COLUMBIA BANKING SYSTEM INC
Form 10-K
March 02, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006 or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 0-20288

COLUMBIA BANKING SYSTEM, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1422237**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1301 A Street

Tacoma, Washington 98402

(Address of principal executive offices) (Zip code)

Registrant s Telephone Number, Including Area Code: (253) 305-1900

Securities Registered Pursuant to Section 12(b) of the Act: None

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 ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (17 C.F.R. 229.405) 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. x

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

¨ Large Accelerated Filer x Accelerated Filer ¨ Non-accelerated Filer

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

The aggregate market value of Common Stock held by non-affiliates of the registrant at June 30, 2006 was $575,306,422 based on the closing sale price of the Common Stock on that date.

The number of shares of registrant s Common Stock outstanding at January 31, 2007 was 16,100,632.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Registrant s definitive 2007 Annual Meeting Proxy Statement Dated March 19, 2007	Part III

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COLUMBIA BANKING SYSTEM, INC.

FORM 10-K ANNUAL REPORT

DECEMBER 31, 2006

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NOTE REGARDING FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K may be deemed to include forward looking statements, which management believes to be a benefit to shareholders. These forward looking statements describe management s expectations regarding future events and developments such as future operating results, growth in loans and deposits, continued success of our style of banking and the strength of the local economy. The words will, believe, expect, should, and anticipate and words of similar construction are intended in part to help identify forwar looking statements. Future events are difficult to predict, and the expectations described above are necessarily subject to risk and uncertainty that may cause actual results to differ materially and adversely. In addition to discussions about risks and uncertainties set forth from time to time in our filings with the SEC, factors that may cause actual results to differ materially from those contemplated by such forward looking statements include, among others, the following possibilities: (1) local, national, and international economic conditions are less favorable than expected or have a more direct and pronounced effect on us than expected and adversely affect our ability to continue internal growth at historical rates and maintain the quality of our earning assets; (2) changes in interest rates reduce interest margins more than expected and negatively affect funding sources; (3) projected business increases following strategic expansion or opening or acquiring new branches are lower than expected; (4) costs or difficulties related to the integration of acquisitions are greater than expected; (5) competitive pressure among financial institutions increases significantly; (6) legislation or regulatory requirements or changes adversely affect the businesses in which we are engaged; and (7) our ability to realize the efficiencies we expect to receive from our investments in personnel and infrastructure.

PART I

ITEM 1. BUSINESS

General

Columbia Banking System, Inc. (referred to in this report as we, our, and the Company) is a registered bank holding company whose wholly owned banking subsidiaries, Columbia State Bank (Columbia Bank) and Bank of Astoria (Astoria), conduct full-service commercial banking business in the states of Washington and Oregon, respectively. Headquartered in Tacoma, Washington, we provide a full range of banking services to small and medium-sized businesses, professionals and other individuals.

Our current organizational structure was put in place and additional management was brought on board in 1993 in order to take advantage of commercial banking business opportunities in our principal market area. At that time, increased consolidations of banks, primarily through acquisitions by out-of-state holding companies, created dislocation of customers and presented opportunities to capture market share. We have grown from four branch offices at January 1, 1993 to 40 branch offices at December 31, 2006.

Our largest wholly owned banking subsidiary, Columbia Bank, has 35 banking offices located in the Tacoma metropolitan area and contiguous parts of the Puget Sound region of Washington state, as well as the Longview and Woodland communities in southwestern Washington state. Substantially all of Columbia Bank s loans, loan commitments and core deposits are within its service areas. Columbia Bank is a Washington state-chartered commercial bank, the deposits of which are insured in whole or in part by the Federal Deposit Insurance Corporation (the FDIC). Columbia Bank is subject to regulation by the FDIC and the Washington State Department of Financial Institutions Division of Banks. Although Columbia Bank is not a member of the Federal Reserve System, the Board of Governors of the Federal Reserve System has certain supervisory authority over the Company, which can also affect Columbia Bank.

Prior Acquisition

On October 1, 2004, the Company completed its acquisition of Astoria, an Oregon state-chartered commercial bank headquartered in Astoria, Oregon. The acquisition was accounted for as a purchase and

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Astoria s results of operations are included in our results beginning October 1, 2004. Astoria operates as a separate banking subsidiary of the Company and has five full service branch offices located within Clatsop and Tillamook Counties, along the northern Oregon coast. The deposits of Astoria are insured in whole or in part by the FDIC. Astoria is subject to regulation by the FDIC and the State of Oregon Department of Consumer and Business Services Division of Finance and Corporate Securities. Although Astoria is not a member of the Federal Reserve System, the Board of Governors of the Federal Reserve System has certain supervisory authority over the Company, which can also affect Astoria. For more information on the acquisition, see Note 2 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Company Management

Name	Principal Position
Melanie J. Dressel	President & Chief Executive Officer
Andrew McDonald	Executive Vice President & Chief Credit Officer
Mark W. Nelson	Executive Vice President & Chief Banking Officer
Gary R. Schminkey	Executive Vice President & Chief Financial Officer

Financial Information about Segments

Within Washington State, we are managed along three major lines of business: commercial banking, retail banking, and real estate lending. In Oregon, we operate as one segment through the Astoria banking subsidiary. Our treasury function, although not considered a line of business, is responsible for the management of investments and interest rate risk. Financial information about segments that conform with accounting principles generally accepted in the United States is presented in Note 19 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Business Overview

Our goal is to be the leading Pacific Northwest regional community banking company while consistently increasing earnings and shareholder value. We continue to build on our reputation for excellent customer service in order to be recognized in all markets we serve as the bank of choice for retail deposit customers, small to medium-sized businesses and affluent households.

We have established a network of 40 branches as of December 31, 2006 from which we intend to grow market share. All Washington branches operate as Columbia Bank and all Oregon branches operate as Bank of Astoria. Western Washington locations consist of twenty-two branches in Pierce County, eight in King County, three in Cowlitz County, and one each in Kitsap and Thurston Counties. Northern Oregon coastal area locations consist of four branches in Clatsop County and one in Tillamook County.

In order to fund our lending activities and to allow for increased contact with customers, we utilize a branch system to better serve retail and business customer depositors. We believe this approach will enable us to expand lending activities while attracting a stable core deposit base. In order to support our strategy of market penetration and increased profitability, while continuing our personalized banking approach and our commitment to asset quality, we have invested in experienced branch, lending and administrative personnel and have incurred related costs in the creation of our branch network. Many of these branches are becoming established within their markets. The resulting efficiencies will provide management with the ability to reallocate the resources previously consumed by these branches to new endeavors.

Business Strategy

Our business strategy is to provide our customers with the financial sophistication and breadth of products of a regional banking company while retaining the appeal and service level of a community bank. We continually evaluate our existing business processes while focusing on maintaining asset quality, expanding total revenue and controlling expenses in an effort to increase our return on average equity and gain operational efficiencies. We believe that as a result of our strong commitment to highly personalized, relationship-oriented customer service, our varied products, our strategic branch locations and the long-standing community presence of our managers, lending officers and branch personnel, we are well positioned to attract and retain new customers and to increase our market share of loans, deposits, and other financial services in the communities we serve. We are committed to increasing market share in the communities we serve by continuing to leverage our existing branch network, adding new branch locations and considering business combinations that are consistent with our expansion strategy throughout the Pacific Northwest.

Products & Services

We place the highest priority on customer service and assist our customers in making informed decisions when selecting from the products and services we offer. We continuously review our products and services to ensure that we provide our customers with the tools to meet their financial institution needs. A more complete listing of all the services and products available to our customers can be found on our website: *www.columbiabank.com*. Some of the core products and services we offer include:

Personal Banking	Business Banking
Checking and Saving Accounts	Checking & Saving Accounts
Online Banking	Online Banking
Electronic Bill Pay	Electronic Bill Pay
Consumer Lending	Cash Management
Residential Lending	Commercial & Industrial Lending
Visa Card Services	Real Estate and Real Estate Construction Lending
Investment Services	Equipment Finance
Private Banking	Small Business Services
	Visa Card Services
	Investment Services
	International Banking
	Merchant Card Services

Personal Banking: We offer our personal banking customers an assortment of checking and saving account products including non-interest and interest bearing checking, savings, money market and certificate of deposit accounts. Overdraft protection is also available with direct links to the customer s checking account. Our online banking service, Columbia Online, provides our personal banking customers with the ability to safely and securely conduct their banking business 24 hours a day, 7 days a week. Personal banking customers are also provided with a variety of borrowing products including fixed and variable rate home equity loans and lines of credit, home mortgages for purchases and refinances, personal loans, and other consumer loans. Eligible personal banking customers with checking accounts are provided a VISA® Check Card which can be used to make purchases and also act as an ATM card. A variety of Visa® Credit Cards are also available to eligible personal banking customers.

Through CB Financial Services, personal banking customers are provided with a full range of investment options including mutual funds, stocks, bonds, retirement accounts, annuities, tax-favored investments, US Government securities as well as long-term care and life insurance policies. Qualified investment professionals are available to provide advisory services and assist customers with retirement and education planning.

Columbia Private Banking offers clientele requiring complex financial solutions and their businesses credit services, deposit and cash management services, and wealth management. Each private banker provides advisory services and coordinates a relationship team of experienced financial professionals to meet the unique needs of each discerning customer.

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Business Banking: We offer our business banking customers an assortment of checking and saving account products including checking, interest bearing money market and certificate of deposit accounts. Cash management customers can access, monitor and manage cash flows effectively and efficiently through a variety of tools, including account analysis, sweep accounts, ACH and other electronic banking services. Business customers, through Columbia Online, have the ability to save time and money through our custom eBusiness solutions products. Standard features of Columbia Online provide customers with the ability to tailor user access by individual, view balances, statements and checks as well as transfer funds, pay bills electronically and export transaction history to accounting software. In addition, we intend to launch our new remote deposit product in early April, providing current and potential business customers a convenient, cost-effective method of making deposits without needing to leave their place of business.

We offer a variety of loan products tailored to meet the various needs of business banking customers. Commercial loan products include accounts receivable, inventory and equipment financing as well as Small Business Administration financing. We also offer commercial real estate loan products for construction and development or permanent financing. Historically, lending activities have been primarily directed toward the origination of real estate and commercial loans. Real estate lending activities have been focused on construction and permanent loans for both owner occupants and investor oriented real estate properties. In addition, the bank has pursued construction and first mortgages on owner occupied, one- to four-family residential properties. Commercial banking has been directed toward meeting the credit and related deposit needs of various sized businesses and professional practice organizations operating in our primary market areas.

We offer our business banking customers a selection of Visa® Cards including the Business Check Card that works like a check where ever VISA® is accepted including ATMs; the Corporate Card which can be used all over the world; the Purchasing Card with established purchasing capabilities based on your business needs; and Business Edition® Plus that earns reward points with every purchase. Our Business ATM Cash Card is also available for fast, easy cash withdrawals 24 hours a day, 7 days a week.

Through CB Financial Services, our business customers are provided with an array of investment options and all the tools and resources necessary to assist them in reaching their investment goals. Some of the investment options available to our business customers include 401(k), Simple IRA, Simple Employee Pensions, Buy-Sell Agreements, Key-Man Insurance, Business Succession Planning and personal investments.

Our International Banking Department provides both large and small businesses with the ability to buy and sell foreign currencies as well as obtain letters of credit and wire funds to their customers and suppliers in foreign countries.

Business clients that utilize Columbia s Merchant Card Services have the ability to accept both Visa® and MasterCard® sales drafts for deposit directly into their business checking account. Merchants are provided with a comprehensive accounting system tailored to meet each merchant s needs, which includes month-to-date credit card deposit information on a transaction statement. Internet access is available to view merchant reports that allow business customers to review merchant statements, authorized, captured, cleared and settled transactions.

Competition

Our industry is highly competitive. Several other financial institutions, having greater resources, compete for banking business in our market areas. Among the advantages of some of these institutions are their ability to make larger loans, finance extensive advertising and promotion campaigns, access international financial markets and allocate their investment assets to regions of highest yield and demand. In addition to competition from other banking institutions, we continue to experience competition from non-banking companies such as credit unions, brokerage houses and other financial services companies. We compete for loans, deposits and other financial services by offering our customers with a similar breadth of products as our larger competitors while delivering a more personalized service level with faster transaction turnaround time.

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Market Areas

Washington: Nearly two-thirds of our total branches within Washington are located in Pierce County with an estimated population of 773,500 residents. At year end we operated twenty two branch locations in Pierce County that accounted for 16%[(1)] of the total deposit market share ranking second amongst our competition. Also located in Pierce County is our Company headquarters in the city of Tacoma and one nearby operational facility. Some of the most significant contributors to the Pierce County economy are the Port of Tacoma which accounts for more than 43,000 jobs, McChord Air Force Base and Fort Lewis Army Base that account for nearly 20% of the County s total employment and the manufacturing industry which supplies the Boeing Company.

We operate eight branch locations in King County, which is Washington s most highly populated county at approximately 1.8 million residents. King County, in particular the Seattle metropolitan area, is a market that has significant growth potential for our Company and will play a key role in our expansion strategy in the future. At year end our share of the King County deposit market was less than 1%[(1)], however, we have made significant inroads within this market through the strategic expansion of our banking team. The north King County economy is primarily made up of the aerospace, construction, computer software and biotechnology industries. South King County with its close proximity to Pierce County is considered a natural extension of our primary market area. The economy of south King County is primarily comprised of residential communities supported by light industrial, retail, aerospace and distributing and warehousing industries.

Some other market areas served by the Company include Cowlitz County where we operate three branch locations that account for 13%[(1)] of the deposit market share, and Kitsap and Thurston County where we operate one branch in each county.

Oregon: Through the acquisition of Astoria in October 2004, we added five branches located in the western portions of Clatsop and Tillamook Counties, in the northern Oregon coastal area. In Clatsop and Tillamook Counties we have 33%[(1)] and 6%[(1)] of the deposit market share, respectively. Oregon market areas provide a significant opportunity for expansion strategies in the future. Both Clatsop and Tillamook Counties are comprised primarily of forestry, commercial fishing, and tourism related businesses.

Employees

As of December 31, 2006 the Company and its banking subsidiaries employed approximately 657 full time equivalent employees. We value our employees and pride ourselves on providing a professional work environment accompanied by comprehensive benefit programs. We are committed to providing flexible and value-added benefits to our employees through a Total Compensation Philosophy which incorporates all compensation and benefits.

Available Information

We file annual reports on Form 10-K, quarterly reports on Form 10-Q, periodic reports on Form 8-K, proxy statements and other information with the United States Securities and Exchange Commission (SEC). The public may obtain copies of these reports and any amendments at the SEC s Internet site, *www.sec.gov*. Additionally, reports filed with the SEC can be obtained through our website at *www.columbiabank.com*. These reports are available through our website as soon as reasonably practicable after they are filed electronically with the SEC. Information contained on our website is not intended to be incorporated by reference into this report.

Supervision and Regulation

General

The following discussion describes elements of the extensive regulatory framework applicable to the Company and the Bank. This regulatory framework is primarily designed for the protection of depositors, federal

(1) Source: FDIC Annual Summary of Deposit Report as of June 30, 2006.

deposit insurance funds and the banking system as a whole, rather than specifically for the protection of shareholders. Due to the breadth 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 in its entirety 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 interpretation or implementation thereof, could have a material effect on our business or operations.

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

Tying Arrangements. We are 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, the Company is expected to act as a source of financial and managerial strength to its subsidiary banks. This means that the Company is required to commit, as necessary, resources to support Columbia Bank and the Bank of Astoria. 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.

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State Law Restrictions. As a Washington corporation, the Company is subject to certain limitations and restrictions under applicable Washington corporate law. For example, state law restrictions in Washington 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 Columbia State Bank and Astoria

General. The deposits of Columbia Bank, a Washington chartered commercial bank, and the Bank of Astoria, an Oregon chartered commercial bank, are insured by the FDIC. As a result, Columbia Bank is subject to supervision and regulation by the Washington Department of Financial Institutions, Division of Banks and the FDIC. The Bank of Astoria is primarily regulated by the Oregon Department of Consumer and Business Services and the FDIC. These agencies have the authority to prohibit banks from engaging in what they believe constitute unsafe or unsound banking practices.

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 covered above and who are not employees; 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, the imposition of a cease and desist order, 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) prohibits management personnel of a bank from serving as a director 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. Federal law imposes certain non-capital safety and soundness standards upon banks. These standards cover, among other things, internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation and benefits. Additional standards apply to asset quality, earnings and stock valuation. An institution that fails to meet these standards must develop a plan acceptable to its regulators, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions.

Interstate Banking And Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act) permits relaxed prior interstate branching restrictions under federal law by permitting nationwide interstate banking and branching under certain circumstances. Generally, bank holding companies may purchase banks in any state, and states may not prohibit these purchases. Additionally, banks are permitted to merge with banks in other states, as

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long as the home state of neither merging bank has opted out under the legislation. 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 agency regulations prohibit banks from using their interstate branches primarily for deposit production and the federal banking agencies have implemented a loan-to-deposit ratio screen to ensure compliance with this prohibition.

Washington and Oregon have both enacted opting in legislation in accordance with the Interstate Act provisions allowing banks to engage in interstate merger transactions, subject to certain aging requirements. Under Washington law, an out-of-state bank may, subject to Department of Financial Institution approval, open de novo branches in Washington or acquire an in-state branch so long as the home state of the out-of-state bank has reciprocal laws with respect to de novo branching or branch acquisitions. In contrast, Oregon restricts an out-of-state bank from opening de novo branches, and no out-of-state bank may conduct banking business at a branch located in Oregon unless the out-of-state bank has converted from, has assumed all, or substantially all, of Oregon deposit liabilities of or has merged with an insured institution that, by itself or together with any predecessor, has been engaged in banking business in Oregon for at least three years.

Deposit Insurance

In February 2006, the President signed federal deposit insurance reform legislation. The legislation (i) required the FDIC to merge the Bank Insurance Fund and the Savings Association Insurance Fund into a newly created Deposit Insurance Fund, which was completed in 2006; (ii) increases the amount of deposit insurance coverage for retirement accounts; (iii) allows for deposit insurance coverage on individual accounts to be indexed for inflation starting in 2010; (iv) provides the FDIC more flexibility in setting and imposing deposit insurance assessments; and (v) provides eligible institutions credits on future assessments.

The Banks deposits are currently insured to a maximum of $100,000 per depositor through the Deposit Insurance Fund. The Banks are each required to pay deposit insurance premiums, which are assessed and paid regularly. The premium amount is based upon a risk classification system established by the FDIC. Banks with higher levels of capital and a low degree of supervisory concern are assessed lower premiums than banks with lower levels of capital or a higher degree of supervisory concern.

Dividends

The principal source of the Company s cash is from dividends received from its subsidiary banks, 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. Oregon and Washington law also limit a bank s ability to pay dividends that are greater than the bank s retained earnings without approval of the applicable banking agency.

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, surplus and undivided profits. Tier II capital generally consists of the allowance for loan losses, hybrid capital instruments, and subordinated debt. The sum of Tier I capital and Tier II capital represents an institution s total capital. The guidelines require that at least 50% of an institution s total capital consist of Tier I capital.

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Risk-based Capital Ratios. The adequacy of an institution s capital is gauged 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 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.

In 2006, the federal banking agencies, including the FDIC and the Federal Reserve, provided notice of proposed rulemaking that would change the existing risk-based capital framework by enhancing its risk sensitivity. Whether such revisions are implemented or what effect they might have on us cannot be predicted at this time, but we do not expect our operations to be significantly impacted.

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.

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 examinations. 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 Legislation

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

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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.

To deter wrongdoing, the Act (i) subjects bonuses issued to top executives to disgorgement if a restatement of a company s financial statements was due to corporate misconduct; (ii) prohibits an officer or director misleading or coercing an auditor; (iii) prohibits insider trades during pension fund blackout periods ; (iv) imposes new criminal penalties for fraud and other wrongful acts; and (v) extends the period during which certain securities fraud lawsuits can be brought against a company or its officers.

As a publicly reporting company, we are subject to the requirements of the Act and related rules and regulations issued by the SEC and NASDAQ. After enactment, we updated our policies and procedures to comply with the Act s requirements and have found that such compliance, including compliance with Section 404 of the Act relating to management control over financial reporting, has resulted in significant additional expense for the Company. We anticipate that we will continue to incur such additional expense in our ongoing compliance.

Anti-terrorism Legislation

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). Certain provisions of the Patriot Act were made permanent and other sections were made subject to extended sunset provisions. 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. While the Patriot Act has had minimal affect on our record keeping and reporting expenses, we do not believe that the renewal and amendment will have a material adverse effect on our business or operations.

Financial Services Modernization

Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 brought about significant changes to the laws affecting banks and bank holding companies. Generally, the Act (i) repeals historical restrictions on preventing banks from affiliating with securities firms; (ii) provides a uniform framework for the activities of banks, savings institutions and their holding companies; (iii) broadens the activities that may be conducted by national banks and banking subsidiaries of bank holding companies; (iv) provides an enhanced framework for protecting the privacy of consumer information and requires notification to consumers of bank privacy policies; and (v) addresses a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions. Bank holding companies that qualify and elect to become financial holding companies can engage in a wider variety of financial activities than permitted under previous law, particularly with respect to insurance and securities underwriting activities.

Effects of Government Monetary Policy

Our earnings and growth are affected not only by general economic conditions, but also by the fiscal and monetary policies of the federal government, particularly the Federal Reserve. The Federal Reserve implements implement national monetary policy for such purposes as curbing inflation and combating recession, but its open market operations in U.S. government securities, control of the discount rate applicable to borrowings from the Federal Reserve, and establishment of reserve requirements against certain deposits, influence the growth of bank loans, investments and deposits, and also affect interest rates charged on loans or paid on deposits. The nature and impact of future changes in monetary policies and their impact on us cannot be predicted with certainty.

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ITEM 1A. RISK FACTORS

Our business exposes us to certain risks. The following is a discussion of what we currently believe are the most significant risks and uncertainties that may affect our business, financial condition and future results.

Economic downturns in the market areas we serve or a rapidly increasing interest rate environment could increase the credit risk within the loan portfolio.

Lending activities are our largest source of credit risk, which is the risk that a borrower will fail to meet their obligations in accordance with agreed upon terms. We manage the credit risk inherent in our loan portfolio through the establishment of sound underwriting policies and procedures. We maintain an allowance for loan and lease losses as well as an allowance for unfunded loan commitments and letters of credit to absorb anticipated future losses. Although we consider our allowance for loan and lease losses and allowance for unfunded loan commitments and letters of credit to be adequate at December 31, 2006, a significant downturn in the economy could result in higher delinquencies and defaults which would negatively impact our financial position. A substantial portion of the loans in our portfolio are variable rate. A rapidly increasing interest rate environment could impair our borrower s ability to service the interest portion of their obligations to us. This could result in decreased net income from increased provisions to the allowance for loan and lease losses as well as decreased interest income resulting from an increase in nonaccrual loans. For additional discussion see Risk Elements in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation of this report.

A rapid change in interest rates could negatively impact net interest income.

We are exposed to interest rate risk, which is the risk that changes in prevailing interest rates will adversely affect assets, liabilities, capital, income and expenses at different times or in different amounts. We utilize a number of measures to monitor and manage interest rate risk, such as income simulations and interest sensitivity (gap) analyses. A number of factors that impact interest rates are beyond our control such as general economic conditions as well as governmental and regulatory policies. The impact of rate changes to our net interest income is determined by the amount of change and the time horizon over which change occurs over. For additional discussion see Item 7A. Quantitative and Qualitative Disclosures about Market Risk of this report.

Competition

We face significant competition from other financial institutions for loans and deposits. We believe the most significant competitive factor is customer service, in addition to interest rates offered on loans and paid on deposits, fee structures, branch locations, and the range of banking services and products offered. Failure to maintain our service culture could increase the susceptibility of our customer base to our competitors marketing campaigns and thwart our efforts to expand our existing customer base. For additional discussion see Competition in Item 1. Business of this report.

Failure to hire or retain management and staff could impede our ability to maintain or grow earnings.

Maintaining our current customer base is reliant upon the retention of key management and personnel across all our business lines. We rely on these talented professionals to manage lines of business which are critical in the generation of operating revenue. In addition, the failure to attract new employees critical to the execution of our expansion plan could result in diminished returns on our investment in these initiatives.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

Locations

Washington: The Company s principal properties in Washington state include our corporate headquarters which is located at 13th & A Street, Tacoma, Washington, in Pierce County, where we occupy 62,000 square feet of office space and 750 square feet of branch space under various operating lease agreements, an operations facility in Lakewood, Washington, where we own 58,000 square feet of office space and an office facility in Tacoma, Washington, that includes a branch where we occupy 26,000 square feet under various operating lease agreements. All Washington state branches operate as Columbia Bank.

In Pierce County we conduct business in twenty additional branch locations, fourteen of which are owned and six of which are leased under various operating lease agreements. In King County we conduct business in eight branch locations, six of which are owned and two of which are leased. In Kitsap, Thurston and Cowlitz counties we conduct business in five branch locations, four of which are owned and one that is leased under various operating lease agreements.

Oregon: The Company s principal properties in Oregon are headquartered in Astoria, Oregon, in Clatsop County, where we own 20,000 square feet of branch and office space. We conduct business in three additional branches in Clatsop County and one branch in Tillamook County, all of which are owned. All Oregon branches operate as Bank of Astoria.

For additional information concerning our premises and equipment and lease obligations, see Note 8 and 16, respectively, to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

ITEM 3. LEGAL PROCEEDINGS

The Company and its banking subsidiaries are parties to routine litigation arising in the ordinary course of business. Management believes that, based on the information currently known to them, any liabilities arising from such litigation will not have a material adverse impact on the Company s financial condition, results of operations or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Quarterly Common Stock Prices and Dividends

Our common stock is traded on the NASDAQ Global Select Market under the symbol COLB . Quarterly high and low closing prices and dividend information for the last two years are presented in the following table. The prices shown do not include retail mark-ups, mark-downs or commissions:

2006	High	Low	Cash Dividend Declared
First quarter	$ 35.49	$ 27.99	$ 0.13
Second quarter	$ 37.39	$ 31.75	0.14
Third quarter	$ 36.67	$ 29.91	0.15
Fourth quarter	$ 36.20	$ 30.90	0.15
For the year	$ 36.67	$ 27.99	$ 0.57

2005	High	Low	Cash Dividend Declared
First quarter	$ 25.83	$ 22.66	$ 0.07
Second quarter	$ 25.30	$ 22.57	0.09
Third quarter	$ 28.84	$ 22.67	0.11
Fourth quarter	$ 29.98	$ 24.51	0.12
For the year	$ 29.98	$ 22.57	$ 0.39

On December 31, 2006, the last sale price for our stock in the over-the-counter market was $35.12. At January 31, 2007, the number of shareholders of record was 1,448. This figure does not represent the actual number of beneficial owners of common stock because shares are frequently held in street name by securities dealers and others for the benefit of individual owners who may vote the shares.

At December 31, 2006, a total of 335,397 stock options were outstanding. Additional information about stock options and other equity compensation plans is included in Note 13 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

The payment of future cash dividends is at the discretion of our Board and subject to a number of factors, including results of operations, general business conditions, growth, financial condition and other factors deemed relevant by the Board of Directors. Our ability to pay future cash dividends is subject to certain regulatory requirements and restrictions which are discussed in the Supervision and Regulation section in Item 1. Business of this report.

Equity Compensation Plan Information

	Year Ended December 31, 2006		
	Number of Shares to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (1)	Weighted-Average Exercise Price of Outstanding Options, Warrants and	Number of Shares Remaining Available for Future Issuance Under Equity Compensation

		Rights	Plans (2)
Equity compensation plans approved by security holders	335,397	$ 15.76	459,640
Equity compensation plans not approved by security holders			

(1) Consists of shares that are subject to outstanding options.

(2) Includes shares available for future issuance under the stock option plans and 87,953 shares available for purchase under the Employee Stock Purchase Plan as of December 31, 2006.

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Five-Year Stock Performance Graph

The following graph shows a five-year comparison of the total return to shareholders of Columbia s common stock, the Nasdaq Composite Index (which is a broad nationally recognized index of stock performance by companies listed on the Nasdaq Stock Market) and the Columbia Peer Group (comprised of banks with assets of $1 billion to $5 billion, all of which are located in the western United States). The definition of total return includes appreciation in market value of the stock as well as the actual cash and stock dividends paid to shareholders. The graph assumes that the value of the investment in Columbia s common stock, the Nasdaq and the Columbia Peer Group was $100 on December 31, 2001, and that all dividends were reinvested.

	Period Ending					
Index	**December 31, 2001**	**December 31, 2002**	**December 31, 2003**	**December 31, 2004**	**December 31, 2005**	**December 31, 2006**
Columbia Banking System, Inc.	100.00	101.46	175.73	215.34	249.77	312.71
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
Columbia Peer Group	100.00	117.96	172.03	225.50	244.41	285.98

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ITEM 6. SELECTED FINANCIAL DATA

Five-Year Summary of Selected Consolidated Financial Data (1)

	2006	2005	2004	2003	2002
	(in thousands, except per share amounts)				
For the Year					
Total revenue	$ 122,435	$ 115,698	$ 94,187	$ 86,651	$ 84,339
Net interest income	$ 97,763	$ 90,912	$ 71,943	$ 63,867	$ 64,289
Provision for loan and lease losses	$ 2,065	$ 1,520	$ 995	$ 2,850	$ 15,780
Noninterest income	$ 24,672	$ 24,786	$ 22,244	$ 22,784	$ 20,050
Noninterest expense	$ 76,134	$ 72,855	$ 61,326	$ 55,960	$ 53,653
Net income	$ 32,103	$ 29,631	$ 22,513	$ 19,522	$ 10,885
Per Share					
Net Income (Basic)	$ 2.01	$ 1.89	$ 1.55	$ 1.39	$ 0.79
Net Income (Diluted)	$ 1.99	$ 1.87	$ 1.52	$ 1.37	$ 0.78
Book Value	$ 15.71	$ 14.29	$ 13.03	$ 10.66	$ 9.48
Averages					
Total Assets	$ 2,473,404	$ 2,290,746	$ 1,919,134	$ 1,696,417	$ 1,601,061
Interest-earning assets	$ 2,265,393	$ 2,102,513	$ 1,769,470	$ 1,544,869	$ 1,454,714
Loans	$ 1,629,616	$ 1,494,567	$ 1,186,506	$ 1,128,941	$ 1,183,922
Securities	$ 623,631	$ 605,395	$ 552,742	$ 401,594	$ 246,995
Deposits	$ 1,976,448	$ 1,923,778	$ 1,690,513	$ 1,483,173	$ 1,360,968
Core deposits	$ 1,433,395	$ 1,423,862	$ 1,238,536	$ 1,017,126	$ 885,008
Shareholders equity	$ 237,843	$ 214,612	$ 169,414	$ 141,129	$ 124,096
Financial Ratios					
Net interest margin	4.49%	4.44%	4.19%	4.23%	4.50%
Return on average assets	1.30%	1.29%	1.17%	1.15%	0.68%
Return on average equity	13.50%	13.81%	13.29%	13.83%	8.77%
Return on average tangible equity (2)	15.88%	16.63%	14.02%	13.83%	8.77%
Efficiency ratio (3)	58.95%	61.20%	63.20%	62.86%	64.46%
Average equity to average assets	9.62%	9.37%	8.83%	8.32%	7.75%
At Year End					
Total assets	$ 2,553,131	$ 2,377,322	$ 2,176,730	$ 1,744,347	$ 1,699,613
Loans	$ 1,708,962	$ 1,564,704	$ 1,359,743	$ 1,078,302	$ 1,175,853
Allowance for loan and lease losses	$ 20,182	$ 20,829	$ 19,881	$ 20,261	$ 19,171
Securities	$ 605,133	$ 585,332	$ 642,759	$ 523,864	$ 337,412
Deposits	$ 2,023,351	$ 2,005,489	$ 1,862,866	$ 1,544,626	$ 1,487,153
Core deposits	$ 1,473,701	$ 1,478,090	$ 1,381,073	$ 1,098,237	$ 980,709
Shareholders equity	$ 252,347	$ 226,242	$ 203,154	$ 150,372	$ 132,384
Full-time equivalent employees	657	651	625	539	525
Banking offices	40	40	39	34	36
Nonperforming assets					
Nonaccrual loans	$ 2,414	$ 4,733	$ 8,222	$ 13,255	$ 16,918
Restructured loans	1,066	124	227		187
Other personal property owned				691	916
Real estate owned		18	680	1,452	130
Total nonperforming assets	$ 3,480	$ 4,875	$ 9,129	$ 15,398	$ 18,151
Nonperforming loans to year end loans	0.20%	0.31%	0.62%	1.23%	1.45%
Nonperforming assets to year end assets	0.14%	0.21%	0.42%	0.88%	1.07%
Allowance for loan and lease losses to year end loans	1.18%	1.33%	1.46%	1.88%	1.63%
Allowance for loan and lease losses to nonperforming loans	579.94%	428.84%	235.31%	152.86%	112.08%
Allowance for loan and lease losses to nonperforming assets	579.94%	427.26%	217.78%	131.58%	105.62%
Net loan charge-offs	$ 2,712	$ 572	$ 2,742	$ 1,760	$ 11,343
Risk-Based Capital Ratios					
Total capital	13.23%	12.97%	12.99%	14.49%	12.32%
Tier I capital	12.21%	11.82%	11.75%	13.24%	11.07%
Leverage ratio	9.86%	9.54%	8.99%	10.03%	9.18%

(1) These unaudited schedules provide selected financial information concerning the Company that should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations of this report.
(2) Annualized net income, excluding core deposit intangible amortization, divided by average daily shareholders equity, excluding average goodwill and average core deposit intangible asset.
(3) Noninterest expense divided by the sum of net interest income and noninterest income on a tax equivalent basis, excluding gains/losses on investment securities, net cost (gain) of OREO and mark-to-market adjustments of interest rate floor instruments.

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In managing our business, we review the efficiency ratio, on a fully taxable-equivalent basis (see definition in table below), which is not defined in accounting principles generally accepted in the United States (GAAP). The efficiency ratio is calculated by dividing noninterest expense by the sum of net interest income and noninterest income on a tax equivalent basis, excluding gains and losses on investment securities, net cost and gains of real estate acquired (OREO) and mark-to-market adjustments of interest rate floor instruments. Other companies may define or calculate this data differently. We believe this presentation provides investors with a more accurate picture of our operating efficiency. In this presentation, net interest income is adjusted to reflect tax-exempt interest income on an equivalent before-tax basis using the federal statutory tax rate of 35 percent for all years presented. Noninterest income and noninterest expense are adjusted for certain items. For additional information see the Noninterest Expense section in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation of this report.

Reconciliation of Selected Financial Data to GAAP Financial Measures (3)

	Years ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
Net interest income (1)	$ 97,763	$ 90,912	$ 71,943	$ 63,867	$ 64,289
Tax equivalent adjustment for non-taxable investment securities interest income (2)	3,882	2,508	2,161	1,540	1,238
Adjusted net interest income	$ 101,645	$ 93,420	$ 74,104	$ 65,407	$ 65,527
Noninterest income	$ 24,672	$ 24,786	$ 22,244	$ 22,784	$ 20,050
(Gain) loss on sale of securities, net	(36)	(6)	6	(222)	(610)
Tax equivalent adjustment for BOLI income (2)	908	849	710	829	697
Adjusted noninterest income	$ 25,544	$ 25,629	$ 22,960	$ 23,391	$ 20,137
Noninterest expense	$ 76,134	$ 72,855	$ 61,326	$ 55,960	$ 53,653
Net gain (cost) of OREO	11	8	13	(139)	1,565
Interest rate floor valuation adjustment	(1,164)				
Adjusted noninterest expense	$ 74,981	$ 72,863	$ 61,339	$ 55,821	$ 55,218
Efficiency ratio	61.3%	63.0%	65.1%	64.6%	63.6%
Efficiency ratio (fully taxable-equivalent)	59.0%	61.2%	63.2%	62.9%	64.5%
Tax Rate	35.0%	35.0%	35.0%	35.0%	35.0%

(1) Amount represents net interest income before provision for loan and lease losses.
(2) Fully Taxable-equivalent basis: Non-taxable revenue is increased by the statutory tax rate to recognize the income tax benefit of the income realized.
(3) These unaudited schedules provide selected financial information concerning the Company that should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation of this report.

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Consolidated Five-Year Statements of Operations (1)

	Years ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share amounts)				
Interest Income:					
Loans	$ 123,998	$ 99,535	$ 68,908	$ 69,427	$ 80,003
Taxable securities	20,008	18,079	16,832	11,344	9,286
Tax-exempt securities	7,042	4,452	3,770	2,575	1,968
Dividends on Federal Home Loan Bank stock	10	56	219	409	566
Federal funds sold and deposits with banks	617	85	337	145	372
Total interest income	151,675	122,207	90,066	83,900	92,195
Interest Expense:					
Deposits	40,838	25,983	16,537	18,304	24,740
Federal Home Loan Bank advances	10,944	3,515	370	652	1,945
Long-term obligations	1,992	1,583	1,162	1,077	1,221
Other borrowings	138	214	54		
Total interest expense	53,912	31,295	18,123	20,033	27,906
Net Interest Income	97,763	90,912	71,943	63,867	64,289
Provision for loan and lease losses	2,065	1,520	995	2,850	15,780
Net interest income after provision for loan and lease losses	95,698	89,392	70,948	61,017	48,509
Noninterest income	24,672	24,786	22,244	22,784	20,050
Noninterest expense	76,134	72,855	61,326	55,960	53,653
Income before income tax	44,236	41,323	31,866	27,841	14,906
Provision for income tax	12,133	11,692	9,353	8,319	4,021
Net Income	$ 32,103	$ 29,631	$ 22,513	$ 19,522	$ 10,885
Net Income Per Common Share:					
Basic	$ 2.01	$ 1.89	$ 1.55	$ 1.39	$ 0.79
Diluted	$ 1.99	$ 1.87	$ 1.52	$ 1.37	$ 0.78
Average number of common shares outstanding (basic)	15,946	15,708	14,558	14,039	13,823
Average number of common shares outstanding (diluted)	16,148	15,885	14,816	14,215	13,984
Total assets at year end	$ 2,553,131	$ 2,377,322	$ 2,176,730	$ 1,744,347	$ 1,699,613
Long-term obligations	$ 22,378	$ 22,312	$ 22,246	$ 22,180	$ 21,433
Cash dividends declared	$ 0.57	$ 0.39	$ 0.26	$ 0.15	$

(1) These unaudited schedules provide selected financial information concerning the Company that should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation of this report.

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Selected Quarterly Financial Data (1)

The following table presents selected unaudited consolidated quarterly financial data for each quarter of 2006 and 2005. The information contained in this table reflects all adjustments, which, in the opinion of management, are necessary for a fair presentation of the results of the interim periods.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year Ended December 31,
	(in thousands, except per share amounts)				
2006					
Total interest income	$ 35,069	$ 37,410	$ 39,166	$ 40,030	$ 151,675
Total interest expense	10,763	13,108	14,761	15,280	53,912
Net interest income	24,306	24,302	24,405	24,750	97,763
Provision for loan and lease losses	215	250	650	950	2,065
Noninterest income	5,973	6,267	6,108	6,324	24,672
Noninterest expense	18,340	21,136	18,098	18,560	76,134
Income before income tax	11,724	9,183	11,765	11,564	44,236
Provision for income tax	3,536	1,944	3,430	3,223	12,133
Net income	$ 8,188	$ 7,239	$ 8,335	$ 8,341	$ 32,103
Net income per common share:					
Basic	$ 0.52	$ 0.45	$ 0.52	$ 0.52	$ 2.01
Diluted	$ 0.51	$ 0.45	$ 0.52	$ 0.52	$ 1.99
2005					
Total interest income	$ 27,570	$ 29,929	$ 31,755	$ 32,953	$ 122,207
Total interest expense	6,269	7,583	8,424	9,019	31,295
Net interest income	21,301	22,346	23,331	23,934	90,912
Provision for loan and lease losses	890	370	245	15	1,520
Noninterest income	5,674	6,128	6,516	6,468	24,786
Noninterest expense	17,277	18,514	18,793	18,271	72,855
Income before income tax	8,808	9,590	10,809	12,116	41,323
Provision for income tax	2,510	2,792	2,857	3,533	11,692
Net income	$ 6,298	$ 6,798	$ 7,952	$ 8,583	$ 29,631
Net income per common share:					
Basic	$ 0.40	$ 0.44	$ 0.50	$ 0.55	$ 1.89
Diluted	$ 0.40	$ 0.43	$ 0.50	$ 0.54	$ 1.87

(1) These unaudited schedules provide selected financial information concerning the Company that should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation of this report.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

This discussion should be read in conjunction with our Consolidated Financial Statements and related notes in Item 8. Financial Statements and Supplementary Data of this report. In the following discussion, unless otherwise noted, references to increases or decreases in average balances in items of income and expense for a particular period and balances at a particular date refer to the comparison with corresponding amounts for the period or date for the previous year.

NOTE REGARDING FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K may be deemed to include forward looking statements, which management believes to be a benefit to shareholders. These forward looking statements describe management s expectations regarding future events and developments such as future operating results, growth in loans and deposits, continued success of our style of banking and the strength of the local economy. The words will, believe, expect, should, and anticipate and words of similar construction are intended in part to help identify forward looking statements. Future events are difficult to predict, and the expectations described above are necessarily subject to risk and uncertainty that may cause actual results to differ materially and adversely. In addition to discussions about risks and uncertainties set forth from time to time in our filings with the SEC, factors that may cause actual results to differ materially from those contemplated by such forward looking statements include, among others, the following possibilities: (1) local, national, and international economic conditions are less favorable than expected or have a more direct and pronounced effect on us than expected and adversely affect our ability to continue internal growth at historical rates and maintain the quality of our earning assets; (2) changes in interest rates reduce interest margins more than expected and negatively affect funding sources; (3) projected business increases following strategic expansion or opening or acquiring new branches are lower than expected; (4) costs or difficulties related to the integration of acquisitions are greater than expected; (5) competitive pressure among financial institutions increases significantly; (6) legislation or regulatory requirements or changes adversely affect the businesses in which we are engaged; and (7) our ability to realize the efficiencies we expect to receive from our investments in personnel and infrastructure.

Critical Accounting Policies

We have established certain accounting policies in preparing our Consolidated Financial Statements that are in accordance with accounting principles generally accepted in the United States. Our significant accounting policies are presented in Note 1 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report. Certain of these policies require the use of judgments, estimates and economic assumptions which may prove inaccurate or are subject to variation that may significantly affect our reported results of operations and financial position for the periods presented or in future periods. Management believes that the judgments, estimates and economic assumptions used in the preparation of the Consolidated Financial Statements are appropriate given the factual circumstances at the time.

We have identified the allowance for loan and lease losses (ALLL) as our most critical accounting policy. The ALLL is established to absorb known and inherent losses in our loan and lease portfolio. Our methodology in determining the appropriate level of the ALLL includes components for a general valuation allowance in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies , a specific valuation allowance in accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan and an unallocated component. Both quantitative and qualitative factors are considered in determining the appropriate level of the ALLL. Quantitative factors include historical loss experience, delinquency and charge-off trends, collateral values, past-due and nonperforming loan trends and the evaluation of specific loss estimates for problem loans. Qualitative factors include existing general economic and business conditions in our market areas as well as the duration of the current business cycle. Changes in any of the factors mentioned could have a significant impact on our calculation of the ALLL. Our ALLL policy and the judgments, estimates and economic assumptions involved are described in greater detail in the Allowance for Loan and Lease Losses and

Unfunded Loan Commitments and Letters of Credit section of this discussion and in Note 1 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Executive Summary

At December 31, 2006, total loans were $1.71 billion compared with $1.56 billion in the prior year, an increase of $144.3 million or 9%. We experienced the most significant growth in commercial business and real estate construction loans which increased $52.0 million and $77.1 million, respectively. Over the past five years our banking team has generated a compound annual growth rate for year end loans of 8%. The growth in our loan portfolio has been achieved while improving upon overall credit quality as our nonperforming loans represented 0.20% of total loans at December 31, 2006, our lowest levels to date. At year end our allowance for loan and lease losses was $20.2 million compared to $20.8 million a year ago. The allowance for loan and lease losses represented 1.18% of our total loan portfolio and 579.94% of total nonperforming loans at year end compared to 1.33% and 428.84%, respectively, one year ago. Net charge-offs increased $2.1 million from the prior year to $2.71 million during 2006. The net charge-offs coupled with the growth in our loan portfolio caused us to increased our provision for loan and lease losses to $2.07 million during 2006 from $1.52 million during 2005.

Deposits were essentially unchanged at $2.02 billion on December 31, 2006 compared to $2.01 billion one year earlier. Core deposits declined $4.4 million or 3%, to $1.47 billion at year end. Over the past five years core deposits have proven to be a stable source of funds with a compound annual growth rate of 12%. Money market demand accounts, noninterest bearing demand, and savings decreased $47.6 million, $23.5 million, and $7.8 million respectively in the current year. These core deposit decreases were offset by an increase of $74.5 million in interest bearing demand accounts. Short-term borrowings increased $129.0 million from the prior year to $226.0 million at December 31, 2006. The increase in borrowings was used to fund growth in the loan portfolio.

The composition and growth of our balance sheet and the effect of rising short-term interest rates generated record earnings for the year. Total revenues (net interest income plus noninterest income) increased 6% to $122.4 million during 2006 as compared to $115.7 million during 2005. Net interest income increased $6.9 million to $97.8 million from $90.9 million in 2005. Noninterest income declined approximately $114,000 to $24.7 million from $24.8 million in 2005. The decrease in noninterest income was primarily due to declining mortgage banking fees, which were down $833,000 from the prior year. The decreased mortgage banking fees are attributed to declining volume due to a combination of market conditions and the effects of transitioning to a new residential mortgage lending platform during the second quarter.

Our net interest margin expanded 5 basis points to 4.49% during 2006 from 4.44% in the prior year. The yield on our average interest-earning assets has benefited from rising short-term interest rates as approximately 40% of our average loan portfolio contains variable or floating rates tied to prime or other indices allowing our loans to reprice faster than our liabilities. The yield on our average loan portfolio increased 95 basis points to 7.61% during 2006 as compared to 6.66% during the prior year. Much of the increase in loan yields was tempered by increased funding costs. The cost of average interest bearing deposits increased 92 basis points to 2.65% from 1.73% in the prior year while our average borrowing costs increased to 5.60% up from 4.00% in the prior year.

Our improved performance during 2006 resulted in higher earnings per diluted share but produced a lower return on average equity. The decline in our equity performance metrics is the result of marginally higher earnings coupled with a 10.8% increase in average shareholders equity. Earnings per diluted share increased $0.12 to $1.99 during 2006 as compared to $1.87 during 2005. Over the last five years our compounded growth rate of earnings per diluted share was 18%. Our return on average tangible equity, which removes from equity the impact of goodwill arising from acquisitions, was 15.88% for the year as compared to 16.63% in 2005. Return on average equity declined to 13.50% in 2006 from 13.81% in 2005.

During 2006 our noninterest expense increased 5% or $3.3 million to $76.1 million. This increase is primarily attributable to a valuation adjustment of $1.2 million on our prime rate floor instruments, increased occupancy costs of $653,000, increased employee compensation and benefits expense of $1.5 million, and a $604,000 increase in

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advertising and promotion expense. Approximately $300,000 of the increase in advertising expense relates to the production of new television commercials. These expense increases were partially offset by lower legal and professional services fees which decreased $1.4 million along with a decline in data processing expense of $590,000.

Share-Based Payments: On January 1, 2006, we began recognizing compensation expense in our financial statements for share-based awards based upon the grant-date fair value of those awards in accordance with SFAS 123(R). Previous financial periods were not required to be revised to reflect this change. Pretax share-based compensation recognized under SFAS 123(R) for the twelve months ended December 31, 2006 was $791,000. This charge reduced both basic and diluted earnings per share by $0.05 for the twelve months ended December 31, 2006. Stock-based compensation recorded during this period related to awards of both share options and shares. We anticipate an additional $2.0 million in pre-tax share-based compensation through 2011 for awards outstanding as of December 31, 2006. Additional impact resulting from adoption of this statement on our financial position and results of operations will be determined by share-based awards granted in future periods and the assumptions on which the value of those share-based awards is based.

Our efficiency ratio [noninterest expense divided by the sum of net interest income and noninterest income on a tax equivalent basis, excluding gain (loss) on sale of investment securities, net cost (gain) of OREO, and mark-to-market adjustments of interest rate floor instruments] was 58.95% for 2006 and 61.20% for 2005. The year over year improvement (decrease) in our efficiency ratio is due to revenues growing faster than expenses.

For the coming year we will continue to focus on actively managing our balance sheet in a manner that minimizes our exposure to potential contraction of our net interest margin in the event of changes in short-term interest rates. We will continue in our efforts to increase market share in all the communities we serve through leveraging our strong base of branches in both Washington and Oregon. As strategic opportunities are identified, we will consider new markets and branch locations that fit both our economic model and our corporate culture.

Results of Operations

Net income for the year increased to $32.1 million compared to $29.6 million in 2005 and $22.5 million in 2004. On a diluted per share basis, net income for the year was $1.99 per share, compared with $1.87 per share in 2005, and $1.52 per share in 2004. The increase in net income during 2006 was primarily a result of greater growth in net interest income, driven primarily by growth in the loan portfolio, compared to operating expenses.

Our results of operations are dependent to a large degree on net interest income. We also generate noninterest income through service charges and fees, merchant services fees, and income from mortgage banking operations. Our operating expenses consist primarily of compensation, employee benefits, and occupancy. Like most financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates, and by government policies and the actions of regulatory authorities. The operating results of Astoria were included in our operating results beginning October 1, 2004.

Net Interest Income

Net interest income is the single largest component of our total revenue. Over the past three years we have become more reliant on net interest income. In 2006 net interest income represented 80% of our total revenues compared to 79% and 76% for 2005 and 2004 respectively. We continue to grow our net interest income increasing it 8%, to $97.8 million in 2006 as compared to $90.9 million in 2005 and $71.9 million in 2004. In the current year interest on loans was a key factor in the growth of our net interest income increasing 25% to $124.0 million. This compares favorably to 2005 and 2004 loan interest earnings of $99.5 million and $68.9 million respectively. Conversely, interest expense increased $22.6 million to $53.9 million during 2006 as compared to $31.3 million in 2005 and $18.1 million in 2004. The upward trend in interest expense over the past two years is primarily due to an increased use of borrowings coupled with rising short-term interest rates. The increase in interest expense during 2005 as compared to 2004 was primarily due to growth in deposits and increased use of FHLB borrowings coupled with increasing short-term interest rates as well as 2005 including a full year of Astoria s results.

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In 2006, we began using derivative instruments to add stability to interest income and to assist in managing our exposure to changes in interest rates. We use interest rate floors as part of our cash flow hedging strategy. Interest rate floors designated as cash flow hedges protect us against movements in interest rates below the instrument s strike rate over the life of the agreement without exchange of the underlying principal amount. During 2006, the floors were used to hedge the variable cash flows associated with existing variable-rate assets. For additional information on our derivatives and hedging activities, see Note 18 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Average Balances and Net Interest Revenue

The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities, the total dollar amounts of interest income on interest-earning assets and interest expense on interest-bearing liabilities, the average yield earned on interest-earning assets and average rate paid on interest-bearing liabilities by category and in total, net interest income, net interest spread, net interest margin and the ratio of average interest-earning assets to interest-earning liabilities:

	2006			2005			2004		
	Average Balances (1)	Interest	Average Rate	Average Balances (1)	Interest (in thousands)	Average Rate	Average Balances (1)	Interest	Average Rate
Interest-Earning Assets									
Loans:									
Commercial business	$ 579,991	$ 47,111	8.12%	$ 550,095	$ 38,393	6.98%	$ 400,494	$ 22,243	5.55%
Lease Financing	12,127	1,847	15.23%	1,242	141	11.35%			
Real estate (2):									
One-to-four family residential	110,343	8,736	7.92%	87,263	5,698	6.53%	79,606	4,481	5.63%
Commercial and five or more family residential properties	778,783	54,344	6.98%	718,601	45,791	6.37%	587,993	35,296	6.00%
Consumer	148,372	11,960	8.06%	137,366	9,512	6.92%	118,413	6,888	5.82%
Total loans	1,629,616	123,998	7.61%	1,494,567	99,535	6.66%	1,186,506	68,908	5.81%
Securities (3)	623,631	30,942	4.96%	605,395	25,095	4.15%	552,742	22,982	4.16%
Interest-earning deposits with banks	12,146	617	5.08%	2,551	85	3.33%	30,222	337	1.12%
Total interest-earning assets	2,265,393	155,557	6.87%	2,102,513	124,715	5.93%	1,769,470	92,227	5.21%
Other earning assets	37,725			36,114			32,737		
Non-earning assets	170,286			152,118			116,927		
Total assets	$ 2,473,404			$ 2,290,745			$ 1,919,134		
Interest-Bearing Liabilities									
Certificates of deposit	$ 543,053	$ 20,985	3.86%	$ 499,916	$ 14,600	2.92%	$ 451,977	$ 10,506	2.32%
Savings accounts	115,802	436	0.38%	113,160	409	0.36%	92,743	320	0.35%
Interest-bearing demand and money market accounts	879,774	19,417	2.21%	889,457	10,974	1.23%	796,124	5,711	0.72%
Total interest-bearing deposits	1,538,629	40,838	2.65%	1,502,533	25,983	1.73%	1,340,844	16,537	1.23%
Federal Home Loan Bank advances	208,593	10,944	5.25%	107,651	3,515	3.27%	20,675	370	1.79%
Long-term obligations	22,343	1,992	8.92%	22,277	1,583	7.11%	22,211	1,162	5.23%
Other borrowings	2,413	138	5.72%	2,847	214	7.52%	2,835	54	1.90%
Total interest-bearing liabilities	1,771,978	53,912	3.04%	1,635,308	31,295	1.91%	1,386,565	18,123	1.31%
Demand and other noninterest-bearing deposits	437,819			421,245			349,669		
Other noninterest-bearing liabilities	25,764			19,580			13,486		
Shareholders equity	237,843			214,612			169,414		
Total liabilities and shareholders equity	$ 2,473,404			$ 2,290,745			$ 1,919,134		

Net interest income (3)	$ 101,645	$ 93,420	$ 74,104
Net interest spread	3.83%	4.02%	3.90%
Net interest margin	4.49%	4.44%	4.19%
Average interest-earning assets to average interest-bearing liabilities	127.85%	128.57%	127.62%

(1) Nonaccrual loans were included in their respective loan categories. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was $2.1 million in 2006, $1.9 million in 2005, $1.2 million in 2004.

(2) Real estate average balances include real estate construction loans.

(3) Yields on fully taxable equivalent basis, based on a marginal tax rate of 35%

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A performance metric that we consistently use to evaluate our success in managing our interest-earning assets and interest-bearing liabilities is the level of our net interest margin. Our net interest margin (net interest income on a fully-taxable equivalent basis divided by average interest-earning assets) remained relatively stable during 2006 and 2005 increasing only 5 basis points [A basis point is 1/100th of 1%, alternatively 100 basis points equals 1.00]. The improvement in our net interest margin during 2006 was primarily due to growth in average loans and securities coupled with stable core deposits. The majority of the increase in average loans during 2006 resulted from the continued efforts of our expanded banking team in certain market areas. The increase in average loans for 2005 includes $117.0 million of loans added through the acquisition of Astoria.

As the Federal Funds Target Rate stabilized our yield on average loans flattened during the second half of 2006. With a stable Federal Funds Target Rate the lag effect, where deposits reprice slower than interest earning assets in a rising rate environment, has diminished. Our cost of average interest bearing deposits steadily increased during 2006 resulting in a net interest margin of 4.43% during the fourth quarter of 2006. Our ability to maintain this level of margin throughout 2007 is dependent upon various economic factors and our ability to continue to attract low cost deposits. An unchanged or increasing net interest margin does not imply that our net income will continue to grow. For additional discussion on how we manage the interest rate risk associated with our interest-earning assets and interest-bearing liabilities see the Interest Rate Sensitivity section in Item 7A. Quantitative and Qualitative Disclosures about Market Risk of this report.

Net Interest Income Rate & Volume Analysis

The following table sets forth the total dollar amount of change in interest income and interest expense. The changes have been segregated for each major category of interest earning-earning assets and interest-bearing liabilities into amounts attributable to changes in volume, changes in rates and changes in rates multiplied by volume. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately to the changes due to volume and the changes due to interest rates:

	2006 Compared to 2005			2005 Compared to 2004		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
			(in thousands)			
Interest Income						
Loans (1)	$ 10,276	$ 14,187	$ 24,463	$ 19,535	$ 11,091	$ 30,626
Securities (TE)	905	4,942	5,847	2,182	(69)	2,113
Interest-earning deposits with banks	488	44	532	207	(458)	(251)
Total interest income (TE)	$ 11,669	$ 19,173	$ 30,842	$ 21,924	$ 10,564	$ 32,488
Interest Expense						
Deposits:						
Certificates of deposit	$ 1,667	$ 4,718	$ 6,385	$ 1,198	$ 2,896	$ 4,094
Savings accounts	10	17	27	73	16	89
Interest-bearing demand	(214)	8,657	8,443	737	4,525	5,262
Total interest on deposits	1,463	13,392	14,855	2,008	7,437	9,445
FHLB advances	5,296	2,133	7,429	2,630	515	3,145
Long-term subordinated debt & trust preferred obligations	6	403	409	3	418	421
Other borrowings	(25)	(51)	(76)		161	161
Total interest expense	$ 6,740	$ 15,877	$ 22,617	$ 4,641	$ 8,531	$ 13,172

TE = Taxable Equivalent

(1) Nonaccrual loans were included in their respective loan categories. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was $2.1 million in 2006, $1.9 million in 2005, $1.2 million in 2004.

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As evidenced by the table presented above, the $30.8 million increase in total interest revenue during 2006, as compared to 2005, was primarily due to increased loan rates and volume coupled with increasing rates on securities. The $22.6 million increase in total interest expense in 2006, as compared to 2005, was a result of increased rates paid on certificate of deposits and interest bearing demand accounts and increased use of short term borrowings such as FHLB advances. The $32.5 million increase in total interest revenue during 2005, as compared to 2004, was primarily due to increased loan volume coupled with increasing rates on loans. The $13.2 million increase in interest expense during 2005, as compared to 2004, is due to increased rates paid on certificates of deposits and interest bearing demand accounts and increased use of FHLB advances.

Provision for Loan and Lease Losses

Our contribution to the provision for loan and lease losses (the provision) was $2.1 million for 2006, compared with $1.5 million for 2005, and $995,000 for 2004. For the years ended December 31, 2006, 2005, and 2004, net loan charge-offs amounted to $2.7 million, $572,000, and $2.7 million, respectively. Expressed as a percentage of average loans, net charge-offs for the years ended December 31, 2006, 2005 and 2004 were 17 basis points, 4 basis points, and 23 basis points, respectively. The charge-offs during 2006, 2005 and 2004 were comprised of several loans. The increased provision in 2006 as compared to 2005 was primarily due to growth in our loan portfolio and the increase in net charge-offs. Net charge-offs in the fourth quarter of 2006 were $1.7 million, compared to net recoveries of $24,000 for the same period in 2005. The increase in net charge offs was primarily centered in one legacy credit originated in December of 1999, which was classified as non-performing in November of 2003. Based upon recently obtained information, management deemed it prudent to recognize a partial loss on the remaining portion of this loan as some of the assets assigned to the bank as additional collateral became impaired and reduced the book value of the loan to $1.1 million from $2.6 million during the quarter ended December 31, 2006. The provision is based on management s estimates resulting from ongoing modeling and qualitative analysis of the characteristics and composition of the loan portfolio. For discussion over the methodology used by management in determining the adequacy of the ALLL see the following Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit section of this discussion.

Noninterest Income

The following table presents the significant components of noninterest income and the related dollar and percentage change from period to period:

	Years ended December 31,						
	2006	$ change	% change	2005	$ change	% change	2004
				(in thousands)			
Fees and other revenue:							
Service charges, loan fees and other fees	$ 11,651	$ 341	3%	$ 11,310	$ 763	7%	$ 10,547
Mortgage banking	288	(833)	(74)%	1,121	(302)	(20)%	1,525
Merchant services fees	8,314	(166)	(2)%	8,480	1,221	17%	7,259
Gain (loss) on sale of securities, net	36	30	500%	6	12	(200)%	(6)
Bank owned life insurance (BOLI)	1,687	110	7%	1,577	259	20%	1,318
Other income	2,696	404	18%	2,292	589	37%	1,601
Total noninterest income	$ 24,672	$ (114)	0%	$ 24,786	$ 2,542	11%	$ 22,244

The decrease in noninterest income during 2006 was primarily due to decreased mortgage banking revenue as well a decline in merchant service revenue. Mortgage banking revenue declined as a result of lower residential loan volumes during 2006. The gross volume for merchant services increased during 2006; however, the increased income attributable to volume was offset by higher net fees paid to the card associations and several

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correspondent banking relationships that were acquired and, hence, no longer using the service. Service charges, loan fees, and other fees were relatively flat during 2006, increasing just 3% over the prior year. The nominal year over year increase in fees is attributed to relatively flat deposit growth coupled with slower loan growth in the current year.

The $2.5 million increase in noninterest income during 2005 was primarily a result of increased service charges and other fees and merchant service revenue. The increase in service charges and other fees was attributed to loan and core deposit growth. Merchant services revenue increased because of the addition of new merchants as well as increased volume from existing clients. In accordance with our investment strategy, we monitor market conditions with a view to realizing gains on our available for sale securities portfolio as market conditions allow. Investment securities sales in 2006 recorded net gains of $36,000, compared to net gains of $6,000 in 2005 and net losses of $6,000 in 2004. There were no impairment charges realized in any of the years presented.

Other Noninterest Income: The following table presents selected items of other noninterest income and the related dollar and percentage change from period to period:

	Years ended December 31,						
	2006	$ change	% change	2005	$ change	% change	2004
				(in thousands)			
Gain on disposal of assets	$ 325	$ 26	9%	$ 299	$ 212	244%	$ 87
Cash management 12-b1 fees	328	41	14%	287	40	16%	247
Stand-by letter of credit fees	249	25	11%	224	43	24%	181
Late charges	232	21	10%	211	13	7%	198
Currency exchange income	266	43	19%	223	43	24%	180
Commercial line of credit fees	55	(35)	(39)%	90	2	2%	88
New Markets Tax Credit dividend	92	32	53%	60	60	100%	
Miscellaneous	1,149	251	28%	898	278	45%	620
Total other noninterest income	$ 2,696	$ 404	18%	$ 2,292	$ 691	43%	$ 1,601

Much of the gain on the sale of assets during 2006 and 2005 consists of the amortized gain on the sale and lease-back of two buildings which occurred in September 2004. The resulting $1.3 million gain on the sale was deferred and recognized over the life of the leases, the unamortized gain balance at December 31, 2006 and 2005 was $784,000 and $1.03 million, respectively, and is included in other liabilities on our consolidated balance sheets. During 2006 and 2005 the Company recognized amortized gains associated with the sale and lease-back transaction of $246,000.

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Noninterest Expense

The following table presents the significant components of noninterest expense and the related dollar and percentage change from period to period:

	Years ended December 31,						
	2006	$ change	% change	2005	$ change	% change	2004
				(in thousands)			
Compensation	$ 28,186	$ 479	2%	$ 27,707	$ 3,759	16%	$ 23,948
Employee benefits	10,583	1,005	10%	9,578	1,298	16%	8,280
Occupancy	10,760	653	6%	10,107	1,670	20%	8,437
Merchant processing	3,361	103	3%	3,258	274	9%	2,984
Advertising and promotion	2,582	604	31%	1,978	(24)	(1)%	2,002
Data processing	2,314	(590)	(20)%	2,904	585	25%	2,319
Legal and professional services	2,099	(1,404)	(40)%	3,503	191	6%	3,312
Taxes, licenses and fees	2,499	481	24%	2,018	383	23%	1,635
Supplies and postage	2,437	147	6%	2,290	228	11%	2,062
Net gain of other real estate owned	(11)	(3)	38%	(8)	5	(38)%	(13)
Other	11,324	1,804	19%	9,520	3,160	50%	6,360
Total noninterest expense	$ 76,134	$ 3,279	5%	$ 72,855	$ 11,529	19%	$ 61,326

The current year increase in noninterest expense is primarily attributed to increased employee compensation and benefit costs, higher occupancy expense, additional advertising expense, and the market valuation adjustment through earnings of our interest rate floor instruments. The increase in compensation and employee benefits for both periods was impacted by increased group medical costs, general wage increases, and expenses related to share based payments. The increase in occupancy expense during 2006 is a result of the first full year of expense for two new branches, the University Place and downtown Puyallup branches, opened in the second and third quarter of 2005, respectively. In addition, we incurred additional occupancy expense associated with the expansion of our King county lending team, increased rent, repairs, and higher depreciation expense. These above expense increases were partially offset by lower legal and professional service fees which decreased $1.4 million due in part to the recovery of $328,000 of previously incurred professional expenses, reduced need for legal services, and lower costs associated with the compliance requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes) during the current year.

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Other Noninterest Expense: The following table presents selected items of other noninterest expense and the related dollar and percentage change from period to period:

	Years ended December 31,						
	2006	$ change	% change	2005 (in thousands)	$ change	% change	2004
Losses on investments in affordable housing partnerships (1)	$ 770	$ 55	8%	$ 715	$ 715	100%	$
Core deposit intangible amortization (CDI)	452	(85)	(16)%	537	398	286%	139
Software support & maintenance	720	53	8%	667	378	131%	289
Federal Reserve Bank processing fees	840	181	27%	659	268	69%	391
Telephone & network communications	1,120	48	4%	1,072	181	20%	891
Recovery of operational and loan commitment losses		50	(100)%	(50)	146	(74)%	(196)
Sponsorships & charitable contributions	661	(38)	(5)%	699	136	24%	563
Travel	338	31	10%	307	91	42%	216
Investor relations	169	(19)	(10)%	188	72	62%	116
Insurance	473	3	1%	470	65	16%	405
Regulatory premiums	269	(49)	(15)%	318	29	10%	289
Director expenses	442	16	4%	426	3	7%	423
Employee expenses	580	58	11%	522	(67)	(11)%	589
ATM Network	593	88	17%	505	(136)	(21)%	641
Miscellaneous	3,897	1,412	57%	2,485	881	55%	1,604
Total other noninterest expense	$ 11,324	$ 1,804	19%	$ 9,520	$ 3,160	50%	$ 6,360

(1) Losses on investment in affordable housing partnerships, future losses are not projected to continue at this level. Losses are offset by tax credits which reduce our income tax liability.

Our ability to control noninterest expense in relation to the level of net total revenue (net interest income plus noninterest income) is measured by the efficiency ratio and indicates the percentage of net total revenue that is used to cover expenses. We calculate our efficiency ratio on a tax equivalent basis and exclude certain income and expense items, such as gains/losses on investment securities, mark-to-market adjustments of interest rate floor instruments, and net cost (gain) of OREO. See our Reconciliation of Selected Financial Data to GAAP Financial Measures in Item 6. Selected Financial Data of this report for our calculation. For the years ended 2006, 2005 and 2004, our efficiency ratio was 58.95%, 61.20% and 63.20%, respectively. Our efficiency ratio improved (lowered) during 2006 due to growth in total revenue exceeding growth in other expenses. The higher efficiency ratio during 2004 was primarily due to Sarbanes implementation expenditures. Continued improvement of the efficiency ratio will depend on loan growth, increases in net interest income, growth of noninterest income and continued expense control.

Income Tax

For the years ended December 31, 2006, 2005, and 2004, we recorded income tax provisions of $12.1 million, $11.7 million, and $9.4 million, respectively. The effective tax rate was 27% in 2006, 28% in 2005 and 29% in 2004. Our income tax provision has increased over the last three years due to increased pre-tax income. Our effective tax rate is less than our statutory rate of 35% and has exhibited a declining trend over the past three years. This decline is primarily due to a significant increase in the amount of tax-exempt municipal securities held in the investment portfolio, tax exempt earnings on bank owned life insurance, and tax credits received on investments in affordable housing partnerships. For additional information, see Note 12 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

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Financial Condition

Our total assets grew 7% to $2.55 billion at December 31, 2006 from $2.38 billion at December 31, 2005. Our increase in total assets was primarily due to growth in our loan portfolio which increased 9% or $144.3 million to $1.71 billion. Our investment portfolio increased 3% or $19.8 million due to the purchase of tax-exempt municipals, collateralized mortgage obligations, and mortgage pass through securities that were a good fit with our asset mix. Deposits balances were essentially flat, increasing 1% or $17.9 million to $2.02 billion. Noninterest bearing deposits decreased $23.5 million to $432.3 million while interest bearing deposits increased $41.4 million to $1.59 billion. Short-term borrowings increased 133% or $129.0 million to $226.0 million. The increased borrowing was used to fund loan growth and securities purchases during 2006. Total equity increased 12% or $26.1 million to $252.3 million due to $32.1 million in net income for 2006.

Investment Portfolio

We invest in securities to generate revenues for the Company, to manage liquidity while minimizing interest rate risk, and to provide collateral for certain public deposits and short-term borrowings. Our investment purchases during 2006 were a component of a strategy for mitigating the impact of a potential decline in short-term rates on our net interest margin. Consistent with our investment strategy, during the upcoming year we may purchase or sell securities in response to changes in interest rates or prepayment characteristics.

The amortized cost amounts represent the Company s original cost for the investments, adjusted for accumulated amortization or accretion of any yield adjustments related to the security. The estimated fair values are the amounts that we believe the securities could be sold for as of the dates indicated. As of December 31, 2006 we had 144 available for sale securities in an unrealized loss position. Based on past experience with these types of securities and our own financial performance, we have the ability and intent to hold these investments to maturity or until fair value recovers above cost. We review these investments for other-than-temporary impairment on an ongoing basis. While our review did not result in an other-than-temporary impairment adjustment as of December 31, 2006, we will continue to review these investments for possible adjustment in the future.

Purchases during 2006 totaled $177.8 million while maturities and repayments totaled $110.8 million compared to purchases of $33.0 million and maturities and repayments of $58.7 million during 2005. We sold $43.1 million of securities for net realized gains of $36,000 during 2006, as compared to $19.6 million of securities sold for net realized gains of $6,000 during 2005. At December 31, 2006 U.S. Government agency mortgage-backed securities (MBS) and U.S. Government agency collateralized mortgage obligations (CMO) comprised 56% of our investment portfolio, state and municipal securities were 31%, and U.S. government agency securities were 13%. All of our MBS and CMO holdings are agency backed. There was no impairment charge recognized during 2006, 2005 or 2004. Approximately 99% of our investment portfolio consists of available for sale securities carried at their fair values. The average duration of our investment portfolio was 4 years and 7 months at December 31, 2006. For further information on our investment portfolio see Note 4 of the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

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The following table presents the contractual maturities and weighted average yield of our investment portfolio:

Securities Available for Sale

	December 31, 2006		
	Amortized Cost	Fair Value	Yield
	(in thousands)		
U.S. Government agency			
Due through 1 year	$ 15,581	$ 15,481	3.00%
Over 1 through 5 years	61,341	59,971	3.93%
Total	$ 76,922	$ 75,452	3.74%
U.S. Government agency mortgage-backed securities & collateralized mortgage obligations (1)			
Over 1 through 5 years	$ 832	$ 816	3.58%
Over 5 through 10 years	112,348	109,171	4.50%
Over 10 years	219,555	215,109	5.15%
Total	$ 332,735	$ 325,096	4.93%
State and municipal securities (2)			
Due through 1 year	$ 1,988	$ 1,969	2.82%
Over 1 through 5 years	3,534	3,455	3.40%
Over 5 through 10 years	21,297	21,309	5.29%
Over 10 years	159,827	163,225	6.18%
Total	$ 186,646	$ 189,958	6.00%
Other securities			
Due through 1 year	$ 1,400	$ 1,400	4.95%
After 10 years	1,000	952	5.13%
Total	$ 2,400	$ 2,352	4.87%

(1) The maturities reported for mortgage-backed securities collateralized mortgage obligations are based on contractual maturities and principal amortization.
(2) Yields on fully taxable equivalent basis, based on a marginal tax rate of 35%.

Securities Held to Maturity

	December 31, 2006		
	Amortized Cost	Fair Value	Yield (1)
	(in thousands)		
State and municipal securities			
Due through 1 year	$ 250	$ 250	6.60%
Over 1 through 5 years	1,274	1,274	6.06%
Over 10 years	298	347	9.65%
Total	$ 1,822	$ 1,871	6.72%

(1) Yields on fully taxable equivalent basis, based on a marginal tax rate of 35%.

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Loan Portfolio

We are a full service commercial bank, which originates a wide variety of loans, and concentrates its lending efforts on originating commercial business and commercial real estate loans. The following table sets forth our loan portfolio by type of loan for the dates indicated:

	December 31,									
	2006	% of Total	2005	% of Total	2004	% of Total	2003	% of Total	2002	% of Total
	(in thousands)									
Commercial business	$ 608,636	35.6%	$ 556,589	35.6%	$ 488,157	35.9%	$ 381,658	35.4%	$ 460,169	39.1%
Lease financing	9,263	0.5	14,385	0.9						
Real estate:										
One-to-four family residential	51,277	3.0	74,930	4.8	49,580	3.7	47,430	4.4	50,119	4.3
Commercial and five or more family residential properties	687,635	40.3	651,393	41.6	595,775	43.8	472,836	43.8	447,662	38.1
Total real estate	738,912	43.3	726,323	46.4	645,355	47.5	520,266	48.2	497,781	42.4
Real estate construction:										
One-to-four family residential	92,124	5.4	41,033	2.6	26,832	2.0	15,577	1.4	17,968	1.5
Commercial and five or more family residential properties	115,185	6.8	89,134	5.7	70,108	5.1	58,998	5.5	93,490	7.9
Total real estate construction	207,309	12.2	130,167	8.3	96,940	7.1	74,575	6.9	111,458	9.4
Consumer	147,782	8.6	140,110	9.0	132,130	9.7	104,240	9.7	109,070	9.3
Subtotal	1,711,902	100.2	1,567,574	100.2	1,362,582	100.2	1,080,739	100.2	1,178,478	100.2
Less deferred loan fees and other	(2,940)	(0.2)	(2,870)	(0.2)	(2,839)	(0.2)	(2,437)	(0.2)	(2,625)	(0.2)
Total loans	$ 1,708,962	100.0%	$ 1,564,704	100.0%	$ 1,359,743	100.0%	$ 1,078,302	100.0%	$ 1,175,853	100.0%
Loans held for sale	$ 933		$ 1,850		$ 6,019		$ 10,640		$ 22,102	

At December 31, 2006, total loans were $1.71 billion compared with $1.56 billion in the prior year, an increase of $144.3 million or 9%. We experienced significant growth in commercial business, commercial real estate, and real estate construction loans. Total loans at December 31, 2006 represented 67% of total assets up from 66% at December 31, 2005. The compound annual growth rate of our loan portfolio over the last five years is 8%.

Commercial Business Loans: Commercial loans increased $52.0 million, or 9%, to $608.6 million from year-end 2005, representing 36% of total loans at year end. We are committed to providing competitive commercial banking in our primary market areas. We believe increases in commercial lending during 2006 were due to the continued confidence of business owners in the sustainibility of our local economy. We expect our commercial lending focus to center around building new customer relationships while continuing to build on already established banking relationships with businesses, and business owners.

Lease Financing: Equipment leasing is the result of a portfolio acquisition made in late 2005. The bulk of the portfolio, approximately 96%, consists of titled transportation type equipment while the remainder of the portfolio is comprised of miscellaneous non-titled equipment. At the present time we are not contemplating any activities that would make lease financing a significant portion of our lending activities.

Real Estate Loans: Residential one to four family loans are used by us to collateralize advances from the FHLB. Our underwriting standards require that one-to-four family portfolio loans generally be owner-occupied and that loan amounts not exceed 80% (90% with private mortgage insurance) of the appraised value or cost, whichever is lower, of the underlying collateral at origination. During 2006 we migrated to an outsourced residential lending underwriting platform. Residential loans are originated on a pre-sold basis provided they meet the underwriting criteria established by our third party provider. If circumstances warrant, we may originate and

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retain loans that fall outside the scope of our third party provider s underwriting guidelines. The decline in residential real estate loans held in our portfolio is a reflection of lower new originations combined with our new outsourced origination platform.

Commercial and five or more family residential real estate loans reflect a mix of owner occupied and income property transactions. Generally, these loans are made to borrowers who have existing banking relationships with us. Our underwriting standards generally require that the loan-to-value ratio for these loans not exceed 75% of appraised value or cost, whichever is lower, and that commercial properties maintain debt coverage ratios (net operating income divided by annual debt servicing) of 1.2 or better. However, underwriting standards can be influenced by competition and other factors. We endeavor to maintain the highest practical underwriting standards while balancing the need to remain competitive in our lending practices.

Real Estate Construction Loans: We originate a variety of real estate construction loans. One-to-four family residential construction loans are originated for the construction of custom homes (where the home buyer is the borrower) and provides financing to builders for the construction of pre-sold homes and speculative residential construction. The increase in real estate construction loans resulted from the origination of several large development loans to well established builders. We endeavor to limit our construction lending risk through adherence to strict underwriting procedures.

Consumer Loans: Consumer loans made by us include automobile loans, boat and recreational vehicle financing, home equity and home improvement loans, and miscellaneous personal loans.

Foreign Outstanding: We are not involved with loans to foreign companies and foreign countries.

For additional information on our loan portfolio, including amounts pledged as collateral on borrowings, see Note 6 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Maturities and Sensitivities of Loans to Changes in Interest Rates

The following table presents the maturity distribution of our commercial and real estate construction loan portfolios and the sensitivity of these loans due after one year to changes in interest rates as of December 31, 2006:

		Maturing		
	Due Through	Over 1 Through	Over 5	
(in thousands)	**1 Year**	**5 Years**	**Years**	**Total**
Commercial business	$ 411,837	$ 151,440	$ 45,359	$ 608,636
Real estate construction	154,166	29,429	23,714	207,309
Total	$ 566,003	$ 180,869	$ 69,073	$ 815,945
Fixed rate loans due after 1 year		$ 140,148	$ 64,801	$ 204,949
Variable rate loans due after 1 year		40,721	4,272	44,993
Total		$ 180,869	$ 69,073	$ 249,942

Risk Elements

The extension of credit in the form of loans or other credit substitutes to individuals and businesses is one of our principal business activities. Our policies and applicable laws and regulations require risk analysis as well as ongoing portfolio and credit management. We manage our credit risk through lending limit constraints, credit review, approval policies, and extensive, ongoing internal monitoring. We also manage credit risk through diversification of the loan portfolio by type of loan, type of industry, type of borrower, and by limiting the aggregation of debt to a single borrower.

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In analyzing our existing portfolio, we review our consumer and residential loan portfolios by their performance as a pool of loans, since no single loan is individually significant or judged by its risk rating, size or potential risk of loss. In contrast, the monitoring process for the commercial business, private banking, real estate construction, and commercial real estate portfolios includes periodic reviews of individual loans with risk ratings assigned to each loan and performance judged on a loan by loan basis.

We review these loans to assess the ability of our borrowers to service all interest and principal obligations and, as a result, the risk rating may be adjusted accordingly. In the event that full collection of principal and interest is not reasonably assured, the loan is appropriately downgraded and, if warranted, placed on non-accrual status even though the loan may be current as to principal and interest payments. Additionally, we assess whether an impairment of a loan warrants specific reserves or a write-down of the loan. For additional discussion on our methodology in managing credit risk within our loan portfolio see the following Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit section and Note 1 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Loan policies, credit quality criteria, portfolio guidelines and other controls are established under the guidance of our Chief Credit Officer and approved, as appropriate, by the Board. Credit Administration, together with the loan committee, has the responsibility for administering the credit approval process. As another part of its control process, we use an independent internal credit review and examination function to provide assurance that loans and commitments are made and maintained as prescribed by our credit policies. This includes a review of documentation when the loan is initially extended and subsequent on-site examination to ensure continued performance and proper risk assessment.

Nonperforming Assets: Nonperforming assets consist of: (i) nonaccrual loans, which generally are loans placed on a nonaccrual basis when the loan becomes past due 90 days or when there are otherwise serious doubts about the collectibility of principal or interest; (ii) in most cases restructured loans, for which concessions, including the reduction of interest rates below a rate otherwise available to that borrower or the deferral of interest or principal, have been granted due to the borrower s weakened financial condition (interest on restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur); (iii) real estate owned; and (iv) personal property owned. Nonperforming assets totaled $3.5 million, or 0.14% of year-end assets at December 31, 2006, compared to $4.9 million or 0.21% of year end assets at December 31, 2005.

The following table sets forth information with respect to our nonaccrual loans, restructured loans, total nonperforming loans (nonaccrual loans plus restructured loans), real estate owned, personal property owned, total nonperforming assets, accruing loans past-due 90 days or more, and potential problem loans:

	December 31,				
	2006	2005	2004 (in thousands)	2003	2002
Nonaccrual:					
Commercial business	$ 1,562	$ 4,316	$ 6,587	$ 9,987	$ 13,767
Leases	215				
Real Estate					
One-to-four family residential	366	376	375	365	139
Commercial and five or more family residential real estate	217		440	1,245	1,842
Real Estate Construction					
One-to-four family residential				663	920
Consumer	54	41	820	995	250
Total nonaccrual loans	2,414	4,733	8,222	13,255	16,918
Restructured:					
Commercial business	1,066	124	227		
One-to-four family residential construction					187
Total restructured loans	1,066	124	227		187
Total nonperforming loans	3,480	4,857	8,449	13,255	17,105
Real estate owned		18	680	1,452	130
Other personal property owned				691	916
Total nonperforming assets	$ 3,480	$ 4,875	$ 9,129	$ 15,398	$ 18,151
Accruing loans past-due 90 days or more	$	$	$ 4	$ 4	$ 7
Foregone interest on nonperforming loans	$ 497	$ 106	$ 920	$ 1,338	$ 1,664
Interest recognized on nonperforming loans	$ 202	$ 45	$ 101	$ 386	$ 568
Potential problem loans	$ 2,288	$ 2,269	$ 2,321	$ 1,342	$ 2,818
Allowance for loan losses	$ 20,182	$ 20,829	$ 19,881	$ 20,261	$ 19,171
Allowance for loan losses to nonperforming loans	579.94%	428.84%	235.31%	152.86%	112.08%
Allowance for loan losses to nonperforming assets	579.94%	427.26%	217.78%	131.58%	105.62%
Nonperforming loans to year end loans	0.20%	0.31%	0.62%	1.23%	1.45%
Nonperforming assets to year end assets	0.14%	0.21%	0.42%	0.88%	1.07%

Nonperforming Loans The Consolidated Financial Statements are prepared according to the accrual basis of accounting. This includes the recognition of interest income on the loan portfolio, unless a loan is placed on nonaccrual status, which occurs when there are serious doubts about the collectibility of principal or interest. Our policy is generally to discontinue the accrual of interest on all loans past due 90 days or more and place them on nonaccrual status.

Nonperforming loans and other nonperforming assets are centered in a number of lending relationships which we consider adequately reserved. Generally, these relationships are well collateralized though loss of principal on certain of these loans will remain in question until the loans are paid or collateral is liquidated. We will continue our collection efforts and liquidation of collateral to recover as large a portion of the nonperforming assets as possible. Substantially, all nonperforming loans are to borrowers within Washington state market areas.

Other Real Estate Owned: As of December 31, 2006 there were no other real estate owned assets, which is comprised of property from foreclosed real estate loans. This reflects a current year decrease of $18,000 compared to a decrease of $662,000 to $18,000 at December 31, 2005.

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Other Personal Property Owned: Other personal property owned (OPPO) is comprised of other, non-real estate property from foreclosed loans. There were no OPPO assets at December 31, 2006 and 2005

Potential Problem Loans: Potential problem loans are loans which are currently performing and are not nonaccrual, restructured or impaired loans, but about which there are sufficient doubts as to the borrower s future ability to comply with repayment terms and which may later be included in nonaccrual, past due, restructured or impaired loans. Potential problem loans totaled $2.3 million at year end 2006 and 2005.

For additional information on our nonperforming loans see Note 6 to our Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit

We maintain an allowance for loan and lease losses (ALLL) to absorb losses inherent in the loan portfolio. The size of the ALLL is determined through quarterly assessments of the probable estimated losses in the loan portfolio. Our methodology for making such assessments and determining the adequacy of the ALLL includes the following key elements:

1. General valuation allowance consistent with SFAS No. 5, Accounting for Contingencies.

2. Criticized/classified loss reserves on specific relationships. Specific allowances for identified problem loans are determined in accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan.

3. The unallocated allowance provides for other credit losses inherent in our loan portfolio that may not have been contemplated in the general and specific components of the allowance. This unallocated amount generally comprises less than 5% of the allowance. The unallocated amount is reviewed periodically based on trends in credit losses, the results of credit reviews and overall economic trends.

On a quarterly basis our Chief Credit Officer reviews with Executive Management and the Board of Directors the various additional factors that management considers when determining the adequacy of the ALLL, including economic and business condition reviews. Factors which influenced management s judgment in determining the amount of the additions to the ALLL charged to operating expense include the following as of the applicable balance sheet dates:

1. Existing general economic and business conditions affecting our market place

2. Credit quality trends, including trends in nonperforming loans

3. Collateral values

4. Seasoning of the loan portfolio

5. Bank regulatory examination results

6. Findings of internal credit examiners

7. Duration of current business cycle

The ALLL is increased by provisions for loan and lease losses (provision) charged to expense, and is reduced by loans charged off, net of recoveries. While we believe the best information available is used by us to determine the ALLL, unforeseen market conditions could result in adjustments to the ALLL, affecting net income, if circumstances differ from the assumptions used in determining the ALLL.

In addition to the ALLL, we maintain an allowance for unfunded loan commitments and letters of credit. We report this allowance as a liability on our Consolidated Balance Sheet. We determine this amount using estimates of the probability of the ultimate funding and losses related to those credit exposures. This methodology is similar to the methodology we use for determining the adequacy of our ALLL. For additional information on our allowance for unfunded loan commitments and letters of credit, see Note 7 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

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Analysis of the ALLL

The following table provides an analysis of our loss experience by loan type for the last five years:

	2006	2005	December 31, 2004 (in thousands)	2003	2002
Total loans, net at year end (1)	$ 1,708,962	$ 1,564,704	$ 1,359,743	$ 1,078,302	$ 1,175,853
Daily average loans	$ 1,629,616	$ 1,494,567	$ 1,186,506	$ 1,128,941	$ 1,183,922
Balance of ALLL at beginning of period	$ 20,829	$ 19,881	$ 20,261	$ 19,171	$ 14,734
Balance acquired through acquisition			1,367		
Charge-offs					
Commercial business	(2,077)	(386)	(2,490)	(2,210)	(6,870)
Real Estate:					
One-to-four family residential				(1)	(6)
Commercial and 5 or more family residential properties	(9)				(3,500)
Real Estate Construction:					
One-to-four family residential construction				(26)	(855)
Commercial and five or more family residential properties		(665)	(260)		
Consumer	(1,109)	(221)	(292)	(315)	(857)
Total charge-offs	(3,195)	(1,272)	(3,042)	(2,552)	(12,088)
Recoveries					
Commercial business	233	218	124	728	158
Real Estate:					
One-to-four family residential	20		1		23
Commercial and 5 or more family residential properties	83				3
Real Estate Construction:					
One-to-four family residential construction	7		25	5	538
Commercial and five or more family residential properties		326			
Consumer	140	156	150	59	23
Total recoveries	483	700	300	792	745
Net charge-offs	(2,712)	(572)	(2,742)	(1,760)	(11,343)
Provision charged to expense	2,065	1,520	995	2,850	15,780
Balance of ALLL at year end	$ 20,182	$ 20,829	$ 19,881	$ 20,261	$ 19,171
Net charge-offs to average loans outstanding	0.17%	0.04%	0.23%	0.16%	0.96%
Allowance for loan losses to year end loans (1)	1.18%	1.33%	1.46%	1.88%	1.63%

(1) Excludes loans held for sale

The increase in the provision during 2006 was due primarily to loan growth coupled with higher net charge-offs during the year. The 2005 provision was a function of loan growth.

We have used the same methodology for ALLL calculations during 2006, 2005 and 2004. Adjustments to the percentages of the ALLL allocated to loan categories are made based on trends with respect to delinquencies

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and problem loans within each pool of loans. There were no significant changes during 2006 in estimation methods or assumptions that affected our methodology for assessing the appropriateness of the ALLL. We maintain a conservative approach to credit quality and will continue to prudently add to our ALLL as necessary in order to maintain adequate reserves. Our credit quality measures improved during 2006 and are among the strongest in our history. We carefully monitor the loan portfolio and continue to emphasize the importance of credit quality while continuously strengthening our loan monitoring systems and controls.

Allocation of the ALLL

The table below sets forth the allocation of the ALLL by loan category:

Balance at End of Period Applicable to:	December 31, 2006 Amount	2006 % of Total Loans*	2005 Amount	2005 % of Total Loans*	2004 Amount	2004 % of Total Loans*	2003 Amount	2003 % of Total Loans*	2002 Amount	2002 % of Total Loans*
					(in thousands)					
Commercial business	$ 9,135	35.6%	$ 11,744	35.6%	$ 10,222	35.9%	$ 12,940	35.4%	$ 13,292	39.1%
Lease financing	493	0.5	316	0.9						
Real estate and construction:										
One-to-four family residential	1,134	8.4	809	7.4	678	5.7	895	5.8	508	5.8
Commercial and five or more family residential properties	8,841	46.9	6,663	47.1	7,995	48.8	5,140	49.1	4,623	45.8
Consumer	281	8.6	677	9.0	985	9.7	1,376	9.7	941	9.3
Unallocated	298		620		1		(90)		(193)	
Total	$ 20,182	100.0%	$ 20,829	100.0%	$ 19,881	100.0%	$ 20,261	100.0%	$ 19,171	100.0%

* Represents the total of all outstanding loans in each category as a percent of total loans outstanding.

As discussed previously, management maintains a conservative approach in determining the adequacy of the ALLL. The unallocated amount at December 31, 2006 reflects recent loan growth in less seasoned relationships which will require aging to determine the probability of default and the level of loss given default.

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Deposits

The following table sets forth the average amount of and the average rate paid on each significant deposit category:

	Years ended December 31, 2006 Average Deposits	2006 Rate	2005 Average Deposits	2005 Rate	2004 Average Deposits	2004 Rate
Interest bearing demand (1)	$ 879,774	2.21%	$ 889,457	1.23%	$ 796,124	0.72%
Savings	115,802	0.38%	113,160	0.35%	92,743	0.35%
Certificates of deposit	543,053	3.86%	499,916	2.92%	451,977	2.32%
Total interest-bearing deposits	1,538,629	2.65%	1,502,533	1.73%	1,340,844	1.23%
Demand and other non-interest bearing	437,819		421,245		349,669	
Total average deposits	$ 1,976,448		$ 1,923,778		$ 1,690,513	

(1) Interest-bearing demand deposits include interest-bearing checking accounts and money market accounts.

During 2006 our total average deposits increased $52.7 million, or 3% as compared to $233.3 million or 14% during 2005. Our focus in increasing our deposit base is centered on core deposit growth, which includes interest and non-interest bearing demand, money market, and savings accounts. Average core deposits increased $9.5 million during 2006 and $185.3 million during 2005.

We believe the stability in average core deposits is due to our strong franchise built through providing our customers with superior customer service. The nominal growth in core deposits compelled us to increase our offering rates in an effort to attract funds at a lower cost than short-term borrowings. As the equity markets continue to improve, the banking industry in general is experiencing lower deposit growth than realized during the past several years. We anticipate continued growth in our deposits with the addition of new customers and expansion of relationships with our existing customer base.

The following table sets forth the amount outstanding of time certificates of deposit and other time deposits in amounts of $100,000 or more by time remaining until maturity and percentage of total deposits:

	December 31, 2006 Time Certificates of Deposit of $100,000 or More		Other Time Deposits of $100,000 or More	
Amounts maturing in:	Amount	Percent of Total Deposits	Amount	Percent of Total Deposits
	(in thousands)			
Three months of less	$ 188,105	9%	$	%
Over 3 through 6 months	38,571	2%		
Over 6 through 12 months	36,435	2%		
Over 12 months	48,181	2%	10,531	1%
Total	$ 311,292	15%	$ 10,531	1%

Other time deposits of $100,000 or more set forth in the table above represent brokered and wholesale deposits. We use brokered and other wholesale deposits as part of our strategy for funding growth. In the future, we anticipate continuing the use of such deposits to fund loan demand or treasury functions.

Short-Term Borrowings

Our short-term borrowings consist of FHLB advances and securities repurchase agreements. We utilize these borrowings as a supplement to our funding sources. FHLB advances are secured by one-to-four family real

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estate mortgages, investment securities, and certain other assets. Securities repurchase agreements are secured by investments. We anticipate we will continue to rely on the same funding sources in the future, and will use those funds primarily to make loans and purchase securities.

The following table sets forth the details of FHLB advances:

	Years ended December 31,		
	2006	2005	2004
		(in thousands)	
FHLB Advances			
Balance at year end	$ 205,800	$ 94,400	$ 68,700
Average balance during the year	$ 208,594	$ 107,651	$ 20,675
Maximum month-end balance during the year	$ 303,000	$ 194,200	$ 68,700
Weighted average rate during the year	5.25%	3.27%	1.79%
Weighted average rate at December 31,	5.56%	4.33%	2.34%

For additional information on our borrowings, including amounts pledged as collateral, see Note 11 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Long-Term Borrowings

During 2001, we, participated in a pooled trust preferred offering through our subsidiary trust (the Trust), whereby the trust issued $22.0 million of 30 year floating rate capital securities. The capital securities constitute guaranteed preferred beneficial interests in debentures issued by the trust. The debentures had an initial rate of 7.29% and a rate of 8.96% at December 31, 2006. The floating rate is based on the 3-month LIBOR plus 3.58% and is adjusted quarterly. Through the Trust we may call the debt at ten years at par, allowing us to retire the debt early if conditions are favorable. Effective December 31, 2003, we adopted Financial Accounting Standards Board Interpretation No. 46 Consolidation of Variable Interest Entities whereby the Trust was deconsolidated with the result being that the trust preferred obligations were reclassified as long-term subordinated debt on our December 31, 2003 Consolidated Balance Sheets and our related investment in the Trust was recorded in other assets on the Consolidated Balance Sheets.

Additionally, we have a $20.0 million line of credit with a large commercial bank with an interest rate indexed to LIBOR. At December 31, 2006 and 2005, the outstanding balance was $0 and $2.5 million, respectively. In the event of discontinuance of the line by either party, we have up to two years to repay any outstanding balance. For additional information on our borrowings, see Note 11 to the Consolidated Financial Statements in Item 8. Financial Statements and Supplementary Data of this report.

Contractual Obligations & Commitments

We are party to many contractual financial obligations, including repayment of borrowings, operating and equipment lease payments, and commitments to extend credit. The table below presents certain future financial obligations of the Company:

	Payments due within time period at December 31, 2006				
				Due after	
	0-12	1-3	4-5	Five	
	Months	Years	Years	Years	Total
			(in thousands)		
Operating & equipment leases	$ 3,112	$ 5,391	$ 5,052	$ 10,942	$ 24,497
Capital lease	138	4			142
FHLB advances	205,800				205,800
Other borrowings	20,198				20,198