

COLUMBIA BANKING SYSTEM INC

Form 10-Q

November 03, 2006

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006.

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

Commission File Number 0-20288

COLUMBIA BANKING SYSTEM, INC.

(Exact name of issuer as specified in its charter)

Washington
(State or other jurisdiction of
incorporation or organization)

91-1422237
(I.R.S. Employer
Identification Number)

1301 A Street
Tacoma, Washington
(Address of principal executive offices)

(253) 305-1900

98402-2156
(Zip Code)

(Issuer's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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, and (2) has been subject to such filing requirements for the past 90 days. Yes No

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 in Rule 12b-2 of the Exchange Act.

Large accelerated filer 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

The number of shares of common stock outstanding at October 31, 2006 was 16,049,477

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Table of Contents**CONSOLIDATED CONDENSED STATEMENTS OF INCOME***Columbia Banking System, Inc.**(Unaudited)*

| <i>(in thousands except per share)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------|---------------------------------------------|---------------|--------------------------------------------|---------------|
| | 2006 | 2005 | 2006 | 2005 |
| Interest Income | | | | |
| Loans | \$ 32,010 | \$ 26,080 | \$ 90,982 | \$ 72,215 |
| Taxable securities | 5,019 | 4,532 | 15,185 | 13,680 |
| Tax-exempt securities | 1,944 | 1,112 | 5,124 | 3,304 |
| Deposits with banks | 174 | 31 | 306 | 55 |
| Federal funds sold | 19 | | 48 | |
| Total interest income | 39,166 | 31,755 | 111,645 | 89,254 |
| Interest Expense | | | | |
| Deposits | 10,868 | 6,871 | 28,767 | 17,873 |
| Federal Home Loan Bank advances | 3,370 | 1,100 | 8,344 | 3,151 |
| Long-term obligations | 519 | 412 | 1,470 | 1,140 |
| Other borrowings | 4 | 41 | 51 | 112 |
| Total interest expense | 14,761 | 8,424 | 38,632 | 22,276 |
| Net Interest Income | 24,405 | 23,331 | 73,013 | 66,978 |
| Provision for loan and lease losses | 650 | 245 | 1,115 | 1,505 |
| Net interest income after provision for loan and lease losses | 23,755 | 23,086 | 71,898 | 65,473 |
| Noninterest Income | | | | |
| Service charges and other fees | 2,891 | 2,955 | 8,632 | 8,388 |
| Mortgage banking | 141 | 189 | 397 | 947 |
| Merchant services fees | 2,154 | 2,355 | 6,366 | 6,392 |
| Net gain on sale of securities available for sale | | | 10 | |
| Bank owned life insurance (BOLI) | 427 | 400 | 1,260 | 1,184 |
| Other | 495 | 617 | 1,683 | 1,407 |
| Total noninterest income | 6,108 | 6,516 | 18,348 | 18,318 |
| Noninterest Expense | | | | |
| Compensation and employee benefits | 9,878 | 9,434 | 28,973 | 28,140 |
| Occupancy | 2,735 | 2,588 | 8,068 | 7,497 |
| Merchant processing | 881 | 906 | 2,552 | 2,454 |
| Advertising and promotion | 608 | 535 | 2,114 | 1,574 |
| Data processing | 475 | 733 | 1,795 | 2,169 |
| Legal and professional services | 580 | 891 | 1,547 | 2,589 |
| Taxes, licenses and fees | 637 | 529 | 1,873 | 1,480 |
| Net cost (gain) on sale of other real estate owned | | 1 | (11) | (8) |
| Other | 2,304 | 3,176 | 10,663 | 8,689 |
| Total noninterest expense | 18,098 | 18,793 | 57,574 | 54,584 |
| Income before income taxes | 11,765 | 10,809 | 32,672 | 29,207 |
| Provision for income taxes | 3,430 | 2,857 | 8,910 | 8,159 |

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| | | | | |
|-----------------------------------------------------|------------------------------------------------------------------------|----------|-----------|-----------|
| <i>Net Income</i> | \$ 8,335 | \$ 7,952 | \$ 23,762 | \$ 21,048 |
| Net income per common share: | | | | |
| Basic | \$.52 | \$ 0.50 | \$ 1.49 | \$ 1.34 |
| Diluted | .52 | 0.50 | 1.47 | 1.33 |
| Dividends paid per common share | \$.15 | \$ 0.11 | \$.42 | \$ 0.27 |
| Average number of common shares outstanding | 15,981 | 15,746 | 15,931 | 15,672 |
| Average number of diluted common shares outstanding | 16,143 | 15,940 | 16,135 | 15,852 |
| | See accompanying notes to consolidated condensed financial statements. | | | |

Table of Contents**CONSOLIDATED CONDENSED BALANCE SHEETS***Columbia Banking System, Inc.**(Unaudited)*

| <i>(in thousands)</i> | September 30, 2006 | December 31, 2005 |
|-------------------------------------------------------------------------------------------------------|-------------------------------|------------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 86,290 | \$ 96,787 |
| Interest-earning deposits with banks | 15,190 | 3,619 |
| Federal funds sold | 4,000 | |
| Total cash and cash equivalents | 105,480 | 100,406 |
| Securities available for sale at fair value (amortized cost of \$606,307 and \$576,919, respectively) | 598,847 | 572,355 |
| Securities held to maturity at cost (fair value of \$2,248 and \$2,587, respectively) | 2,197 | 2,524 |
| Federal Home Loan Bank stock at cost | 10,453 | 10,453 |
| Loans held for sale | 1,160 | 1,850 |
| Loans, net of deferred loan fees of (\$2,649) and (\$2,870), respectively | 1,655,809 | 1,564,704 |
| Less: allowance for loan and lease losses | 20,926 | 20,829 |
| Loans, net | 1,634,883 | 1,543,875 |
| Interest receivable | 13,684 | 11,671 |
| Premises and equipment, net | 44,997 | 44,690 |
| Other real estate owned | | 18 |
| Goodwill | 29,723 | 29,723 |
| Other | 66,026 | 59,757 |
| Total Assets | \$ 2,507,450 | \$ 2,377,322 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing | \$ 455,773 | \$ 455,838 |
| Interest-bearing | 1,564,292 | 1,549,651 |
| Total deposits | 2,020,065 | 2,005,489 |
| Federal Home Loan Bank advances | 191,900 | 94,400 |
| Other borrowings | 699 | 2,572 |
| Long-term subordinated debt | 22,362 | 22,312 |
| Other liabilities | 26,623 | 26,307 |
| Total liabilities | 2,261,649 | 2,151,080 |
| Commitments and contingent liabilities | | |
| Shareholders' equity: | | |
| Preferred stock (no par value) Authorized, 2 million shares; none outstanding | | |
| | September 30, | December 31, |
| | 2006 | 2005 |
| Common stock (no par value) | | |
| Authorized shares | 63,034 | 63,034 |

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| | | | | |
|--------------------------------------------|--------|--------|--------------|--------------|
| Issued and outstanding | 16,047 | 15,831 | 166,420 | 162,973 |
| Retained earnings | | | 83,104 | 66,051 |
| Accumulated other comprehensive loss | | | (3,723) | (2,782) |
| Total shareholders' equity | | | 245,801 | 226,242 |
| Total Liabilities and Shareholders' Equity | | | \$ 2,507,450 | \$ 2,377,322 |

See accompanying notes to consolidated condensed financial statements.

Table of Contents**CONSOLIDATED CONDENSED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY***Columbia Banking System, Inc.**(Unaudited)*

| <i>(in thousands)</i> | Common stock | | Retained Earnings | Deferred Compensation | Accumulated Other Comprehensive Income (Loss) | Total Shareholders Equity |
|----------------------------------------------------------------------------------------------------------|------------------|-------------------|-------------------|-----------------------|-----------------------------------------------|---------------------------|
| | Number of Shares | Amount | | | | |
| Balance at January 1, 2005 | 15,594 | \$ 159,693 | \$ 42,552 | \$ | \$ 909 | \$ 203,154 |
| Comprehensive income: | | | | | | |
| Net income | | | 21,048 | | | 21,048 |
| Unrealized losses on securities available for sale, net of tax of \$526 | | | | | (1,040) | (1,040) |
| Total comprehensive income | | | | | | 20,008 |
| Issuance of stock under equity compensation plan | 198 | 1,932 | | | | 1,932 |
| Issuance of restricted stock under equity compensation plan | 16 | 389 | | (389) | | |
| Amortization of deferred compensation restricted stock | | | | 263 | | 263 |
| Tax benefit associated with exercise of stock options | | 748 | | | | 748 |
| Cash dividends paid on common stock | | | (4,232) | | | (4,232) |
| Balance at September 30, 2005 | 15,808 | \$ 162,762 | \$ 59,368 | \$ (126) | \$ (131) | \$ 221,873 |
| Balance at January 1, 2006 | 15,831 | \$ 163,065 | \$ 66,051 | \$ (92) | \$ (2,782) | \$ 226,242 |
| Comprehensive income: | | | | | | |
| Net income | | | 23,762 | | | 23,762 |
| Reclassification of net gains on securities available for sale included in net income, net of tax of \$4 | | | | | (6) | (6) |
| Unrealized losses on securities available for sale, net of tax of \$1,128 | | | | | (2,068) | (2,068) |
| Unrealized gains from cash flow hedging instruments | | | | | 1,133 | 1,133 |
| Total comprehensive income | | | | | | 22,821 |
| Transition adjustment related to adoption of SFAS 123(R) | | (92) | | 92 | | |
| Issuance of stock under equity compensation plan | 140 | 2,158 | | | | 2,158 |
| Equity compensation awards | 76 | 407 | | | | 407 |
| Tax benefit associated with exercise of stock options | | 882 | | | | 882 |
| Cash dividends paid on common stock | | | (6,709) | | | (6,709) |
| Balance at September 30, 2006 | 16,047 | \$ 166,420 | \$ 83,104 | \$ | \$ (3,723) | \$ 245,801 |

See accompanying notes to consolidated condensed financial statements.

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| <i>(in thousands)</i> | Nine Months Ended September 30, | |
|-----------------------------------------------------------------------------------|------------------------------------|-----------|
| | 2006 | 2005 |
| Operating Activities | | |
| Net income | \$ 23,762 | \$ 21,048 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 1,115 | 1,505 |
| Deferred income tax expense (benefit) | (796) | 801 |
| Deferred loan fees, net of amortization | (221) | 198 |
| Stock based compensation expense | 576 | 263 |
| Tax benefit associated with stock compensation plan | (882) | (748) |
| Gains on sale of real estate owned and other personal property owned | (11) | (8) |
| Gains on sale of investment securities | (10) | |
| Depreciation and amortization | 7,136 | 6,986 |
| Net realized gain on sale of assets | (227) | (167) |
| (Increase) decrease in loans held for sale | 690 | (685) |
| Decrease in interest receivable | (2,013) | (878) |
| Increase in interest payable | 481 | 500 |
| Stock dividends from Federal Home Loan Bank stock | | (43) |
| Net changes in other assets and liabilities | (3,376) | (2,824) |
| Net cash provided by operating activities | 26,224 | 25,948 |
| Investing Activities | | |
| Proceeds from maturities of securities available for sale | 101,932 | 47,584 |
| Purchases of securities available for sale | (137,549) | (5,908) |
| Proceeds from sales of securities available for sale | 3,865 | 1,618 |
| Proceeds from maturities of securities held to maturity | 328 | 328 |
| Purchases of Federal Home Loan Bank stock | | (2,566) |
| Proceeds from sales of Federal Home Loan Bank stock | | 2,917 |
| Loans originated and acquired, net of principal collected | (91,902) | (151,018) |
| Purchases of premises and equipment | (3,797) | (3,891) |
| Proceeds from disposal of premises and equipment | 206 | 1,048 |
| Proceeds from sales of real estate and other personal property owned | 29 | 688 |
| Net cash used in investing activities | (126,888) | (109,200) |
| Financing Activities | | |
| Net increase in deposits | 14,576 | 129,760 |
| Repayment of other borrowings | (2,500) | |
| Proceeds from Federal Home Loan Bank advances | 2,024,720 | 857,480 |
| Repayment of Federal Home Loan Bank advances | (1,927,220) | (866,855) |
| Cash dividends paid on common stock | (6,709) | (4,232) |
| Proceeds from other borrowings | | 159 |
| Proceeds from issuance of common stock, net | 1,989 | 2,943 |
| Tax benefit associated with stock compensation plan | 882 | |
| Other, net | | (69) |
| Net cash provided by financing activities | 105,738 | 119,186 |
| Increase in cash and cash equivalents | 5,074 | 35,934 |
| Cash and cash equivalents at beginning of period | 100,406 | 54,656 |

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| | | |
|-------------------------------------------------------------------------|------------|-----------|
| Cash and cash equivalents at end of period | \$ 105,480 | \$ 90,590 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | \$ 38,470 | \$ 21,652 |
| Cash paid for income taxes | 10,505 | 8,311 |
| Supplemental disclosures of noncash investing and financing activities: | | |
| Purchase of investment in affordable housing partnership | \$ | \$ 6,900 |

See accompanying notes to consolidated condensed financial statements.

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Columbia Banking System, Inc.

1. Basis of Presentation and Critical Accounting Policies***(a) Basis of Presentation***

The interim unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for condensed interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain financial information and footnotes have been omitted or condensed. The consolidated condensed financial statements include the accounts of the Company, and its wholly owned banking subsidiaries Columbia Bank and Bank of Astoria (Astoria). All significant intercompany transactions and accounts have been eliminated in consolidation. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair statement of the results for the interim periods presented have been included. The results of operations for the nine months ended September 30, 2006 are not necessarily indicative of results to be anticipated for the year ending December 31, 2006. The accompanying interim unaudited consolidated condensed financial statements should be read in conjunction with the financial statements and related notes contained in the Company's 2005 Annual Report on Form 10-K.

(b) Critical Accounting Policies

Management has identified the accounting policies related to the allowance for loan and lease losses as critical to an understanding of our financial statements. These policies and related estimates are discussed in Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations under the heading Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit in our 2005 Annual Report on Form 10-K. There have not been any material changes in our critical accounting policies relating to the allowance for loan and lease losses as compared to those disclosed in our 2005 Annual Report on Form 10-K.

2. Recent Developments

Adoption of SFAS 123(R): Effective January 1, 2006, the Company started recognizing compensation expense for stock options and other share-based payments with the adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, as described in note 3 below.

Designation of Cash Flow Hedge: Effective July 26, 2006 the Company began cash flow hedge accounting treatment for its derivative financial instruments as prescribed by Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), as amended, as described in note 4 below.

Recently Issued Accounting Pronouncements: In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainties in Incomes Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is assessing the impact of adopting the new pronouncement, which will become effective January 1, 2007, but it is not expected to have a material impact.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. It defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company is assessing the impact of adopting the new pronouncement, which will become effective January 1, 2008, but it is not expected to have a material impact.

3. Stock Based Compensation Plans

Effective January 1, 2006, the Company adopted SFAS 123(R) using the modified prospective method, which establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, over the requisite service period. Previously, the Company applied Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations, as permitted by SFAS No. 123, *Accounting for Stock Based Compensation*.

Determining Fair Value under SFAS 123(R)

Valuation and Amortization Method. The Company estimates the fair value of stock-based awards granted using the Black-Scholes option valuation model. The fair value of all awards is amortized on a straight-line basis over the requisite service periods, which are generally the vesting periods.

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Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The expected life is determined based on historical experience with similar awards, giving consideration to the contractual terms and vesting schedules.

Expected Volatility. Volatility of our common stock is estimated at the date of grant based on the historical volatility of the stock. The volatility factor used in the Black-Scholes option valuation model is based on historical stock prices over the most recent period commensurate with the estimated expected life of the award.

Risk-Free Interest Rate. The risk-free interest rate used in the Black-Scholes option valuation model is based on the U.S. Treasury curve in effect at the time of the award.

Expected Dividend Yield. The expected dividend is based on dividend trends and the market value of the Company's stock price at the time of the award.

There were no stock options granted by the Company during the nine months ended September 30, 2006 or during the three months ended September 30, 2005. Assumptions utilized in the Black-Scholes option valuation model for options granted during the nine months ended September 30, 2005 are summarized as follows:

| | For The Nine |
|------------------------------------|---------------------|
| | Months Ended |
| | 9/30/2005 |
| <i>(Black-Scholes Assumptions)</i> | |
| Expected Life (in years) | 5.16 |
| Expected Volatility | 35.12% |
| Risk-free Interest Rate | 4.21% |
| Expected Dividend Yield | 1.52% |

Stock-based Compensation Under SFAS 123(R)

Total stock-based compensation expense recognized in the consolidated condensed statements of income for the three and nine months ended September 30, 2006 was \$248,000 and \$576,000, respectively, before income taxes. The related estimated tax benefit was \$87,000 and \$202,000 for the three and nine months ended September 30, 2006. Total stock-based compensation for the three months ended September 30, 2006 consisted of stock option and restricted stock expense of \$56,000 and \$192,000, respectively. For the nine months ended September 30, 2006, total stock-based compensation expense consisted of stock option and restricted stock expense of \$169,000 and \$407,000 respectively.

At September 30, 2006 there were 150,075 non-vested stock options and awards that had a weighted average grant date fair value of \$21.53. As of September 30, 2006, the Company had \$2.0 million of total unrecognized compensation cost related to non-vested stock-based awards granted under its equity compensation plan. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures and new awards. The Company expects to recognize this cost ratably over a period of 3 years for stock options and 5 years for stock awards.

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The following table shows the effect on 2005 net earnings and earnings per share had compensation cost been recognized based upon the estimated fair value on the grant date of stock options and restricted stock, in accordance with SFAS 123, as amended by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure (in thousands, except earnings per share):

| | For The Three Months Ended 9/30/2005 | For The nine Months Ended 9/30/2005 |
|--------------------------------------------------------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
| Net income attributable to common stock: | | |
| As reported | \$ 7,952 | \$ 21,048 |
| Add: Total stock-based compensation expense included in reported net income, net of tax | 60 | 163 |
| Deduct: Total stock based compensation expense determined under fair value method for all awards, net of tax | (112) | (792) |
| Pro forma net income | \$ 7,900 | \$ 20,419 |
| Net income per common share: | | |
| Basic: | | |
| As reported | \$ 0.50 | \$ 1.34 |
| Pro forma | 0.50 | 1.30 |
| Diluted: | | |
| As reported | \$ 0.50 | \$ 1.33 |
| Pro forma | 0.50 | 1.29 |

Disclosures for the periods ended September 30, 2006 are not presented because the amounts are recognized in the consolidated condensed financial statements.

Stock Activity Under Plan

At September 30, 2006, the Company had one equity compensation plan that provides for the granting of stock options and restricted stock awards to eligible employees and directors. Additional information regarding this plan is disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. At September 30, 2006, a maximum of 2,191,482 shares were authorized under the plan, of which a net 1,814,545 were granted, 1,393,685 have been exercised, and 376,937 were available for future grants.

Options and awards granted, exercised, canceled and expired under our equity compensation plan are summarized as follows:

| | Stock Option Activity | Restricted Share Activity | Weighted-Average Exercise Price |
|-----------------------------------------|--------------------------|------------------------------|------------------------------------|
| Balance at January 1, 2006 | 477,672 | 8,000 | \$ 15.08 |
| Granted | | 81,275 | |
| Forfeited | (2,000) | (5,350) | 6.34 |
| Exercised | (132,737) | (6,000) | 13.59 |
| Balance at September 30, 2006 | 342,935 | 77,925 | \$ 12.80 |
| Total Exercisable at September 30, 2006 | 270,785 | | \$ 13.36 |

4. Derivatives and Hedging Activities

The Company holds loans that have variable rates, thus creating exposure to the variability or uncertainty of future cash flows due to changes in interest rates. The Company's objective and strategy is to reduce its exposure to decreases in cash flows relating to receipts on its prime-based variable-rate loans. The Company entered into derivative contracts to manage this risk of overall changes in cash flows associated with those prime-based variable-rate loans. Derivative instruments currently utilized by the Company include only interest rate floors. Interest rate floors

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are agreements in which payments are made when a reference rate falls below the strike rate. All derivatives are reported at their fair value on the Consolidated Condensed Balance Sheets. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

The Company purchased \$200 million of five-year prime-based interest rate floors with an effective date of April 3, 2006. At purchase, these floors were not designated as a hedging instrument and, as such, gains or losses in the fair value of

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the instruments were recognized in earnings in the period of change. For the three months ended September 30, 2006, the Company recognized a gain of \$611,000 which represented the change in fair value of the interest rate floors from the end of the second quarter of 2006 to July 26, 2006, the date of hedge designation. For the nine months ended September 30, 2006, the Company recognized a loss of \$1.2 million which represented the change in fair value of the interest rate floors from date of purchase to July 26, 2006, the date of hedge designation. These amounts are included in other noninterest expense on the consolidated condensed statements of income.

Cash flow hedges

To minimize the volatility in earnings associated with the changes in fair value of these interest rate floor instruments, the Company began applying cash flow hedge accounting treatment, as prescribed by SFAS 133, as amended, as of July 26, 2006 to all of its interest rate floor instruments. In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings during the same period in which the hedged item affects earnings. The change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

SFAS 133, as amended, requires contemporaneous documentation of the Company's hedge relationships. Such documentation includes the nature of the risk being hedged, the identification of the cash flow, or cash flows, that share the risk exposure that is designated as being hedged, the selection of the instrument that will be used to hedge the identified risk and the method used to assess the effectiveness of the hedge relationship. The Company performs its effectiveness assessments and measures ineffectiveness by comparing the actual floor with a hypothetically perfect floor as discussed in SFAS 133 Implementation Issue No. G20. Under this approach, the cumulative change in fair value of the actual floor will be compared to the cumulative change in fair value of a hypothetically perfect floor with key features that exactly match the key features of the hedged transactions. The correlations between the hedging instruments and hedged items are assessed at inception of the hedge and on an ongoing basis, which includes determining whether the hedge relationship is expected to be highly effective in offsetting changes in cash flows of hedged items.

All components of each derivative instrument's gain or loss are included in the assessment of hedge effectiveness. For the three and nine months ended September 30, 2006, the Company recognized no net losses in earnings due to hedge ineffectiveness of cash flow hedges. As of September 30, 2006, accumulated other comprehensive income included \$60,000 of deferred net gains related to derivative instruments designated as cash flow hedges of prime-based variable-rate loans that are expected to be reclassified into earnings during the next twelve months.

5. Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share for the three and nine month periods ended September 30, 2006 and 2005 (in thousands, except for per share data):

| | For The Three Months Ended 9/30/2006 | For The Three Months Ended 9/30/2005 | For The Nine Months Ended 9/30/2006 | For The Nine Months Ended 9/30/2005 |
|--------------------------------------------------------------------------------------------------|-----------------------------------------------|-----------------------------------------------|-------------------------------------------|-------------------------------------------|
| Net income | \$ 8,335 | \$ 7,952 | \$ 23,762 | \$ 21,048 |
| Weighted average common shares outstanding (for basic calculation) | 15,981 | 15,746 | 15,931 | 15,672 |
| Dilutive effect of outstanding common stock options | 162 | 194 | 204 | 180 |
| Weighted average common stock and common equivalent shares outstanding (for diluted calculation) | 16,143 | 15,940 | 16,135 | 15,852 |
| Earnings per common share basic | \$ 0.52 | \$ 0.50 | \$ 1.49 | \$ 1.34 |
| Earnings per common share diluted | \$ 0.52 | \$ 0.50 | \$ 1.47 | \$ 1.33 |

Potential dilutive shares consist of the incremental common shares issuable upon the exercise of outstanding stock options using the treasury stock method. Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three- and

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nine-month periods ended September 30, 2006, there were no anti-dilutive shares outstanding related to options to acquire common stock. For both the three- and nine-month periods ended September 30, 2005, anti-dilutive shares outstanding related to options to acquire common stock totaled 41,500.

Table of Contents**6. Dividends**

On January 26, 2006, the Company declared a quarterly cash dividend of \$0.13 per share, payable on February 22, 2006 to shareholders of record as of the close of business on February 8, 2006. On April 26, 2006, the Company declared a quarterly cash dividend of \$0.14 per share, payable on May 24, 2006, to shareholders of record at the close of business May 10, 2006. On July 27, 2006, the Company declared a quarterly cash dividend of \$0.15 per share, payable on August 23, 2006, to shareholders of record at the close of business August 9, 2006. Subsequent to quarter end, on October 26, 2006, the Company declared a quarterly cash dividend of \$0.15 per share, payable on November 22, 2006, to shareholders of record at the close of business November 8, 2006. The payment of cash dividends is subject to Federal regulatory requirements for capital levels and other restrictions. In addition, the cash dividends paid by Columbia Bank and Bank of Astoria to the Company are subject to both Federal and State regulatory requirements.

7. Business Segment Information

Within Washington State, the Company is managed along three major lines of business: commercial banking, retail banking, and real estate lending. In Oregon, the Company operates as one segment through the Astoria banking subsidiary. The treasury function of the Company, included in the Other category, although not considered a line of business, is responsible for the management of investments and interest rate risk.

The Company generates segment results that include balances directly attributable to business line activities. The financial results of each segment are derived from the Company's general ledger system. Overhead, including sales and back office support functions, and other indirect expenses are not allocated to the major lines of business. Since the Company is not specifically organized around lines of business, most reportable segments comprise more than one operating activity.

The principal activities conducted by commercial banking are the origination of commercial business loans and private banking services. Retail banking includes all deposit products, with their related fee income, and all consumer loan products as well as commercial loan products offered in the Company's branch offices. Real estate lending offers single-family residential, multi-family residential, and commercial real estate loans.

The organizational structure of the Company and its business line financial results are not necessarily comparable with information from other financial institutions.

Financial highlights by lines of business are as follows:

Condensed Statements of Income:

| | Three Months Ended September 30, 2006 | | | | | Total |
|---------------------------------------------------|---------------------------------------|------------|------------|---------------------|------------|--------------|
| | Oregon | Commercial | Retail | Washington | Other | |
| (in thousands) | Astoria | Banking | Banking | Real Estate Lending | | |
| Net interest income after provision for loan loss | \$ 2,213 | \$ 4,849 | \$ 18,093 | \$ 718 | \$ (2,118) | \$ 23,755 |
| Other income | 351 | 358 | 1,553 | 80 | 3,766 | 6,108 |
| Other expense | (1,505) | (2,596) | (4,471) | (269) | (9,257) | (18,098) |
| Contribution to overhead and profit | 1,059 | 2,611 | 15,175 | 529 | (7,609) | 11,765 |
| Income taxes | | | | | | (3,430) |
| Net income | | | | | | \$ 8,335 |
| Total assets | \$ 222,168 | \$ 921,552 | \$ 449,355 | \$ 229,788 | \$ 684,587 | \$ 2,507,450 |

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| <i>(in thousands)</i> | Three Months Ended September 30, 2005 | | | | | | |
|---------------------------------------------------|---------------------------------------|-----------------------|--------------------|-------------------|------------|--------------|-------|
| | Oregon | | Washington Real | | | | Total |
| | Astoria | Commercial Banking | Retail Banking | Estate Lending | Other | | |
| Net interest income after provision for loan loss | \$ 2,080 | \$ 5,044 | \$ 14,604 | \$ 1,700 | \$ (342) | \$ 23,086 | |
| Other income | 338 | 306 | 1,655 | 269 | 3,948 | 6,516 | |
| Other expense | (1,452) | (1,558) | (4,651) | (596) | (10,536) | (18,793) | |
| Contribution to overhead and profit | 966 | 3,792 | 11,608 | 1,373 | (6,930) | 10,809 | |
| Income taxes | | | | | | (2,857) | |
| Net income | | | | | | \$ 7,952 | |
| Total assets | \$ 211,218 | \$ 743,049 | \$ 474,077 | \$ 265,076 | \$ 629,476 | \$ 2,322,896 | |

| <i>(in thousands)</i> | Nine Months Ended September 30, 2006 | | | | | | |
|---------------------------------------------------|--------------------------------------|-----------------------|--------------------|-------------------|------------|--------------|-------|
| | Oregon | | Washington Real | | | | Total |
| | Astoria | Commercial Banking | Retail Banking | Estate Lending | Other | | |
| Net interest income after provision for loan loss | \$ 6,355 | \$ 14,317 | \$ 53,084 | \$ 2,654 | \$ (4,512) | \$ 71,898 | |
| Other income | 1,127 | 1,075 | 4,645 | 296 | 11,205 | 18,348 | |
| Other expense | (4,394) | (6,572) | (13,426) | (1,149) | (32,033) | (57,574) | |
| Contribution to overhead and profit | 3,088 | 8,820 | 44,303 | 1,801 | (25,340) | 32,672 | |
| Income taxes | | | | | | (8,910) | |
| Net income | | | | | | \$ 23,762 | |
| Total assets | \$ 222,168 | \$ 921,552 | \$ 449,355 | \$ 229,788 | \$ 684,587 | \$ 2,507,450 | |

| <i>(in thousands)</i> | Nine Months Ended September 30, 2005 | | | | | | |
|---------------------------------------------------|--------------------------------------|-----------------------|--------------------|-------------------|------------|--------------|-------|
| | Oregon | | Washington Real | | | | Total |
| | Astoria | Commercial Banking | Retail Banking | Estate Lending | Other | | |
| Net interest income after provision for loan loss | \$ 6,067 | \$ 15,037 | \$ 39,028 | \$ 5,389 | \$ (48) | \$ 65,473 | |
| Other income | 845 | 827 | 4,740 | 955 | 10,951 | 18,318 | |
| Other expense | (4,256) | (5,572) | (13,612) | (1,558) | (29,586) | (54,584) | |
| Contribution to overhead and profit | 2,656 | 10,292 | 30,156 | 4,786 | (18,683) | 29,207 | |
| Income taxes | | | | | | (8,159) | |
| Net income | | | | | | \$ 21,048 | |
| Total assets | \$ 211,218 | \$ 743,049 | \$ 474,077 | \$ 265,076 | \$ 629,476 | \$ 2,322,896 | |

8. Securities

The following table presents the composition and carrying value of the Company's available for sale investment portfolio:

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| | September 30, 2006 | December 31, 2005 |
|-------------------------------------------------------------------------------------------|--------------------|-------------------|
| | (in thousands) | |
| Securities Available for Sale | | |
| U.S. Government agency | \$ 75,649 | \$ 154,860 |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 334,952 | 288,790 |
| State and municipal securities | 186,497 | 126,951 |
| Other securities | 1,749 | 1,754 |
| Total | \$ 598,847 | \$ 572,355 |

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Unrealized losses and fair values of securities available for sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of September 30, 2006 are summarized as follows:

| <i>(in thousands)</i> | Less than 12 Months | | 12 Months or More | | Total | |
|-------------------------------------------------------------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agency | \$ | \$ | \$ 75,649 | \$ (1,892) | \$ 75,649 | \$ (1,892) |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 83,013 | (1,998) | 231,845 | (6,887) | 314,858 | (8,885) |
| State and municipal securities | 35,863 | (369) | 15,895 | (388) | 51,758 | (757) |
| Total | \$ 118,876 | \$ (2,367) | \$ 323,389 | \$ (9,167) | \$ 442,265 | \$ (11,534) |

At September 30, 2006, there were 19 U.S. Government agency securities in an unrealized loss position, all of which were in a continuous loss position for 12 months or more. The unrealized losses on U.S. Government agency securities were caused by interest rate increases subsequent to the purchase of the individual securities. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. Because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2006.

At September 30, 2006, there were 83 state and municipal government securities in an unrealized loss position, of which 37 were in a continuous loss position for 12 months or more. The unrealized losses on state and municipal securities were caused by interest rate increases subsequent to the purchase of the individual securities. Management monitors published credit ratings of these securities for adverse changes. As of September 30, 2006 none of the obligations of state and local government entities held by the Company had an adverse credit rating. Because the decline in fair value is attributable to changes in interest rates rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2006.

At September 30, 2006, there were 72 U.S. Government agency mortgage-backed securities & collateralized mortgage obligations securities in an unrealized loss position, of which 58 were in a continuous loss position for 12 months or more. The unrealized losses on U.S. Government agency mortgage-backed securities & collateralized mortgage obligations were caused by interest rate increases subsequent to the purchase of the securities. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of market value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2006.

Table of Contents**9. Comprehensive Income**

The components of comprehensive income are as follows:

| <i>(in thousands)</i> | Three Months Ended September 30, | |
|----------------------------------------------------------------------------|---------------------------------------------|-------------|
| | 2006 | 2005 |
| Net income as reported | \$ 8,335 | \$ 7,952 |
| Unrealized gains (losses) on securities available for sale: | | |
| Unrealized holding gains (losses) arising during the period | 8,605 | (869) |
| Tax (expense) benefit | (3,063) | 282 |
| Net unrealized gains (losses) on securities available for sale, net of tax | 5,542 | (587) |
| Unrealized gains from cash flow hedging instruments | 1,133 | |
| Total comprehensive income | \$ 15,010 | \$ 7,365 |

| <i>(in thousands)</i> | Nine Months Ended September 30, | |
|--------------------------------------------------------------------------------------|--------------------------------------------|-------------|
| | 2006 | 2005 |
| Net income as reported | \$ 23,762 | \$ 21,048 |
| Unrealized losses on securities available for sale: | | |
| Unrealized holding losses arising during the period | (3,196) | (1,566) |
| Tax benefit | 1,128 | 526 |
| Net unrealized losses on securities available for sale, net of tax | (2,068) | (1,040) |
| Less: reclassification adjustment of realized gains on securities available for sale | (10) | |
| Tax benefit | 4 | |
| Net realized gains on sale of securities available for sale, net of tax | (6) | |
| Unrealized gains from cash flow hedging instruments | 1,133 | |
| Total comprehensive income | \$ 22,821 | \$ 20,008 |

10. Allowance for Loan and Lease Losses

The Company maintains an allowance for loan and lease losses to absorb losses inherent in the loan portfolio. The size of the allowance is determined through quarterly assessments of the estimated probable losses in the loan portfolio. The Company's methodology for making such assessments and determining the adequacy of the allowance includes a general valuation allowance consistent with SFAS No. 5, *Accounting for Contingencies* and 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*.

On a quarterly basis the Chief Credit Officer of the Company reviews with Executive Management and the Board of Directors the various additional factors that management considers when determining the adequacy of the allowance, including economic and business condition reviews. These factors include existing general economic and business conditions affecting the Company's market place, credit quality trends, including trends in nonperforming loans, collateral values, seasoning of the loan portfolio, bank regulatory examination results, findings of internal credit examiners and the duration of current business cycles. The allowance is increased by provisions charged to operations, and is reduced by loans charged-off, net of recoveries. While management believes it uses the best information available to determine the allowance for loan losses, unforeseen market conditions could result in adjustments to the allowance, and net income could be affected, if circumstances differ from the assumptions used in determining the allowance.

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The following table presents activity in the allowance for loan losses for the three and nine months ended September 30, 2006 and 2005:

| <i>(in thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Beginning balance | \$ 20,990 | \$ 20,587 | \$ 20,829 | \$ 19,881 |
| Provision charged to expense | 650 | 245 | 1,115 | 1,505 |
| Loans charged-off | (843) | (110) | (1,423) | (1,135) |
| Recoveries | 129 | 68 | 405 | 539 |
| Ending balance | \$ 20,926 | \$ 20,790 | \$ 20,926 | \$ 20,790 |

Changes in the allowance for unfunded loan commitments and letters of credit are summarized as follows:

| <i>(in thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------------------------------|-------------------------------------|--------|------------------------------------|--------|
| | 2006 | 2005 | 2006 | 2005 |
| Beginning balance | \$ 339 | \$ 339 | \$ 339 | \$ 289 |
| Net changes in the allowance for unfunded loan commitments and letters of credit | | | | 50 |
| Ending balance | \$ 339 | \$ 339 | \$ 339 | \$ 339 |

11. Goodwill and Intangible Assets

The Company had \$29.7 million in goodwill at September 30, 2006 and December 31, 2005. At September 30, 2006 and December 31, 2005, the Company had a core deposit intangible (CDI) asset of \$3.0 million and \$3.4 million, respectively. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets , goodwill is not amortized but is reviewed for potential impairment during the third quarter on an annual basis, or if events or circumstances indicate a potential impairment, at the reporting unit level. An impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. Based on our testing performed as of September 30, 2006, there is no indication that goodwill is impaired. The CDI is evaluated for impairment if events and circumstances indicate a possible impairment based on undiscounted cash flow projections. The CDI is amortized on an accelerated basis over an estimated life of approximately 10 years. Amortization expense related to the CDI was \$113,000 and \$339,000 for the three and nine months ended September 30, 2006, respectively, and \$134,000 and \$402,000 for the three and nine months ended September 30, 2005, respectively. Amortization expense related to the CDI is included in other noninterest expense on the consolidated condensed statements of income.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion should be read in conjunction with the unaudited consolidated condensed financial statements of Columbia Banking System, Inc. (referred to in this report as we, our, and the Company) and notes thereto presented elsewhere in this report and with the December 31, 2005 audited consolidated financial statements and its accompanying notes included in our recent Annual Report on Form 10-K. 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 one year earlier.

NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q 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

Management has identified the accounting policies related to the allowance for loan and lease losses as critical to an understanding of our financial statements. These policies and related estimates are discussed in Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations under the heading Allowance for Loan and Lease Losses and Unfunded Loan Commitments and Letters of Credit in our 2005 Annual Report on Form 10-K. There have not been any material changes in our critical accounting policies relating to the allowance for loan and lease losses as compared to those disclosed in our 2005 Annual Report on Form 10-K.

RESULTS OF OPERATIONS

Our results of operations are dependent to a large degree on our net interest income. We also generate noninterest income through service charges and fees, mortgage banking operations, merchant services fees, and bank owned life insurance. Our operating expenses consist primarily of compensation and employee benefits, occupancy, merchant card processing, data processing and legal and professional fees. 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 actions of regulatory authorities.

Net Interest Income

Net interest income before provision for loan and lease losses for the three months ended September 30, 2006 increased 5% to \$24.4 million from \$23.3 million for the same period in 2005. Net interest income before provision for loan and lease losses for the nine months ended September 30, 2006 increased 9% to \$73.0 million from \$67.0 million for the same period in 2005. On a tax-equivalent basis, net interest margin (net interest income divided by average interest earning assets) decreased to 4.41% for the current quarter from 4.45% for the same quarter last year. However, the net interest margin increased to 4.51% for the nine months ended September 30, 2006 from 4.39% for the same period in 2005. For the three months and nine months ended September 30, 2006, deposit and borrowing costs have increased faster than our loan yields. If this trend continues we could experience additional compression of our net interest margin.

Interest income for the third quarter of 2006 was \$39.2 million, an increase of \$7.4 million, or 23%, over the same period in 2005. Loans averaged \$1.647 billion with an average yield of 7.71% for the three months ended September 30, 2006

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compared to average loans of \$1.534 billion and an average yield of 6.74% for the same period in 2005. For the nine months ended September 30, 2006, interest income increased \$22.4 million, or 25%, as compared to the same period last year. Loans averaged \$1.610 billion with an average yield of 7.56% for the nine months ended September 30, 2006 compared to average loans of \$1.481 billion and an average yield of 6.52% for the same period in 2005.

Interest expense for the third quarter of 2006 was \$14.8 million, an increase of \$6.3 million, or 75%, over the same period in 2005. The increase in interest expense is primarily due to rate increases on interest bearing deposits and an increased volume of Federal Home Loan Bank (FHLB) advances. The average cost of interest bearing deposits increased 101 basis points to 2.81% for the three months ended September 30, 2006 compared to an average cost of 1.80% for the same period in 2005. FHLB advances averaged \$243.5 million for the three months ended September 30, 2006, an increase of \$126.7 million, or 109%, for the same period in 2005. The average cost of interest bearing deposits increased 92 basis points to 2.53% for the nine months ended September 30, 2006 compared to an average cost of 1.61% for the same period in 2005. FHLB advances averaged \$215.6 million for the nine months ended September 30, 2006, an increase of \$83.1 million, or 63%, for the same period in 2005.

The following tables set 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 and net interest margin.

| <i>(in thousands)</i> | Three months ending September 30, 2006 | | | Three months ending September 30, 2005 | | |
|-------------------------------------------------------------|-------------------------------------------|------------------------------|-----------------|-------------------------------------------|------------------------------|-----------------|
| | Average Balances (1) | Interest Earned / Paid | Average Rate | Average Balances (1) | Interest Earned / Paid | Average Rate |
| ASSETS | | | | | | |
| Loans, net | \$ 1,647,471 | \$ 32,010 | 7.71% | \$ 1,534,281 | \$ 26,063 | 6.74% |
| Securities (2) | 627,821 | 8,031 | 5.08% | 598,204 | 6,288 | 4.17% |
| Interest-earning deposits with banks and federal funds sold | 15,059 | 193 | 5.10% | 3,744 | 31 | 3.31% |
| Total interest-earning assets | \$ 2,290,351 | \$ 40,234 | 6.97% | \$ 2,136,229 | \$ 32,382 | 6.01% |
| Other earning assets | 37,927 | | | 36,307 | | |
| Noninterest-earning assets | 176,093 | | | 152,726 | | |
| Total assets | \$ 2,504,371 | | | \$ 2,325,262 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | | | | |
| Certificates of deposit | \$ 541,462 | \$ 5,475 | 4.01% | \$ 496,967 | \$ 3,794 | 3.03% |
| Savings accounts | 114,769 | 105 | 0.36% | 115,346 | 103 | 0.35% |
| Interest-bearing demand and money market accounts | 878,638 | 5,288 | 2.39% | 899,627 | 2,974 | 1.31% |
| Total interest-bearing deposits | 1,534,869 | 10,868 | 2.81% | 1,511,940 | 6,871 | 1.80% |
| Federal Home Loan Bank advances | 243,513 | 3,370 | 5.49% | 116,789 | 1,100 | 3.74% |
| Long-term subordinated debt | 22,351 | 519 | 9.21% | 22,285 | 412 | 7.33% |
| Other borrowings and interest-bearing liabilities | 206 | 4 | 7.69% | 2,870 | 41 | 5.67% |
| Total interest-bearing liabilities | \$ 1,800,939 | \$ 14,761 | 3.25% | \$ 1,653,884 | \$ 8,424 | 2.02% |
| Noninterest-bearing deposits | 440,234 | | | 436,082 | | |
| Other noninterest-bearing liabilities | 24,926 | | | 16,988 | | |
| Shareholders equity | 238,272 | | | 218,308 | | |
| Total liabilities & shareholders equity | \$ 2,504,371 | | | \$ 2,325,262 | | |
| equity | | | | | | |
| Net interest income (2) | | \$ 25,473 | | | \$ 23,958 | |

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| | | |
|---------------------|-------|-------|
| Net interest margin | 4.41% | 4.45% |
|---------------------|-------|-------|

- (1) Nonaccrual loans have been included in the tables as loans carrying a zero yield. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was \$463,000 and \$568,000 for the three months ended September 30, 2006 and 2005, respectively.
- (2) Tax-exempt income is calculated on a tax equivalent basis, based on a marginal tax rate of 35%

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| <i>(in thousands)</i> | Nine months ending September 30, 2006 | | | Nine months ending September 30, 2005 | | |
|-------------------------------------------------------------|------------------------------------------|-----------------------------|-----------------|------------------------------------------|-----------------------------|-----------------|
| | Average Balances (1) | Interest Earned/ Paid | Average Rate | Average Balances (1) | Interest Earned/ Paid | Average Rate |
| ASSETS | | | | | | |
| Loans, net | \$ 1,609,739 | \$ 90,983 | 7.56% | \$ 1,481,255 | \$ 72,214 | 6.52% |
| Securities (2) | 630,895 | 23,138 | 4.90% | 614,231 | 18,850 | 4.10% |
| Interest-earning deposits with banks and federal funds sold | 9,558 | 353 | 4.96% | 2,366 | 55 | 3.09% |
| Total interest-earning assets | \$ 2,250,192 | \$ 114,474 | 6.80% | \$ 2,097,852 | \$ 91,119 | 5.81% |
| Other earning assets | 37,516 | | | 35,915 | | |
| Noninterest-earning assets | 170,723 | | | 148,248 | | |
| Total assets | \$ 2,458,431 | | | \$ 2,282,015 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | | | | |
| Certificates of deposit | \$ 535,716 | \$ 14,981 | 3.74% | \$ 486,620 | \$ 10,207 | 2.80% |
| Savings accounts | 117,278 | 320 | 0.37% | 111,775 | 288 | 0.34% |
| Interest-bearing demand and money market accounts | 869,439 | 13,466 | 2.07% | 882,968 | 7,378 | 1.12% |
| Total interest-bearing deposits | 1,522,432 | 28,767 | 2.53% | 1,481,363 | 17,873 | 1.61% |
| Federal Home Loan Bank advances | 215,649 | 8,344 | 5.17% | 132,517 | 3,151 | 3.18% |
| Long-term subordinated debt | 22,334 | 1,470 | 8.80% | 22,268 | 1,140 | 6.84% |
| Other borrowings and interest-bearing liabilities | 1,033 | 51 | 6.60% | 2,860 | 112 | 5.24% |
| Total interest-bearing liabilities | \$ 1,761,448 | \$ 38,632 | 2.93% | \$ 1,639,008 | \$ 22,276 | 1.82% |
| Noninterest-bearing deposits | 437,955 | | | 414,556 | | |
| Other noninterest-bearing liabilities | 25,013 | | | 16,846 | | |
| Shareholders equity | 234,015 | | | 211,605 | | |
| Total liabilities & shareholders equity | \$ 2,458,431 | | | \$ 2,282,015 | | |
| equity | | | | | | |
| Net interest income (2) | | \$ 75,842 | | | \$ 68,843 | |
| Net interest margin | | | 4.51% | | | 4.39% |

(1) Nonaccrual loans have been included in the tables as loans carrying a zero yield. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was \$1.5 million and \$1.4 million for the nine months ended September 30, 2006 and 2005, respectively.

(2) Tax-exempt income is calculated on a tax equivalent basis, based on a marginal tax rate of 35%

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The following tables set 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 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:

| <i>(in thousands)</i> | Three Months Ended September 30, 2006 Compared to 2005 | | |
|-------------------------------------------------------------|-------------------------------------------------------------------|-----------------|-----------------|
| | Increase (Decrease) Due to | | |
| | Volume | Rate | Total |
| Interest Earning Assets | | | |
| Loans (1) | \$ 2,199 | \$ 3,748 | \$ 5,947 |
| Securities (2) | 379 | 1,364 | 1,743 |
| Interest earning deposits with banks and federal funds sold | 145 | 17 | 162 |
| Interest income (2) | \$ 2,723 | \$ 5,129 | \$ 7,852 |
| Interest bearing liabilities | | | |
| Deposits: | | | |
| Certificates of deposit | \$ 450 | \$ 1,231 | \$ 1,681 |
| Savings accounts | (1) | 3 | 2 |
| Interest-bearing demand and money market accounts | (126) | 2,440 | 2,314 |
| Total interest on deposits | 323 | 3,674 | 3,997 |
| Federal Home Loan Bank advances | 1,754 | 516 | 2,270 |
| Long-term subordinated debt | 2 | 105 | 107 |
| Other borrowings and interest bearing liabilities | (52) | 15 | (37) |
| Interest expense | \$ 2,027 | \$ 4,310 | \$ 6,337 |

(1) Nonaccrual loans have been included in the tables as loans carrying a zero yield. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was \$463,000 and \$568,000 for the three months ended September 30, 2006 and 2005, respectively.

(2) Tax-exempt income is calculated on a tax equivalent basis, based on a marginal tax rate of 35%

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| <i>(in thousands)</i> | Nine Months Ended September 30, 2006 Compared to 2005 | | |
|-------------------------------------------------------------|------------------------------------------------------------------|------------------|------------------|
| | Volume | Rate | Total |
| Interest Earning Assets | | | |
| Loans (1) | \$ 7,263 | \$ 11,506 | \$ 18,769 |
| Securities (2) | 611 | 3,677 | 4,288 |
| Interest earning deposits with banks and federal funds sold | 265 | 33 | 298 |
| Interest income (2) | \$ 8,139 | \$ 15,216 | \$ 23,355 |
| Interest bearing liabilities | | | |
| Deposits: | | | |
| Certificates of deposit | \$ 1,373 | \$ 3,401 | \$ 4,774 |
| Savings accounts | 15 | 17 | 32 |
| Interest-bearing demand and money market accounts | (210) | 6,298 | 6,088 |
| Total interest on deposits | 1,178 | 9,716 | 10,894 |
| Federal Home Loan Bank advances | 3,217 | 1,976 | 5,193 |
| Long-term subordinated debt | 4 | 326 | 330 |
| Other borrowings and interest bearing liabilities | (90) | 29 | (61) |
| Interest expense | \$ 4,309 | \$ 12,047 | \$ 16,356 |

(1) Nonaccrual loans have been included in the tables as loans carrying a zero yield. Amortized net deferred loan fees were included in the interest income calculations. The amortization of net deferred loan fees was \$1.5 million and \$1.4 million for the nine months ended September 30, 2006 and 2005, respectively.

(2) Tax-exempt income is calculated on a tax equivalent basis, based on a marginal tax rate of 35%

Provision for Loan and Lease Losses

During the third quarter of 2006, the Company allocated \$650,000 to its provision for loan and lease losses, compared to \$245,000 for the same period in 2005. The increased allocation for the three months ending September 30, 2006 is due to moderate loan growth during the period coupled with net loan charge-offs of \$714,000 as compared to \$42,000 for the third quarter of 2005. For the first nine months of 2006, the Company allocated \$1.1 million to its provision for loan and lease losses, compared to \$1.5 million for the same period in 2005. This decreased allocation is consistent with the rate of loan growth for the first nine months of 2006 compared to the same period in 2005.

Noninterest Income

Noninterest income decreased \$408,000, or 6%, to \$6.1 million for the third quarter of 2006 from \$6.5 million for the third quarter of 2005. The decrease is due in part to decreases in merchant services fees, service charges and other fees as well as mortgage banking income. Merchant services revenue decreased \$201,000, or 9%, during the third quarter of 2006 as compared to the same period in 2005. This decrease is due, in part, to higher interchange fees. Service charges and other fees were \$64,000, or 2%, less during the third quarter of 2006 as compared to the same period in 2005. Our mortgage banking income decreased \$48,000, or 25% when compared with the third quarter of 2005. For the nine months ended September 30, 2006, noninterest income increased \$30,000 compared to the same period in 2005. Decreases in mortgage banking income for the nine months ended September 30, 2006, due to increases in competitive pricing in the secondary market, were offset by increases in services charges and other fees as well as other income.

Noninterest Expense

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Noninterest expense decreased \$695,000, or 4%, to \$18.1 million for the third quarter of 2006 from \$18.8 million for the same period last year. This decrease is attributable in part to the valuation adjustment of our prime rate floor instruments of \$611,000 as well as data processing and legal and professional services which decreased \$258,000 and \$311,000, respectively. For the nine months ended September 30, 2006 noninterest expense increased \$3.0 million, or 5%, to \$57.6 million from \$54.6 million the same period last year. This increase is primarily attributable to the prime rate floor market valuation adjustment of \$1.2 million, increased occupancy expenses of \$571,000, and \$300,000 associated with the production expense for new television commercials. We expect to utilize the new television commercials for up to 3 years. The increase in occupancy expenses from the third quarter of 2005 is due to additional branch locations, increased rent,

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repairs and maintenance, and depreciation expenses. These increases were partially offset by lower legal and professional services fees which decreased \$1.0 million.

Share-Based Payments: During the first quarter of 2006, we began recognizing compensation expense in our financial statements based upon the fair value of our share-based payments 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 three and nine months ended September 30, 2006 was \$248,000 and \$576,000, respectively. This charge reduced both basic and diluted earnings per share by \$0.02 and \$0.04 for the three and nine months ended September 30, 2006, respectively. Stock-based compensation recorded during this period related to both stock options and restricted stock awards. We anticipate an additional \$2.0 million in pre-tax share-based compensation through 2011 for awards outstanding as of September 30, 2006. Additional impact resulting from adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be impacted by actual exercise behavior and the relative market prices at exercise.

The following table presents selected items included in other noninterest expense and the associated change from period to period:

| | Three months ended September 30, 2006 | | Increase (Decrease) Amount | Nine months ended September 30, 2006 | | Increase (Decrease) Amount |
|---------------------------------------------------------|---------------------------------------------|----------|----------------------------------|--------------------------------------------|----------|----------------------------------|
| Core deposit intangible amortization | \$ 113 | \$ 134 | \$ (21) | \$ 339 | \$ 402 | \$ (63) |
| Software support & maintenance | 178 | 154 | 24 | 529 | 414 | 115 |
| Telephone & network communications | 253 | 274 | (21) | 828 | 820 | 8 |
| Federal Reserve Bank processing fees | 240 | 173 | 67 | 672 | 463 | 209 |
| Supplies | 304 | 274 | 30 | 911 | 806 | 105 |
| Postage | 286 | 337 | (51) | 929 | 907 | 22 |
| Investor relations | 18 | 18 | | 153 | 171 | (18) |
| Travel | 87 | 75 | 12 | 231 | 227 | 4 |
| ATM network | 138 | 134 | 4 | 435 | 382 | 53 |
| Sponsorships & charitable contributions | 103 | 90 | 13 | 535 | 461 | 74 |
| Regulatory premiums | 65 | 82 | (17) | 203 | 251 | (48) |
| Directors fees | 113 | 101 | 12 | 332 | 322 | 10 |
| Employee expenses | 115 | 128 | (13) | 419 | 396 | 23 |
| Insurance | 117 | 112 | 5 | 353 | 354 | (1) |
| Losses on investment in affordable housing partnerships | 220 | 586 | (366) | 589 | 586 | 3 |
| Interest rate floor valuation adjustment | (611) | | (611) | 1,164 | | 1,164 |
| Misc | 565 | 504 | 61 | 2,041 | 1,727 | 314 |
| Total other non-interest expense | \$ 2,304 | \$ 3,176 | \$ (872) | \$ 10,663 | \$ 8,689 | \$ 1,974 |

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 58.8% for the third quarter 2006 and was 59.5% for nine months ended September 30, 2006, compared to 61.3% and 62.2% for the same periods in 2005. The year-to-date improvement (decrease) in the efficiency ratio is due to increases in net interest income relative to noninterest expense and our continued diligence in expense control.

Table of Contents**Reconciliation of Financial Data to GAAP Financial Measures**

| <i>(in thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------------------------------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net interest income (1) | \$ 24,405 | \$ 23,331 | \$ 73,013 | \$ 66,978 |
| Tax equivalent adjustment for non-taxable investment securities interest income (2) | 1,068 | 627 | 2,829 | 1,865 |
| Adjusted net interest income | \$ 25,473 | \$ 23,958 | \$ 75,842 | \$ 68,843 |
| Noninterest income | \$ 6,108 | \$ 6,516 | \$ 18,348 | \$ 18,318 |
| Gain on sale of investment securities, net | | | (10) | |
| Tax equivalent adjustment for BOLI income (2) | 230 | 216 | 675 | 637 |
| Adjusted noninterest income | \$ 6,338 | \$ 6,732 | \$ 19,013 | \$ 18,955 |
| Noninterest expense | \$ 18,098 | \$ 18,793 | \$ 57,574 | \$ 54,584 |
| Net gain (cost) on sale of OREO | 0 | (1) | 11 | 8 |
| Interest rate floor valuation adjustment | 611 | | (1,164) | |
| Adjusted noninterest expense | \$ 18,709 | \$ 18,792 | \$ 56,421 | \$ 54,592 |
| Efficiency ratio (fully taxable-equivalent) | 58.8% | 61.2% | 59.5% | 62.2% |
| Statutory Tax Rate | 35.0% | 35.0% | 35.0% | 35.0% |

(1) Amount represents net interest income before provision for loan 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.

Income Taxes

We recorded an income tax provision of \$3.4 million and \$8.9 million for the third quarter and first nine months of 2006, respectively, compared with a provision of \$2.9 million and \$8.2 million for the same periods in 2005. The effective tax rate for the third quarter of 2006 and 2005 was 29% and 26%, respectively, as well as 27% and 28% for the nine months ended September 30, 2006 and 2005. For additional information, refer to the Company's annual report on Form 10-K for the year ended December 31, 2005.

Credit Risk Management

The extension of credit in the form of loans or other credit products 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 limits to a single borrower. 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 the borrower to service all of its 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 nonaccrual status even though the loan may be current as to principal and interest payments. Additionally, we review these types of loans for impairment in accordance with SFAS No. 114, Accounting by Creditors for the Impairment of a Loan. Impaired loans are considered for nonaccrual status and will typically remain as such until all principal and interest payments are brought current and the prospects for future

payments in accordance with the loan agreement appear relatively certain.

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 internal credit review process independent of the lending and credit administration functions to provide assurance that loans and commitments are made and maintained as prescribed by its credit policies. This includes a review of documentation when the loan is initially extended and subsequent monitoring to assess continued performance and proper risk assessment.

Table of Contents**Loan Portfolio Analysis**

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 the Company's loan portfolio by type of loan for the dates indicated:

| <i>(in thousands)</i> | September 30, | | December 31, 2005 | |
|----------------------------------------------------------------------|---------------|------------|-------------------|------------|
| | 2006 | % of Total | December 31, 2005 | % of Total |
| Commercial business | \$ 589,634 | 35.6% | \$ 556,589 | 35.6% |
| Lease financing | 10,981 | 0.7 | 14,385 | 0.9 |
| Real estate: | | | | |
| One-to-four family residential | 49,507 | 3.0 | 74,930 | 4.8 |
| Commercial and five or more family residential commercial properties | 704,452 | 42.5 | 651,393 | 41.6 |
| Total real estate | 753,959 | 45.5 | 726,323 | 46.4 |
| Real estate construction: | | | | |
| One-to-four family residential | 77,093 | 4.7 | 41,033 | 2.6 |
| Commercial and five or more family residential commercial properties | 80,918 | 4.9 | 89,134 | 5.7 |
| Total real estate construction | 158,011 | 9.6 | 130,167 | 8.3 |
| Consumer | 145,873 | 8.8 | 140,110 | 9.0 |
| Sub-total loans | 1,658,458 | 100.2 | 1,567,574 | 100.2 |
| Less: Deferred loan fees | (2,649) | (0.2) | (2,870) | (0.2) |
| Total loans | \$ 1,655,809 | 100% | \$ 1,564,704 | 100% |
| Loans held for sale | \$ 1,160 | | \$ 1,850 | |

Total loans (excluding loans held for sale) at September 30, 2006 increased \$91 million, to \$1.656 billion from \$1.565 billion at year-end 2005.

Commercial Loans: As of September 30, 2006, commercial loans increased \$33.0 million, or 6%, to \$589.6 million from \$556.6 million at year-end 2005, representing 35.6% of total loans at September 30, 2006 and December 31, 2005. Management is committed to providing competitive commercial lending in the Company's primary market areas. Management believes that increases in commercial lending during the first nine months of 2006 were due to increased confidence of business owners in response to an improving economy. Management expects to continue to expand its commercial lending products and to emphasize in particular its relationship banking with businesses, and business owners.

Lease Financing: Due primarily to contractual repayments, our lease financing portfolio decreased \$3.4 million or, 24%, to \$11.0 million from \$14.4 million at year-end 2005, representing 0.7% of total loans at September 30, 2006 as compared with 0.9% of total loans at December 31, 2005. The addition of equipment leasing is the result of a portfolio acquisition made by the Company in late 2005.

Real Estate Loans: Residential one-to-four family loans decreased \$25.4 million to \$49.5 million at September 30, 2006, representing 3.0% of total loans, compared with \$74.9 million, or 4.8%, of total loans at December 31, 2005. These loans are used by the Company to collateralize outstanding advances from the FHLB. Generally, the Company's policy is to originate residential loans for sale to third parties. Those residential loans are secured by properties located within the Company's primary market areas, and typically have loan-to-value ratios of 80% or lower. However, the loan amounts may exceed 80% with private mortgage insurance and other underwriting criteria.

Commercial and five-or-more family residential real estate lending increased \$53.1 million, or 8%, to \$704.5 million at September 30, 2006, representing 42.5% of total loans, from \$651.4 million, or 41.6% of total loans at December 31, 2005. Generally, commercial and five-or-more family residential real estate loans are made to borrowers who have existing banking relationships with the Company. The Company's

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underwriting standards generally require that the loan-to-value ratio for these loans not exceed 75% of appraised value, cost, or discounted cash flow value, as appropriate, 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. The Company endeavors to maintain the highest practical underwriting standards while balancing the need to remain competitive in its lending practices.

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Real Estate Construction Loans: The Company originates 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 provide financing to builders for the construction of pre-sold homes and speculative residential construction. Construction loans on one-to-four family residences increased \$36.1 million, or 88%, to \$77.1 million at September 30, 2006, representing 4.7% of total loans, from \$41.0 million, or 2.6% of total loans at December 31, 2005. Commercial and five-or-more family real estate construction loans decreased \$8.2 million, or 9%, to \$80.9 million at September 30, 2006, representing 4.9% of total loans, from \$89.1 million, or 5.7% of total loans at December 31, 2005. The Company endeavors to limit its construction lending risk during both robust and slower building cycles through adherence to strict underwriting procedures.

Consumer Loans: At September 30, 2006, the Company had \$145.9 million of consumer loans outstanding, representing 8.8% of total loans, an increase of \$5.8 million, or 4%, compared with \$140.1 million at December 31, 2005. Consumer loans made by the Company include automobile loans, boat and recreational vehicle financing, home equity and home improvement loans and miscellaneous personal loans.

Foreign Loans: The Company's banking subsidiaries are not involved with loans to foreign companies or foreign countries.

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.

Total nonperforming assets increased slightly to \$4.90 million or 0.20% of period-end assets at September 30, 2006 from \$4.88 million, or 0.21% of period-end assets at December 31, 2005.

The following tables set forth, at the dates indicated, information with respect to nonaccrual loans, restructured loans, total nonperforming loans (nonaccrual loans plus restructured loans), real estate owned, other personal property owned, and total nonperforming assets of the Company:

| <i>(in thousands)</i> | September 30, 2006 | December 31, 2005 |
|-----------------------------------|--------------------|-------------------|
| Nonaccrual: | | |
| Commercial business | \$ 3,205 | \$ 4,316 |
| Leases | 389 | |
| Real estate: | | |
| One-to-four family residential | 235 | 376 |
| Commercial | 187 | |
| Consumer | 85 | 41 |
| Total nonaccrual loans | 4,101 | 4,733 |
| Restructured: | | |
| Commercial business | 804 | 124 |
| Total nonperforming loans | 4,905 | 4,857 |
| Real estate owned | | 18 |
| Total nonperforming assets | \$ 4,905 | \$ 4,875 |

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 a nonaccrual basis, which occurs when there are serious doubts about the collectibility of principal or interest. The policy of the Company generally is to discontinue the accrual of interest on all loans past due 90 days or more and place them on nonaccrual status.

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Nonperforming loans were \$4.905 million or 0.30% of total loans (excluding loans held for sale) at September 30, 2006, compared to \$4.875 million, or 0.31% of total loans at December 31, 2005. Nonaccrual loans decreased \$632,000, or 13% from year-end 2005 to \$4.101 million at September 30, 2006.

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Nonaccrual loans and other nonperforming assets are centered in a small number of lending relationships which management considers 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. The Company will continue its collection efforts and liquidation of collateral to recover as large a portion of the nonaccrual assets as possible. Substantially, all nonperforming loans are to borrowers within the state of Washington.

Other Real Estate Owned: Other real estate owned (OREO), is comprised of property from foreclosed real estate loans. During the third quarter of 2006, the Company did not acquire any OREO as compared to incurring \$1,000 of costs related to OREO for the same period in 2005. For the nine months ended September 30, 2006 the Company sold \$18,000 of OREO for net realized gains of \$11,000. During the first nine months of 2005, the Company sold \$995,000 and transferred \$315,000 of OREO for net gains of \$8,000. There were no foreclosures, recoveries of previously charged-off balances or write-downs during the first nine months of 2006.

Other Personal Property Owned: Other personal property owned (OPPO) is comprised of other, non-real estate property from foreclosed loans. The Company had no outstanding OPPO balance at September 30, 2006 and December 31, 2005. There were no foreclosures, additions or charge-offs of OPPO during the first nine months of 2006.

Allowance for Loan and Lease Losses

At September 30, 2006, the Company's allowance for loan and lease losses was \$20.9 million, or 1.26% of total loans (excluding loans held for sale), 427% of nonperforming loans and 427% of nonperforming assets. This compares with an allowance of \$20.8 million, or 1.33% of the total loan portfolio, excluding loans held for sale, 429% of nonperforming loans, and 427% of nonperforming assets at December 31, 2005.

There have been no significant changes during the first nine months of 2006 in estimation methods or assumptions that affected the Company's methodology for assessing the appropriateness of the allowance for loan and lease losses. Adjustments to the percentages of the allowance allocated to loan categories are made based on trends with respect to delinquencies and problem loans within each pool of loans. The Company maintains a conservative approach to credit quality and will continue to prudently add to its loan and lease loss allowance as necessary in order to maintain adequate reserves. The Company's credit quality measures continue to improve into the third quarter of 2006 from the year-ended 2005 and are some of the strongest in the Company's history. Management carefully monitors the loan portfolio and continues to emphasize credit quality and strengthening of its loan monitoring systems and controls.

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The following table provides an analysis of the Company's allowance for loan and lease losses at the dates and the periods indicated:

| <i>(in thousands)</i> | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------------------------------|-------------------------------------|--------------|------------------------------------|--------------|
| | 2006 | 2005 | 2006 | 2005 |
| Beginning balance | \$ 20,990 | \$ 20,587 | \$ 20,829 | \$ 19,881 |
| Charge-offs: | | | | |
| Commercial business | (439) | (30) | (545) | (270) |
| Commercial real estate | | | | (665) |
| Consumer | (404) | (80) | (878) | (200) |
| Total charge-offs | (843) | (110) | (1,423) | (1,135) |
| Recoveries: | | | | |
| Commercial business | 38 | 10 | 202 | 117 |
| Commercial real estate | 9 | 28 | 64 | 298 |
| Real estate: One-to-four family residential | 20 | | 20 | |
| Real estate construction: One-to-four family residential | | | 7 | |
| Consumer | 62 | 30 | 112 | 124 |
| Total recoveries | 129 | 68 | 405 | 539 |
| Net charge-offs | (714) | (42) | (1,018) | (596) |
| Provision charged to expense | 650 | 245 | 1,115 | 1,505 |
| Ending balance | \$ 20,926 | \$ 20,790 | \$ 20,926 | \$ 20,790 |
| Total loans, net at end of period (1) | \$ 1,655,809 | \$ 1,511,386 | \$ 1,655,809 | \$ 1,511,386 |
| Allowance for loan losses to total loans | 1.26% | 1.38% | 1.26% | 1.38% |

(1) Excludes loans held for sale

During the third quarter of 2006, the Company had net loan charge-offs of \$714,000, compared to \$42,000 in the same period of 2005. For the first nine months of 2006, the Company had net loan charge-offs of \$1.0 million, compared to \$596,000 during the same period of 2005. The net charge-offs during the first nine months of 2006 were comprised of several loans.

Securities

At September 30, 2006, the Company's securities (securities available for sale and securities held to maturity) increased \$26.2 million, or 5% to \$601.0 million from \$574.9 million at year-end 2005. During the first nine months of 2006, the Company purchased securities totaling \$137.5 million and received principal payments inclusive of maturities of \$102.3 million. There were no sales of securities during the third quarter of 2006 or 2005. During the first nine months of 2006 the Company sold \$3.8 million of securities available for sale at their carrying value resulting in a gain of \$10,000. Approximately 99% of the Company's securities are classified as available for sale and carried at fair value. These securities are used by management as part of its asset/liability management strategy and may be sold in response to changes in interest rates or significant prepayment risk. In accordance with the Company's investment strategy, management monitors market conditions with a view to realize gains on its available for sale securities portfolio when prudent. At September 30, 2006, the market value of securities available for sale had an unrealized loss of \$4.8 million (net of tax) as compared to an unrealized loss of \$2.8 (net of tax) at December 31, 2005. The change in market value of securities available for sale is due primarily to fluctuations in interest rates.

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The following table sets forth our securities portfolio by type for the dates indicated:

| | September 30, 2006 | December 31, 2005 |
|-------------------------------------------------------------------------------------------|-----------------------|----------------------|
| | (in thousands) | |
| Securities Available for Sale | | |
| U.S. Government agency | \$ 75,649 | \$ 154,860 |
| U.S. Government agency mortgage-backed securities and collateralized mortgage obligations | 334,952 | 288,790 |
| State and municipal securities | 186,497 | 126,951 |
| Other securities | 1,749 | 1,754 |
| Total | \$ 598,847 | \$ 572,355 |

| | September 30, 2006 | December 31, 2005 |
|------------------------------------|-----------------------|----------------------|
| | (in thousands) | |
| Securities Held to Maturity | | |
| State & municipal securities | \$ 2,197 | \$ 2,524 |

Liquidity and Sources of Funds

The Company's primary sources of funds are customer deposits and advances from the Federal Home Loan Bank of Seattle (the FHLB). These funds, together with loan repayments, loan sales, retained earnings, equity and other borrowed funds, are used to make loans, to acquire securities and other assets, and to fund continuing operations.

Deposit Activities

Our deposit products include a wide variety of transaction accounts, savings accounts and time deposit accounts. Total deposits increased \$15 million, or 1%, to \$2.020 billion at September 30, 2006 from \$2.005 billion at December 31, 2005. Core deposits (demand deposit, savings, and money market accounts) decreased \$17.5 million, or 1% during the first nine months of 2006 while certificate of deposit balances increased \$32 million, or 6% compared to year-end 2005. Average core deposits decreased to \$1.434 billion during the third quarter of 2006, from \$1.467 billion in the fourth quarter 2005.

With higher consumer confidence in the equity markets, we recognize that some of the deposit growth that occurred during the past several years is likely migrating back to those markets. Competitive pressure from banks in our market areas with a strained liquidity posture has also slowed our deposit growth. However, in the long-term we anticipate continued growth in our core deposits through the addition of new product offerings, new customers and from our current client base.

We have established a branch system to serve its consumer and business depositors. In addition, management's strategy for funding growth is to make use of brokered and other wholesale deposits. At September 30, 2006, brokered and other wholesale deposits (excluding public deposits) totaled \$10.5 million, less than 1% of total deposits, down from \$10.9 million at December 31, 2005. The brokered deposits have varied maturities.

The following table sets forth the Company's deposit base by type of product for the dates indicated:

| | September 30, 2006 | December 31, 2005 | September 30, 2005 |
|-------------------------------------------|-----------------------|----------------------|-----------------------|
| <i>Deposit Composition (in thousands)</i> | | | |
| Demand and other non interest bearing | \$ 455,773 | \$ 455,838 | \$ 465,122 |
| Interest bearing demand | 395,281 | 339,686 | 343,198 |
| Money market | 495,933 | 563,973 | 571,934 |
| Savings | 113,647 | 118,604 | 116,808 |

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| | | | |
|-------------------------|--------------|--------------|--------------|
| Certificates of deposit | 559,431 | 527,388 | 496,738 |
| Total deposits | \$ 2,020,065 | \$ 2,005,489 | \$ 1,993,800 |

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We rely on FHLB advances to supplement our funding sources. The FHLB serves as another source of both short and long-term borrowings. FHLB advances are secured by one-to-four family real estate mortgages and certain other assets including our investment securities. At September 30, 2006, the Company had FHLB advances of \$191.9 million, compared to advances of \$94.4 million at December 31, 2005. Management anticipates that the Company will continue to rely on the same sources of funds in the future primarily to make loans and purchase securities.

During 2001, the Company, through a special purpose trust (the Trust) participated in a pooled trust preferred offering, 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 9.07% at September 30, 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 debentures at any time for a premium and after ten years at par, allowing us to retire the debt early if conditions are favorable.

The trust preferred obligations are classified as long-term subordinated debt and our related investment in the Trust is recorded in other assets on the consolidated balance sheet. The balance of the long-term subordinated debt was \$22.4 million at September 30, 2006 and \$22.3 million at December 31, 2005. The subordinated debt payable to the Trust is on the same interest and payment terms as the trust preferred obligations issued by the Trust.

Contractual Obligations & Commitments

The Company is party to many contractual financial obligations, including repayment of borrowings, operating and equipment lease payments, commitments to extend credit and investments in affordable housing partnerships. At September 30, 2006, the Company had commitments to extend credit of \$770.8 million compared to \$698.6 million at December 31, 2005.

Capital Resources

Shareholders' equity at September 30, 2006 was \$245.8 million, up 9% from \$226.2 million at December 31, 2005. The increase is due primarily to net income of \$23.8 million for the first nine months of 2006. Shareholders' equity was 9.8% and 9.5% of total period-end assets at September 30, 2006, and December 31, 2005, respectively.

Capital Ratios: Banking regulations require bank holding companies to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. In addition, banking regulators have adopted risk-based capital guidelines, under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common shareholders' equity and trust preferred obligations, less goodwill and certain identifiable intangible assets, while Tier II capital includes the allowance for loan losses and subordinated debt, both subject to certain limitations. Regulatory minimum risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and total capital (combined Tier I and Tier II) of 8% to be considered adequately capitalized .

Federal Deposit Insurance Corporation regulations set forth the qualifications necessary for a bank to be classified as well capitalized , primarily for assignment of FDIC insurance premium rates. To qualify as well capitalized, banks must have a Tier I risk-adjusted capital ratio of at least 6%, a total risk-adjusted capital ratio of at least 10%, and a leverage ratio of at least 5%. Failure to qualify as well capitalized can negatively impact a bank's ability to expand and to engage in certain activities.

The Company and its subsidiaries qualify as well-capitalized at September 30, 2006 and December 31, 2005.

| | Company | | Columbia Bank | | Astoria | | Requirements | |
|---------------------------------|-----------|------------|---------------|------------|-----------|------------|------------------------|------------------|
| | 9/30/2006 | 12/31/2005 | 9/30/2006 | 12/31/2005 | 9/30/2006 | 12/31/2005 | Adequately capitalized | Well-capitalized |
| Total risk-based capital ratio | 13.24% | 12.97% | 12.57% | 12.52% | 11.61% | 14.79% | 8% | 10% |
| Tier I risk-based capital ratio | 12.16% | 11.82% | 11.49% | 11.38% | 10.53% | 13.61% | 4% | 6% |
| Leverage ratio | 9.66% | 9.54% | 8.26% | 9.32% | 8.55% | 10.23% | 4% | 5% |

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Stock Repurchase Program

In March 2002 the Board of Directors approved a stock repurchase program whereby the Company may systematically repurchase up to 500,000 of its outstanding shares of Common Stock. The Company may repurchase shares from time to time in the open market or in private transactions, under conditions which allow such repurchases to be accretive to earnings while maintaining capital ratios that exceed the guidelines for a well-capitalized financial institution. As of September 30, 2006 the Company had not repurchased any shares of common stock in this current stock repurchase program.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

A number of measures are used to monitor and manage interest rate risk, including income simulations and interest sensitivity (gap) analyses. An income simulation model is the primary tool used to assess the direction and magnitude of changes in net interest income resulting from changes in interest rates. Basic assumptions in the model include prepayment speeds on mortgage-related assets, cash flows and maturities of other investment securities, loan and deposit volumes and pricing. These assumptions are inherently subjective and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and changes in market conditions and management strategies, among other factors. At September 30, 2006, based on the measures used to monitor and manage interest rate risk, there has not been a material change in the Company's interest rate risk since December 31, 2005. For additional information, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations referenced in the Company's 2005 Annual Report on Form 10-K.

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures as required by Rule 13a-15(b) of the Securities Exchange Act of 1934. Based on that evaluation, the CEO and CFO have concluded that as of the end of the period covered by this report, our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and timely reported as provided in the SEC's rules and forms.

Changes in Internal Controls Over Financial Reporting

There was no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II - OTHER INFORMATION

Item 1. 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 1A. RISK FACTORS

There have been no material changes from risk factors previously disclosed in the Company's 2005 Annual Report on Form 10-K.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
None.

Item 3. DEFAULTS UPON SENIOR SECURITIES
None.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
None.

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Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

COLUMBIA BANKING SYSTEM, INC.

Date: November 3, 2006

By */s/ MELANIE J. DRESSEL*
Melanie J. Dressel
President and Chief Executive Officer

(Principal Executive Officer)

Date: November 3, 2006

By */s/ GARY R. SCHMINKEY*
Gary R. Schminkey
Executive Vice President and

Chief Financial Officer

(Principal Financial Officer)

Date: November 3, 2006

By */s/ CLINT E. STEIN*
Clint E. Stein
Senior Vice President and

Chief Accounting Officer

(Principal Accounting Officer)