securities and their approximate fair values at September 30, 2009 and December 31, 2008 were as follows:

	Amortized Cost	September 30, 2009 Gross Unrealized Gains		Gross Unrealized Losses	Fair Value
		(\$ in thousands)			
Securities available for sale:					
U.S. government agency securities	\$ 7,205	\$ 114	\$ 30	\$ 7,289	
Corporate debt obligations	500		4	496	
State and municipal securities	9,857	510	66	10,301	
Mortgage backed securities	5,225	360		5,585	
	\$ 22,787	\$ 984	\$ 100	\$ 23,671	
December 31, 2008					
	Amortized Cost	Gross Unrealized Gains		Gross Unrealized Losses	Fair Value
		(\$ in thousands)			
Securities available for sale:					
U.S. government agency securities	\$ 8,491	\$ 155	\$	\$ 8,646	
U.S. treasury securities	2,998	2		3,000	
Corporate debt obligations	500		18	482	
Mortgage backed securities	6,310	284		6,594	
	\$ 18,299	\$ 441	\$ 18	\$ 18,722	
December 31, 2008					
	Amortized Cost	Gross Unrealized Gains		Gross Unrealized Losses	Fair Value
		(\$ in thousands)			
Securities held to maturity:					
State and municipal securities	\$ 7,512	\$ 229	\$ 7	\$ 7,734	

Table of Contents**NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

	September 30, 2009					
	Impaired Less Than 12 Months		Impaired 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(\$ in thousands)					
U.S. government agency securities	\$ 3,674	\$ 30	\$	\$	\$ 3,674	\$ 30
Corporate debt obligations			496	4	496	4
State and municipal securities	259	1	119	65	378	66
	\$ 3,933	\$ 31	\$ 615	\$ 69	\$ 4,548	\$ 100

	December 31, 2008					
	Impaired Less Than 12 Months		Impaired 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(\$ in thousands)					
Corporate debt obligations	\$	\$	\$ 482	\$ 18	\$ 482	\$ 18
State and municipal securities	246	7			246	7
	\$ 246	\$ 7	\$ 482	\$ 18	\$ 728	\$ 25

Management has evaluated the above securities and does not believe that any individual unrealized loss as of September 30, 2009, represents an other-than-temporary impairment. The decline in fair market value of these securities is generally due to changes in interest rates since purchase and is not related to any known decline in the creditworthiness of the issuer. At September 30, 2009, seven securities had unrealized losses.

At September 30, 2009, the Bank owned \$1.3 million of stock of the Federal Home Loan Bank of Seattle (FHLB). As a condition of membership in the FHLB, the Bank is required to purchase and hold a certain amount of FHLB stock, which is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. FHLB stock has a par value of \$100 per share, is carried at cost, and is subject to impairment testing per ASC 320-10-35. The FHLB recently announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (FHFA), its primary regulator, and that it would suspend future dividends and the repurchase and redemption of outstanding capital stock. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in the FHLB's balance sheet. As a result, an other than temporary impairment has not been recorded for the Bank's investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. Management will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of the Bank's investment.

Table of Contents**NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Scheduled maturities of securities available for sale at September 30, 2009, are as follows:

	Available for sale	
	Amortized Cost	Fair Value
	(\$ in thousands)	
Due in one year or less	\$ 1,111	\$ 1,140
Due from one year to five years	4,274	4,479
Due from five to then years	8,905	9,149
Due after ten years	3,272	3,318
Mortgage backed securities	5,225	5,585
	\$ 22,787	\$ 23,671

At September 30, 2009 and December 31, 2008, securities with an amortized cost of \$19.9 million and \$25.8 million, respectively, were pledged to secure public deposits, repurchase agreements, and for other purposes as required or permitted by law. The market value for these securities was \$20.7 million and \$26.5 million at September 30, 2009 and December 31, 2008, respectively.

NOTE 6. Loans

Loan detail by category is as follows:

	September 30, 2009	December 31, 2008
	(\$ in thousands)	
1-4 family and multi-family real estate	\$ 45,830	\$ 41,453
Commercial real estate	135,818	131,597
Commercial construction	40,574	53,039
Commercial non-real estate	57,142	65,656
Land and land development	35,390	37,927
Consumer	10,273	10,316
	325,027	339,988
Allowance for loan losses	(6,334)	(4,737)
Net deferred loan fees	(750)	(946)
	\$ 317,943	\$ 334,305

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

September 30, 2009		December 31, 2008	
Loan Amount	Specific Reserve	Loan Amount	Specific Reserve

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	(\$ in thousands)		(\$ in thousands)	
Impaired Loans:				
Loans placed on nonaccrual	\$ 13,555	\$ 1,000	\$ 16,030	\$ 767
Loans on accrual status	205		3,864	136
Total impaired loans	\$ 13,760	\$ 1,000	\$ 19,894	\$ 903

NOTE 7. Allowance for Loan Losses

The Bank maintains an allowance for loan losses at a level considered adequate by management to provide for probable credit losses in the Bank's loan portfolio. Future credit losses are estimated through an analysis of various factors affecting the performance of the loan portfolio, including: individual review of problem loans, including an evaluation of the quality of underlying collateral; current business conditions and the Bank's

Table of Contents**NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

historical loan loss experience; the term, in years, that the average loan is expected to remain on the Bank's books; and other factors that management determines to be relevant at the time of the analysis. In accordance with accounting and regulatory requirements, the portion of the allowance relating to unused loan commitments and other off-balance sheet items is reclassified to Other liabilities. Changes in the allowance for loan losses for the periods indicated were as follows:

	Three months ended		Nine months ended	
	9/30/2009	9/30/2008	9/30/2009	9/30/2008
	(\$ in thousands)		(\$ in thousands)	
Balance, beginning of period	\$ 4,425	\$ 3,225	\$ 4,737	\$ 2,711
Add reserve for probable losses on unused loan commitments and off-balance sheet (OBS) items	167	96	262	267
Balance, beginning of period, including OBS reserve	4,592	3,321	4,999	2,978
Provision for loan losses	2,400	625	5,300	1,000
Loan charge-offs	(502)	(357)	(3,818)	(406)
Loan recoveries	6	5	15	22
Balance, end of period, prior to adjustment for OBS items	6,496	3,594	6,496	3,594
Reclassification of OBS reserve to Other liabilities	(162)	(106)	(162)	(106)
Balance, end of period	\$ 6,334	\$ 3,488	\$ 6,334	\$ 3,488

NOTE 8. Borrowed Funds

Borrowed funds consist of the following:

	September 30, 2009	December 31, 2008
	(\$ in thousands)	
Federal Home Loan Bank (FHLB) advances	\$ 22,526	\$ 20,490
Other borrowed funds		2,892
	\$ 22,526	\$ 23,382

FHLB advances are secured by a blanket pledge on Bank assets and specifically by certain loan balances. Other borrowed funds consisted of a note payable to a local bank, which was paid in full on February 13, 2009.

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

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	September 30, 2009		December 31, 2008	
	Line Amount	Outstanding Balance	Line Amount	Outstanding Balance
	<i>(\$ in thousands)</i>			
Federal Home Loan Bank	\$ 36,308	\$	\$ 35,033	\$
Pacific Coast Bankers Bank	10,000		10,000	3,465
Zions Bank	100		5,000	
Key Bank			10,000	
U.S. Bank			1,500	

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NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the first quarter of 2009, KeyBank and U.S. Bank cancelled the Bank's operating lines of credit. In addition, Zions Bank reduced the Bank's line of credit from \$5 million to \$100 thousand.

NOTE 9. Capital Lease Liability

The capital lease liability outstanding on September 30, 2009 and December 31, 2008 is related to a ground lease, with a purchase option, that the Bank entered into in early 2005 (a copy of the ground lease was filed as an Exhibit to the Company's annual report on Form 10-KSB filed with the SEC on March 24, 2005). As a capitalized lease, the value of the property is included as an asset on the consolidated statement of financial condition in Premises and equipment, net, and the net present value of future payments is included as a liability in Capital lease liability.

NOTE 10. Material Contracts

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

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

NOTE 11. Junior Subordinated Debentures

In June 2005, the Company issued junior subordinated debentures with an aggregate value of \$5.16 million to Northwest Bancorporation Capital Trust I (the Trust), with interest fixed at 5.95% through June 30, 2010, thereafter re-pricing quarterly at three-month LIBOR plus 1.70%. The Trust issued \$155 thousand of common securities to the Company and capital securities with an aggregate liquidation amount of \$5 million to third-party investors. The common securities are included in Other assets on the consolidated statement of financial condition; the subordinated debentures are detailed individually in this report and are included in Borrowed funds in the consolidated financial statements included in the annual report on Form 10-K for the year ended December 31, 2008. The subordinated debentures are includable as Tier I capital for regulatory purposes. The subordinated debentures and the capital securities pay interest and dividends, respectively, on a quarterly basis, which are included in interest expense. The subordinated debentures will mature on June 30, 2035, at which time the capital securities must be redeemed. The subordinated debentures and capital securities can be redeemed prior to maturity, at the Company's discretion, in whole or in part, beginning June 30, 2010, at par value. The Company has provided a full and unconditional guarantee of the obligations of the Trust under the capital

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securities in the event of default. The Trust is not consolidated in these financial statements, pursuant to Financial Accounting Standards Board Interpretation No. 46(R), Consolidation of Variable Interest Entities. The Company reports the junior subordinated debentures within the liabilities section of the consolidated statements of financial condition.

The following table presents a summary of trust preferred securities at September 30, 2009 and December 31, 2008:

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

NOTE 12. Common Stock

On April 15, 2008, the Board of Directors declared a twenty-cent (\$0.20) per share annual cash dividend that was paid on June 13, 2008 to shareholders of record as of May 9, 2008. No cash dividends have been declared in 2009.

NOTE 13. Fair Value Measurements

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

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

The following table summarizes the Company's financial instruments that were measured at fair value on a recurring basis at September 30, 2009:

Description of Financial Instrument	Fair Value	Fair Value Measurement Level			Nine months ended 9/30/2009 Total Gain
		Level 1	Level 2	Level 3	
	(\$ in thousands)				
Securities available for sale	\$ 23,671	\$	\$ 23,671	\$	\$ 112

The unrealized gain or loss on securities available for sale is recorded in Comprehensive Income (Loss) net of tax effect.

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NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Certain financial assets are measured at fair value on a non-recurring basis from application of lower of cost or market accounting or write-downs of individual assets due to impairment. The following table summarizes the Company's financial instruments that were measured at fair value on a non-recurring basis at September 30, 2009, and the total loss recognized as a result of fair value adjustments for the nine months ended September 30, 2009:

Description of Financial Instrument	Fair Value	Fair Value Measurement Level			Nine months ended 9/30/2009 Total Loss
		Level 1	Level 2	Level 3	
Impaired loans	\$ 12,760	\$		\$ 12,760	\$ 3,001
Foreclosed real estate and other repossessed assets	3,880			3,880	300

Impaired loans included above, with the exception of \$205 thousand in restructured notes, were over 90 days past due and have been placed on nonaccrual status. The loss reflected above includes partial principal charge-offs of \$2.25 million, application of interest payments received as a reduction of principal totaling \$291 thousand and increases in specific reserves in the allowance for loan losses totaling \$455 thousand. The losses were reported in the Consolidated Statement of Operations as a reduction of interest and fees on loans totaling \$291 thousand with the remaining loss resulting in increased provision for loan losses during the period.

The following methods and significant assumptions were used to estimate fair values:

Securities available for sale. The fair values of securities available for sale are generally measured using information from a third-party pricing service. If quoted prices are available in an active market, securities are classified as Level 1 measurements and include Treasury Department securities. If quoted prices in active markets are not available, fair values are estimated using pricing models (quoted prices of securities with similar characteristics or discounted cash flows) and classified as Level 2 measurements.

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

Impaired Loans. Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or market value. Market value is measured based on the value of the collateral securing these loans. The value of real estate collateral is determined based on an independent appraisal. The value of business equipment, inventory and accounts receivable collateral is typically based on the net book value on the business' financial statements, but in some cases an appraisal is obtained for equipment and inventory. Appraised and reported values may be discounted based on management's review and analysis, which may include historical knowledge, changes in market conditions, estimated selling and other anticipated costs, and/or expertise and knowledge of the customer and the customer's business. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses and is reported in the Total Loss column above.

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

	September 30, 2009		December 31, 2008	
	Carrying Amount	Estimated Fair Value (\$ in thousands)	Carrying Amount	Estimated Fair Value
Financial Assets:				
Cash and due from banks	\$ 8,906	\$ 8,906	\$ 9,363	\$ 9,363
Federal funds sold/interest bearing balances at other financial institutions	8,820	8,820	2,050	2,050
Securities available for sale	23,671	23,671	18,722	18,722
Securities held to maturity			7,512	7,734
Federal Home Loan Bank stock	1,261	1,261	1,106	1,106
Loans and loans held for sale, net	321,560	326,884	335,437	340,478
Bank owned life insurance	3,640	3,640	3,691	3,691
Financial Liabilities:				
Deposits	326,062	328,602	316,054	318,961
Securities sold under agreements to repurchase	794	794	22,101	22,101
Federal funds purchased			3,465	3,465
Borrowed funds	22,526	23,051	23,382	24,025
Junior subordinated debentures	5,155	5,144	5,155	5,126

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

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

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

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

Federal funds purchased: The carrying amount approximates fair value.

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

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

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

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

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NORTHWEST BANCORPORATION, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. Income Tax (Benefit) Expense

The effective tax rates presented for the nine months ended September 30, 2009 are not consistent with the nine months ended September 30, 2008 or the Company's historical effective tax rates. Our normal, expected statutory income tax rate is 36.0%, representing a blend of the statutory federal income tax rate of 34.0% and apportioned effects of the Idaho income tax rate of 7.6%. Our effective tax rates have historically been lower than statutory tax rates due to permanent differences arising primarily from nontaxable interest income on state and municipal securities and nontaxable gains in bank owned life insurance. The effect of these permanent differences combined with a loss before income taxes, and adjustments related to certain state deferred tax benefits, has resulted in a higher effective tax benefit percentage in the nine months ending September 30, 2009.

As of September 30, 2009 and December 31, 2008, the Company had recorded net deferred income tax assets (which are included in other assets in the accompanying consolidated statements of financial condition) of approximately \$712 thousand and \$444 thousand, respectively. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is more likely than not that all or a portion of the deferred tax asset will not be realized. More likely than not is defined as greater than a 50% probability of occurrence. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Management's assessment is primarily dependent on historical taxable income and projections of future taxable income, which are directly related to the Company's core earnings capacity and its prospects to generate core earnings in the future. In assessing the need for a valuation allowance, we examine our historical cumulative trailing three-year pre-tax income (loss) quarterly. If we have historical cumulative income, we consider this to be strong positive evidence. To the extent we do not have cumulative income, we examine this to determine if there were any unusual or non-recurring items which would not be indicative of our operating results or expected to occur in the future.

Based upon management's analysis of available evidence, it has determined that it is more likely than not that the Company's deferred income tax assets as of September 30, 2009 will be fully realized and, therefore, no valuation allowance was recorded. However, the Company can give no assurance that in the future its deferred tax asset will not be impaired since such determination is based on projections of future earnings, which are subject to uncertainty and estimates that may change given the uncertain economic outlook, banking industry conditions and other factors.

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

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

Forward-Looking Statements

From time to time, the Company and its senior managers have made and will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be contained in this report and in other documents that the Company files with the Securities and Exchange Commission (the SEC). Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Also, forward-looking statements can generally be identified by words such as may, could, should, would, believe, anticipate, estimate, seek, expect, intend, plan and similar expressions.

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

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

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

applicable laws and regulations and legislative or regulatory changes;

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

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

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

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

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

technological and management changes;

growth and acquisition strategies;

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

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

changes in consumer spending and saving habits;

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

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

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

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in the Company's 2008 Annual Report on Form 10-K.

Table of Contents**Summary of Critical Accounting Policies**

The SEC defines critical accounting policies as those that require the application of management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in future periods. The accounting policies that the Company's management have identified as critical to understanding the Company's financial statements and operating results are described in Note 1 of the Notes to Consolidated Financial Statements in the Company's annual report on Form 10-K for the year ended December 31, 2008. There have been no significant changes in our application of accounting policies since December 31, 2008.

Comparison of Results of Operations for the Three Months and Nine Months Ended September 30, 2009 and 2008**Summary**

The Company reported a net loss applicable to common shares of \$804 thousand for the three months ended September 30, 2009, compared to net income of \$203 thousand for the comparable period in 2008. The third quarter net loss resulted in a \$2.16 million loss for the first nine months of 2009, compared to net income of \$1.14 million for the first nine months of 2008. The provision for loan losses increased to \$5.3 million for the nine months ended September 30, 2009, compared to \$1.0 million for the same period in 2008. The Bank increased provisioning during the three months ended September 30, 2009 to \$2.4 million, due to a higher level of nonperforming loans, delinquencies and net charge-offs.

During the first nine months of 2009, total assets decreased \$6.8 million, or 1.7%, and total gross loans decreased \$15.0 million, or 4.4%; deposits grew \$10 million or 3.2% during the same period.

The table below summarizes the Company's financial performance for the three months and nine months ended September 30, 2009 and 2008:

Financial Highlights

	Three months ended September 30, 2009 2008 % Change			Nine months ended September 30, 2009 2008 % Change		
	(\$ in thousands, except per share data)			(\$ in thousands, except per share data)		
Results of Operations:						
Interest income	\$ 5,505	\$ 5,901	-6.7%	\$ 16,429	\$ 17,397	-5.6%
Interest expense	2,043	2,614	-21.8%	6,347	7,722	-17.8%
Net interest income	3,462	3,287	5.3%	10,082	9,675	4.2%
Provision for loan losses	2,400	625	284.0%	5,300	1,000	430.0%
Net interest income after provision for loan losses	1,062	2,662	-60.1%	4,782	8,675	-44.9%
Noninterest income	764	642	19.0%	2,453	1,861	31.8%
Noninterest expense	3,163	2,991	5.8%	10,362	8,831	17.3%
(Loss) income before income taxes	(1,337)	313	-527.2%	(3,127)	1,705	-283.4%
Income tax (benefit) expense	(706)	110	-741.8%	(1,394)	564	-347.2%
Net (loss) income	(631)	203	-410.8%	(1,733)	1,141	-251.9%
Preferred stock dividends and discount accretion	173			431		
Net (loss) income applicable to common shares	\$ (804)	\$ 203	-496.1%	\$ (2,164)	\$ 1,141	-289.7%
Share Data:						
Basic earnings (loss) per common share	\$ (0.34)	\$ 0.09		\$ (0.91)	\$ 0.48	
Diluted earnings (loss) per common share	\$ (0.34)	\$ 0.09		\$ (0.91)	\$ 0.48	
Selected Ratios:						

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Return on average assets	-0.81%	0.21%	-0.72%	0.42%
Return on average equity	-8.96%	2.90%	-9.22%	5.44%
Net interest income to average earning assets	3.76%	3.66%	3.66%	3.79%
Efficiency ratio	74.85%	76.13%	82.66%	76.60%
Noninterest income to average assets	0.77%	0.67%	0.82%	0.68%
Noninterest expense to average assets	3.17%	3.12%	3.45%	3.23%
Ending shareholders' equity to average assets	8.94%	7.03%	8.91%	7.56%
Nonperforming loans to gross loans	4.17%	2.37%	4.17%	2.37%
Allowance for loan losses to gross loans	1.95%	1.04%	1.95%	1.04%

Table of Contents*Net Interest Income*

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

The following table presents an analysis of the Bank's net interest income and net interest margin for the three months ended September 30, 2009 and 2008:

	Three months ended September 30,					
	Average Balance	2009 Interest Income or Expense	Average Yield or Cost	Average Balance	2008 Interest Income or Expense	Average Yield or Cost
(\$ in thousands)						
ASSETS						
Loans, gross ^{1,2}	\$ 338,753	\$ 5,272	6.23%	\$ 330,610	\$ 5,583	6.75%
Taxable investments	13,394	134	4.00%	18,669	226	4.84%
Nontaxable investments ³	9,038	91	4.03%	7,721	77	3.99%
FHLB stock	1,181		0.00%	890	2	0.90%
Federal funds sold & interest-bearing deposits with banks	6,208	8	0.52%	1,083	13	4.80%
Total interest earning assets	368,574	5,505	5.97%	358,973	5,901	6.58%
Less reserve for probable loan losses	(5,183)			(3,288)		
Cash and due from banks	8,456			6,746		
Other non-earning assets	27,247			20,563		
Total assets	\$ 399,094			\$ 382,994		
LIABILITIES AND SHAREHOLDERS' EQUITY						
NOW accounts	15,251	17	0.45%	14,049	31	0.88%
Money market accounts	28,521	64	0.90%	32,187	144	1.79%
Savings accounts	42,116	138	1.31%	36,747	236	2.57%
Time certificates of deposit	181,382	1,539	3.39%	174,356	1,843	4.23%
Total interest bearing deposits	267,270	1,758	2.63%	257,339	2,254	3.50%
Securities sold under repurchase agreements	3,496		0.00%	17,566	57	1.30%
Borrowed funds	22,977	206	3.59%	21,400	225	4.21%
Junior subordinated note ⁴	5,155	79	6.13%	5,155	78	6.05%
Total borrowed funds	31,628	285	3.60%	44,121	360	3.26%
Total interest bearing liabilities	298,898	2,043	2.73%	301,460	2,614	3.47%
Demand deposits	62,456			48,565		
Other liabilities	1,852			4,972		
Shareholders' equity	35,888			27,997		
Total liabilities and shareholders' equity	\$ 399,094			\$ 382,994		
Net interest income		\$ 3,462			\$ 3,287	
Net interest spread			3.24%			3.11%

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Net interest income to average earning assets (margin)	3.76%	3.66%
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Comments:

1. Nonaccrual loan balances are included in average loan balances; however, no interest income is imputed to nonaccrual loans.
2. Loan fee income in the amount of \$127 thousand and \$170 thousand is included in loan interest income for 2009 and 2008, respectively.
3. Yields have not been adjusted on tax-exempt investments to determine a tax-equivalent yield.
4. Junior subordinated note interest is fixed at 5.95%. Interest is computed using 360/365, which results in a higher annual percentage rate.

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The following table presents an analysis of the Bank's net interest income and net interest margin for the nine months ended September 30, 2009 and 2008:

	Nine months ended September 30,					
	Average Balance	2009 Interest Income or Expense	Average Yield or Cost	Average Balance	2008 Interest Income or Expense	Average Yield or Cost
ASSETS						
Loans, gross ^{1,2}	\$ 332,579	\$ 15,718	6.30%	\$ 307,088	\$ 16,302	7.08%
Taxable investments	11,473	444	5.16%	20,448	757	4.94%
Nontaxable investments ³	9,624	255	3.53%	7,321	229	4.17%
FHLB stock	1,261		0.00%	746	6	1.07%
Federal funds sold & interest-bearing deposits with banks	12,494	12	0.13%	5,012	103	2.74%
Total interest earning assets	367,431	16,429	5.96%	340,615	17,397	6.81%
Less reserve for probable loan losses	(5,097)			(3,022)		
Cash and due from banks	9,187			7,119		
Other non-earning assets	28,748			19,971		
Total assets	\$ 400,269			\$ 364,683		
LIABILITIES AND SHAREHOLDERS' EQUITY						
NOW accounts	16,965	48	0.38%	14,274	91	0.85%
Money market accounts	26,432	186	0.94%	32,161	445	1.84%
Savings accounts	43,231	408	1.26%	28,775	508	2.35%
Time certificates of deposit	178,214	4,814	3.60%	171,233	5,719	4.45%
Total interest bearing deposits	264,842	5,456	2.75%	246,443	6,763	3.66%
Securities sold under repurchase agreements	852	7	1.10%	18,569	205	1.47%
Borrowed funds	23,589	650	3.67%	14,147	520	4.90%
Junior subordinated note ⁴	5,155	234	6.05%	5,155	234	6.05%
Total borrowed funds	29,596	891	4.01%	37,871	959	3.38%
Total interest bearing liabilities	294,438	6,347	2.87%	284,314	7,722	3.62%
Demand deposits	66,550			47,722		
Other liabilities	7,982			4,683		
Shareholders' equity	31,299			27,964		
Total liabilities and shareholders' equity	\$ 400,269			\$ 364,683		
Net interest income		\$ 10,082			\$ 9,675	
Net interest spread			3.09%			3.19%
Net interest income to average earning assets (margin)			3.66%			3.79%

Comments:

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1. Nonaccrual loan balances are included in average loan balances; however, no interest income is imputed to nonaccrual loans.
 2. Loan fee income in the amount of \$441 thousand and \$500 thousand is included in loan interest income for 2009 and 2008, respectively.
 3. Yields have not been adjusted on tax-exempt investments to determine a tax-equivalent yield.
 4. Junior subordinated note interest is fixed at 5.95%. Interest is computed using 360/365, which results in a higher annual percentage rate.
- Loans, the highest yielding component of earning assets, represented 91.9% of average earning assets during the third quarter, compared to 90.5% and 90.2% for the nine month periods ending September 30, 2009 and 2008, respectively. The average yield on loans declined 52 basis points to 6.23% for the third quarter from 6.75% for the comparable period in 2008. The average loan yield declined 78 basis points throughout 2009, declining to 6.30% for the nine-month period ending September 30, 2009, compared to 7.08% for the comparable period in 2008. The reduction in yield is primarily a result of a lower Prime Rate, a key index to which a majority of our loan rates are tied. During the first nine months of 2009, the average Prime Rate was 3.25% compared to 5.49% during the same time last year. The increase in nonaccrual loans has also had a negative impact on the average loan yield.

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Interest income on earning assets for the nine months ended September 30, 2009 was \$16.4 million representing a decrease of \$968 thousand, or 5.6%, compared to \$17.4 million for the same period in 2008. Interest expense on interest bearing liabilities for the nine months ended September 30, 2009 was \$6.3 million representing a decrease of \$1.4 million, or 17.8%, compared to \$7.7 million for the same period in 2008. The decrease in interest income occurred despite a \$26.8 million increase in average interest earning assets, and the interest expense fell despite a \$10.1 million increase in average interest bearing liabilities. The reduction in both interest income and interest expense reflects the effects of a decreased interest rate environment. Also contributing to the decline in interest income are higher levels of nonperforming assets, including nonaccrual loans for which accrued interest is reversed upon reaching nonperforming status.

The percentage of average interest earning assets funded by average interest bearing liabilities decreased to 80.1% from 83.5% for the nine months ended September 30, 2009 and 2008, respectively. This increased slightly during the third quarter to 81.1%. Deposits represented 89.9% of average interest bearing liabilities at September 30, 2009, compared to 86.7% at September 30, 2008. The cost of interest bearing funds for the third quarter was 2.73% compared to 2.87% and 3.62% for the first nine months of 2009 and 2008, respectively. The cost of interest bearing funds continued to decline during 2009 as time certificates of deposits re-priced throughout the period. The Bank should continue to see reductions in the near-term as time certificates of deposit re-price to lower current offering rates.

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

	Three months ended September 30, 2009 vs. 2008			Nine months ended September 30, 2009 vs. 2008		
	Volume	Rate	Total	Volume	Rate	Total
	Increase (decrease) due to changes in:			Increase (decrease) due to changes in:		
	(\$ in thousands)			(\$ in thousands)		
Interest earning assets						
Loans	\$ 1,440	\$ (1,751)	\$ (311)	\$ 1,801	\$ (2,385)	\$ (584)
Securities	(56)	(24)	(80)	(157)	(136)	(293)
Fed funds sold/interest-bearing balances	(6)	1	(5)	(252)	161	(91)
Total interest earning assets	1,378	(1,774)	(396)	1,392	(2,360)	(968)
Interest bearing liabilities						
NOW accounts	3	(17)	(14)	22	(65)	(43)
Money market accounts	(15)	(65)	(80)	(69)	(190)	(259)
Savings accounts	42	(140)	(98)	(1,359)	1,259	(100)
Time certificates of deposit	78	(382)	(304)	245	(1,150)	(905)
Securities sold under repurchase agreements	(25)	(32)	(57)	(156)	(42)	(198)
Borrowed funds	20	(38)	(18)	208	(78)	130
Total interest bearing liabilities	103	(674)	(571)	(1,109)	(266)	(1,375)
Total increase (decrease) in net interest income	\$ 1,275	\$ (1,100)	\$ 175	\$ 2,501	\$ (2,094)	\$ 407

Net interest income for the nine months ended September 30, 2009 improved \$407 thousand, or 4.1%, to \$10.1 million from \$9.7 million for the nine months ended September 30, 2008. The net interest income increased despite a reduction in interest income of \$968 thousand. The reduction in interest income was more than offset by a \$1.4 million decrease in interest expense resulting in the net increase for the period. As a result of the decrease in interest expense, net interest income for the third quarter also improved \$175 thousand, or 5.3%, to \$3.5 million from \$3.3 million for the comparable quarter in 2008.

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The annualized net interest margin was 3.76% for the third quarter compared to 3.66% and 3.79% for the first nine months of 2009 and 2008, respectively. The decrease in net interest margin between the nine month periods in 2008 and 2009 is the result of greater decreases in yields on earning assets compared to the decreases in rates paid on deposits, repurchase accounts and borrowed funds. The increase in the third quarter net interest margin is primarily a result of lower cost of interest bearing funds and increases in noninterest-bearing deposits.

The Bank anticipates that competition from other financial institutions and reduced loan demand will continue to place pressure on its net interest margin. Current Federal Reserve policy has resulted in a Prime Rate of 3.25% during 2009, and the pressure on net interest margin is expected to continue so long as the Federal Reserve maintains its Federal funds target at a rate that ranges from 0.0% to 0.25%. The Bank's primary strategy for increasing net interest margin in the near-term is to manage funding costs. The Bank expects to accomplish this, in part, through continuous re-pricing of time certificates of deposit, along with a renewed focus on obtaining noninterest-bearing demand deposit accounts. However, as part of its liquidity management strategy, the Bank also intends to modify the mix of interest earning in the near-term to a higher concentration of securities and other liquid investments. This liquidity management strategy is expected to result in a conversion of higher yielding loans to lower yielding securities, which is expected to have a negative impact on the Bank's net interest margin.

Interest Rate Risk

Presented in the table below are the results of an analysis of interest rate risk vulnerability performed using the Bank's financial information as of September 30, 2009. Generally, the results of our analysis indicate that our exposure to interest rate volatility is within management's target of no more than plus or minus ten-percent when applying an interest rate shock of plus or minus two hundred basis points. Rate increases of 1.00%, 2.00% and 3.00% were modeled, while a decrease of 0.25% was modeled since the Federal Reserve's current Target Discount Rate is 0.25% and cannot go lower than 0%. The results of the net interest income analysis performed as of September 30, 2009, are within guidelines established by the Bank's Board of Directors, as shown in the table below.

It is management's goal to limit the negative impact of a change in rates of plus or minus two hundred basis points to no more than twenty-five percent of the economic value of equity. Management therefore modeled rate increases of 1.00%, 2.00%, 3.00% and a decrease of 0.25%. The results of the economic value of equity analysis performed as of September 30, 2009, are presented in the table below to illustrate the estimated effect of changing rates on book value of equity and are within limits established by the Bank's Board of Directors.