

INTERMOUNTAIN COMMUNITY BANCORP

Form 10-Q

November 07, 2008

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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, 2008**  
**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO Commission File Number 000-50667 INTERMOUNTAIN COMMUNITY BANCORP (Exact name of registrant as specified in its charter)**

**Idaho**  
(State or other jurisdiction of incorporation or organization)

**82-0499463**  
(I.R.S. Employer Identification No.)

**414 Church Street, Sandpoint, Idaho 83864**  
(Address of principal executive offices) (Zip Code)  
**(208) 263-0505**

(Registrant's telephone number, including area code)

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

Class	Outstanding as of November 4, 2008
Common Stock (no par value)	8,315,239

**Intermountain Community Bancorp**  
**FORM 10-Q**  
**For the Quarter Ended September 30, 2008**

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**PART I Financial Information**  
**Item 1 Financial Statements**  
**Intermountain Community Bancorp**  
**Consolidated Balance Sheets**  
**(Unaudited)**

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
	<b>(Dollars in thousands)</b>	
<b>ASSETS:</b>		
Cash and cash equivalents:		
Interest bearing	\$ 861	\$ 149
Non-interest bearing and vault	22,151	26,851
Restricted cash	2,746	4,527
Federal funds sold	20,315	6,565
Interest Bearing Certificates of Deposits	192	
Available-for-sale securities, at fair value	132,011	158,791
Held-to-maturity securities, at amortized cost	16,110	11,324
Federal Home Loan Bank of Seattle (FHLB) stock, at cost	2,310	1,779
Loans held for sale	1,500	4,201
Loans receivable, net	766,625	756,549
Accrued interest receivable	6,776	8,207
Office properties and equipment, net	44,843	42,090
Bank-owned life insurance	7,952	7,713
Goodwill	11,662	11,662
Other intangible assets	612	723
Prepaid expenses and other assets, net	12,579	7,528
 Total assets	 \$ 1,049,245	 \$ 1,048,659
 <b>LIABILITIES:</b>		
Deposits	\$ 770,367	\$ 757,838
Securities sold subject to repurchase agreements	87,213	124,127
Advances from Federal Home Loan Bank of Seattle	54,000	29,000
Cashiers checks issued and payable	989	1,509
Accrued interest payable	2,057	3,027
Other borrowings	40,623	36,998
Accrued expenses and other liabilities	5,036	6,041
 Total liabilities	 960,285	 958,540
 Commitments and contingent liabilities		
 Common stock, no par value; 29,040,000 shares authorized; 8,403,137 and 8,313,005 shares issued and 8,305,769 and 8,248,710 shares outstanding	 76,349	 76,746
Accumulated other comprehensive income (loss)	(3,350)	1,327
Retained earnings	15,961	12,046

Total stockholders' equity	88,960	90,119
Total liabilities and stockholders' equity	\$ 1,049,245	\$ 1,048,659

The accompanying notes are an integral part of the consolidated financial statements.

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**Intermountain Community Bancorp  
Consolidated Statements of Income  
(Unaudited)**

	Three Months Ended September 30,		Nine months Ended September 30,	
	2008	2007	2008	2007
	(Dollars in thousands, except per share data)		(Dollars in thousands, except per share data)	
Interest income:				
Loans	\$ 14,098	\$ 17,383	\$ 43,058	\$ 48,754
Investments	1,991	1,701	6,073	5,339
Total interest income	16,089	19,084	49,131	54,093
Interest expense:				
Deposits	3,627	4,909	10,932	13,974
Other borrowings	1,352	1,812	4,588	5,437
Total interest expense	4,979	6,721	15,520	19,411
Net interest income	11,110	12,363	33,611	34,682
Provision for losses on loans	(2,474)	(1,221)	(4,872)	(3,228)
Net interest income after provision for losses on loans	8,636	11,142	28,739	31,454
Other income:				
Fees and service charges	2,325	2,353	6,671	6,285
Mortgage Banking Operations	413	846	1,205	2,186
Bank-owned life insurance	83	80	238	239
Gain (loss) on sale of securities		(38)	2,182	(38)
Other	193	343	728	1,150
Total other income	3,014	3,584	11,024	9,822
Operating expenses	11,422	10,718	33,316	30,352
Income before income taxes	228	4,008	6,447	10,924
Income tax provision	(2)	(1,590)	(2,298)	(4,229)

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Net income	\$	226	\$	2,418	\$	4,149	\$	6,695
Earnings per share basic	\$	0.03	\$	0.29	\$	0.50	\$	0.82
Earnings per share diluted	\$	0.03	\$	0.28	\$	0.49	\$	0.78
Weighted average shares outstanding basic		8,305,236		8,223,257		8,287,541		8,193,268
Weighted average shares outstanding diluted		8,461,591		8,592,975		8,531,037		8,608,796

The accompanying notes are an integral part of the consolidated financial statements.

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**Intermountain Community Bancorp  
Consolidated Statements of Cash Flows  
(Unaudited)**

	<b>Nine months Ended September 30, 2008                      2007 (Dollars in thousands)</b>	
Cash flows from operating activities:		
Net income	\$ 4,149	\$ 6,695
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,615	1,863
Stock-based compensation expense	(244)	305
Net amortization of premiums on securities	(143)	(425)
Excess tax benefit related to stock-based compensation		(361)
Provisions for losses on loans	4,872	3,228
Amortization of core deposit intangibles	111	120
(Gain) loss on sale of loans, investments, property and equipment	(2,681)	(304)
(Gain) loss on sale of other real estate owned	5	
Accretion of deferred gain on sale of branch property	(9)	(12)
Net accretion of loan and deposit discounts and premiums	(17)	(58)
Deferred income tax benefit		329
Increase in cash surrender value of bank-owned life insurance	(238)	(239)
Change in:		
Loans held for sale	2,701	3,564
Accrued interest receivable	1,431	(1,007)
Prepaid expenses and other assets	(4,130)	(1,864)
Accrued interest payable	(970)	932
Accrued expenses and other liabilities	(2,222)	(5,209)
 Net cash provided by operating activities	 5,230	 7,557
 Cash flows from investing activities:		
Purchases of available-for-sale securities	(47,374)	(156,935)
Purchases of FHLB Stock	(705)	
Proceeds from redemption of FHLB Stock	175	
Proceeds from calls or maturities of available-for-sale securities	59,022	121,627
Principal payments on mortgage-backed securities	10,272	6,166
Purchases of held-to-maturity securities	(6,127)	(5,070)
Proceeds from calls or maturities of held-to-maturity securities	1,305	194
Origination of loans, net of principal payments	(41,668)	(103,430)
Proceeds from sale of loans	28,972	4,763
Purchase of office properties and equipment	(5,554)	(18,281)
Proceeds from sale of office properties and equipment	8	2,243
Net change in federal funds sold	(13,750)	19,555
Proceeds from sale of other real estate owned	471	
Improvements and other changes in other real estate owned		271



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Net change in Certificates of Deposit with other institutions	(192)	
Net change in restricted cash	1,781	(141)
Net cash used in investing activities	(13,364)	(129,038)

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**Intermountain Community Bancorp**  
**Consolidated Statements of Cash Flows (continued)**  
**(Unaudited)**

	<b>Nine months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>	
Cash flows from financing activities:		
Net change in demand, money market and savings deposits	\$ (3,484)	\$ 59,340
Net change in certificates of deposit	16,008	25,277
Net change in repurchase agreements	(36,913)	(1,699)
Principal reduction of note payable	(31)	(27)
Excess tax benefit related to stock-based compensation		361
Proceeds from exercise of stock options	102	348
Repayments of FHLB borrowings	(5,000)	(10,000)
Proceeds from FHLB borrowings	30,000	34,000
Retirement of Treasury Stock	(193)	
Proceeds from other borrowings	3,657	11,249
Net cash provided by financing activities	4,146	118,849
Net change in cash and cash equivalents	(3,988)	(2,632)
Cash and cash equivalents, beginning of period	27,000	24,377
Cash and cash equivalents, end of period	\$ 23,012	\$ 21,745
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 15,974	\$ 20,111
Income taxes	3,585	4,100
Noncash investing and financing activities:		
Restricted stock issued	647	703
Deferred gain on sale/leaseback		312
10% stock dividend		15,186
Accrual of liability for split dollar life insurance	389	
Loans converted to Other Real Estate Owned	1,743	

The accompanying notes are an integral part of the consolidated financial statements.

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**Intermountain Community Bancorp**  
**Consolidated Statements of Comprehensive Income**  
**(Unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Nine months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>			
Net income	\$ 226	\$ 2,418	\$ 4,149	\$ 6,695
Other comprehensive income (loss):				
Change in unrealized gains (losses) on investments and MBS available for sale	(2,660)	595	(7,221)	184
Qualifying cash flow hedge	(315)		(315)	
Less deferred income tax provision (benefit)	1,053	(235)	2,859	(73)
Net other comprehensive income (loss)	(1,922)	360	(4,677)	111
Comprehensive income (loss)	\$ (1,696)	\$ 2,778	\$ (528)	\$ 6,806

The accompanying notes are an integral part of the consolidated financial statements.

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**Intermountain Community Bancorp**  
**Notes to Consolidated Financial Statements**

**1. Basis of Presentation:**

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2007. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Term note payable (1)	\$ 8,279	\$ 8,279
Term note payable (2)	8,248	8,248
Term note payable (3)	951	982
Term note payable (4)	23,145	19,489
Total other borrowings	\$ 40,623	\$ 36,998

(1) In January 2003, the Company issued \$8.0 million of Trust Preferred securities through its subsidiary, Intermountain Statutory Trust I. The debt associated with these securities bore a fixed interest rate for a period of five years from issue date and now bears interest on a variable basis tied to the 90-day LIBOR (London Inter-Bank

Offering Rate)  
index plus  
3.25%, with  
interest only  
paid quarterly.  
The rate on this  
borrowing was  
6.73% at  
September 30,  
2008. The debt  
is callable by  
the Company  
quarterly and  
matures in  
March 2033.  
During the third  
quarter of 2008,  
the Company  
entered into an  
interest rate  
swap contract  
with Pacific  
Coast Bankers  
Bank. The  
purpose of the  
\$8.2 million  
notional value  
swap is to  
convert the  
variable rate  
payments made  
on our Trust  
Preferred I  
obligation to a  
series of fixed  
rate payments  
for five years, as  
a hedging  
strategy to help  
manage the  
Company's  
interest-rate  
risk. See Note  
A.

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- (2) In March 2004, the Company issued \$8.0 million of Trust Preferred securities through its subsidiary, Intermountain Statutory Trust II. The debt associated with these securities bears interest on a variable basis tied to the 90-day LIBOR index plus 2.8%, with interest only paid quarterly. The rate on this borrowing was 5.59% at September 30, 2008. The debt is callable by the Company in March 2009 and matures in April 2034. See Note A.
- (3) In January 2006, the Company purchased land to build its new headquarters, the Sandpoint Center in Sandpoint, Idaho. It entered into a Note Payable with the sellers of the property in the amount of \$1.13 million,

with a fixed rate of 6.65%, payable in equal installments. The note matures in February 2026.

- (4) In December 2007, the Company renewed a borrowing agreement with Pacific Coast Banker's Bank in the amount of \$25.0 million. The borrowing agreement is a revolving line of credit with a variable rate of interest tied to LIBOR with a maturity date of January 18, 2009. It is anticipated that this line will either be paid down with the sale of the building or refinanced with a longer term instrument. The collateral for the credit line is all of Panhandle State Bank's stock and the Sandpoint Center. Under the restrictive covenants of the borrowing agreement, Intermountain cannot incur additional debt outside of its

normal course of business over \$5.0 million without Pacific Coast Banker's Bank's consent, and Intermountain is obligated to provide information regarding its financial position and loan portfolio on a regular basis. At September 30, 2008, the balance outstanding was \$23.1 million at a rate of 5.67%.

A) Intermountain's obligations under the above debentures issued by its subsidiaries constitute a full and unconditional guarantee by Intermountain of the Statutory Trusts' obligations under the Trust Preferred Securities. In accordance with Financial Interpretation No. 46 (Revised), "Consolidation of Variable Interest Entities" (FIN No. 46R), the trusts are not consolidated and the debentures and related amounts are treated as debt of Intermountain.

#### 4. Earnings Per Share:

The following table presents the basic and diluted earnings per share computations:

	<b>Three Months Ended September 30,</b> <b>(Dollars in thousands, except per share amounts)</b>					
	<b>2008</b>			<b>2007</b>		
	<b>Net</b>	<b>Weighted</b>	<b>Per</b>	<b>Net</b>	<b>Weighted</b>	<b>Per</b>
	<b>Income</b>	<b>Avg.</b>	<b>Share</b>	<b>Income</b>	<b>Avg.</b>	<b>Share</b>
	<b>\$</b>	<b>Shares</b>	<b>Amount</b>	<b>\$</b>	<b>Shares</b>	<b>Amount</b>
Basic computations	\$ 226	8,305,236	\$ 0.03	\$ 2,418	8,223,257	\$ 0.29
Effect of dilutive securities:						
Common stock options and stock grants		156,355	(0.00)		369,718	(0.01)
Diluted computations	\$ 226	8,461,591	\$ 0.03	\$ 2,418	8,592,975	\$ 0.28

**Nine months Ended September 30,**  
**(Dollars in thousands, except per share amounts)**



	2008			2007		
	Net	Weighted	Per	Net	Weighted	Per
	Income	Avg.	Share	Income	Avg.	Share
		Shares	Amount		Shares	Amount
Basic computations	\$ 4,149	8,287,541	\$ 0.50	\$ 6,695	8,193,268	\$ 0.82
Effect of dilutive securities:						
Common stock options and stock grants		243,496	(0.01)		415,528	(0.04)
Diluted computations	\$ 4,149	8,531,037	\$ 0.49	\$ 6,695	8,608,796	\$ 0.78

**Table of Contents****5. Operating Expenses:**

The following table details Intermountain's components of total operating expenses:

	<b>Three Months Ended</b>		<b>Nine months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>			
Salaries and employee benefits	\$ 6,446	\$ 6,646	\$ 18,922	\$ 19,088
Occupancy expense	2,005	1,544	5,596	4,381
Advertising	378	437	1,069	1,008
Fees and service charges	452	398	1,421	1,069
Printing, postage and supplies	396	349	1,105	1,096
Legal and accounting	407	354	1,342	960
Other expense	1,338	990	3,861	2,750
Total operating expenses	\$ 11,422	\$ 10,718	\$ 33,316	\$ 30,352

Salaries and employee benefits expense decreased \$166,000, or 0.9%, over the nine-month period last year as a result of decreased staffing levels and lower incentive expense, including the reversal of \$640,000 in accrued pre-tax expense related to a long-term bonus plan for executives that will likely not be paid out at year end.

Occupancy expenses increased \$1.2 million, or 27.7%, for the nine-month period ended September 30, 2008 compared to the same period one year ago. These increases reflected additional building expense from new facilities opened in 2007 and 2008 and additional computer hardware and software purchased to enhance security, compliance and business continuity.

Increases in computer service fees, debit card expenses and credit card acceptance fees resulted in a \$352,000, or 32.9% increase in fees and service charges over the same nine-month period last year. Higher volumes of activity by the Company's customers generated these increases.

Legal and accounting fees were \$382,000, or 39.8% higher than the same nine-month period in 2007 as a result of payments made to a consultant engaged to assist the Company in streamlining business processes. The fees for this engagement ended in September 2008.

Other expenses increased \$1.1 million, or 40.4%, for the nine-month period over the same period last year. The increase in other expenses can be attributed to the reinstatement of FDIC insurance fees industry-wide and increases in collection and other real-estate owned expenses caused by the weakening credit environment. In addition, the 2008 comparative numbers are negatively impacted by the reversal in 2007 of \$384,000 in expenses as a result of lowering the allowance for unfunded loan commitments in conjunction with new federal guidance issued last year.

**6. Stock-Based Compensation Plans:**

The Company utilizes its stock to compensate employees and directors under the 1999 Director Stock Option Plan, the 1999 Employee Plan and the 1988 Employee Plan (together the "Stock Option Plans"). Options to purchase Intermountain common stock have been granted to employees and directors under the Stock Option Plans at prices equal to the fair market value of the underlying stock on the dates the options were granted. The

options vest 20% per year, over a five-year period, and expire in 10 years. At September 30, 2008, there were 200,229 shares available for grant. The Company did not grant options to purchase Intermountain common stock during either the nine months ended September 30, 2008 or 2007.

For the nine months ended September 30, 2008 and 2007, stock option expense totaled \$101,000 and \$97,000, respectively. The Company has approximately \$34,000 remaining to expense related to the non-vested stock options outstanding at September 30, 2008. This expense will be recorded over a weighted average period of 3.0 months. The expense for the stock options was calculated using the Black-Scholes valuation model per Statement 123 (R). Assumptions used in the Black-Scholes option-pricing model for options issued in years prior to 2005 are as follows:

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Dividend yield	0.0%
Expected volatility	17.0% - 46.6%
Risk free interest rates	4.0% - 7.1%
Expected option lives	5 - 10 years

In 2003, shareholders approved a change to the 1999 Employee Option Plan to provide for the granting of restricted stock awards. The Company has granted restricted stock to directors and employees beginning in 2005. The restricted stock vests 20% per year, over a five-year period. The Company granted 51,633 and 32,524 restricted shares with a grant date fair value of \$647,000 and \$704,000 during the nine months ended September 30, 2008 and 2007, respectively. For the nine months ended September 30, 2008 and 2007, restricted stock expense totaled \$247,000 and \$174,000, respectively. Total expense related to stock-based compensation is comprised of restricted stock expense, stock option expense and expense related to the 2006-2008 Long-Term Incentive Plan ( LTIP ). The LTIP expense is based on anticipated company performance over a 3-year period and has a 5-year vesting period. During the nine months ended September 30, 2008, the Company reversed \$640,000 in accrued incentives related to the LTIP as it appeared that asset growth and ROE targets required by the plan would not be met by the end of this year. Total expense related to stock-based compensation recorded in the nine months ended September 30, 2008 and 2007 was (\$245,000) and \$305,000, respectively.

A summary of the changes in stock options outstanding for the nine months ended September 30, 2008 is presented below:

	<b>Nine months ended September 30, 2008</b> <b>(dollars in thousands, except per share amounts)</b>		
	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Life (Years)</b>
Beginning Options Outstanding, Jan 1, 2008	487,329	\$ 5.48	
Options Granted			
Exercises	(23,452)	4.38	
Forfeitures	(510)	13.12	
Ending options outstanding, September 30, 2008	463,367	5.52	2.4
Exercisable at September 30, 2008	443,669	\$ 5.30	2.3

The total intrinsic value of options exercised during the nine months ended September 30, 2008 and 2007 was \$104,000 and \$1,157,000, respectively.

A summary of the Company's nonvested restricted shares for the nine months ended September 30, 2008 is presented below:

		Weighted-Average Grant-Date Fair Value
Nonvested Shares	Shares	

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Nonvested at January 1, 2008	64,295	\$	19.53
Granted	51,633		12.54
Vested	(15,256)		18.10
Forfeited	(3,304)		18.05
Nonvested at September 30, 2008	97,368	\$	16.09

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As of September 30, 2008, there was \$1.4 million of unrecognized compensation cost related to nonvested share-based compensation arrangements granted under this plan. This cost is expected to be recognized over a weighted-average period of 3.6 years.

**7. Fair Value Measurements**

Effective January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

**Level 1 inputs** Unadjusted quoted process in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

**Level 2 inputs** Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

**Level 3 inputs** Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

The available-for-sale securities category and interest rate swap category are the only balance sheet categories the Company is required by generally accepted accounting principles to account for at fair value for the period ended September 30, 2008. The following table presents information about the Company's assets measured at fair value on a recurring basis as of September 30, 2008, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value (dollars in thousands).

Description	Fair Value Sept 30, 2008	Fair Value Measurements At September 30, 2008, Using		
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities	\$ 132,011	\$	\$ 98,230	\$ 33,781
Interest Rate Swap	315		315	
<b>Total Assets Measured at Fair Value</b>	<b>\$ 132,326</b>	<b>\$</b>	<b>\$ 98,545</b>	<b>\$ 33,781</b>

**Fair Value Measurement Transfers**

	Level		
	1	Level 2	Level 3
June 30, 2008 Balance	\$	\$131,319	
Transfers from Level 2 to Level 3		(33,781)	\$33,781
Other Adjustments, including fair value adjustments, principal payments, maturities and new purchases		1,007	
September 30, 2008 Balance		\$ 98,545	\$33,781

*Available for Sale Securities.* Securities totaling \$98.2 million classified as available for sale are reported at fair value utilizing Level 2 inputs, because active markets existed for these securities as of September 30, 2008. For these securities, the Company obtained fair value measurements from an independent pricing service and internally validated these measurements. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus, prepayment speeds, credit information and the bond s terms and conditions, among other things.

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The available for sale portfolio also includes \$33.8 million in super senior or senior tranche collateralized mortgage obligations not backed by a government or other agency guarantee for which an active market did not exist as of September 30, 2008. These securities continue to hold A or above ratings by at least two independent rating agencies, but because of disruptions in the current market for mortgage-backed securities and collateralized mortgage obligations, an active market does not exist. This is evidenced by a significant widening in the bid-ask spread for these types of securities and the limited volume of actual trades made. As a result, less reliance can be placed on easily observable market data, such as pricing on transactions involving similar types of securities, in determining their current fair value. As such, while the Company appropriately considered the observable market-based inputs for these securities, it has classified them within Level 3 of the fair value hierarchy because significant adjustments were required to determine the fair value at the September 30 measurement date.

In valuing these securities, the Company utilized the same independent pricing service as for its level 2 securities and internally validated these measurements. In addition to the observable market-based input including dealer quotes, market spreads, live trading levels and execution data, the service also employed a present-value income model that considered the nature and timing of the cash flows and the relative risk of receiving the anticipated cash flows as agreed. The discount rates used were based on a risk-free rate, adjusted by a risk premium for each security. In accordance with the requirements of Statement 157, the Company has determined that the risk-adjusted discount rates utilized appropriately reflect the Company's best estimate of the assumptions that market participants would use in pricing the assets in a current transaction to sell the asset at the measurement date. Risks include nonperformance risk (that is, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions). To the extent possible, the pricing service and the Company validated the results from these models with independently observable data.

Using joint guidance from the SEC Office of the Chief Accountant and FASB staff issued Oct 10, 2008 as FSP FAS 157-3, which provided further clarification on fair value accounting, the Company also evaluated these and other securities in the investment portfolio for Other than Temporary Impairment. In conducting this evaluation, the Company evaluated the following factors:

The length of time and the extent to which the market value of the securities have been less than their cost;

The financial condition and near-term prospects of the issuer or obligation, including any specific events, which may influence the operations of the issuer or obligation such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; and The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

Based on the factors above, the Company has determined that none of its securities were subject to Other than Temporary Impairment, (OTTI) as of September 30, 2008. Because of current disruptions in the market for non-agency guaranteed securities, the Company focused particular attention on the collateralized mortgage obligations discussed above. Based on the very high probability of receiving the cash flows contractually committed even under various stress-testing scenarios, and the ability of the Company to hold the securities until the sooner of recovery in market value or maturity, the Company has determined that no OTTI exists at this time.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.



This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The company did not elect the fair value option for financial assets as of January 1, 2008, the effective date of this standard.

*Interest Rate Swaps.* During the third quarter, the Company entered into an interest rate swap contract with Pacific Coast Bankers Bank. The purpose of the \$8.2 million notional value swap is to convert the variable rate payments

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made on our Trust Preferred I obligation (see Footnote 3 – Other Borrowings) to a series of fixed rate payments for five years, as a hedging strategy to help manage the Company’s interest-rate risk. This contract is carried as an asset or liability at fair value, and as of September 30, 2008, it was a liability with a fair value of \$315,000.

**8. New Accounting Pronouncements:**

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, Effective Date of FASB Statement No. 157. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

On October 10, 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. The FSP clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective immediately, and includes prior period financial statements that have not yet been issued, and therefore the Company is subject to the provision of the FSP effective September 30, 2008. See Notes to Financial Statements, Note 7, Fair Value Measurements for further discussion of the impact of SFAS No. 157 and the additional guidance issued.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008, the effective date of the standard.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements ( SFAS 160 ). SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. The effective date for SFAS 160 is for annual periods beginning on or after December 15, 2008. Early adoption and retroactive application of SFAS 160 to fiscal years preceding the effective date are not permitted. The Company is evaluating the impact of adoption on its Consolidated Financial Statements.

In December 2007, the FASB issued Statement No. 141(R) *Business Combinations*. This statement replaces FASB Statement No. 141 *Business Combinations*. SFAS No. 141(R) establishes principles and requirements for how an acquiring company (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The new standard is effective for the Company on January 1, 2009. The Company is currently evaluating the impact of adopting SFAS No. 141(R) on the Consolidated Financial Statements, but does not expect any material impact unless the Company engages in new business combinations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ( SFAS 161 ). SFAS 161 requires specific disclosures regarding the location and amounts of derivative instruments in the Company s financial statements, how derivative instruments and related hedged items are accounted for, and how derivative instruments and related hedged items affect the Company s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued and for fiscal years and interim periods after November 15, 2008. Early application is permitted. SFAS 161 impacts the Company s disclosure, but not its accounting treatment for derivative instruments and related hedged items. The Company s adoption of SFAS 161 will impact the disclosures in the Consolidated Financial Statements.

In May 2008, FASB issued Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in

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conformity with GAAP in the United States (the GAAP hierarchy). SFAS No. 162 divides the body of GAAP into four categories by level of authority. This statement is effective in the fourth quarter of 2008.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4 ( EITF 06-4 ), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. Effective January 1, 2008, the Company recorded a liability in the amount of \$389,000 and a reduction in equity in the amount of \$235,000 to record the liability as of January 1, 2008.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value through Earnings ( SAB 109 ). Previously, SAB 105, Application of Accounting Principles to Loan Commitments, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company believes the impact of this standard to be immaterial.

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

*This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see Forward-Looking Statements. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Intermountain's Form 10-K for the year ended December 31, 2007.*

### **General**

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

Panhandle State Bank, a wholly owned subsidiary of the Company, was first opened in 1981 to serve the local banking needs of Bonner County, Idaho. Panhandle State Bank is regulated by the Idaho Department of Finance, the State of Washington Department of Financial Institutions, the Oregon Division of Finance and Corporate Securities and by the Federal Deposit Insurance Corporation ( FDIC ), its primary federal regulator and the insurer of its deposits.

Since opening in 1981, the Bank has continued to grow by opening additional branch offices throughout Idaho. During 1999, the Bank opened its first branch under the name of Intermountain Community Bank, a division of Panhandle State Bank, in Payette, Idaho. Over the next several years, the Bank continued to open branches under both the Intermountain Community Bank and Panhandle State Bank names. In January 2003, the Bank acquired a branch office from Household Bank F.S.B. located in Ontario, Oregon, which is now operating under the Intermountain Community Bank name. In 2004, Intermountain acquired Snake River Bancorp, Inc. ( Snake River ) and its subsidiary bank, Magic Valley Bank, and the Bank now operates three branches under the Magic Valley Bank name in south central Idaho. In 2005 and 2006, the Company opened branches in Spokane Valley and downtown Spokane, Washington, respectively, and operates these branches under the name of Intermountain Community Bank of Washington. It also opened branches in Kellogg and Fruitland, Idaho.

In 2006, Intermountain also opened a Trust & Wealth division, and purchased a small investment company, Premier Alliance, which now operates as Intermountain Community Investment Services (ICI). The acquisition and development of these services improves the Company's ability to provide a full-range of financial services to its targeted customers. In 2007, the Company relocated its Spokane Valley office to a larger facility housing retail, commercial, and mortgage

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banking functions and administrative staff. In the second quarter 2008, the Bank completed the Sandpoint Center, its new corporate headquarters, and relocated the Sandpoint branch and administrative staff into the building.

Based on asset size at September 30, 2008, Intermountain is the largest independent commercial bank headquartered in the state of Idaho, with consolidated assets of \$1.05 billion. Intermountain competes with a number of international banking groups, out-of-state banking companies, state banking organizations, local community banks, savings banks, savings and loans, and credit unions throughout its market area.

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

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

### **Current Economic Challenges and Future Outlook**

By all measures, the third quarter of 2008 was one of the most challenging periods for financial institutions in recent history. National economic conditions continued to worsen, as unemployment increased, housing continued its steep decline and both equity and fixed income markets contracted sharply. Against this backdrop, financial markets tightened considerably, as banks and other investors hoarded cash and global credit markets contracted. These circumstances prompted unprecedented government intervention, as the US Treasury, Federal Reserve and other central banks responded to the growing financial crisis with a variety of programs designed to shore up financial institutions and restore confidence and liquidity to the market. This activity, along with the widely publicized failure of Lehman Brothers and Washington Mutual, created high levels of concern among bank customers about the safety of their money.

Government actions, particularly the expansion of FDIC insurance and Treasury's announced program to inject capital directly into banks, appears to have created some stability in the financial markets. However, considerable concern still remains about the economy and the financial markets in general, which will likely lead to further caution on the part of businesses and consumers and additional economic contraction. Most economists now agree that we are in a recession that will likely last for several quarters or more, as the economy seeks to de-lever and rebalance itself.

In comparison to other markets, the economies of Idaho, eastern Washington and eastern Oregon exhibited relative strength during this period. The region's relative economic diversity, low cost and attractive quality of life continue to buffer it against the worst impacts of the global and national downturn. However, it became more evident in the third quarter that the region would not be immune from the troubles besieging other markets. Real estate sales and valuations declined sharply, regional unemployment rates increased, and spending activity slowed.

Company performance during the third quarter reflected the challenges facing the economy and financial industry. In particular, the Company experienced the following:

Slowing loan demand, particularly from higher quality borrowers, as businesses and consumers retrenched.

Continued margin pressures, as the Federal Reserve lowered its target Fed Funds rate, which negatively impacted the Bank's prime lending rate, at the same time that other market rates spiked and competition for deposit dollars increased.

Higher non-performing loans and credit losses, as general credit conditions worsened, and the decline in real estate values accelerated in the Company's markets.

Continuing pressure on fee income, particularly fees derived from mortgage banking activity.

Company management responded to the unprecedented market conditions by reducing balance sheet risk and engaging in extensive customer communication, marketing and education efforts. In particular, the Company intentionally slowed asset growth rates, boosted deposit gathering efforts, and invested in lower-yielding, but safer, more liquid assets.

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Management's focus clearly was and continues to be on ensuring the safety and security of the Bank and its customers. These actions, when combined with the significant economic challenges facing the Company, had negative impacts on third quarter earnings.

While not fully reflected in the Company's expense metrics, management continued with expense control efforts in the third quarter, reducing staff and cutting costs in controllable expense areas such as travel, employee incentives, supplies and entertainment. These were offset by increases in other expenses, such as FDIC insurance, loan collection costs, and facility expenses that cannot be reduced rapidly, if at all. Company management has decided against engaging in across-the-board, rapid expense reductions in favor of a more measured approach that focuses on changing business processes, and eliminating expenses that have little immediate or future potential for revenue generation or risk reduction. This reflects management's emphasis on building a strong culture, infrastructure and balance sheet that positions it well for future growth opportunities.

We anticipate that both the national and regional economy will continue to experience significant challenges in the near future. With the residential real estate market continuing to struggle, unemployment rates rising, consumer spending slowing, and food prices projected to remain high, we do not anticipate a rapid turnaround in industry or Company performance. However, we believe that long-term opportunities will arise for institutions who position themselves to take advantage of them, and we are taking such steps. In particular, we continue to hold and build strong regulatory capital and loss reserve levels, are stepping up our deposit-gathering efforts, and are increasing our already strong leadership positions in the communities we serve. In addition, we are engaging in extensive marketing and community educational efforts, and anticipate the continuation of these efforts. Our mission remains to solidify these core competencies, improve our business processes and efficiency, and position the Company for future growth and value creation during both difficult and stable economic times.

**Critical Accounting Policies**

The accounting and reporting policies of Intermountain conform to Generally Accepted Accounting Principles (GAAP) and to general practices within the banking industry. The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Intermountain's management has identified the accounting policies described below as those that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of Intermountain's Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Income Recognition.** Intermountain recognizes interest income by methods that conform to general accounting practices within the banking industry. In the event management believes collection of all or a portion of contractual interest on a loan has become doubtful, which generally occurs after the loan is 90 days past due, Intermountain discontinues the accrual of interest and reverses any previously accrued interest recognized in income deemed uncollectible. Interest received on nonperforming loans is included in income only if recovery of the principal is reasonably assured. A nonperforming loan is restored to accrual status when it is brought current or when brought to 90 days or less delinquent, has performed in accordance with contractual terms for a reasonable period of time, and the collectibility of the total contractual principal and interest is no longer in doubt.

**Allowance For Loan Losses.** In general, determining the amount of the allowance for loan losses requires significant judgment and the use of estimates by management. This analysis is designed to determine an appropriate level and allocation of the allowance for losses among loan types and loan classifications by considering factors affecting loan losses, including: specific losses; levels and trends in impaired and nonperforming loans; historical bank and industry loan loss experience; current national and local economic conditions; volume, growth and composition of the portfolio; regulatory guidance; and other relevant factors. Management monitors the loan portfolio to evaluate the adequacy of the allowance. The allowance can increase or decrease based upon the results of management's analysis.

The amount of the allowance for the various loan types represents management's estimate of probable incurred losses inherent in the existing loan portfolio based upon historical bank and industry loan loss experience for each loan type. The allowance for loan losses related to impaired loans is based on the fair value of the collateral for collateral dependent loans, and on the present value of expected cash flows for non-collateral dependent loans. For



collateral dependent loans, this evaluation requires management to make estimates of the value of the collateral and any associated holding and selling costs, and for non-collateral dependent loans, estimates on the timing and risk associated with the receipt of contractual cash flows.

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Individual loan reviews are based upon specific quantitative and qualitative criteria, including the size of the loan, loan quality classifications, value of collateral, repayment ability of borrowers, and historical experience factors. The historical experience factors utilized are based upon past loss experience, trends in losses and delinquencies, the growth of loans in particular markets and industries, and known changes in economic conditions in the particular lending markets. Allowances for homogeneous loans (such as residential mortgage loans, personal loans, etc.) are collectively evaluated based upon historical bank and industry loan loss experience, trends in losses and delinquencies, growth of loans in particular markets, and known changes in economic conditions in each particular lending market. The Allowance for Loan Losses analysis is presented to the Audit Committee for review.

Management believes the allowance for loan losses was adequate at September 30, 2008. While management uses available information to provide for loan losses, the ultimate collectability of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions and other relevant factors. A slowdown in economic activity could adversely affect cash flows for both commercial and individual borrowers, as a result of which the Company could experience increases in nonperforming assets, delinquencies and losses on loans.

A reserve for unfunded commitments is maintained at a level that, in the opinion of management, is adequate to absorb probable losses associated with the Bank's commitment to lend funds under existing agreements such as letters or lines of credit. Management determines the adequacy of the reserve for unfunded commitments based upon reviews of individual credit facilities, current economic conditions, the risk characteristics of the various categories of commitments and other relevant factors. The reserve is based on estimates, and ultimate losses may vary from the current estimates. These estimates are evaluated on a regular basis and, as adjustments become necessary, they are recognized in earnings in the periods in which they become known through charges to other non-interest expense. Draws on unfunded commitments that are considered uncollectible at the time funds are advanced are charged to the reserve for unfunded commitments. Provisions for unfunded commitment losses, and recoveries on commitment advances previously charged-off, are added to the reserve for unfunded commitments, which is included in the accrued expenses and other liabilities section of the Consolidated Statements of Financial Condition.

**Investments.** Assets in the investment portfolio are initially recorded at cost, which includes any premiums and discounts. Intermountain amortizes premiums and discounts as an adjustment to interest income using the interest yield method over the life of the security. The cost of investment securities sold, and any resulting gain or loss, is based on the specific identification method.

Management determines the appropriate classification of investment securities at the time of purchase. Held-to-maturity securities are those securities that Intermountain has the intent and ability to hold to maturity, and are recorded at amortized cost. Available-for-sale securities are those securities that would be available to be sold in the future in response to liquidity needs, changes in market interest rates, and asset-liability management strategies, among others. Available-for-sale securities are reported at fair value, with unrealized holding gains and losses reported in stockholders' equity as a separate component of other comprehensive income, net of applicable deferred income taxes.

Management evaluates investment securities for other than temporary declines in fair value on a periodic basis. If the fair value of investment securities falls below their amortized cost and the decline is deemed to be other than temporary, the securities will be written down to current market value and the write down will be deducted from earnings. There were no investment securities which management identified to be other-than-temporarily impaired for the nine months ended September 30, 2008. Charges to income could occur in future periods due to a change in management's intent to hold the investments to maturity, a change in management's assessment of credit risk, or a change in regulatory or accounting requirements. See Footnote 7, *Fair Value Measurements*, for additional discussion on management's evaluation of the fair value of its available-for-sale securities and its other-than-temporary impairment analysis.

**Goodwill and Other Intangible Assets.** Goodwill arising from business combinations represents the value attributable to unidentifiable intangible elements in the business acquired. Intermountain's goodwill relates to value inherent in the banking business and the value is dependent upon Intermountain's ability to provide quality, cost-effective services in a competitive market place. As such, goodwill value is supported ultimately by revenue that

is driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost-effective services over sustained periods can lead to impairment of goodwill that could adversely impact earnings in future periods. Goodwill is not amortized, but is subjected to impairment analysis each December. In addition, generally accepted accounting principles require an impairment analysis to be conducted any time a triggering event occurs in relation to goodwill. Management believes that the significant market disruption in the financial sector and the declining market valuations experienced over the past nine months created a triggering event. As such, management conducted an interim evaluation of the carrying value of goodwill in June 2008, and updated this evaluation in September 2008. As a result of this analysis, no impairment was considered necessary as of September 30, 2008. However, future events could cause management to conclude that Intermountain's goodwill is impaired, which would result in the recording of an impairment

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loss. Any resulting impairment loss could have a material adverse impact on Intermountain's financial condition and results of operations.

Other intangible assets consisting of core-deposit intangibles with definite lives are amortized over the estimated life of the acquired depositor relationships.

**Real Estate Owned.** Property acquired through foreclosure of defaulted mortgage loans is carried at the lower of cost or fair value less estimated costs to sell. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable.

Intermountain reviews its real estate owned for impairment in value whenever events or circumstances indicate that the carrying value of the property may not be recoverable. In performing the review, if expected future undiscounted cash flow from the use of the property or the fair value, less selling costs, from the disposition of the property is less than its carrying value, a loss is recognized. Because of rapid declines in real estate values in the current distressed environment, management has increased the frequency and intensity of its valuation analysis on its OREO properties. As a result of this analysis, carrying values on some of these properties have been reduced, and it is reasonably possible that the carrying values could be reduced again in the near term.

### **Intermountain Community Bancorp**

#### **Comparison of the Three and Nine month Periods Ended September 30, 2008 and 2007**

#### **Results of Operations**

**Overview.** Intermountain recorded net income of \$226,000, or \$0.03 per diluted share for the three months ended September 30, 2008, compared with \$2.3 million or \$0.27 per diluted share for the second quarter of 2008 and net income of \$2.4 million or \$0.28 per diluted share, for the three months ended September 30, 2007. Intermountain recorded net income of \$4.1 million or \$0.50 per diluted share, for the nine months ended September 30, 2008, compared with net income of \$6.7 million or \$0.78 per diluted share, for the nine months ended September 30, 2007.

The annualized return on average assets ( ROA ) was 0.09%, 0.88% and 0.95% for the three months ended September 30, 2008, June 30, 2008 and September 30, 2007, respectively, and 0.53% and 0.93% for the nine months ended September 30, 2008 and 2007, respectively. The annualized return on average equity ( ROE ) was 1.0%, 10.0% and 11.4% for the three months ended September 30, 2008, June 30, 2008 and September 30, 2007, respectively, and 6.1% and 10.9% for the nine months ended September 30, 2008 and 2007, respectively. The decrease in both the return on average assets and the return on average equity over the prior nine-month period resulted from decreased net income, which did not keep pace with the increases in average assets and average equity.

The Company's three- and nine-month results ended September 30, 2008 clearly reflect increasingly difficult economic and credit conditions, combined with the adverse impacts of the significant decrease in market interest rates over the past year. Given the challenging conditions and heightened customer concerns about the safety of banks, management took additional steps in the third quarter to strengthen its balance sheet. In particular, it refocused efforts on deposit gathering, reduced residential real estate loan balances outstanding, and shifted funds into more liquid, but lower yielding assets. These efforts improved the regulatory capital, reserve and liquidity positions of the Bank, but also added pressure to earnings, as the company experienced lower asset yields and slightly higher funding costs. While it appears that customer concerns may be calming, management believes it is still prudent to focus on monitoring and managing its credit portfolio, preserving and building upon its already strong capital and liquidity position, enhancing its core deposit gathering competencies, and streamlining its operations. We believe that earnings will continue to be challenged in the near term, but effective positioning of the Company, its balance sheet and its infrastructure will create opportunities for future improvement and growth. With this long-term focus, we remain resolute in our commitment to serve our employees, customers and communities during this time. We believe this commitment will create significant opportunities for the Company as the industry experiences profound changes over the next few years.

**Net Interest Income.** The most significant component of earnings for the Company is net interest income, which is the difference between interest income from the Company's loan and investment portfolios, and interest expense from deposits, repurchase agreements and other borrowings. During the three months ended September 30, 2008, June 30, 2008 and September 30, 2007, net interest income was \$11.1 million, \$11.2 million, and \$12.4 million, respectively. During the nine months ended September 30, 2008 and 2007, net interest income was \$33.6 million and

\$34.7 million, respectively, a decrease of 3.09%.

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Average interest-earning assets increased by 6.3% to \$968.9 million for the three months ended September 30, 2008, compared to \$911.2 million for the three months ended September 30, 2007. The growth was driven by increases in average loans of \$24.9 million or 3.2% and in average investments and cash of \$32.8 million or 23.9% over the three month period in 2007. For the nine months ended September 30, 2008, average interest-earning assets increased 8.2% compared to the same period in 2007. For the nine-month period, average loans increased 7.1% or \$51.5 million while investments increased 13.9% or \$20.2 million. Loan growth continued to reflect increases in both existing markets and strong contributions from the new branches added in the last few years. The increase in investments and cash resulted from the Company's decision to place additional funding in short-term investments and cash equivalents to create additional short-term liquidity.

Average interest-bearing liabilities increased by 7.0% or \$62.4 million, including \$22.3 million (3.0%) growth in average deposits and \$40.1 million (26.0%) growth in other borrowings for the three month period ending September 2008 compared to September 2007. For the nine months ending September 30, 2008, average interest-bearing liabilities increased 9.3% or \$79.7 million compared to the nine months ending September 30, 2007. Increases in average deposits reflected both core deposit growth in the bank's markets and the addition of brokered certificates of deposit to create additional short-term liquidity. Much of the growth in other borrowings over this period resulted from increases in Federal Home Loan Bank advances used to fund loan growth and an investment-leverage strategy executed by the Company in late 2007 to protect against falling rates. With market rates falling rapidly while deposit rates lagged in terms of adjustments downward, the Company found it advantageous to obtain advances at favorable rates during this period of time. The Company also advanced additional funds from a holding company credit line to fund construction of the company's new headquarters. The net growth in the Company's interest-earning assets contributed approximately \$2.1 million to the net interest income of the Bank for the nine months ended September 30, 2008 versus the same period last year.

However, the positive impacts of increases in earning assets were more than offset by declines in the net interest margin. Net interest spread during the three months ended September 30, 2008, June 30, 2008, and September 30, 2007 was 4.54%, 4.76%, and 5.34%, respectively. Net interest margin was 4.56% for the three months ended September 30, 2008, a 0.23% decrease from three months ended June 30, 2008 and a 0.82% decrease from the same period last year. After some stabilization of margin in the second quarter of 2008, the Company experienced an additional decline in the third quarter. Factors contributing to this decline include the shift of funds into safer, lower-yielding assets, higher deposit costs in a competitive deposit market, and interest reversals on a few non-accrual loans. These factors are likely to again impact the margin in the fourth quarter, along with additional disconnects between the prime rate, which is declining in response to Federal Reserve actions, and other rates controlled more by supply and demand, such as LIBOR. This disconnect is exaggerating the downward pressure on asset yields and the upward pressure on the Company's funding rates. Net interest margins for the nine months ending September 30, 2008 and September 30, 2007 were 4.74% and 5.30%, respectively, again reflecting the factors mentioned above. Reductions in the margin over the same nine month prior period contributed a loss of \$2.8 million in net interest income.

Given the current level of interest rates, the bias toward potentially more Fed rate reductions and a competitive funding market, there is little the Company can prudently do to rapidly increase the Company's margin in the short-term. As such, management is focusing on building a balance sheet and core customer base to sustain current margin as much as possible, and prepare for a resumption in more normal economic and rate conditions in the future.

**Provision for Losses on Loans.** Management's policy is to establish valuation allowances for estimated losses by charging corresponding provisions against income. This evaluation is based upon management's assessment of various factors including, but not limited to, current and anticipated future economic trends, historical loan losses, delinquencies, underlying collateral values, as well as current and potential risks identified in the portfolio.

The provision for losses on loans increased to \$2.5 million for the three months ended September 30, 2008, compared to a provision of \$2.1 million for the three months ended June 30, 2008, and \$1.2 million for the three months ended September 30, 2007. The provision totaled \$4.9 million for the first nine months of 2008, compared to \$3.2 million for the nine months ended September 30, 2007. Net charge offs for the three months ended September 30, 2008 totaled \$2.3 million compared to \$1.2 million for the three months ended June 30, 2008, and \$611,000 for the

three months ended September, 30 2007. Net charge offs for the nine months ended September 30, 2008 totaled \$3.6 million compared to \$1.6 million for the same period in 2007. Annualized net charge-offs to average net loans increased to 1.17% for the three months ended September 30, 2008 compared to 0.61% for the three months ended June 30, 2008 and 0.32% for the three months ended September 30, 2007. Annualized net chargeoff rates for the 2008 nine-month period totaled 0.61% versus 0.30% in 2007. The increase in chargeoffs and provision in the third quarter reflected continuing challenges in the Company's residential real estate construction and land development loan portfolio. The Company took write-downs on a number of troubled real estate loans to reflect rapidly declining real estate valuations, and liquidated several loans, including one \$5 million credit, at discounted prices. While the Company believes it has identified and is actively managing

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its troubled real estate credits, elevated chargeoff and provision levels may continue for a few more quarters as markets continue to weaken and real estate valuations adjust downward.

The loan loss allowance to total loans ratio increased to 1.67% at September 30, 2008, compared to 1.62% at June 30, 2008 and 1.48% at September 30, 2007, respectively. Management believes this level of loan loss allowance is adequate for the balance and the mix of the loan portfolio at this time.

The following table summarizes loan loss allowance activity for the periods indicated.

	<b>Nine months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>	
Balance at January 1	\$ 11,761	\$ 9,837
Provision for losses on loans	4,872	3,228
Amounts written off, net of recoveries	(3,600)	(1,650)
Transfers		(3)
Allowance loans, September 30	13,033	11,412
Allowance unfunded commitments, January 1	18	482
Adjustment	(10)	(389)
Transfers		3
Allowance unfunded commitments, September 30	8	96
Total credit allowance including unfunded commitments	\$ 13,041	\$ 11,508

Reflective of the challenging economy the Company's overall credit quality continued to deteriorate from the second quarter of this year and the same period last year. At September 30, 2008, Intermountain's total classified assets were \$40.5 million, compared with \$39.1 million at June 30, 2008 and \$21.3 million at September 30, 2007. Classified assets are loans that management believes it may experience some problems in obtaining repayment under the contractual terms of the loan. However, categorizing a loan as classified does not necessarily mean that the company will experience any loss of expected principal or interest. Non-performing assets increased to \$22.7 million at September 30, 2008, compared to \$12.6 million at June 30, 2008, and \$2.6 million at September 30, 2007. Non-performing loans totaled \$19.9 million at September 30, 2008 versus \$9.7 million and \$1.5 million at June 30, 2008 and September 30, 2007, respectively. Other real estate owned totaled \$2.8 million at September 30, 2008 versus \$2.8 million and \$1.1 million at June 30, 2008 and September 30, 2007, respectively.

Non-performing assets comprised 2.2% of total assets at September 30, 2008, and 1.2% and 0.25% at June 30, 2008 and September 30, 2007, respectively. Non-performing assets to tangible equity plus the loan loss allowance were 25.25% at September 30, 2008 versus 13.80% at June 30, 2008 and 3.04% at September 2007. While higher, these totals compare favorably to many peer banks and are well below the ratios experienced by troubled banks. The 30 day and over loan delinquency rates were 1.09% at September 30, 2008, versus 0.29% at June 30, 2008, and 1.28% at September 30, 2007. Residential land and construction loans continue to make up most of the non-performing loan total, reflecting the ongoing severe weakness in the housing market. The Company has evaluated and is carefully monitoring its exposure to these types of assets in the current challenging environment, and is continuing to work with weaker borrowers to stabilize or liquidate its position.

While the Company's credit quality has softened, management has added resources to manage the portfolio even more actively, with a focus on identifying and resolving problems as quickly as possible. As troubled loans arise, it is analyzing current and projected conditions and evaluating carefully whether to liquidate immediately or work with borrowers to avoid liquidation. Given the worsening economic forecast, some level of heightened loss activity is



likely to continue, but based on its internal analysis, including stress testing of its portfolio under differing economic scenarios, management continues to believe that its current level of loan loss reserves and capital can withstand credit losses well in excess of those reasonably anticipated or experienced in prior economic downturns.

**Other Income.** Total other income was \$3.0 million, \$5.2 million, and \$3.6 million for the three months ended September 30, 2008, June 30, 2008, and September 30, 2007, respectively. Total other income was \$11.0 million and \$9.8 million for the nine months ended September 30, 2008 and 2007, respectively. 2008 results included a \$2.2 million pre-tax gain on the sale of \$32.0 million in investment securities in April 2008. Management sold these securities, recognized the

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gain, and reinvested the proceeds in securities with similar risk profiles but higher predicted returns over multiple interest-rate scenarios.

Driven largely by increases in trust, investment and debit card income, fees and service charge income increased by \$386,000 or 6.14% for the nine month period ended September 30, 2008, compared to the same nine month period last year. This was offset, however, by a \$981,000 decrease in mortgage banking activity and reductions in the Company's contractual income from its secured card portfolio, as new card marketing and activity slowed during this period. The Company continues to expand its marketing activity for trust, investment and insurance services, and add more business solutions to its product mix. In addition, it rolled out new programs in the third quarter to increase distribution, activation and usage of its debit cards. These efforts, along with several other new upcoming initiatives are expected to have a positive impact on fee income in the future.

**Operating Expenses.** Operating expenses were \$11.4 million for the three months ended September 30, 2008, compared to \$10.6 million for the three months ended June 30, 2008 and \$10.7 million for the three months ended September 30, 2007. Operating expenses were \$33.3 million for the nine months ended September 30, 2008, a 9.8% increase compared to \$30.4 million for the nine months ended September 30, 2007.

The Company's efficiency ratio was 80.9% for the three months ended September 30, 2008, compared to 64.8% for three months ended June 30, 2008 and 67.2% for the three months ended September 30, 2007. For the comparative nine month periods, the efficiency ratio equaled 74.6% in 2008 versus 68.2% in 2007. The Company has been executing strategies to reduce controllable expenses to improve efficiency. However, flat asset growth combined with decreases in the net interest margin and mortgage banking income, and increases in expenses that are less controllable in the short-term, such as facilities and FDIC premiums, have hampered efficiency gains. Company management will continue to refine business processes and control staffing and other more controllable costs, but is not pursuing across-the-board expense cuts at this time because of the potential negative impacts on company culture, community perception and long-term results.

Salaries and employee benefits were \$6.4 million for the three months ended September 30, 2008, a 16.6% increase over the three months ended June 30, 2008 and a 3.0% decrease over the three months ended September 30, 2007. Second quarter 2008 comparative results were impacted by the reversal of \$640,000, pre-tax, in accrued executive bonuses that are not likely to be paid at the end of the year. Salaries and employee benefits were \$18.9 million for the nine months ended September 30, 2008, a 0.87% decrease compared to \$19.1 million for the nine months ended September 30, 2007. The Company achieved these results by reducing staffing levels and decreasing executive and employee incentive accruals during the first nine months of this year. These efforts offset a substantial increase in medical premiums for 2008. At September 30, 2008, full-time-equivalent employees totaled 442, compared with 465 at September 30, 2007.

Occupancy expenses were \$2.0 million for the three months ended September 30, 2008, a 3.4% increase compared to the three months ended June 30, 2008 and a 29.9% increase compared to the three months ended September 30, 2007. Occupancy expenses were \$5.6 million for the nine months ended September 30, 2008, a 27.7% increase compared to \$4.4 million for the nine months ended September 30, 2007. These increases reflected additional building expense from new facilities opened in 2007 and 2008 and additional computer hardware and software purchased to enhance security, compliance and business continuity. In particular, the opening of the Spokane Valley Office in August 2007 and the new Sandpoint Center in April 2008 impacted these results. These expense levels will likely stabilize in future periods, as the Company leases out the remaining Sandpoint Center space and has no significant plans for branch expansion in the near future.

Other non-interest expenses were \$2.9 million for the three months ended September 30, 2008, a 6.2% decrease over the three months ended June 30, 2008 and a 17.9% increase compared to the three months ended September 30, 2007. Other non-interest expenses were \$8.7 million for the nine months ended September 30, 2008, a 28.4% increase compared to \$6.8 million for the nine months ended September 30, 2007. The increase in other expenses can be attributed to a \$392,000 increase in consulting fees to streamline business processes, a \$382,000 increase as a result of the reinstatement of FDIC insurance fees industry-wide and smaller increases in loan collection and computer services fees. In addition, the 2008 comparative numbers are negatively impacted by the reversal in 2007 of \$384,000 as a result of adjusting the allowance for unfunded loan commitments down.

Increases in FDIC insurance premiums and near-term loan collection expenses will likely continue to negatively impact the Company's expenses. However, the impacts of the business process improvement efforts are taking hold in other areas, including salary, benefits, printing, supply and travel expenses. Management anticipates that as it completes the action plans developed under these initiatives over the next few months and resumes increased asset growth levels, its efficiency and expense ratios will improve in future periods.

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**Income Tax Provision.** Intermountain recorded federal and state income tax provisions of \$2 thousand, \$1.4 million and \$1.6 million for the three months ended September 30, 2008, June 30, 2008 and September 30, 2007, respectively. Intermountain recorded federal and state income tax provisions of \$2.3 million and \$4.2 million for the nine months ended September 30, 2008 and 2007, respectively. The effective tax rates were 1.0%, 37.5% and 39.7% for the three months ended September 30, 2008, June 30, 2008 and September 30, 2007, respectively. The effective tax rates were 35.7% and 38.7% for the nine months ended September 30, 2008 and 2007, respectively. The decline in the effective tax rates over last year reflects lower pre-tax income, a higher level of investment tax credits, and additional tax benefits realized from changes in federal tax policy.

**Financial Position**

**Assets.** At September 30, 2008, Intermountain's assets were \$1.05 billion, up \$586,000 from \$1.05 billion at December 31, 2007. During this period, increases in loans receivable, cash and cash equivalents, investments held to maturity and office properties and equipment were offset by decreases in investments available-for-sale. Asset growth, and particularly loan growth, was relatively muted during both the third quarter and the nine-month period as management sought to bolster its financial position in the face of volatile economic and liquidity conditions.

**Investments.** Intermountain's investment portfolio at September 30, 2008 was \$150.4 million, a decrease of \$21.5 million from the December 31, 2007 balance of \$171.9 million. The decrease was primarily due to the maturity of short-term U. S. Government obligations and paydowns on mortgage-backed securities. Funds from this decrease were used to help fund the moderate expansion of the loan portfolio and the increase in highly liquid cash and cash equivalents. As of September 30, 2008, the balance of the unrealized loss on investment securities, net of federal income taxes, was \$3.0 million, compared to an unrealized gain at December 31, 2007 of \$1.3 million. The sale of the \$32.0 million investment security at a pre-tax gain of \$2.2 million, illiquid markets for some of the Company's securities, and increasing long-term market rates decreased the market value of the securities, resulting in an unrealized loss at September 30, 2008. As discussed in Footnote 7 in the Consolidated Financial Statements above, Company management conducted careful analysis to develop reasonable market valuations for its available-for-sale securities and to determine that all of the unrealized loss noted above reflects temporary impairments of the securities in the portfolio.

**Loans Receivable.** At September 30, 2008 net loans receivable totaled \$766.6 million, up \$10.1 million or 1.3% from \$756.5 million at December 31, 2007. During the nine months ended September 30, 2008, total loan originations were \$440.9 million compared with \$498.0 million for the prior year's comparable period. The decreases were primarily due to slowing economic conditions and tighter underwriting standards, particularly related to land, subdivision development and construction lending. While the Company is utilizing tighter underwriting standards and reducing its concentration in residential real estate loans, it continues to seek strong loan opportunities in commercial, consumer, agricultural and commercial real estate segments.

The following table sets forth the composition of Intermountain's loan portfolio at the dates indicated. Loan balances exclude deferred loan origination costs and fees and allowances for loan losses.

	September 30, 2008		December 31, 2007	
	Amount	%	Amount	%
	(Dollars in thousands)			
Commercial	\$ 231,364	29.66	\$ 240,421	31.27
Commercial real estate	412,099	52.84	383,018	49.80
Residential real estate	107,175	13.74	114,010	14.83
Consumer	24,123	3.09	26,285	3.42
Municipal	5,182	0.67	5,222	0.68
Total loans receivable	779,943	100.00	768,956	100.00
Net deferred origination fees	(285)		(646)	
Allowance for losses on loans	(13,033)		(11,761)	

Loans receivable, net	\$ 766,625	\$ 756,549
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Weighted average yield at end of period	7.01%	8.16%
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The following table sets forth Intermountain's loan originations for the periods indicated.

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	Three Months Ended September 30,			Nine months Ended September 30,		
	2008	2007	% Change (Dollars in thousands)	2008	2007	% Change
Commercial	\$ 48,544	\$ 43,857	10.7	\$ 173,189	\$ 205,925	(15.9)
Commercial real estate	64,898	47,920	35.4	198,337	194,289	2.1
Residential real estate	20,078	29,079	(31.0)	59,745	75,055	(20.4)
Consumer	2,695	6,587	(59.1)	8,943	16,484	(45.7)
Municipal	165	3,365	(95.1)	640	6,268	(89.8)
Total loans originated	\$ 136,380	\$ 130,808	4.3	\$ 440,854	\$ 498,021	(11.5)

Total commercial real estate loans, including construction, and land acquisition and development loans comprised 403.2% of estimated Tier 1 capital at September 30, 2008, as compared to 407.7% at June 30, 2008 and 408.4% at September 30, 2007. Construction, acquisition and development loans comprised 260.2% of estimated Tier 1 capital versus 264.9% at June 30, 2008 and 305.2% at September 30, 2007, respectively. For these loan ratios, commercial real estate balances are calculated using guidelines issued as part of more general guidance on real estate concentrations by the federal banking regulators in 2007. As reflected in the figures above, the Company is working to reduce its concentration of construction, acquisition and development loans, with further decreases expected in upcoming periods as existing loans continue to roll off. The Company's commercial real estate and construction, acquisition and development portfolios are dispersed throughout its market area, with heavier concentrations in north Idaho, Canyon County and the Magic Valley. The Company has relatively limited exposure to the Boise market.

**Office Properties and Equipment.** Office properties and equipment increased 6.5% to \$44.8 million from \$42.1 million at December 31, 2007 due primarily to continued progress on the Sandpoint Center. The building is now complete and the Company's Sandpoint branch and administrative staff have been relocated. Management is now working to lease the remaining space to other interested parties.

**BOLI and All Other Assets.** Bank-owned life insurance ( BOLI ) and other assets increased to \$27.3 million at September 30, 2008 from \$23.5 million at December 31, 2007. The increase was primarily due to increases in the net deferred tax asset, prepaid expenses and accrued interest receivable. Intangible assets decreased slightly as a result of continuing amortization of the core deposit intangible. As discussed above in the Critical Accounting Policies section, the Company again evaluated its goodwill asset in the third quarter and determined that no impairment existed.

**Deposits.** Total deposits increased \$12.5 million to \$770.4 million at September 30, 2008 from \$757.8 million at December 31, 2007. In addition to slowing economic conditions and a reduction in real-estate related customer balances, negative publicity and high rates offered by national banks impacted the Company's deposit volumes during the nine-month period. However, in this challenging and competitive market environment, the Company increased deposits by \$28.7 million in the third quarter as it re-focused on core deposit growth. Management has shifted resources and implemented compensation plans, promotional strategies and new products to spur local deposit growth. It also increased its usage of short-term brokered certificates of deposit in the third quarter to enhance its short-term liquidity position.

The following table sets forth the composition of Intermountain's deposits at the dates indicated.

	September 30, 2008		December 31, 2007	
	Amount	%	Amount	%
	(Dollars in thousands)			
Demand	\$ 147,816	19.2	\$ 159,069	21.0
NOW and money market 0.0% to 6.07%	323,484	42.0	308,857	40.8
Savings and IRA 0.0% to 4.2%	80,290	10.4	87,149	11.5

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Certificate of deposit accounts	218,777	28.4	202,763	26.7
Total deposits	\$ 770,367	100.0	\$ 757,838	100.0
Weighted average interest rate on certificates of deposit		3.23%		4.57%

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***Borrowings.*** Deposit accounts are Intermountain's primary source of funds. Intermountain also relies upon advances from the Federal Home Loan Bank of Seattle, repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. These borrowings totaled \$181.8 million and \$190.1 million at September 30, 2008 and December 31, 2007, respectively. The decrease resulted from decreases in repurchase agreements and Fed Funds borrowed, partially offset by increases in FHLB advances and credit line borrowing. FHLB advances were used to fund loan growth and the repurchase agreement decreases, as advance rates compared favorably during this period to other borrowing rates. The credit line was utilized to complete the Sandpoint Center. See *Liquidity and Sources of Funds* for additional information.

**Interest Rate Risk**

The results of operations for financial institutions may be materially and adversely affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values and the monetary and fiscal policies of the federal government. Like all financial institutions, Intermountain's net interest income and its NPV (the net present value of financial assets, liabilities and off-balance sheet contracts), are subject to fluctuations in interest rates. Intermountain utilizes various tools to assess and manage interest rate risk, including an internal income simulation model that seeks to estimate the impact of various rate changes on the net interest income and net income of the bank. This model is validated by comparing results against various third-party estimations. Currently, the model and third-party estimates indicate that Intermountain is slightly asset-sensitive. An asset-sensitive bank generally sees improved net interest income and net income in a rising rate environment, as its assets reprice more rapidly and/or to a greater degree than its liabilities. The opposite is true in a falling interest rate environment. When market rates fall, an asset-sensitive bank tends to see declining income. Net interest income results for the past year reflect this, as short-term market rates fell 4.25% over the past 14 months, resulting in significantly lower net interest income and net income levels, particularly in relation to the level of interest-earning assets.

To minimize the long-term impact of fluctuating interest rates on net interest income, Intermountain promotes a loan pricing policy of utilizing variable interest rate structures that associates loan rates to Intermountain's internal cost of funds and to the nationally recognized prime lending rate. While this strategy has had adverse impacts in the current unusual rate environment, the approach historically has contributed to a relatively consistent interest rate spread over the long-term and reduces pressure from borrowers to renegotiate loan terms during periods of falling interest rates. Intermountain currently maintains over fifty percent of its loan portfolio in variable interest rate assets.

Additionally, the extent to which borrowers prepay loans is affected by prevailing interest rates. When interest rates increase, borrowers are less likely to prepay loans. When interest rates decrease, borrowers are generally more likely to prepay loans. However, in the current tight credit markets, prepayment speeds are relatively slow even given the significant drop in interest rates. Prepayments may affect the levels of loans retained in an institution's portfolio, as well as its net interest income. Intermountain maintains an asset and liability management program intended to manage net interest income through interest rate cycles and to protect its income by controlling its exposure to changing interest rates.

On the liability side, Intermountain seeks to manage its interest rate risk exposure by maintaining a relatively high percentage of non-interest bearing demand deposits, interest-bearing demand deposits and money market accounts. These instruments tend to lag changes in market rates and may afford the bank more protection in increasing interest rate environments, but can also be changed relatively quickly in a declining rate environment. The Bank utilizes various deposit pricing strategies and other borrowing sources to manage its rate risk.

As discussed above, Intermountain uses a simulation model designed to measure the sensitivity of net interest income and net income to changes in interest rates. This simulation model is designed to enable Intermountain to generate a forecast of net interest income and net income given various interest rate forecasts and alternative strategies. The model is also designed to measure the anticipated impact that prepayment risk, basis risk, customer maturity preferences, volumes of new business and changes in the relationship between long-term and short-term interest rates have on the performance of Intermountain. The results of current modeling are within guidelines established by the Company for changes in net interest income, but outside of guidelines for changes in net income, particularly in a 100 and 300 basis point downward adjustment in market rates, a scenario that management believes is unlikely given current market interest rates. The scenario analysis for net income has also been impacted by the lower



current year earnings of the Company, which increases the impact of both downward and upward adjustments. In general, model results reflect performance improvement in the case of a rising rate environment, and a marginal additional negative impact in a falling rate environment.

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Intermountain is continuing to pursue strategies to manage the level of its interest rate risk while increasing its long-term net interest income and net income; 1) through the origination and retention of variable and fixed-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans, and 2) by increasing the level of its core deposits, which are generally a lower-cost, less rate-sensitive funding source than wholesale borrowings. There can be no assurance that Intermountain will be successful implementing any of these strategies or that, if these strategies are implemented, they will have the intended effect of reducing interest rate risk or increasing net interest income.

Intermountain also uses gap analysis, a traditional analytical tool designed to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to reprice in a given period. Intermountain calculated its one-year cumulative repricing gap position to be negative 31% at both September 30, 2008 and December 31, 2007, respectively. Management attempts to maintain Intermountain's gap position between positive 20% and negative 35%. At September 30, 2008 Intermountain's gap position was within the recommended guidelines.

**Liquidity and Sources of Funds**

As a financial institution, Intermountain's primary sources of funds from assets include the collection of loan principal and interest payments, cash flows from various investment securities, and sales of loans, investments or other assets. Liability financing sources consist primarily of customer deposits, repurchase obligations with local customers, advances from FHLB Seattle and correspondent bank borrowings.

Deposits increased to \$770.4 million at September 30, 2008 from \$757.8 million at December 31, 2007, primarily due to increases in NOW accounts and certificates of deposit. This increase, along with a \$25 million increase in Federal Home Loan Bank advances, was used to fund the moderate increase in loan balances and a larger reduction in repurchase agreement balances outstanding. At September 30, 2008 and December 31, 2007, securities sold subject to repurchase agreements were \$87.2 million and \$124.1 million, respectively. The drop reflected seasonal reductions in municipal customer balances, along with movement of funds by customers to higher-yielding sources, both inside and outside the Bank. These borrowings are required to be collateralized by investments with a market value exceeding the face value of the borrowings. Under certain circumstances, Intermountain could be required to pledge additional securities or reduce the borrowings.

During the nine months ended September 30, 2008, cash used in investing activities consisted primarily of the funding of new loan volumes. During the same period, cash used in financing activities consisted primarily of decreases in demand deposits, money market accounts and savings deposits, and a reduction in the Company's repurchase agreements. These reductions were offset by increases in NOW accounts, certificates of deposit, and other borrowings.

Intermountain's credit line with FHLB Seattle provides for borrowings up to a percentage of its total assets subject to general collateralization requirements. At September 30, 2008, the Company's credit line represented a total borrowing capacity of approximately \$118.7 million, of which \$54.0 million was being utilized. Intermountain also borrows on an unsecured basis from correspondent banks and other financial entities. Correspondent banks and other financial entities provided additional borrowing capacity of \$141.3 million at September 30, 2008. As of September 30, 2008 there were no unsecured funds borrowed.

Intermountain maintains an active liquidity monitoring and management plan, and has worked aggressively over the past year to expand its sources of alternative liquidity. In addition to the sources indicated above, the Company is finalizing a new credit line with the Federal Reserve with an expected initial borrowing capability of approximately \$25 million, marketing the CDARs deposit exchange and purchase program, and maintaining its strong ratings with the national certificate of deposit brokers. Given extremely volatile conditions in the third quarter, the Company took additional protective measures to enhance liquidity, including intensive customer education and communication efforts, movement of funds into highly liquid assets and increased emphasis on deposit-gathering efforts. Because of its relatively low reliance on non-core funding sources and the additional efforts undertaken to improve liquidity discussed above, management believes that the Company's liquidity risk is moderate and manageable.

**Capital Resources**

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Intermountain's total stockholders' equity was \$89.0 million at September 30, 2008, compared with \$90.1 million at December 31, 2007. The decrease in total stockholders' equity was primarily due to an increase in the unrealized loss on the investment portfolio. This offset the gains resulting from retaining the net income of the Company. Stockholders' equity was 8.5% of total assets at September 30, 2008 and 8.6% at December 31, 2007.

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At September 30, 2008, Intermountain had an unrealized loss of \$3.0 million, net of related income taxes, on investments classified as available-for-sale, as compared to an unrealized gain of \$1.3 million, net of related income taxes, on investments classified as available-for-sale at December 31, 2007. The sale of the \$32.0 million investment security at a pre-tax gain of \$2.2 million, illiquid markets for some of the Company's securities, and increasing long-term market rates decreased the market value of the securities, resulting in the unrealized loss. Fluctuations in prevailing interest rates and turmoil in global debt markets continue to cause volatility in this component of accumulated comprehensive loss in stockholders' equity and may continue to do so in future periods.

Intermountain issued and has outstanding \$16.5 million of Trust Preferred Securities. The indenture governing the Trust Preferred Securities limits the ability of Intermountain under certain circumstances to pay dividends or to make other capital distributions. The Trust Preferred Securities are treated as debt of Intermountain. These Trust Preferred Securities can be called for redemption beginning in March 2008 by the Company at 100% of the aggregate principal plus accrued and unpaid interest. See Note 3 of Notes to Consolidated Financial Statements.

Intermountain and Panhandle are required by applicable regulations to maintain certain minimum capital levels and ratios of total and Tier 1 capital to risk-weighted assets, and of Tier I capital to average assets. Intermountain and Panhandle plan to maintain their capital resources and regulatory capital ratios through the retention of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At September 30, 2008, Intermountain exceeded both its internal guidelines and all such regulatory capital requirements and was well-capitalized pursuant to FFIEC regulations. Given current economic conditions, the Company's internal standards call for minimum capital levels higher than those required by regulators to be considered well-capitalized. On October 3, 2008, Congress approved and the President signed the Emergency Economic Stabilization Act of 2008 (the Act). The Troubled Assets Relief Program (TARP) is the heart of the Act and provides the Secretary of the Treasury the authority to purchase troubled assets from eligible financial institutions in an aggregate amount of up to \$700 billion. Under the Act, the Treasury created the Capital Purchase Program (CPP) that enables the federal government to purchase equity in participating financial institutions to help restore credit markets. Application to participate in the CPP must be submitted by November 14, 2008. Management is currently evaluating the terms of the program to determine whether it will apply.

The following tables set forth the amounts and ratios regarding actual and minimum core Tier 1 risk-based and total risk-based capital requirements, together with the amounts and ratios required in order to meet the definition of a well-capitalized institution as reported on the quarterly FFIEC call report at September 30, 2008.

	Actual		Capital Requirements		Well-Capitalized Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets):						
The Company	\$107,394	11.87%	\$72,366	8%	\$90,458	10%
Panhandle State Bank	108,603	12.01%	72,367	8%	90,459	10%
Tier I capital (to risk-weighted assets):						
The Company	96,065	10.62%	36,183	4%	54,275	6%
Panhandle State Bank	97,274	10.75%	36,184	4%	54,275	6%
Tier I capital (to average assets):						
The Company	96,065	9.28%	41,405	4%	51,757	5%
Panhandle State Bank	97,274	9.46%	41,131	4%	51,414	5%

**Off Balance Sheet Arrangements and Contractual Obligations**

Intermountain, in the conduct of ordinary business operations, routinely enters into contracts for services. These contracts may require payment for services to be provided in the future and may also contain penalty clauses for the early termination of the contracts. Intermountain is also party to financial instruments with off-balance sheet risk in

the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Management does not believe that these off-balance sheet arrangements have a material current effect on Intermountain's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, but there is no assurance that such arrangements will not have a future effect.

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The following table represents Intermountain's on-and-off balance sheet aggregate contractual obligations to make future payments as of September 30, 2008.

	<b>Total</b>	<b>Payments Due by Period</b>			<b>More than 5 years</b>
		<b>Less than 1 year</b>	<b>1 to 3 years</b>	<b>3 to 5 years</b>	
			<b>(Dollars in thousands)</b>		
Long-term debt (1)	\$ 84,596	\$ 1,616	\$ 12,721	\$ 32,241	\$ 38,018
Short-term debt (1)	125,922	125,922			
Capital lease obligations					
Operating lease obligations (2)	14,190	1,054	1,501	1,323	10,312
Purchase obligations (3)	488	488			
Other long-term liabilities reflected on the registrant's balance sheet under GAAP					
<b>Total</b>	<b>\$ 225,196</b>	<b>\$ 129,080</b>	<b>\$ 14,222</b>	<b>\$ 33,564</b>	<b>\$ 48,330</b>

(1) Includes interest payments.

(2) Excludes recurring accounts payable, accrued expenses and other liabilities, repurchase agreements and customer deposits, all of which are recorded on the Company's balance sheet.

(3) The Company is completing construction of the 94,000 square foot Sandpoint Center. The Sandpoint branch and

administrative  
staff were  
relocated to the  
Sandpoint  
Center during  
the second  
quarter of 2008.

### **New Accounting Pronouncements**

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, Effective Date of FASB Statement No. 157. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

On October 10, 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. The FSP clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective immediately, and includes prior period financial statements that have not yet been issued, and therefore the Company is subject to the provision of the FSP effective September 30, 2008. See Notes to Financial Statements, Note 7, Fair Value Measurements for further discussion of the impact of SFAS No. 157 and the additional guidance issued.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008, the effective date of the standard.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interest in Consolidated Financial Statements ( SFAS 160 ). SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. The effective date for SFAS 160 is for annual periods beginning on or after December 15, 2008. Early adoption and retroactive application of SFAS 160 to fiscal years preceding the effective date are not permitted. The Company is evaluating the impact of adoption on its Consolidated Financial Statements.

In December 2007, the FASB issued Statement No. 141(R) *Business Combinations*. This statement replaces FASB Statement No. 141 *Business Combinations*. SFAS No. 141(R) establishes principles and requirements for how an

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acquiring company (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The new standard is effective for the Company on January 1, 2009. The Company is currently evaluating the impact of adopting SFAS No. 141(R) on the Consolidated Financial Statements, but does not expect any material impact unless the Company engages in new business combinations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ( SFAS 161 ). SFAS 161 requires specific disclosures regarding the location and amounts of derivative instruments in the Company's financial statements; how derivative instruments and related hedged items are accounted for; and how derivative instruments and related hedged items affect the Company's financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued and for fiscal years and interim periods after November 15, 2008. Early application is permitted. SFAS 161 impacts the Company's disclosure, but not its accounting treatment for derivative instruments and related hedged items. The Company's adoption of SFAS 161 will impact the disclosures in the Consolidated Financial Statements.

In May 2008, FASB issued Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States (the GAAP hierarchy). SFAS No. 162 divides the body of GAAP into four categories by level of authority. This statement is effective in the fourth quarter of 2008.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4 ( EITF 06-4 ), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. Effective January 1, 2008, the Company recorded a liability in the amount of \$389,000 and a reduction in equity in the amount of \$235,000 to record the liability as of January 1, 2008.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value through Earnings ( SAB 109 ). Previously, SAB 105, Application of Accounting Principles to Loan Commitments, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company believes the impact of this standard to be immaterial.

### **Forward-Looking Statements**

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

Forward-looking statements provide our expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and



uncertainties. These statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond our control, which could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

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the strength of the United States economy in general and the strength of the local economies and real estate markets in which Intermountain conducts its operations;

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

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

applicable laws and regulations and legislative or regulatory changes;

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

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

Intermountain's success in gaining regulatory approvals, when required;

technological and management changes;

announcement and successful and timely implementation of growth, acquisition and efficiency strategies;

Intermountain's ability to successfully integrate entities that may be or have been acquired;

changes in consumer spending and saving habits; and

Intermountain's success at managing the risks involved in the foregoing.

**Item 3 Quantitative and Qualitative Disclosures About Market Risk**

The information set forth under the caption Item 7A. Quantitative and Qualitative Disclosures about Market Risk included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, is hereby incorporated herein by reference.

**Item 4 Controls and Procedures**

(a) **Evaluation of Disclosure Controls and Procedures:** An evaluation of Intermountain's disclosure controls and procedures (as required by section 13a-15(b) of the Securities Exchange Act of 1934 (the "Act")) was carried out under the supervision and with the participation of Intermountain's management, including the Chief Executive Officer and the Chief Financial Officer. Our Chief Executive Officer and Chief Financial Officer concluded that based on that evaluation, our disclosure controls and procedures as currently in effect are effective, as of September 30, 2008, in ensuring that the information required to be disclosed by us in the reports we file or submit under the Act is

(i) accumulated and communicated to Intermountain's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) **Changes in Internal Control over Financial Reporting:** In the nine months ended September 30, 2008, there were no changes in Intermountain's internal control over financial reporting that materially affected, or are reasonably likely to materially affect, Intermountain's internal control over financial reporting.

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**PART II Other Information**

**Item 1 Legal Proceedings**

Intermountain and Panhandle are parties to various claims, legal actions and complaints in the ordinary course of business. In Intermountain's opinion, all such matters are adequately covered by insurance, are without merit or are of such kind, or involve such amounts, that unfavorable disposition would not have a material adverse effect on the consolidated financial position or results of operations of Intermountain.

**Item 1A Risk Factors**

**As a financial holding company, our earnings are dependent upon the performance of our bank as well as business, economic and political conditions.**

Intermountain is a legal entity separate and distinct from the Bank. Our right to participate in the assets of the Bank upon the Bank's liquidation, reorganization or otherwise will be subject to the claims of the Bank's creditors, which will take priority except to the extent that we may be a creditor with a recognized claim.

The Company is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. These restrictions may affect the amount of dividends the Company may declare for distribution to its shareholders in the future.

Earnings are impacted by business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, monetary supply, fluctuations in both debt and equity capital markets, and the strength of the U.S. economy and the local economies in which we operate. Business and economic conditions that negatively impact household or corporate incomes could decrease the demand for our products and increase the number of customers who fail to pay their loans.

**A further downturn in the local economies or real estate markets could negatively impact our banking business.**

The Company has a high concentration in the real estate market and a downturn in the local economies or real estate markets could negatively impact our banking business. Because we primarily serve individuals and businesses located in northern, southwestern and southcentral Idaho, eastern Washington and southeastern Oregon, a significant portion of our total loan portfolio is originated in these areas or secured by real estate or other assets located in these areas. As a result of this geographic concentration, the ability of customers to repay their loans, and consequently our results, are impacted by the economic and business conditions in our market areas. While the Pacific Northwest economy typically lags the national economy, the effects of the global and national economic slowdown have impacted our market area. Any additional adverse economic or business developments or natural disasters in these areas could cause uninsured damage and other loss of value to real estate that secures our loans or could negatively affect the ability of borrowers to make payments of principal and interest on the underlying loans. In the event of such adverse development or natural disaster, our results of operations or financial condition could be adversely affected. Our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would more likely suffer losses on defaulted loans.

Furthermore, current uncertain geopolitical trends and variable economic trends, including uncertainty regarding economic growth, inflation and unemployment, may negatively impact businesses in our markets. While the short-term and long-term effects of these events remain uncertain, they could adversely affect general economic conditions, consumer confidence, market liquidity or result in changes in interest rates, any of which could have a negative impact on the banking business.

**We cannot predict the effect of the recently enacted federal rescue plan.**

Congress recently enacted the Emergency Economic Stabilization Act of 2008, which is intended to stabilize the financial markets, including providing funding of up to \$700 billion to purchase troubled assets and loans from financial institutions. The legislation also increases the amount of deposit account insurance coverage from \$100,000 to \$250,000 for interest-bearing deposit accounts and non-interest bearing transaction accounts, the latter of which are fully insured until December 31, 2009. Most recently, the federal government agreed to invest \$125 billion in preferred stock of nine U.S. financial institutions, and to make available up to another \$125 billion for investment in preferred stock of other U.S. financial institutions, on certain terms and conditions. The full effect of this wide-ranging legislation on the national economy and financial institutions, particularly on mid-sized institutions like us, cannot

now be predicted.

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**Changes in market interest rates could adversely affect our earnings.**

Our earnings are impacted by changing market interest rates. Changes in market interest rates impact the level of loans, deposits and investments, the credit profile of existing loans, the rates received on loans and investment securities, and the rates paid on deposits and borrowings. One of our primary sources of income from operations is net interest income, which is equal to the difference between the interest income received on interest-earning assets (usually loans and investment securities) and the interest expense incurred in connection with interest-bearing liabilities (usually deposits and borrowings). These rates are highly sensitive to many factors beyond our control, including general economic conditions, both domestic and foreign, and the monetary and fiscal policies of various governmental and regulatory authorities. Net interest income can be affected significantly by changes in market interest rates. Changes in relative interest rates may reduce net interest income as the difference between interest income and interest expense decreases.

Market interest rates have shown considerable volatility over the past several years. After rising through much of 2005 and the first half of 2006, short-term market rates flattened and the yield curve inverted through the latter half of 2006 and the first half of 2007. In this environment, short-term market rates were higher than long-term market rates, and the amount of interest we paid on deposits and borrowings increased more quickly than the amount of interest we received on our loans, mortgage-related securities and investment securities. In the latter half of 2007 and throughout 2008, short-term market rates declined significantly and unexpectedly, causing asset yields to decline and margin compression to occur. If this trend continues, it could cause our net interest margin to decline further and profits to decrease.

Should rates start rising again, interest rates would likely reduce the value of our investment securities and may decrease demand for loans and make it more difficult for borrowers to repay their loans. Increasing market interest rates may also depress property values, which could affect the value of collateral securing our loans.

An increase in interest rates could also have a negative impact on our results of operations by reducing the ability of borrowers to repay their current loan obligations. These circumstances could not only result in increased loan defaults, foreclosures and write-offs, but also necessitate further increases to the allowances for loan losses.

Should market rates fall further, rates on our assets may fall faster than rates on our liabilities, resulting in decreased income for the bank. Fluctuations in interest rates may also result in disintermediation, which is the flow of funds away from depository institutions into direct investments that pay a higher rate of return and may affect the value of our investment securities and other interest-earning assets.

Our cost of funds may increase because of general economic conditions, unfavorable conditions in the capital markets, interest rates and competitive pressures. We have traditionally obtained funds principally through deposits and borrowings. As a general matter, deposits are a cheaper source of funds than borrowings, because interest rates paid for deposits are typically less than interest rates charged for borrowings. If, as a result of general economic conditions, market interest rates, competitive pressures, or other factors, our level of deposits decrease relative to our overall banking operation, we may have to rely more heavily on borrowings as a source of funds in the future, which may negatively impact net interest margin.

**Competition may adversely affect our ability to attract and retain customers at current levels.**

The banking and financial services businesses in our market areas are highly competitive. Competition in the banking, mortgage and finance industries may limit our ability to attract and retain customers. We face competition from other banking institutions, savings banks, credit unions and other financial institutions. We also compete with non-bank financial service companies within the states that we serve and out of state financial intermediaries that have opened loan production offices or that solicit deposits in our market areas. There has also been a general consolidation of financial institutions in recent years, which results in new competitors and larger competitors in our market areas.

In particular, our competitors include major financial companies whose greater resources may provide them a marketplace advantage. Areas of competition include interest rates for loans and deposits, efforts to obtain deposits and the range and quality of services provided. Because we have fewer financial and other resources than larger institutions with which we compete, we may be limited in our ability to attract customers. In addition, some of the current commercial banking customers may seek alternative banking sources as they develop needs for credit facilities larger than we can accommodate. If we are unable to attract and retain customers, we may be unable to continue our

loan and deposit growth, and our results of operations and financial condition may otherwise be negatively impacted.

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**Additional market concern over investment securities backed by mortgage loans could create losses in the Company's investment portfolio**

A majority of the Company's investment portfolio is comprised of securities where mortgages are the underlying collateral. These securities include agency-guaranteed mortgage backed securities and collateralized mortgage obligations, and non-agency-guaranteed collateralized mortgage obligations. With the national downturn in real estate markets and the rising mortgage delinquency and foreclosure rates, investors are increasingly concerned about these securities. The potential for subsequent discounting, if deemed to be other than a temporary impairment, could lead to the permanent impairment in the value of these investments. This impairment could negatively impact earnings and the Company's capital position.

**We may not be able to successfully implement our internal growth strategy.**

We have pursued and intend to continue to pursue an internal growth strategy, the success of which will depend primarily on generating an increasing level of loans and deposits at acceptable risk levels and terms, without proportionate increases in non-interest expenses. There can be no assurance that we will be successful in implementing our internal growth strategy. Furthermore, the success of our growth strategy will depend on maintaining sufficient regulatory capital levels and on continued favorable economic conditions in our market areas.

**There are risks associated with potential acquisitions.**

We may make opportunistic acquisitions of other banks or financial institutions from time to time that further our business strategy. These acquisitions could involve numerous risks including lower than expected performance or higher than expected costs, difficulties in the integration of operations, services, products and personnel, the diversion of management's attention from other business concerns, changes in relationships with customers and the potential loss of key employees. Any acquisitions will be subject to regulatory approval, and there can be no assurance that we will be able to obtain such approvals. We may not be successful in identifying further acquisition candidates, integrating acquired institutions or preventing deposit erosion or loan quality deterioration at acquired institutions. Competition for acquisitions in our market area is highly competitive, and we may not be able to acquire other institutions on attractive terms. There can be no assurance that we will be successful in completing future acquisitions, or if such transactions are completed, that we will be successful in integrating acquired businesses into our operations. Our ability to grow may be limited if we are unable to successfully make future acquisitions.

**We may not be able to replace key members of management or attract and retain qualified relationship managers in the future.**

We depend on the services of existing management to carry out our business and investment strategies. As we expand, we will need to continue to attract and retain additional management and other qualified staff. In particular, because we plan to continue to expand our locations, products and services, we will need to continue to attract and retain qualified commercial banking personnel and investment advisors. Competition for such personnel is significant in our geographic market areas. The loss of the services of any management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our results of operations, financial conditions and prospects.

**The allowance for loan losses may be inadequate.**

Our loan customers may not repay their loans according to the terms of the loans, and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. We therefore may experience significant loan losses, which could have a material adverse effect on our operating results.

We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We rely on our loan quality reviews, our experience and our evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. Increases in this allowance result in an expense for the period. If, as a result of general economic conditions or a decrease in asset quality, management determines that additional increases in the allowance for loan losses are necessary, we may incur additional expenses.





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Our loans are primarily secured by real estate, including a concentration of properties located in northern, southwestern and southcentral Idaho, eastern Washington and southeastern Oregon. While the Pacific Northwest economy has generally outperformed the rest of the nation in recent years, the effects of a slowdown are being felt. A continued deterioration in the regional economy could adversely affect cash flows for both commercial and individual borrowers, thus causing the Company to experience increases in problem assets, delinquencies, and losses on loans. If an earthquake, volcanic eruption or other natural disaster were to occur in one of our major market areas, loan losses could occur that are not incorporated in the existing allowance for loan losses.

### **We are expanding our lending activities into potentially riskier areas.**

We have identified commercial real estate and commercial business loans as areas for increased lending emphasis. While increased lending diversification is expected to increase interest income, non-residential loans carry greater historical risk of payment default than long-term residential real estate loans. As the volume of these loans increase, credit risk may increase. In the event of substantial borrower defaults, our provision for loan losses would increase and therefore, earnings would be reduced. As the Company lends in diversified areas such as commercial real estate, commercial, agricultural, real estate, commercial construction and residential construction, the Company may incur additional risk if one lending area experienced difficulties due to economic conditions.

### **Our stock price can be volatile.**

Our stock price can fluctuate widely in response to a variety of factors, including actual or anticipated variations in quarterly operating results, recommendations by securities analysts and news reports relating to trends, concerns and other issues in the financial services industry. Other factors include new technology used or services offered by our competitors, operating and stock price performance of other companies that investors deem comparable to us, and changes in government regulations.

General market fluctuations, industry factors and general economic and political conditions and events, such as future terrorist attacks and activities, economic slowdowns or recessions, interest rate changes or credit loss trends, also could cause our stock price to decrease regardless of our operating results.

### **Current subprime and prime mortgage market volatility could have a negative impact on the Company's lending operations.**

Current weakness in the subprime mortgage market is spreading into all mortgage markets and generally impacting lending operations of many financial institutions. The Company is not significantly involved in subprime mortgage activities, so its current direct exposure is limited. However, to the extent the subprime market volatility affects the marketability of all mortgage loans, the real estate market, and consumer spending in general, it may have an indirect adverse impact on the Company's lending operations, loan balances and non-interest income and, ultimately, its net income.

### **The FDIC has increased insurance premiums to rebuild and maintain the federal deposit insurance fund.**

Due to recent events and the state of the economy, the FDIC has increased federal deposit insurance premiums beginning in the first quarter of 2009 to double what we have recently paid. The increase of these premiums will add to our cost of operations and could have a significant impact on the bank.

### **Negative publicity regarding the liquidity of financial institutions may have a negative impact on Company operations**

Publicity and press coverage of the banking industry has been decidedly negative recently. Continued negative reports about the industry may cause both customers and shareholders to question the safety, soundness and liquidity of banks in general or our bank in particular. This may have an adverse impact on both the operations of the Company and its stock price.

### **Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

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**Item 3 Defaults Upon Senior Securities**

Not applicable.

**Item 4 Other Information**

Not Applicable

**Item 5 Exhibits**

<b>Exhibit No.</b>	<b>Exhibit</b>
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 of Chief Executive Officer and Chief Financial Officer 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 registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**INTERMOUNTAIN COMMUNITY  
BANCORP**  
(Registrant)

November 6, 2008  
Date

By: /s/ Curt Hecker

**Curt Hecker**  
President  
and Chief Executive Officer

November 6, 2008  
Date

By: /s/ Doug Wright

**Doug Wright**  
Executive Vice President  
and Chief Financial Officer

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