INTERMOUNTAIN COMMUNITY BANCORP
Form 10-K
February 28, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K
(Mark One)

þ	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the year ended December 31, 2013
OR	
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from to

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

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

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

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock (no par value)
(Title of class)
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

As of June 30, 2013, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported on the NASDAQ Capital Market, was $52,425,697.

As of February 24, 2014, the number of shares outstanding of the registrant's Voting Common Stock, no par value per share, was 2,701,214 and the number of shares outstanding of Non Voting Common Stock, no par value, was 3,839,688.

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PART I — Financial Information
Forward-Looking Statements
CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

- deterioration in economic conditions that could result in increased loan and lease losses;
- inflation and interest rate levels, and market and monetary fluctuations;
- changes in market interest rates and spreads, which could adversely affect our net interest income and profitability;
- trade, monetary and fiscal policies and laws, including interest rate and income tax policies of the federal government;
- growth and acquisition strategies;
- applicable laws and regulations and legislative or regulatory changes, including the ultimate financial and operational burden of financial regulatory reform legislation;
- our ability to attract new deposits and loans and leases;
- competitive market pricing factors;
- the effects of any further adverse regulatory action;
- our ability to raise capital or incur debt on reasonable terms;
- the risks associated with lending and potential adverse changes in credit quality;
- risks associated with concentrations in real estate-related loans;
- declines in real estate values supporting loan collateral;
- increased loan delinquency rates;
- the timely development and acceptance of our new products and services;
- the willingness of customers to substitute competitors’ products and services for our products and services;
- consolidation in the financial services industry in our markets, resulting in the creation of larger financial institutions who may have greater resources that could change the competitive landscape;
- technological changes;
- our ability to recruit and retain key management and staff;
- changes in estimates and assumptions used in financial accounting;
- our critical accounting policies and the implementation of such policies;
- potential interruption or breach in security of our systems;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;
- changes in consumer spending, saving and borrowing habits;
- the strength of the United States economy in general and the strength of the local economies in which Intermountain conducts its operations;
- stability of funding sources and continued availability of borrowings;
- our success in gaining regulatory approvals, when required;
- results of regulatory examinations that could restrict growth; and
- our success at managing the risks involved in the foregoing.

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

Item 1. BUSINESS

General

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

Panhandle State Bank ("PSB" or "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.

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

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

Recent Developments

Net income applicable to common stockholders for the years ended December 31, 2013 and 2012 was $10.1 million and $1.9 million, respectively. The 2013 annual net income included an income tax benefit of $6.1 million associated with the reversal of a deferred tax asset valuation allowance. The increase of $1.9 million in income before income taxes over the period reflects lower credit costs as a result of continued improvements in asset quality.

On January 9, 2013, the Company's voting common stock moved from the “Over the Counter” exchange to the NASDAQ Capital Markets Exchange.

On November 20, 2013, the Company entered into and consummated the transactions contemplated by a letter agreement (the “Repurchase Agreement”) with the U.S. Department of Treasury ("Treasury") in connection with the redemption of the preferred stock issued under the Capital Purchase Program. Under the Repurchase Agreement, the Company redeemed from the Treasury all of its 27,000 outstanding shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, originally issued to Treasury for a total redemption price of $27 million, plus all accrued and unpaid dividends. The redemption was partially funded from proceeds received from a term loan in the amount of $7 million from NexBank SSB. The Bank up-streamed a dividend of $20 million with appropriate regulatory approvals to fund the balance of the redemption price.

Business Strategy & Opportunities

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

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

- A strong, loyal and low-cost deposit franchise with proven growth capabilities: 78% of Intermountain's deposits at December 31, 2013 are in low-cost transaction accounts, resulting in a cost of funds that has consistently been below its peer group. Intermountain has maintained this low-cost deposit focus while growing since 1999 from the 8th ranked bank by deposit market share to the 3rd in the core markets it serves (Source: FDIC Deposit Market Share and Federal Financial Institutions Examination Council ("FFIEC") Uniform Bank Performance Report ("UBPR") data).

- A sophisticated risk management system and overall much lower risk exposure: Tempered by its experiences during the current downturn, Intermountain has developed a refined credit loss forecasting system, an integrated approach to credit, liquidity, capital and other risk factors, and a well-seasoned credit administration function. Its current non-performing asset (NPA) to total asset ratio ranks below many of its peers, and solvency and liquidity risk exposure are also relatively low. It continues to manage its interest-rate sensitivity closely in this unusually low market rate environment, so that it is not exposed to unmanageable risk, particularly in a rising rate environment.
- An operational and compliance infrastructure built for future profitable growth: During the past several years, Intermountain has focused on upgrading talent, technology and operational processes to facilitate further balance sheet growth while simultaneously reducing the expenses associated with these upgrades. Operating expenses are down significantly from prior years and should continue to decrease as additional initiatives are implemented.
- A strong and growing trust and investment services function: Income in this area has improved significantly over the past several years as the Company has focused on cross-selling these services into our customer base. The growth in this area has helped offset regulatory pressures on other fee income sources.
- A highly experienced management team: The executive and senior management team averages over 20 years in banking experience, most of which has been in the Company's defined core and growth markets.

Management believes that the economic and financial crises of the past several years have fundamentally changed the future landscape for community banks. In a slower growth, more conservative environment, further consolidation of the industry is inevitable. Those banks and management teams with strong market positions, solid infrastructure, effective risk management systems, and staying power will be able to capitalize on growth opportunities created by this changing environment, including potential acquisitions. Management has defined potential opportunities in terms of prospects within the Company's core markets of north, southwest rural, and south central Idaho, and within its growth markets of Spokane, Boise, and contiguous eastern Washington and northern Idaho counties. While there is no assurance that the Company will pursue, or be successful in pursuing acquisition opportunities in this new environment, we believe we are now well-positioned to take advantage of growth opportunities in the changing landscape.

Lending conditions are improving but still challenging, with moderate borrowing demand, keen competition for quality borrowers, and historically low rates. Management is responding by diversifying its current portfolio and positioning for prudent growth opportunities. It believes these prospects will include pursuing attractive commercial credits in its markets, originating commercial real estate loans to strong borrowers, expanding and diversifying its agricultural portfolio, and expanding its already strong government-guaranteed loan marketing efforts. Compressed loan rates are likely to continue until either market rates increase or some market consolidation occurs, and the Company remains cautious about extending the duration of its loan or securities portfolio at the low rates prevalent in the current market. However, management believes it is better positioned than many of its peers, given its low-cost of funds, strong market position, capital and liquidity to work through these challenges.

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

Management continues to undertake significant efforts to improve its efficiency, with several initiatives completed in 2013, which will result in lower technology and printing expenses in future years.

Primary Market Area

The Company conducts its primary banking business through its bank subsidiary, Panhandle State Bank. The Bank maintains its main office in Sandpoint, Idaho and has 18 other branches. In addition to the main office, seven branch offices operate under the name of Panhandle State Bank. Eight branches are operated under the name Intermountain Community Bank, a division of Panhandle State Bank, and three branches operate under the name Magic Valley Bank, a division of Panhandle State Bank. Sixteen of the Company's branches are located in northern, southwestern

and south central Idaho, two branches are located in Spokane, Washington, and one branch is located in eastern Oregon. The Company focuses its banking and other services on individuals, professionals, and small to medium-sized businesses throughout its market area.
The Bank’s primary service area covers four distinct geographical regions. The north Idaho and eastern Washington region encompasses the four northernmost counties in Idaho, including Boundary County, Bonner County, Shoshone County and Kootenai County and Spokane County in eastern Washington. Bonner and Boundary Counties are heavily forested and contain numerous lakes. As such, the economies of these counties are primarily based on tourism, real estate development and natural resources, including logging, mining and agriculture. Bonner County has also experienced expansion in the areas of light industrial, commercial, retirement and retail development over the past ten years, and management believes both counties are likely to continue

benefiting from Canadian spending and investment as the dollar has weakened against the Canadian currency. Shoshone County continues to experience expansion in the areas of residential and tourism development relating to the outdoor recreation industry in the area and has seen a resurgence in mining activity as mineral prices, although volatile, are higher than in the 1990s or early 2000s. Kootenai County is more diverse than the other northern Idaho counties, with light industrial, high-tech, commercial, retail, medical, tourism and real estate development all contributing to the economic base. Spokane County is the regional hub for the inland northwest region, serving as the medical, retail, business, transportation and educational center for a region that includes eastern Washington, northern Idaho and western Montana. It is also experiencing growth in light manufacturing, distribution and technology-based industries. Spokane County has traditionally experienced a steadier economy with less volatility than other regions, and is currently improving at a moderate pace. Intermountain holds 58% of its loans and 51% of its deposits in the northern Idaho and eastern Washington region.

The second region served by the Bank encompasses two counties in southwestern Idaho (Payette, and Washington) and one county in southeastern Oregon (Malheur). The economies of these counties are primarily based on agriculture and related or supporting businesses. A variety of crops are grown in the area including beans, onions, corn, apples, peaches, cherries and sugar beets. Livestock, including cattle, sheep and pigs, are also raised. Agriculture has been strong over the past several years, cushioning the impact of the national downturn on these counties. The Company holds 20% of its loans and 24% of its deposits in this region.

The third region, known as the greater Boise area, is comprised of two counties, Ada and Canyon. The cities of Boise, Nampa and Caldwell were hit hard in the recession because of excessive residential and commercial real estate development, volatility in the area’s high-tech industries, and reductions in other corporate and state and local government activity. The local economy stabilized in 2011 and is now improving, as private sector hiring has picked up, government employment has stopped declining and much of the excess real estate inventory has been absorbed. 12% of the Company’s loans and 10% of its deposits are in this region.

The fourth region served by the Bank encompasses two counties in south central Idaho (Twin Falls and Gooding), also known as the Magic Valley region. The economies of these counties are primarily based on agriculture and related or supporting businesses. A variety of crops are grown in the area including beans, peas, corn, hay, sugar beets and potatoes. Fish farms, dairies and beef cattle are also contributors to the local economy. The area is also experiencing growth in light manufacturing and retail development, including the opening of a significant new yogurt plant and the relocation of several other smaller companies, which combined are expected to add more than 1,500 additional jobs to the region. The Company has 5% of its loans and 9% of its deposits in the Magic Valley region.

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

Competition

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

The Company has employed these competitive tools to grow market share over the past thirteen years, since it began expanding beyond its Sandpoint, Idaho base. During this time period, the Company has grown from eighth overall in market share in its defined core markets to third, with a consolidated market share of 10.7%. The Spokane and Boise market areas represent potential future growth markets for the Company, as total market deposits in these two counties exceed by a two-to-one margin the total market deposits in the Company’s core markets. The Company has a relatively small, but growing presence in Spokane County with strong local market talent. The Company does not have any branches in Ada County, which includes Boise, but has a number of key managers who came from or worked in the Boise area. The Company also sees opportunities in the Idaho and eastern Washington counties contiguous to its current service area, as they contain a number of smaller struggling competitors, and management is familiar with many of the bankers and customers in these markets.

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

Lending Activities

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

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

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

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

non-owner occupied properties, but favors owner-occupied loans. Non-owner occupied commercial real estate loans are restricted to projects with high occupancy and low loan-to-value ratios, and/or borrowers with established track records and the ability to fund potential project cash flow shortfalls from other income sources or liquid assets. Project due diligence is conducted by the Bank, to help provide for adequate contingencies, collateral and/or government guaranties. General underwriting requirements are dependent upon the type of property being taken as collateral and the occupancy status. For desirable property types, a minimum DSC of 1.25 and maximum LTV of 75% is required.
Consumer Loans. The Bank offers a variety of consumer loans, including personal loans, motor vehicle loans, boat loans, recreational vehicle loans, home improvement loans, home equity loans, open-end credit lines, both secured and unsecured, and overdraft protection credit lines. The Bank's terms and underwriting on these loans are consistent with what is offered by competing community banks and credit unions, which generally require sufficient verified and documented disposable income, solid credit histories, and equity in the collateral. Generally, underwriting guidelines include a maximum debt to income of 40%, credit scores

exceeding 700, and maximum LTVs ranging from 80% on home equity loans and lines to 50% to 90% on other types of consumer collateral. Loans for the purchase of new autos typically range up to 60 months. Loans for the purchase of smaller RV's, pleasure crafts and used vehicles range up to 60 months. Loans for the purchase of larger RV's and larger pleasure crafts, mobile homes, and home equity loans range up to 120 months (180 months if credit factors and value warrant). Unsecured loans are usually limited to two years, except for credit lines, which may have terms of up to 60 months. Relationship lending is emphasized, which, along with credit control practices, minimizes risk in this type of lending.

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

Credit Quality Management

Details of Intermountain's problem asset classifications and allowance for credit losses are as follows:

Classified and Nonperforming Assets. To measure the quality of loans and other real estate owned ("OREO"), the Company has established guidelines for classifying and determining provisions for anticipated losses. Intermountain's system employs the risk rating categories of "substandard," "doubtful" and "loss" for its classified assets. Substandard assets have deficiencies, which give rise to the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Doubtful assets have the same weaknesses as substandard assets, and on the basis of currently existing facts, are also deemed to have a high probability of loss. The portion of the asset considered uncollectible and of such little value that it should not be included as an asset of the Company is classified as a loss. In such cases, the Company establishes a specific valuation reserve.

The credit administration group focuses on identifying and resolving potential problem credits before they become classified. When an asset becomes classified, management of the relationship is assumed by the Company's special assets team. This team actively engages the borrower and guarantor to remedy the situation by requesting updated financial information from the borrower(s) and guarantor(s) to determine a course of action. In addition, updated collateral values are obtained on those deemed impaired in order for Company management to perform evaluations for regulatory and decision making purposes. When possible, the Company will require the borrower to provide additional collateral. In conjunction with the receipt of additional collateral, Intermountain will sometimes modify the terms of the loan. Often the modified terms of the loan are consistent with terms that the Company would offer a new borrower. If the borrower is having financial difficulties and the modification of terms is considered concessionary, Intermountain designates the loan as a "troubled debt restructure" and determines whether it also needs to be reported as a nonperforming loan. A loan designated as a non-performing troubled debt restructuring may be returned to accrual status after the borrower performs in accordance with the modified loan terms, generally for a period of at least six months.

Intermountain also may permit a borrower to sell the underlying collateral for less than the outstanding balance on the loan if the current collateral evaluation supports the offer price. These transactions are known as "short sales." In such situations, the Company typically requires the borrower to sign a new note or bring cash to closing for the resulting deficiency.

If Intermountain and a borrower are unable to achieve an acceptable resolution, the Company may take a deed in lieu of foreclosure or initiate foreclosure on the underlying collateral. Under such circumstances, Intermountain also simultaneously evaluates legal action for recovery against the borrowers and guarantors. After obtaining the collateral, the Company actively works to sell the collateral.

Allowance for Credit Losses. Intermountain regularly reviews its classified assets for impairment. If a loan is determined to be impaired, Intermountain determines the appropriate impairment method to be used, the present value method or the fair value method. The present value method measures the present value of expected future cash flows discounted at the loan's effective interest rate. The fair value method is used when a loan is considered collateral dependent. For loans that are considered collateral-dependent, the difference between the fair value of the collateral and the book balance of the loan is generally charged off as a confirmed loss. During times of declining real estate values, a specific reserve may be recorded on collateral-dependent impaired loans to recognize market declines since the last appraisal. For certain non-collateral-dependent loans, Intermountain generally establishes a specific reserve for the difference between fair value and book value of these loans, as the loss is not defined as a confirmed loss because it is not based solely on collateral values. Allowances are established and periodically adjusted, if necessary, based on the review of information obtained through on-site inspections, market analysis, appraisals and purchase offers. Intermountain maintains an allowance for credit losses at a level deemed appropriate by management to provide for probable losses related to specifically identified loans and probable losses in the remaining portfolio, as well as unfunded commitments. The allowance is based upon historical loss experience, loan migration analysis, delinquency trends, portfolio size, concentrations of risk, prevailing and anticipated economic conditions, industry experience, estimated collateral values, management's assessment of credit risk inherent in the portfolio, specific problem loans and other relevant factors. The portfolio is grouped into standard industry categories for loans collectively evaluated for impairment based on characteristics such as loan class, borrower and collateral. Both regional and bank-specific loan migration to loss data are used to determine the annual "probability of default." The annual probability of default is adjusted for the estimated loss emergence period and may be further adjusted based on an assessment of qualitative factors. Intermountain establishes the expected loss rate on loans using actual regional and bank-specific loss rates on charged-off and foreclosed loans from 1992 forward to estimate the amount that would be lost if a default were to occur, which is termed the "loss given default." The adjusted probability of default is multiplied by the loss given default to calculate the expected losses for each loan class. Intermountain may make other adjustments to the allowance for loan loss for the unimpaired portfolio to reflect specific circumstances impacting a particular loan class or group of borrowers.

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to be a confirmed loss. Because the allowance for credit losses is based on management's estimate, ultimate losses may materially differ from the estimates.

Company Investments in Marketable Securities

Intermountain invests primarily in Freddie Mac, Fannie Mae and the Government National Mortgage Association ("Ginnie Mae") mortgage-backed securities ("MBS") and collateralized mortgage obligations ("CMOs"), and in municipal bonds. The Company also has smaller investments in Small Business Administration ("SBA") guaranteed pools, corporate bonds and non-agency CMOs. These investments provide Intermountain with a relatively liquid source of interest income and collateral, which can be used to secure borrowings and assist with managing the interest rate risk and credit risk of the balance sheet.

Deposit Services

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

Company Borrowings

Although deposits are Intermountain's primary source of funds, the Company also uses other borrowings to supplement its deposit gathering efforts. These borrowings include advances from the FHLB, repurchase agreements, primary credits and term auction facilities from the Federal Reserve, and federal funds purchased. See "MD&A—Liquidity and Capital Resources."

The FHLB of Seattle is part of a system that consists of 12 regional Federal Home Loan Banks that provide secured credit to financial institutions. As a condition of membership in the FHLB of Seattle, PSB is required to own stock of the FHLB of Seattle, with the amount determined as the greater of either a percentage of PSB's total mortgage related assets, or a percentage of the Company's total advances outstanding from the FHLB of Seattle. At December 31, 2013, PSB held more than the minimum FHLB of Seattle stock ownership requirement.

Intermountain also borrows funds under repurchase agreements with local municipal entities pursuant to which it sells investments (generally, U.S. agency obligations and MBS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. The use of repurchase agreements and other secured borrowings may expose Intermountain to certain risks, including the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines.

The Company also currently has a $6.8 million senior note outstanding with NexBank, as noted earlier, and trust preferred obligations totaling $16.5 million, both of which represent long-term debt outstanding.

Investment Services

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

Trust & Wealth Management Services

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

Other Services

Other consumer-oriented services include automated teller machines ("ATMs"), debit cards, safe deposit boxes, internet and phone banking services, savings bonds, VISA/MasterCard credit cards, mobile banking access, electronic statements, and Certificate of Deposit Account Registry Service ("CDARS") certificates of deposit and money market accounts.

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

Employees

The Company employed 271 full-time equivalent employees at December 31, 2013, up slightly from 270 at the end of 2012. None of the employees are represented by a collective bargaining unit and the Company believes it has good relations with its employees.

Supervision and Regulation

General

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

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

Federal Bank Holding Company Regulation

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

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

Holding Company Control of Nonbanks. With some exceptions, the BHCA also prohibits a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities that, by statute or by Federal Reserve regulation or order, have been identified as activities closely related to the business of banking or of managing or controlling banks.

Transactions with Affiliates. Subsidiary banks of a bank holding company are subject to restrictions imposed by the Federal Reserve Act on extensions of credit to the holding company or its subsidiaries, on investments in their securities and on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit the Company's ability to obtain funds from the Bank for its cash needs, including funds for payment of dividends, interest and operational expenses.

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

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

State Law Restrictions

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

Federal and State Regulation of the Bank

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

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

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

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

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

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

Interstate Banking and Branching

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

Dividends

The principal source of the Company's cash is from dividends received from the Bank, which are subject to government regulation and limitations. Regulatory authorities may prohibit banks and bank holding companies from paying dividends in a manner that would constitute an unsafe or unsound banking practice or would reduce the amount of its capital below that necessary to meet minimum applicable regulatory capital requirements. Idaho law also limits a bank's ability to pay dividends subject to surplus reserve requirements. Basel III introduces additional limitations on banks’ ability to issue dividends by imposing a capital conservation buffer requirement.

Capital Adequacy

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

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

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

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

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

Basel III. Basel III updates and revises significantly the current international bank capital accords (so-called “Basel I” and “Basel II”). Basel III is intended to be implemented by participating countries for large, internationally active banks. However, standards consistent with Basel III will be formally implemented in the United States through a series of regulations, some of which may apply to other banks. In addition to the standards agreed to by the Basel III Committee, the U.S. implementing rules also incorporate certain provisions of the Dodd-Frank Act. Among other things, Basel III:

- Creates “Tier 1 Common Equity,” a new measure of regulatory capital closer to pure tangible common equity than the present Tier 1 definition;
- Establishes a required minimum risk-based capital ratio for Tier 1 Common Equity at 4.5 percent and adds a 2.5 percent capital conservation buffer;
- Increases the required Tier 1 Capital risk-based ratio to 6.0 percent and the required total capital risk-based ratio to 8.0 percent;
- Increases the required leverage ratio to 4.0 percent; and
- Allows for permanent grandfathering of non-qualifying instruments, such as trust preferred securities, issued prior to May 19, 2010 for depository institution holding companies with less than $15 billion in total assets as of year-end 2009, subject to a limit of 25 percent of Tier 1 capital.

The full impact of the Basel III rules cannot be determined at this time as many regulations are still being written and the implementation of currently released regulations for banks not subject to the advanced approach rule, such as the Company and the Bank, will not begin until January 1, 2015. Certain aspects of Basel III will be phased in over a period of time after January 1, 2015.

Regulatory Oversight and Examination

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

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

Corporate Governance and Accounting

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

Anti-terrorism

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

Financial Services Modernization

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

Troubled Asset Relief Program

The Treasury established the TARP Capital Purchase Program ("CPP") to provide direct equity investment in qualified financial institutions during the financial crisis. The program requires participating institutions to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions and declaration of dividends. Under the CPP, the Treasury made an equity investment in the Company in 2008 through its purchase of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A. This equity investment was repurchased by the Company in November, 2013.

Deposit Insurance

The Bank's deposits are insured under the Federal Deposit Insurance Act, up to the maximum applicable limits and are subject to deposit insurance assessments designed to tie what banks pay for deposit insurance to the risks they pose. The Dodd-Frank Act broadened the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital. In addition, the Dodd-Frank Act raised the minimum designated reserve ratio (the FDIC is required to set the reserve ratio each year) of the Deposit Insurance Fund ("DIF") from 1.15% to 1.35%; requires that the DIF meet that minimum ratio of insured deposits by 2020; and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The FDIC has established a higher reserve ratio of 2% as a long-term goal beyond what is required by statute. The deposit insurance assessments to be paid by the Bank could increase as a result.

Insurance of Deposit Accounts. The Emergency Economic Stabilization Act of 2008 (“EESA”) included a provision for a temporary increase from $100,000 to $250,000 per depositor in deposit insurance. The temporary increase was made permanent under the Dodd-Frank Act. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category. EESA also temporarily raised the limit on federal deposit insurance coverage to an unlimited amount for non-interest or low-interest bearing demand deposits. Unlimited coverage for non-interest transaction accounts expired December 31, 2012.

The Dodd-Frank Act

As a result of the financial crisis, on July 21, 2010 the Dodd-Frank Act was signed into law. The Dodd-Frank Act significantly changed the bank regulatory structure and is affecting the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies, including the Company and the Bank. The full impact of the Dodd-Frank Act may not be known for years. Some of the provisions of the Dodd-Frank Act that may impact our business are summarized below.

Corporate Governance. The Dodd-Frank Act requires publicly traded companies to provide their shareholders with (i) a non-binding shareholder vote on executive compensation, (ii) a non-binding shareholder vote on the frequency of such vote, (iii) disclosure of “golden parachute” arrangements in connection with specified change in control transactions, and (iv) a non-binding shareholder vote on golden parachute arrangements in connection with these change in control transactions.

Prohibition Against Charter Conversions of Troubled Institutions. The Dodd-Frank Act generally prohibits a depository institution from converting from a state to federal charter, or vice versa, while it is subject to an enforcement action unless the bank seeks prior approval from its regulator and complies with specified procedures to ensure compliance with the enforcement action.

Consumer Financial Protection Bureau. The Dodd-Frank Act created a new, independent federal agency called the Bureau of Consumer Financial Protection (“CFPB”). The CFPB has broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws applicable to banks and thrifts with greater than $10 billion in assets. Smaller institutions are subject to certain rules promulgated by the CFPB but will continue to be examined and supervised by their federal banking regulators for compliance purposes. The CFPB has issued numerous regulations amending the Truth in Lending Act that will increase the compliance burden of the Bank.

Repeal of Demand Deposit Interest Prohibition. The Dodd-Frank Act repeals the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Proposed Legislation

General. Proposed legislation is introduced in almost every legislative session. Certain of such legislation could dramatically affect the regulation of the banking industry. We cannot predict if any such legislation will be adopted or if it is adopted how it would affect the business of the Company or the Bank. Recent history has demonstrated that new legislation or changes to existing laws or regulations usually results in a greater compliance burden and therefore generally increases the cost of doing business.

Effects of Government Monetary Policy

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

Where you can find more information

The periodic reports Intermountain files with the SEC are available on Intermountain’s website at http://www.intermountainbank.com after the reports are filed with the SEC. The SEC maintains a website located at http://sec.gov that also contains this information. The Company will provide you with copies of these reports, without charge, upon request made to:

Investor Relations
Intermountain Community Bancorp
414 Church Street
Sandpoint, Idaho 83864
(208) 263-0505

Item 1A. RISK FACTORS

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

The slow pace of the economic recovery could have an adverse effect on our future results of operations or market price of our stock.

The national economy and the financial services sector in particular, are still facing significant challenges. Substantially all of our loans are to businesses and individuals in northern, southwestern and south central Idaho, eastern Washington and southwestern Oregon. These markets continue to face many of the same challenges as the national economy, including continued relatively high levels of unemployment and a slow recovery in commercial and residential real estate. Although some economic indicators are moderately improved both nationally and in the markets we serve, unemployment remains high and there remains substantial uncertainty regarding when and how strongly a sustained economic recovery will occur. A further deterioration in economic conditions in the nation as a whole or in the markets we serve could result in the following consequences, any of which could have an adverse impact, which may be material, on our business, financial condition, results of operations and prospects, and could also cause the market price of our stock to decline:

- economic conditions may worsen, increasing the likelihood of credit defaults by borrowers;
- loan collateral values, especially as they relate to commercial and residential real estate, may decline, thereby increasing the severity of loss in the event of loan defaults;
- nonperforming assets and write-downs of assets underlying troubled credits could adversely affect our earnings;
- demand for banking products and services may decline, including services for low cost and non-interest-bearing deposits; and
- changes and volatility in interest rates may negatively impact the yields on earning assets and the cost of interest-bearing liabilities.

Our allowance for loan losses may not be adequate to cover actual loan losses, which could adversely affect our earnings.

We maintain an allowance for loan losses in an amount that we believe is adequate to provide for losses inherent in our loan portfolio. While we strive to carefully manage and monitor credit quality and to identify loans that may be deteriorating, at any time there are loans included in the portfolio that may result in losses, but that have not yet been identified as potential problem loans. Through established credit practices, we attempt to identify deteriorating loans and adjust the loan loss reserve accordingly. However, because future events are uncertain, there may be loans that deteriorate in an accelerated time frame. As a result, future additions to the allowance may be necessary. Because the loan portfolio contains a number of loans with relatively large balances, deterioration in the credit quality of one or more of these loans may require a significant increase to the allowance for loan losses. Future additions to the allowance may also be required based on changes in the financial condition of borrowers, such as have resulted due to the current economic conditions or as a result of actual events turning out differently than forecasted in the assumptions we use to determine the allowance for loan losses. With respect to real estate loans and property taken in satisfaction of such loans (“other real estate owned” or “OREO”), we can be required to recognize significant declines in the value of the underlying real estate collateral or OREO quite suddenly as new appraisals are performed in the normal course of monitoring the credit quality of the loans. Our ability to recover on real estate loans by selling or disposing of the underlying real estate collateral is adversely impacted by declining appraised values, which increases the likelihood we will suffer losses on defaulted loans beyond the amounts provided for in the allowance for loan losses. This, in turn, could require material increases in our provision for loan losses.

Additionally, federal banking regulators, as an integral part of their supervisory function, periodically review our allowance for loan losses. These regulatory agencies may require us to recognize further loan loss provisions or charge-offs based upon their judgments, which may be different from ours. Any increase in the allowance for loan losses would have a negative effect, which may be material, on our financial condition and results of operations.

Additional provisions for credit loss may be necessary to supplement the allowance for loan and lease losses in the future, which could affect our financial condition.

We have incurred significant losses in recent years. While there has been continued improvement in the quality of our loan portfolio and a corresponding improvement in operating results, economic conditions remain uncertain. As such, significant additional provisions for credit losses may be necessary to supplement the allowance for loan and lease losses in the future, which could cause us to incur a net loss in the future and could adversely affect the price of, and market for, our common stock.

Concentration in real estate loans and any further deterioration in the real estate markets we serve could require material increases in our allowance for loan losses and adversely affect our financial condition and results of operations.

The sluggish recovery of the economy continues to affect our market areas. At December 31, 2013, 62.4% of our loans were secured with real estate as the primary collateral. Any further deterioration or a continued slow recovery in the local economies we serve could have a material adverse effect on our business, financial condition and results of operations due to a weakening of our borrowers' ability to repay these loans and a decline in the value of the collateral securing them. In light of the continuing effects of the recent economic downturn, real estate values have been significantly affected. As we have experienced, significant declines in real estate collateral can occur quite suddenly as new appraisals are performed in the normal course of monitoring the credit quality of the loan. This, in turn, could require material increases in our allowance for loan losses and adversely affect our financial condition and results of operations, perhaps materially.

Our ability to receive dividends from our banking subsidiary accounts for most of our revenue and could affect our liquidity and ability to pay future dividends.

We are a separate and distinct legal entity from our banking subsidiary, Panhandle State Bank. We receive substantially all of our revenue from dividends from our banking subsidiary. Under normal circumstances, these dividends are the principal source of funds to fund holding company expenses and pay dividends on our common and preferred stock and principal and interest on our outstanding debt. The other primary sources of liquidity for the parent Company are capital or borrowings. Various federal and/or state laws and regulations limit the amount of dividends that the Bank may pay us. For example, Idaho law limits a bank's ability to pay dividends subject to surplus reserve requirements. Also, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. Limitations on our ability to receive dividends from our subsidiary could have a material adverse effect on our liquidity and on our ability to pay future dividends on common or preferred stock. Additionally, if our subsidiary's earnings are not sufficient to make dividend payments to us while maintaining adequate capital levels, we may not be able to make future dividend payments to our common and preferred shareholders or principal and interest payments on our outstanding debt.

As of December 31, 2013 we are current on our dividend payments on our trust preferred securities. However, in the future, if we do not make payments on our trust preferred securities for over 20 consecutive quarters, we could be in default under those securities.

A tightening of credit markets and liquidity risk could adversely affect our business, financial condition and results of operations.

A tightening of the credit markets or any inability to obtain adequate funds for continued loan growth at an acceptable cost could negatively affect our asset growth and liquidity position and, therefore, our earnings capability. In addition to core deposit growth, maturity of investment securities and loan payments, the Bank also relies on alternative funding sources including unsecured borrowing lines with correspondent banks, borrowing lines with the Federal Home Loan Bank and the Federal Reserve Bank, public time certificates of deposits and out of area and brokered time certificates of deposit. Our ability to access these sources could be impaired by deterioration in our financial condition as well as factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations for the financial services industry or serious dislocation in the general credit markets. In the event such disruption should occur, our ability to access these sources could be negatively affected, both as to price and availability, which would limit, and/or potentially raise the cost of, the funds available to the Company.

The FDIC has increased insurance premiums and imposed special assessments to rebuild and maintain the federal deposit insurance fund, and any additional future premium increases or special assessments could have a material adverse effect on our business, financial condition and results of operations.

The Dodd-Frank Act broadened the base for FDIC insurance assessments and assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. In addition, the Dodd-Frank Act established 1.35% as the minimum deposit insurance fund reserve ratio. The FDIC has determined that the fund reserve ratio should be 2.0% and has adopted a plan under which it will meet the statutory minimum fund reserve ratio of 1.35% by the statutory deadline of September 30, 2020. Although the Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $10 billion of the increase in the statutory minimum fund reserve ratio to 1.35% from the former statutory minimum of 1.15%, the overall impact may result in an increase in the deposit insurance assessments to be paid by the Company.

On February 7, 2011, the FDIC issued final rules, effective April 1, 2011, implementing changes to the assessment rules resulting from the Dodd-Frank Act. The adopted regulations: (1) modify the definition of an institution's deposit insurance assessment base; (2) alter certain adjustments to the assessment rates; (3) revise the assessment rate schedules in light of the new assessment base and altered adjustments; and (4) provide for the automatic adjustment of the assessment rates in the future when the reserve ratio reaches certain milestones.

Despite the FDIC's actions to restore the deposit insurance fund, the fund will suffer additional losses in the future due to failures of insured institutions. There may be additional significant deposit insurance premium increases, special assessments or prepayments in order to restore the insurance fund's reserve ratio. Any significant premium increases or special assessments could have a material adverse effect on the Company's financial condition and results of operations.

We may be required, in the future, to recognize impairment with respect to investment securities, including the FHLB stock we hold.

Our available-for-sale securities portfolio has decreased to $251.6 million at December 31, 2013 or 26.8% of our assets from $280.2 million at December 31, 2012 or 28.8% of our assets. This decrease is largely because of the principal payments on our mortgage-backed securities portfolio, moving a portion of our available-for sale portfolio to held-to-maturity, and adding new investments to the held-to-maturity portfolio. Our securities portfolio contains whole loan private mortgage-backed securities and currently includes securities with unrecognized losses. The national downturn in real estate markets and elevated mortgage delinquency and foreclosure rates have increased credit losses in the portfolio of loans underlying these securities and resulted in substantial discounts in their market values. Any further deterioration in the loans underlying these securities and resulting market discounts could lead to other-than-temporary impairment in the value of these investments. We evaluate the securities portfolio for any other-than-temporary impairment each reporting period, as required by generally accepted accounting principles, and as of December 31, 2013, no securities had been determined to be other than temporarily impaired ("OTTI"). Future evaluations of our securities portfolio may require us to recognize additional impairment charges with respect to other holdings. For example, it is possible that government-sponsored programs to allow mortgages to be refinanced to lower rates could materially adversely impact the yield on our portfolio of mortgage-backed securities, since a significant portion of our investment portfolio is composed of such securities.

In addition, as a condition to membership in the Federal Home Loan Bank of Seattle ("FHLB"), we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB. At December 31, 2013, we had stock in the FHLB of Seattle totaling $2.2 million. The FHLB stock held by us is carried at cost and is subject to recoverability testing under applicable accounting standards. The FHLB recently began paying dividends on the stock again, and it has been repurchasing stock since mid 2012. As of December 31, 2013, we did not recognize an impairment charge related to our FHLB stock holdings. However, future negative changes to the financial condition of the FHLB may require us to recognize an impairment charge with respect to FHLB stock.

Recent levels of market volatility were unprecedented and we cannot predict whether they will return.

The capital and credit markets have been experiencing volatility and disruption from time-to-time over the last several years, at times reaching unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain companies without regard to those companies' underlying financial strength. If similar levels of market disruption and volatility return, we may experience various adverse effects, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

We operate in a highly regulated environment and we cannot predict the effects of recent and pending federal legislation.

We are subject to extensive regulation, supervision and examination by federal and state banking authorities. As a publicly traded company, we are subject to regulation by the Securities and Exchange Commission. In addition, we began trading our stock on the NASDAQ stock exchange on January 9, 2013 and are therefore subject to additional regulations. Any change in applicable regulations or federal, state or local legislation, or in policies or interpretations or regulatory approaches to compliance and enforcement, income tax laws and accounting principles, could have a substantial impact on us and our operations. Changes in laws and regulations may also increase our expenses by imposing additional fees or taxes or restrictions on our operations. Additional legislation and regulations that could significantly affect our powers, authority and operations may be enacted or adopted in the future, which could have a material adverse effect on our financial condition and results of operations. Failure to appropriately comply with any such laws, regulations or principles could result in sanctions by regulatory agencies or damage to our reputation, all of which could adversely affect our business, financial condition or results of operations.

In that regard, sweeping financial regulatory reform legislation was enacted in July 2010. Among other provisions, the legislation (i) created a new Bureau of Consumer Financial Protection with broad powers to regulate consumer financial products such as credit cards and mortgages, (ii) created a Financial Stability Oversight Council comprised of the heads of other regulatory agencies, (iii) will lead to new capital requirements from federal banking agencies, (iv) places new limits on electronic debit card interchange fees, and (v) requires the Securities and Exchange Commission and national stock exchanges to adopt significant new corporate governance and executive compensation reforms.

The third installment of the Basel Accords (the "Basel III") for U.S. financial institutions is expected to be phased in between 2013 and 2019. Basel III sets forth more robust global regulatory standards on capital adequacy, qualifying capital instruments, leverage ratios, market liquidity risk, and stress testing, which may be stricter than standards currently in place. The implementation of these new standards could have an adverse impact on our financial position and future earnings due to, among other things, the increased minimum Tier 1 capital ratio requirements that will be

implemented.
The new legislation and regulations are expected to increase the overall costs of regulatory compliance.
Further, regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws or regulations by financial institutions and holding companies in the performance of their supervisory and enforcement duties. Recently, these powers have been utilized more frequently due to the serious national, regional and local economic conditions we are facing. The exercise of regulatory authority may have a negative impact on our financial condition and results of operations. Additionally, our business is affected significantly by the fiscal and monetary policies of the U.S. federal government and its agencies, including the Federal Reserve Board.
We cannot predict the full effects of recent legislation or the various other governmental, regulatory, monetary and fiscal initiatives which have been and may be enacted on the financial markets generally, or on the Company and on the Bank specifically. The terms and costs of these activities, or the failure of these actions to help stabilize the financial markets, asset prices, market

liquidity and a continuation or worsening of current financial market and economic conditions could materially and adversely affect our business, financial condition, results of operations, and the trading price of our common stock.

Changes in accounting standards could materially impact our financial statements.

From time to time the Financial Accounting Standards Board and the SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be very difficult to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in our restating prior period financial statements.

Fluctuating interest rates could adversely affect our profitability and the market value of our investment securities portfolio.

Our profitability is dependent to a large extent upon our net interest income, which is the difference between the interest earned on loans, securities and other interest-earning assets and interest paid on deposits, borrowings, and other interest-bearing liabilities. Because of the differences in maturities and re-pricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our net interest margin, and, in turn, our profitability. We manage our interest rate risk within established guidelines and generally seek an asset and liability structure that insulates net interest income from large deviations attributable to changes in market rates. However, our interest rate risk management practices may not be effective in a highly volatile rate environment.

The current unusual interest rate environment poses particular challenges. Market rates remain low right now and the Federal Reserve Board has indicated that it will likely maintain low short-term interest rates for the foreseeable future. The Federal Reserve is also purchasing significant amounts of Treasury and Agency bonds in the public market, lowering yields on these instruments and on most other longer-term fixed income instruments as well. This extended period of low rates, when combined with keen competition for high-quality borrowers, may cause additional downward pressure on the yield on the Company's loan and investment portfolios. In addition, low rates accelerate prepayment rates on our mortgage-backed securities, which also negatively impacts yields. Since the Company's cost of interest-bearing liabilities is already at record lows, the impact of decreasing asset yields may have a more adverse impact on the Company's net interest income.

In addition, the current low level of market rates poses risk to the value of our investment securities portfolio, and as a result, our capital levels. Any increase in rates, and particularly a significant increase, will have a negative impact on the market value of the Company's available-for-sale investment securities portfolio. Since this portfolio is carried at market value on the balance sheet, a reduction in its value will reduce the Company's capital levels. Alternatively, attempts to mitigate this risk by shortening the duration of the portfolio or purchasing more variable rate securities will have an adverse impact on current earnings, because current yields are low.

We face strong competition from financial services companies and other companies that offer banking services.

The banking and financial services businesses in our market area are highly competitive and increased competition may adversely impact the level of our loans and deposits. Ultimately, we may not be able to compete successfully against current and future competitors. These competitors include national banks, foreign banks, regional banks, and other community banks. We also face competition from many other types of financial institutions, including finance companies, brokerage firms, insurance companies, credit unions, and other financial intermediaries. In particular, our competitors include both major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous locations and mount extensive promotional and advertising campaigns, and credit unions, whose tax-advantaged status allow them to compete aggressively. Areas of competition include interest rates for loans and deposits, efforts to obtain loan and deposit customers, and a range in quality of products and services provided, including new technology-driven products and services. If we are unable to attract and retain banking customers, we may be unable to maintain or grow our loans or deposits.

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

Over the long-term, 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. We may not 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 favorable economic conditions in our market areas.

Unexpected losses, our inability to successfully implement our tax planning strategies in future reporting periods, or IRS Section 382 limitations resulting from the successful completion of the 2012 capital raise may require us to establish a tax valuation allowance in the future.

At December 31, 2013, we maintained $21.7 million in net deferred income tax assets, of which $13.5 million was related to net operating losses sustained in 2009, 2010, and 2012. We evaluate our deferred income tax assets for recoverability based on all available evidence. This process involves significant management judgment about assumptions that are subject to change from period to period based on changes in tax laws, our ability to successfully implement tax planning strategies, or variances between our future projected operating performance and our actual results. We are required to establish a valuation allowance for deferred income tax assets if we determine, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred income tax assets may not be realized. In determining the more-likely-than-not criterion, we evaluate all positive and negative available evidence as of the end of each reporting period. In this regard, we had maintained a valuation allowance for deferred income tax assets until its reversal at the end of 2013. The potential establishment of a new deferred income tax asset valuation allowance in the future will be determined based upon changes in the expected realization of the net deferred income tax assets. The realization of the deferred income tax assets ultimately depends on the existence of sufficient taxable income in either the carryback or carryforward periods under the tax law.

Due to the significant estimates involved in evaluating the future recoverability of the deferred tax assets, it is possible that we will be required to establish a new valuation allowance in future reporting periods that would materially reduce our capital ratios. Such a charge could also have a material adverse effect on our results of operations, financial condition and capital position.

The future annual recoverability of tax benefits resulting from net operating loss carryforwards is also limited by the sale of securities pursuant to the Purchase Agreements that were executed in 2012 to raise capital, because such sale caused an “ownership change”, as defined in IRC Section 382. These IRC Section 382 limitations will impact the timing of the recoverability of the deferred tax assets.

We are subject to a variety of operational risks, including reputational risk, legal risk and compliance risk, and the risk of fraud or theft by employees or outsiders, which may adversely affect our business and results of operations.

We are exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, and unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems. If personal, non-public, confidential or proprietary information of customers in our possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include, for example, if such information were erroneously provided to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets) which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that we (or our vendors') business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could result in a diminished ability of us to operate our business (for example, by requiring us to expend significant resources to correct the defect), as well as potential liability to clients, reputational damage and regulatory intervention, which could adversely affect our business, financial condition and results of operations, perhaps materially.

A failure in or breach of our operational or security systems, or those of our third party service providers, including as a result of cyber attacks, could disrupt our business, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs and cause losses.

As a financial institution, the Company's operations rely heavily on the secure processing, storage and transmission of confidential and other information on our computer systems and networks. Any failure, interruption or breach in security or operational integrity of these systems could result in failures or disruptions in our online banking system, customer relationship management, general ledger, deposit and loan servicing and other systems. The security and integrity of our systems could be threatened by a variety of interruptions or information security breaches, including those caused by computer hacking, cyber attacks, electronic fraudulent activity or attempted theft of financial assets. We cannot assure you that any such failures, interruption or security breaches will not occur, or if they do occur, that they will be adequately addressed. While we have certain protective policies and procedures in place, the nature and sophistication of the threats continue to evolve. The Company may be required to expend significant additional resources in the future to modify and enhance our protective measures.

Additionally, we face the risk of operational disruption, failure, termination or capacity constraints of any of the third parties that facilitate our business activities, including exchanges, clearing agents, clearing houses or other financial intermediaries. Such parties could also be the source of an attack on, or breach of, our operational systems.

Two examples highlight the risk and exposure currently facing the Company and all financial institutions:

- In 2012, the computer system of one of the Company's customers was hacked into and the online banking system compromised. As a result, the hacker was able to electronically deposit fraudulent funds into the account and simultaneously electronically withdraw those funds. While the Company was able to recover the majority of the funds through its own collection efforts and from its insurance, the Company still incurred a loss as a result of the breach of the customer's computer. In response, the Company further tightened its online banking system security by installing and implementing additional security technology, resulting in additional costs and more complex customer processing requirements.
- As is currently common in the industry, the Company is also frequently notified by its own third-party providers and other unaffiliated data networks of potential breaches of customer's debit and credit card account information. In some cases, only the account number is breached, and in others, more detailed and specific identifying information is released. In the final months of 2013, one large regional retailer and one large national retailer suffered breaches of their customers' debit and credit card data. Because we issued cards to customers who were impacted by these breaches, we suffered additional loss and expense in closing and replacing the impacted cards. Depending on the type of information that is released, the Company generally informs the impacted customers, closes the impacted accounts, reimburses any loss suffered by the customers, and/or provides recommendations on other potential actions customers can take. The actions taken result in added cost for the Company and its customers, and may negatively impact the reputation of the Company and the broader financial industry.

As highlighted in the examples above, any failures, interruptions or security breaches in our information systems could damage our reputation, result in additional operating losses or loss of customer business, result in a violation of privacy or other laws, or expose us to civil litigation, regulatory fines or losses not covered by insurance.

As a result of the transactions completed by the securities purchase agreements dated January 23, 2012 with certain investors ("Purchase Agreements"), Castle Creek Capital Partners IV, L.P. (“Castle Creek”) and affiliates of Stadium Capital Management LLC (“Stadium”) became substantial holders of our Common Stock.

Upon the completion of the transactions contemplated by the Purchase Agreements, Castle Creek and Stadium each became holders of a 33.3% ownership interest, and 9.9% and 14.9% voting interest, respectively, in Intermountain (after giving effect to the exercise of certain warrants issued thereby). Each of these two companies have a representative on our board and each has a representative on the Bank's Board of Directors. Although Castle Creek and Stadium each entered into certain passivity agreements with the Federal Reserve in connection with their investments in us, Castle Creek and Stadium each have substantial influence over our corporate policy and business strategy. In pursuing their economic interests, Castle Creek and Stadium may have interests that are different from the interests of our other shareholders.

Resales of our Common Shares in the public market may cause the market price of our Common Shares to fall.

We issued a large number of shares of Common Stock and securities that have converted into Non-Voting Common Stock to the investors pursuant to the Purchase Agreements. The investors have certain registration rights with respect to the shares of Common Stock held by them. The registration rights for certain Investors will allow them to sell their shares without compliance with the volume and manner of sale limitations under Rule 144 promulgated under the Securities Act. The market value of our Common Stock could decline as a result of sales by the Investors from time to time of a substantial amount of the shares of Common Stock held by them.

The market for our Common Stock historically has experienced significant price and volume fluctuations.

The market for our Common Stock historically has experienced and may continue to experience significant price and volume fluctuations similar to those experienced by the broader stock market in recent years. Generally, the fluctuations experienced by the broader stock market have affected the market prices of securities issued by many companies for reasons unrelated to their operating performance and may adversely affect the price of our Common Stock. In addition, our announcements of our quarterly operating results, changes in general conditions in the economy or the financial markets and other developments affecting us, our affiliates or our competitors could cause the market price of our Common Stock to fluctuate substantially.

We may pursue additional capital in the future, which could dilute the holders of our outstanding Common Stock and may adversely affect the market price of our Common Stock.

Although we recently completed a significant capital raise, in the current economic environment we may consider alternatives for raising capital when opportunities to raise capital at attractive prices present themselves, in order to further strengthen our capital and better position ourselves to take advantage of opportunities that may arise in the future. Such alternatives may include issuance and sale of common stock or preferred stock, or borrowings by the Company, with proceeds contributed to the Bank. Any such capital raising alternatives could dilute the holders of our outstanding common stock and may adversely affect the market price of our common stock.

Our common stock is subordinate to our indebtedness and preferred stock.

Shares of our common stock are equity interests in the Company and do not constitute indebtedness. As such, shares of our common stock will rank junior to all indebtedness and other non-equity claims on the Company with respect to assets available to satisfy claims on the Company, including in a liquidation of the Company. Additionally, holders of our common stock are subject to the prior dividend and liquidation rights of any holders of our preferred stock then outstanding.

Certain provisions in our Articles of Incorporation could make a third party acquisition of us difficult.

Our Articles of Incorporation contain provisions that could make it more difficult for a third party to acquire us by means of a tender offer, a proxy contest, merger or otherwise (even if doing so would be beneficial to our shareholders) and for holders of our common stock to receive any related takeover premium for their common stock. These provisions may have the effect of lengthening the time required for a person to acquire control of us through a tender offer, a proxy contest, merger or otherwise, and may deter any potentially hostile offers or other efforts to obtain control of us. These provisions could also limit the price that investors might be willing to pay in the future for shares of our common stock.

Item 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. PROPERTIES

The Company's headquarters are located in Sandpoint, Idaho, in a leased facility. As of December 31, 2013, the Company owns 11 offices, owns 2 other buildings subject to a ground lease, and leases 6 other facilities within its primary market areas in Idaho, eastern Oregon and eastern Washington. The properties that the Company occupies are used for corporate purposes, and are considered suitable and adequate for its present needs.

Item 3. 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 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Price and Dividend Information

The Company's Common Stock is traded on the NASDAQ Capital Markets under the symbol "IMCB". The Company has also issued non-voting common stock to certain investors. The non-voting common stock is not traded on any exchange or

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quotation system. Unless otherwise indicated, references throughout this report to “Common Stock” mean the Company's voting common stock.
As of February 24, 2014, there were 10 NASDAQ Market Makers. The range of high and low sales prices for the Company’s Common Stock for each quarter during the two most recent fiscal years is as follows:
Quarterly Common Stock Price Ranges

	2013		2012	
Quarter	High	Low	High	Low
1st	$ 13.50	$ 11.31	$ 13.00	$ 9.40
2nd	14.00	12.82	12.30	10.10
3rd	16.25	13.15	11.80	10.30
4th	16.45	14.59	13.00	11.25

All prices have been adjusted to reflect the impact of a 10-for-1 reverse stock split completed by the Company in October, 2012. At February 24, 2014 the Company had 2,701,214 shares of Common Stock outstanding held by approximately 1,700 shareholders of record. On January 9, 2013, the Company's voting common stock began trading on NASDAQ. However, Intermountain’s stock is still relatively thinly traded, with daily average volumes totaling 676 in 2013 and 313 in 2012, on a reverse split-adjusted basis.
The Company historically has not paid cash dividends, but may do so in the future. 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.
On December 19, 2008, the Company issued 27,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, no par value with a liquidation preference of $1,000 per share (“Series A Preferred Stock”) and a ten-year warrant to purchase up to 653,226 shares (or 65,323 shares on a reverse split-adjusted basis) of Common Stock, no par value, as part of the Troubled Asset Relief Program — Capital Purchase Program of the U.S. Department of Treasury (“U.S. Treasury”). The 27,000 shares were subsequently repurchased by the Company on November 19, 2013 for $27 million. The original $27.0 million cash proceeds were allocated between the Series A Preferred Stock and the warrant to purchase Common Stock based on the relative estimated fair values at the date of issuance. The fair value of the warrants was determined under the Black-Scholes model. The model includes assumptions regarding the Company’s common stock prices, dividend yield, and stock price volatility as well as assumptions regarding the risk-free interest rate. The exercise price for the warrants, which are still outstanding, is $62.00 per share on a reverse split-adjusted basis.
Prior to its repurchase in 2013, cash dividends on the Series A Preferred Stock accrued and were paid quarterly at a rate of 5% per year. The shares of Series A Preferred Stock had no stated maturity, did not have voting rights except in certain limited circumstances and were not subject to mandatory redemption or a sinking fund.
The Series A Preferred Stock had priority over the Company’s Common Stock with regard to the payment of dividends and liquidation distributions. The Series A Preferred Stock qualified as Tier 1 capital. The agreement with the U.S. Treasury contained limitations on certain actions of the Company including the payment of quarterly cash dividends on the Company’s Common Stock in excess of current cash dividends paid in the previous quarter and the repurchase of its Common Stock during the first three years of the agreement. In addition, the Company agreed that, while the U.S. Treasury owned the Series A Preferred Stock, the Company’s employee benefit plans and other executive compensation arrangements for its senior executive officers were required to comply with Section 111(b) of the Emergency Economic Stabilization Act of 2008.
On January 20, 2012, the Company entered into securities purchase agreements with certain investors (the “Securities Purchase Agreements”), pursuant to which such investors purchased in private placements, and the Company issued to the investors, (i) an aggregate of 12,350,352 shares (1,235,036 split-adjusted shares) of the Company's Common Stock for $1.00 per share ($10.00 split adjusted), (ii) an aggregate of 698,992.96 shares of the Company's Mandatorily Convertible Cumulative Participating Preferred Stock, Series B (“Series B Preferred Stock”), for $50.00 per share, which Series B Preferred Stock converted automatically at $1.00 per share into shares of a new series of non-voting common stock, no par value (“Non-Voting Common Stock”), upon shareholder approval of an amendment to the Company's Amended and Restated Articles of Incorporation to authorize such Non-Voting Common Stock (the

"Articles Amendment"), and (iii) warrants to purchase up to 1,700,000 shares (170,000 split adjusted) of the Non-Voting Common Stock at $1.00 per share ($10.00 split adjusted). The conversion of the Series B preferred stock resulted in the issuance of 34,949,648 shares of non-voting common stock, or 3,494,965 shares on a split-adjusted basis.

As a result of the approval of the Articles Amendment regarding the Non-Voting Common Stock, the Company is authorized to issue up to 10,000,000 shares of Non-Voting Common Stock, on a split-adjusted basis. Shares of the Non-Voting Common

Stock shall convert into shares of the Company's Common Stock upon certain transfers made in accordance with and as permitted by guidance and policies established by the Board of Governors of the Federal Reserve System.
The foregoing securities were offered and sold in reliance upon an exemption from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. Pursuant to the terms of the Securities Purchase Agreements, the Company filed appropriate registration statements for the resale of securities issued to the investors.
In May 2012, the Company successfully completed an $8.7 million registered Common Stock rights offering, including the purchase of unsubscribed shares by investors in the Company's January private placement. As a result of the capital raise, the Company issued 3,549,130 shares (354,913 split-adjusted shares) to investors not participating in the January private placement, and 1,703,681 shares (170,369 split-adjusted) of Common Stock and 3,447,189 shares (344,719 split-adjusted) of Non-Voting Common Stock to investors who participated in the January private placement.
Other than discussed above, there have been no securities of the Company sold within the last two years that were not registered under the Securities Act of 1933, as amended.
Equity Compensation Plan Information
The Company has historically maintained equity compensation plans that provided for the grant of awards to its officers, directors and employees. These plans consisted of the 1988 Employee Stock Option Plan, the Amended and Restated 1999 Employee Stock Option and Restricted Stock Plan and the 1999 Director Stock Option Plan. Each of these plans has expired and shares may no longer be awarded under these plans. However, unexercised options or unvested awards remain under these plans.
At the 2012 shareholder annual meeting, the Company's shareholders approved a new Employee Stock Option and Restricted Stock Plan ("2012 Plan") with substantially the same terms as the Amended and Restated 1999 Employee Stock Option and Restricted Stock Plan. Restricted stock grants totaling 100,000 shares, or the total amount authorized by shareholders under the 2012 plan, were issued on December 27, 2013, of which 2,392 were repurchased to cover employee tax liabilities. 50% of the shares vested immediately and the other 50% vest over the next two years.
The following table sets forth information regarding shares reserved for issuance pursuant to outstanding awards:

Plan Category	Number of Shares to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Shares Reflected in Column(a) (c))
Equity compensation plans approved by shareholders	56,079	$ 10.25	—

Issuer Purchases of Equity Securities
The following table provides information with respect to Common Stock purchases by the Company during the fiscal year 2013. The chart includes repurchases made during the entire fiscal year to reflect transactions occurring during the first quarter which were inadvertently omitted from the relevant quarterly report, as well as those made in the fourth quarter. The repurchases below represent the stock-for-stock net settlement of tax withholding on restricted stock awards that settled during the fiscal year 2013 and were the only repurchases made.

Period (2013)	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs

February 1 - February 28	68	$13.50	—	$—
October 1 - October 31	—	—	—	—
November 1 - November 30	—	—	—	—
December 1 - December 31	2,392	15.22	—	—
Total	2,460	$14.36	—	$—

Item 6. SELECTED FINANCIAL DATA

The following selected financial data (in thousands) of the Company is derived from the Company's historical audited consolidated financial statements and related notes. The information set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes contained elsewhere in this Form 10-K.

	For the Year Ended December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands, except per share)				
INCOME STATEMENT DATA					
Total interest income	$33,331	$35,876	$41,813	$46,217	$54,070
Total interest expense	(3,598)	(5,083)	(6,812)	(10,785)	(16,170)
Net interest income	29,733	30,793	35,001	35,432	37,900
Provision for loan losses	(559)	(4,306)	(7,289)	(24,012)	(36,329)
Net interest income after provision for losses on loans	29,174	26,487	27,712	11,420	1,571
Total other income	10,562	10,717	10,469	10,856	11,788
Total other expense	(34,083)	(33,433)	(38,330)	(54,894)	(49,630)
Income (loss) before income taxes	5,653	3,771	(149)	(32,618)	(36,271)
Income tax (provision) benefit	6,118	8	152	882	14,360
Net income (loss)	11,771	3,779	3	(31,736)	(21,911)
Preferred stock dividend	1,673	1,891	1,808	1,716	1,662
Net income (loss) applicable to common stockholders	$10,098	$1,888	$(1,805)	$(33,452)	$(23,573)
Net income (loss) per share(1)					
Basic	$1.57	$0.33	$(2.15)	$(39.89)	$(28.2)
Diluted	$1.55	$0.32	$(2.15)	$(39.89)	$(28.2)
Weighted average common shares outstanding(1)					
Basic	6,444,556	5,806,958	840,654	838,562	836,065
Diluted	6,494,089	5,825,283	840,654	838,562	836,065
Cash dividends per share	—	—	—	—	—

(1) Earnings per share and weighted average shares outstanding have been adjusted retroactively for the effect of stock splits and dividends, including the 10-for-1 reverse stock split effective October 5, 2012.

	December 31,				
	2013	2012	2011	2010	2009
BALANCE SHEET DATA					
Total assets	$939,648	$972,139	$934,218	$1,005,109	$1,079,644
Available-for-sale securities, at fair value	251,638	280,169	219,039	183,081	181,784
Net loans receivable	514,834	520,768	502,252	563,228	655,602
Deposits	706,050	748,934	729,373	778,833	819,321
Securities sold subject to repurchase agreements	99,888	76,738	85,104	105,116	95,233
Advances from Federal Home Loan Bank	4,000	4,000	29,000	34,000	49,000
Other borrowings	23,410	16,527	16,527	16,527	16,527
Stockholders' equity	94,012	114,434	61,616	59,353	88,627

RETURNS ON AVERAGE ASSETS, COMMON STOCKHOLDERS' EQUITY AND AVERAGE COMMON STOCKHOLDERS' EQUITY TO AVERAGE ASSETS

For the Years Ended December 31,	2013		2012	
Return on Average Assets	1.25	%	0.39	%
Return on Average Common Stockholders’ Equity	11.33	%	2.75	%
Average Tangible Stockholders’ Equity to Average Tangible Assets(1)	11.75	%	10.51	%
Average Tangible Common Stockholders’ Equity to Average Tangible Assets(2)	9.47	%	7.18	%

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(1) Average tangible stockholders' equity is average stockholders’ equity less average net other intangible assets.
(2) Average tangible common stockholders' equity is average common stockholders’ equity less average net other intangible assets.

Management believes tangible stockholders' equity, average tangible common stockholders' equity and the tangible common equity ratios are meaningful measures of capital adequacy. Management believes the exclusion of certain intangible assets in the computation of tangible equity and tangible common equity ratios provide a meaningful base for period-to-period and company-to-company comparisons, which management believes will assist investors in analyzing the operating results and capital of the Company. Tangible stockholders' equity is calculated as total stockholders’ equity less goodwill and other intangible assets. Tangible common stockholders' equity is calculated as total stockholders’ equity less preferred stock and less goodwill and other intangible assets. In addition, tangible assets are total assets less goodwill and other intangible assets. The tangible stockholders' equity ratio is calculated as tangible stockholders’ equity divided by tangible assets. The tangible common stockholders' equity ratio is calculated as tangible common stockholders’ equity divided by tangible assets. These ratios are considered non-GAAP financial measures and should be viewed in conjunction with the total stockholders’ equity and the total stockholders’ equity ratio.

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

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and Notes thereto presented elsewhere in this report. This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. For a discussion of the risks and uncertainties inherent in such statements, see “Forward-Looking Statements” and “Risk Factors” in Part I of this report.

Overview & History

Intermountain Community Bancorp (“Intermountain” or the “Company”) is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. Panhandle State Bank ("PSB" or "Bank"), a wholly owned subsidiary of the Company, was first opened in 1981 to serve the local banking needs of Bonner County, Idaho. PSB is regulated by the Idaho Department of Finance, the State of Washington Department of Financial Institutions, the Oregon Division of Finance and Corporate Securities and by the Federal Deposit Insurance Corporation (“FDIC”), its primary federal regulator and the insurer of its deposits.

Since opening in 1981, the Bank has continued to grow by opening additional branch offices throughout Idaho and has also expanded into the states of Oregon and Washington. Intermountain also operates Trust & Investment Services divisions, which provide investment, insurance, wealth management and trust services to its clients.

The slow pace of national and regional economic recovery has slowed the Company’s growth over the past several years. In response, Company management shifted its priorities to improving asset quality, raising additional capital, maintaining a conservative balance sheet and improving the efficiency of its operations. Significant progress has been made in these areas, and management is now pursuing prudent growth opportunities, both organically and through acquisition.

On January 9, 2013, the Company's voting common stock moved from the “Over the Counter” exchange to the NASDAQ Capital Markets Exchange.

As disclosed above, on November 20, 2013, the Company redeemed the 27,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, originally issued to Treasury for a total redemption price of $27 million, plus all accrued and unpaid dividends. The redemption was partially funded from proceeds received from a term loan in the amount of $7 million from NexBank SSB. The Bank up-streamed a dividend of $20 million with appropriate regulatory approvals to fund the balance of the redemption price.

Results of Operations

Overview. Net income applicable to common shareholders improved to $10.1 million, or $1.55 per diluted share, for 2013, from $1.9 million, or $0.32 per diluted share, in 2012. 2013 results included a $6.1 million tax benefit resulting from the reversal of the Company's deferred tax asset valuation allowance. This reversal and a much lower loan loss provision in 2013 offset modest decreases in net interest income and other income, and a moderate increase in operating expense. Operating expenses were negatively impacted by higher costs related to equity compensation granted to raise key employee compensation levels to market, a valuation reserve established on the installment sale of the Company's one remaining other real estate owned (OREO) property, and one-time expenses related to significant upgrades to the Company's technology.

The annualized return on average assets (“ROAA”) was 1.25% for the year ended December 31, 2013, as compared to 0.39% in 2012, and the return on average common equity (“ROAE”) was 11.33% in 2013 and 2.75% in 2012.

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 on deposits, repurchase agreements and other borrowings. Net interest income was $29.7 million and $30.8 million for 2013 and 2012, respectively. The decrease in net interest income from last year primarily reflects lower interest income on loans and investments resulting from declines in rate. Average loan volume increased $9.4 million from the prior period, but low market rates and intense competition for strong borrowers continued to pressure the Company's loan yields. Investment portfolio income was also down, as increases in average volumes were offset by rate reductions. Interest expense on deposits continued to decrease as deposit rates declined in response to lower market rates, and CD volumes continued to contract. The decrease in interest expense on other borrowings from last year reflected lower average borrowing volumes and lower rates paid on those borrowings.

The net interest margin decreased moderately from 3.57% in 2012 to 3.50% in 2013 for the reasons noted above. The Company anticipates that low market rates, strong competition for borrowers and heavy loan refinance activity will continue to pressure net interest margin in 2014 and perhaps beyond. The current environment is particularly challenging, as low market rates tighten current spreads and reduce net interest income, but extending the duration of loans or investments creates relatively high degrees of extension and mark-to-market risk. In light of these conditions, management has taken a conservative stance in trying to maintain income while keeping asset duration relatively short. It has done so by continuing to balance the production and purchase of longer-term loans and investment securities with offsetting variable rate or short-term loans and securities. Other efforts to mitigate this situation include migrating cash and investments into the higher yielding loan portfolio, paying off higher rate liabilities and reducing rates on other interest-bearing liabilities.

The following table provides information on net interest income for the past two years, setting forth average balances of interest-earning assets and interest-bearing liabilities, the interest income earned and interest expense recorded thereon and the resulting average yield-cost ratios.

Average Balance Sheets and Analysis of Net Interest Income

	For the Year Ended December 31, 2013			
	Average Balance	Interest Income/ Expense	Average Yield/Cost	
	(Dollars in thousands)			
Loans receivable, net(1)	$526,535	$26,973	5.12	%
Securities(2)	293,205	6,291	2.15	%
Interest-bearing cash and cash equivalents	29,590	67	0.23	%
Total earning assets	849,330	33,331	3.92	%
Non interest-bearing cash and cash equivalents	18,713			
Office property and equipment, net	35,410			
Other assets	28,269			
Total assets	$931,722			
Time deposits of $100,000 or more	$56,751	$753	1.33	%
Other interest-bearing deposits	420,489	1,231	0.29	%
Short-term borrowings	77,249	680	0.88	%
Other borrowed funds	20,111	934	4.64	%
Total interest-bearing liabilities	574,600	3,598	0.63	%
Non interest-bearing deposits	232,088			
Other liabilities	12,991			
Stockholders’ equity	112,043			
Total liabilities and stockholders’ equity	$931,722			
Net interest income		$29,733		
Net interest margin			3.50	%

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Average Balance Sheets and Analysis of Net Interest Income

	For the Year Ended December 31, 2012		
	Average Balance	Interest Income/ Expense	Average Yield/Cost
	(Dollars in thousands)		
Loans receivable, net(1)	$517,115	$28,172	5.45 %
Securities(2)	289,653	7,574	2.61 %
Interest-bearing cash and cash equivalents	56,419	130	0.23 %
Total earning assets	863,187	35,876	4.16 %
Non interest-bearing cash and cash equivalents	18,275		
Office property and equipment, net	36,598		
Other assets	29,513		
Total assets	$947,573		
Time deposits of $100,000 or more	$89,763	$1,132	1.26 %
Other interest-bearing deposits	434,976	1,870	0.43 %
Short-term borrowings	82,145	1,072	1.30 %
Other borrowed funds	20,528	1,009	4.92 %
Total interest-bearing liabilities	627,412	5,083	0.81 %
Non interest-bearing deposits	198,511		
Other liabilities	15,378		
Stockholders' equity	106,272		
Total liabilities and stockholders' equity	$947,573		
Net interest income		$30,793	
Net interest margin			3.57 %

(1) Non-accrual loans are included in the average balance, but interest on such loans is not recognized in interest income.

(2) Municipal interest income is not presented on a tax-equivalent basis, and represents a small portion of total interest income.

The following rate/volume analysis depicts the increase (decrease) in net interest income attributable to: (1) volume fluctuations (change in average balance multiplied by prior period rate); (2) interest rate fluctuations (change in rate multiplied by prior period average balance); and (3) volume/rate (changes in rate multiplied by changes in volume) when compared to the preceding year.

Changes Due to Volume and Rate 2013 versus 2012

	Volume	Rate	Volume/ Rate	Total
	(Dollars in thousands)			
Loans receivable, net	$513	$(1,682)	$(30)	$(1,199)
Securities	93	(1,359)	(17)	(1,283)
Interest-bearing cash and cash equivalents	(62)	(2)	1	(63)
Total interest income	544	(3,043)	(46)	(2,545)
Time deposits of $100,000 or more	(416)	58	(21)	(379)
Other interest-bearing deposits	(62)	(596)	20	(638)
Short-term borrowings	(64)	(348)	21	(391)
Other borrowed funds	(20)	(56)	—	(76)
Total interest expense	(562)	(942)	20	(1,484)

Net interest income	$1,106	$(2,101)	$(66)	$(1,061)

Net Interest Income — 2013 Compared to 2012

The Company’s net interest income decreased to $29.7 million in 2013 from $30.8 million in 2012. The net interest income change attributable to volume changes was a favorable $1.1 million from 2012 as increases in average loans and securities and decreases in average deposits and Federal Home Loan Bank advances combined to offset decreases in average interest-bearing cash and increases in repurchase agreement balances. The favorable impacts of volume changes were more than offset, however, by a $2.1 million reduction resulting from unfavorable changes in rates. Lower rates for loans and investments resulted in about $3.0 million in reduced net interest income, and offset the $942,000 positive impact from lowering liability rates. The interplay between rate and volume factors resulted in a $66,000 decrease in net interest income for the period.

The yield on interest-earning assets decreased 0.24% in 2013 from 2012, while the cost of interest-bearing liabilities decreased 0.18% during the same period. As noted above, the overall earning-asset yield was impacted by continued decreases in both loan and investment yields, as low market rates, keen competition for quality loans, strong demand for fixed income securities and high prepayment speeds on mortgage-backed securities all put pressure on yield. Rates paid on interest bearing cash equivalents remained between 0.00% and 0.25% throughout 2013, meaning that the $29.6 million in average interest bearing cash equivalents balances earned only minimal income.

The yield on the Company’s loans, at 5.12%, was down 0.33% from the prior year for the reasons noted above. Interest reversals on non-accrual and other problem loans totaling $187,000 were much less of a factor than in prior years, as the Company continued to successfully improve the quality of the credit portfolio. Problem loans include loans charged off directly or transferred to OREO. The securities portfolio yield also decreased, although it partially recovered later in the year as rising market rates moderately improved yields and significantly lowered prepayments on mortgage-backed securities. Based on current and projected market rates for the next 18 months, the Company anticipates continued moderate improvement in investment yields, but continued pressure on loan yields. Management will seek to offset the negative impacts of this pressure by migrating cash into the higher-yielding investment and loan portfolios.

Offsetting some of the impact of lower interest income, the Company lowered its interest expense by $1.5 million or 29.2% in 2013. Overall, average interest-bearing liabilities decreased by $52.8 million as the reduction in assets created opportunities to pay down, release or convert higher cost interest-bearing liabilities. Active management strategies and low market rates reduced the average cost on its interest-bearing liabilities from 0.81% to 0.63% while maintaining its solid relationship-based deposit base. The overall cost of interest-bearing deposits decreased from 0.42% to 0.28% as a result of repricing both time and non-maturity deposits down during the year. Average non-interest bearing deposits increased by $33.6 million and total non interest bearing demand deposits comprise 29% of the average deposit portfolio. This compares favorably to the Company's peers and provides a low-cost funding source in any interest-rate environment. The cost of FHLB advances and other short-term borrowings decreased from 1.30% to 0.88%, and these volumes were also reduced as the Company paid off a $25 million FHLB advance late in 2012 that lowered 2013 average volumes. The average balance on other borrowed funds was relatively flat from 2012 to 2013, but the cost of the borrowings decreased from 4.92% to 4.64% as a swap on one of the Company's trust preferred obligations matured, lowering the effective interest expense on this instrument. Given its liquidity position and current market rates, the Company anticipates that it will continue to reduce interest expense in 2014 through lower CD pricing and the continued payoff of higher-rate wholesale funding.

Provision for Losses on Loans & Credit Quality

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, and underlying collateral values, as well as current and potential risks identified in the portfolio. See Note 3 of the "Notes to Consolidated Financial Statements" for additional information on asset quality, loan portfolio trends and provision for loan loss trends.

The provision for losses on loans totaled $559,000 for the year ended December 31, 2013, compared to a provision of $4.3 million for the year ended December 31, 2012. Net chargeoffs in 2013 totaled $815,000, down significantly from the $9.1 million reported in 2012. The following table summarizes provision and loan loss allowance activity for the periods indicated.

Trend Analysis of the Allowance for Loan Losses

	December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands)				
Balance Beginning January 1	$(7,943)	$(12,690)	$(12,455)	$(16,608)	$(16,433)
Charge-Offs					
Commercial loans	407	2,649	1,366	10,603	5,037
Commercial real estate loans	703	4,548	2,594	5,610	3,194
Commercial construction loans	—	243	217	1,393	4,982
Land and land development loans	186	1,601	3,056	8,622	19,817
Agriculture loans	288	32	400	1,055	988
Multifamily loans	—	—	—	16	53
Residential loans	230	1,256	757	2,019	1,598
Residential construction loans	—	—	34	101	241
Consumer loans	246	422	624	490	1,001
Total Charge-offs	2,060	10,751	9,048	29,909	36,911
Recoveries					
Commercial loans	(738)	(453)	(755)	(628)	(144)
Commercial real estate loans	(81)	(466)	(293)	(311)	—
Commercial construction loans	(15)	(10)	(3)	(391)	(1)
Land and land development loans	(82)	(283)	(507)	(175)	(347)
Agriculture loans	(65)	(117)	(103)	(31)	—
Residential loans	(91)	(196)	(157)	(50)	(9)
Residential construction loans	(1)	(7)	—	—	—
Consumer loans	(172)	(166)	(176)	(158)	(256)
Total Recoveries	(1,245)	(1,698)	(1,994)	(1,744)	(757)
Net Charge-offs	815	9,053	7,054	28,165	36,154
Provision for losses on loans	(559)	(4,306)	(7,289)	(24,012)	(36,329)
Balance at end of period	$(7,687)	$(7,943)	$(12,690)	$(12,455)	$(16,608)
Ratio of net charge-offs to loans outstanding	0.16%	1.71%	1.37%	4.89%	5.38%
Allowance — Unfunded Commitments					
Balance Beginning January 1	$(15)	$(13)	$(17)	$(11)	$(13)
Adjustment	(1)	(2)	4	(6)	2
Allowance — Unfunded Commitments at end of period	$(16)	$(15)	$(13)	$(17)	$(11)

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The following tables provide additional information on the loan portfolio, non-accrual loans and the loan loss allowance assigned to each loan type for the two most recent years.

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

	December 31, 2013				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	21.8	%	$113,736	$1,819	$ 1,431
Commercial real estate loans	34.7	%	181,207	2,455	167
Commercial construction loans	1.4	%	7,383	177	—
Land and land development loans	5.5	%	28,946	1,067	161
Agriculture loans	18.5	%	96,584	726	213
Multifamily loans	3.5	%	18,205	33	—
Residential real estate loans	11.3	%	59,172	1,192	693
Residential construction loans	0.5	%	2,531	56	—
Consumer loans	1.7	%	9,033	136	3
Municipal loans	1.1	%	5,964	26	—
Totals	100.0	%	$522,761	$7,687	$ 2,668

	December 31, 2012				
	Percent of Loans to Total Loans		Gross Loans	Allowance	Non-Accrual Loans
Commercial loans	23.0	%	$121,307	$2,156	$ 4,042
Commercial real estate loans	35.4	%	186,844	2,762	1,716
Commercial construction loans	0.7	%	3,832	101	—
Land and land development loans	5.9	%	31,278	1,197	246
Agriculture loans	16.3	%	85,967	228	98
Multifamily loans	3.1	%	16,544	51	—
Residential real estate loans	11.4	%	60,020	1,144	423
Residential construction loans	0.2	%	940	24	—
Consumer loans	1.8	%	9,626	202	4
Municipal loans	2.3	%	12,267	78	—
Totals	100.0	%	$528,625	$7,943	$ 6,529

The loan portfolio is segregated into impaired loans for which a specific reserve is calculated by management, and loans for which a reserve is calculated using an allowance model. The following table provides information on each of these categories.

Composition of the Loan Loss Allowance

	December 31				
	2013	2012	2011	2010	2009
	(Dollars in thousands)				
Collective Allocation	$6,181	$6,379	$6,439	$8,235	$10,234
Impaired Allocation	1,506	1,564	6,251	4,220	6,374
Allowances for Loan Loss	$7,687	$7,943	$12,690	$12,455	$16,608

For impaired loans with a specific reserve, management evaluates each loan and derives the reserve based on such factors as expected collectability, collateral value and guarantor support. For loans with reserves calculated by the model, the model

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mathematically derives a base reserve allocation for each loan using probability of default and loss given default rates based on both historical company and regional industry experience. This base reserve allocation is then modified by management considering factors such as the current economic environment, portfolio delinquency trends, collateral valuation trends, quality of underwriting and quality of collection activities. The reserves derived from the model are reviewed and modified by management, then added to the reserve for specifically identified loans to produce the total reserve. Management believes that this methodology provides a reasonable, reliable and verifiable reserve calculation and is in compliance with regulatory and accounting guidance.

Local economic conditions stabilized and the quality of the Company's credit portfolio improved significantly in 2013 as the Company's aggressive resolution efforts paid dividends during the year in significant reductions in problem loans and loss exposure. Still, credit conditions remain uncertain and the Company continues to proactively manage its portfolio and allowance. The allowance ended the year at $7.7 million or 1.47% of total loans, as compared to 1.50% at the end of 2012. At December 31, 2013, the allowance for loan losses totaled 288.1% of non-performing loans (“NPLs”), up from 121.7% at year end 2012, as non-accrual loans declined significantly during the year.

Given current economic uncertainty, management continues to evaluate and adjust the loan loss allowance carefully and frequently to reflect the most current information available concerning the Company’s markets and loan portfolio. In its evaluation, management considers current economic and borrower conditions in both the pool of loans subject to specific impairment, and the pool subject to a more generalized allowance based on historical and other factors. The allocation for specifically impaired loans ("ASC 310-10-35") decreased modestly in 2013 as the Company continued to resolve its impaired credits, but at a slower pace than the significant gains made in prior years. In general, portfolio losses are no longer concentrated in any particular industry or loan type, as prior efforts to reduce exposure in construction, land development and commercial real estate loans have decreased the exposure in these segments considerably. When a loan is characterized as impaired, the Company performs a specific evaluation of the loan, focusing on potential future cash flows likely to be generated by the loan, current collateral values underlying the loan, and other factors such as government guarantees or guarantor support that may impact repayment. Based on this evaluation, it sets aside a specific reserve for this loan and/or charges down the loan to its net realizable value (selling price of collateral less estimated closing costs) if it is unlikely that the Company will receive any cash flow beyond the amount obtained from liquidation of the collateral. If the loan continues to be impaired, management periodically re-evaluates the loan for additional potential impairment, and charges it down or adds to reserves if appropriate.The allocation of the allowance to the non-specific loan pool ("ASC 450-20") also declined modestly from 2012, reflecting stabilized conditions in the rest of the Company's loan portfolio. In calculating the reserve for this pool, management evaluates both regional and loan-specific historical loss trends to develop its base reserve level on a loan-by-loan basis. The regional historical loss trends are based on data from 1992 to the present day and encompass several different economic and credit cycles. Management then modifies those reserves by considering the risk grade of the loan, current economic conditions, the recent trend of defaults, trends in collateral values, underwriting and other loan management considerations, and unique market-specific factors such as water shortages or other natural phenomena. The 2013 ending allowance reflected still uncertain market conditions, offset by conservative credit underwriting and management practices employed by the Company over the past few years.

General trending information with respect to non-performing loans, non-performing assets, and other key portfolio metrics is as follows (dollars in thousands):
Credit Quality Trending

	At December 31,				
	2013	2012	2011	2010	2009
	(In thousands)				
Loans past due in excess of 90 days and still accruing	$—	$—	$—	$66	$586
Non-accrual loans	2,668	6,529	9,292	11,451	18,468
Total non-performing loans (“NPLs”)	2,668	6,529	9,292	11,517	19,054
OREO	3,684	4,951	6,650	4,429	11,538
Total non-performing assets (“NPAs”)	$6,352	$11,480	$15,942	$15,946	$30,592
Classified loans (1)	$23,056	$24,933	$53,207	$54,085	$77,175
Troubled debt restructured loans (2)	$10,047	$6,719	$7,236	$5,455	$4,604
Total allowance related to non-accrual loans	$84	$536	$676	$1,192	$965
Interest income recorded on non-accrual loans (3)	$187	$424	$716	$848	$1,126
Non-accrual loans as a percentage of net loans receivable	0.52 %	1.25 %	1.85 %	2.03 %	2.82 %
Total non-performing loans as a % of net loans receivable	0.52 %	1.25 %	1.85 %	2.04 %	2.91 %
Allowance for loan losses (“ALLL”) as a percentage of non-performing loans	288.1 %	121.7 %	136.6 %	108.1 %	87.2 %
Total NPAs as a % of total assets	0.68 %	1.18 %	1.71 %	1.59 %	2.83 %
Total NPAs as a % of tangible capital + ALLL (“Texas Ratio”)	6.25 %	9.39 %	21.51 %	22.30 %	32.85 %
Loan delinquency ratio (30 days and over)	0.24 %	0.13 %	0.28 %	0.55 %	1.06 %

(1) Classified loan totals are inclusive of non-performing loans and may also include troubled debt restructured loans, depending on the grading of these restructured loans.
(2) Includes accruing restructured loans of $9.2 million and non-accruing restructured loans of $831,000. No other funds are available for disbursement on restructured loans.
(3) Interest income on non-accrual loans based on year-to-date interest totals.

The $3.9 million decrease in non-accrual loans from December 31, 2012 to December 31, 2013 reflected ongoing workout efforts by the Company's special assets team. This team continued to migrate properties through the collections process and made steady progress in reducing overall levels of non-accrual loans through multiple management strategies, including borrower workout and individual note sales to local and regional investors. NPAs, which include other real estate owned ("OREO") properties decreased by $5.1 million, as the Company continued to successfully liquidate properties in 2013. These ratios compare favorably to the Company's peer groups, particularly in the northwest. Loan delinquencies (30 days or more past due) were up slightly from year end 2012, but still reflect strong performance in the general loan portfolio.

The following tables provide additional trending and geographical information on the Company's NPAs:

Nonperforming Asset Trending By Category

	December 31 2013	September 30 2013	June 30 2013	March 31 2013	December 31 2012
	(Dollars in thousands)				
Commercial	$1,431	$ 1,066	$1,417	$1,573	$4,042
Commercial real estate	167	261	2,728	2,910	1,716
Commercial construction	—	—	—	—	—
Land and land development	3,845	4,415	4,626	4,852	5,118
Agriculture	213	527	276	276	98
Residential real estate	693	814	173	186	502
Residential construction	—	—	—	—	—
Consumer	3	3	91	4	4
Total NPAs by Categories	$6,352	$ 7,086	$9,311	$9,801	$11,480

All major loan types experienced decreases from the prior year end, reflecting sales and collection activity. Land and land development loans still comprise the greatest proportion of NPA totals, primarily as a result of one large relationship. The majority of NPAs are in the North Idaho/Eastern Washington region, reflecting the Company's higher loan totals in these areas.

The Company has entered into an installment sales agreement to sell its final remaining OREO property over a five-year period. While the contract requires full payment of the balance recorded by the Company, because of the installment sales contract, accounting guidance requires the maintenance of the OREO balance on the Company's books and the establishment of a $539,000 valuation reserve against the balance. The Company anticipates recovery of this reserve over the five-year period.

All NPAs are reported at the Company's best estimate of net realizable value. The Company has evaluated the borrowers and the collateral underlying these loans and determined the probability of recovery of the loans' principal balance. Given the volatility in the current market, the Company continues to monitor these assets closely and revalue the collateral on a frequent and periodic basis. This re-evaluation may create the need for additional write-downs or additional loss reserves on these assets.

At December 31, 2013 and 2012, classified loans (loans with risk grades 6, 7 or 8) by loan type are as follows (dollars in thousands):

	December 31,	
Classified Loans	2013	2012
Commercial loans	$7,520	$7,693
Commercial real estate loans	3,659	5,156
Land and land development loans	1,041	1,515
Agriculture loans	4,038	2,143
Multifamily loans	3,751	5,118
Residential real estate loans	2,960	3,045
Consumer loans	87	262
Total classified loans	$23,056	$24,932

Classified loans are loans for which management believes it may experience some problems in obtaining repayment under the contractual terms of the loan, and are inclusive of the Company's non-accrual loans. However, categorizing a loan as classified does not necessarily mean that the Company will experience any or significant loss of expected principal or interest.

The Company reduced its classified loans by $1.9 million in 2013. The total balance of classified loans reached a peak of $96.2 million in July 2009, and has been reduced by 76.0% since then, as a result of the workout and disposition efforts of the Company’s special assets team. As a percentage of the Company’s net loans, classified loans reached a peak of 13.9% in November 2009, and have now dropped to 4.5% at the end of 2013.

Classified loan balances were lower in every loan segment except agriculture at the end of 2013. Agriculture loans increased modestly as higher input prices put pressure on several farming operations. The remaining classified loans also generally have stronger borrowers, healthier collateral positions and/or stronger guarantors than prior classified balances that were heavily dominated by more speculative land and construction loans.

As with NPAs, the geographical distribution of the Company's classified loans reflects the distribution of the Company's loan portfolio and the relative recoveries of its various regions, with higher distributions in the "North Idaho/Eastern Washington" region, and decreased levels in southern Idaho.

Local economies and real estate valuations continued to improve in 2013, but at a relatively slow pace. As such, management believes that classified loans, non-performing assets, and credit losses will likely continue to decline in 2014. Given market volatility and future uncertainties, management cannot assure nor guarantee the accuracy of these future forecasts.

Management continues to focus its efforts on managing down the level of non-performing assets, classified loans and delinquencies. It uses a variety of analytical tools and an integrated stress testing program involving both qualitative and quantitative modeling to assess the current and projected state of its credit portfolio. The results of this program are integrated with the Company's capital and liquidity modeling programs to manage and mitigate future risk in these areas as well.

Other Income

The following table details dollar amount and percentage changes of certain categories of other income for the two years ended December 31.

	2013 Amount	% of Total	Percent Change Prev. Yr	2012 Amount	% of Total
	(Dollars in thousands)				
Fees and service charges	$4,866	46 %	3 %	$4,732	44 %
Commissions & fees from trust & investment advisory services	2,344	22 %	49 %	1,568	15 %
Loan related fee income	2,312	22 %	(23)%	2,987	28 %
Net gain on sale of securities	301	3 %	(62)%	794	7 %
Net gain (loss) on sale of other assets	1	— %	(95)%	19	— %
Other-than-temporary credit impairment on investment securities	(63)	(1)%	(82)%	(357)	(3)%
BOLI income	324	3 %	(6)%	345	3 %
Hedge fair value adjustment	326	3 %	(200)%	(326)	(3)%
Unexercised warrant liability fair value adjustment	(114)	(1)%	(163)%	180	2 %
Other income	265	3 %	(66)%	775	7 %
Total	$10,562	100 %	(1)%	$10,717	100 %

Total other income was $10.6 million and $10.7 million for the twelve months ended December 31, 2013 and 2012, respectively, as higher trust and investment services income and a positive hedge fair value adjustment were offset by lower mortgage origination fees, securities gains, secured savings contract income and a negative unexercised warrant liability fair value adjustment.

Fees and service charges earned on deposit accounts continued to be the Company's primary source of other income. Fees and service charges for the twelve month period ended December 31, 2013 totaled $4.9 million versus $4.7 million for the same period last year. Higher debit card and monthly deposit service fees offset a continued reduction in overdraft charges resulting from new federal regulations that came into effect in July 2010 and July 2011. The Company implemented new fee structures in mid-2012, which positively impacted fee levels for the full year in 2013. Fees from trust and investment services totaled $2.3 million in 2013, a 49.5% increase from 2012 as the Company continued to emphasize the development of this business.

Loan related fee income decreased by $675,000 for the twelve months ended December 31, 2013 compared to one year ago as mortgage origination activity declined as a result of higher mortgage rates, particularly in the latter half of the year. Loan servicing income increased moderately, as the loan volume that the Company services continues to increase. The Company anticipates lower mortgage origination activity to continue in 2014, as higher rates have dampened demand for refinances.

The Company recognized $301,000 in gains on the sale of securities, which helped offset moderate additional credit impairments on securities that are classified as other than temporarily impaired ("OTTI"). The two securities classified as OTTI were sold during 2013. The Company also recorded a positive $326,000 fair value adjustment related to a cash flow hedge on one of the Company's trust preferred obligations that matured in 2013. This reversed the negative adjustment in 2012, which resulted from the loss of hedge effectiveness on the instrument. Partially offsetting this positive adjustment was a $114,000 negative fair value adjustment taken on the Company's unexercised warrant liability. This liability was created by the issuance of three-year warrants for 1,700,000 shares, and on a reverse-split adjusted basis, 170,000 shares, to investors as part of the Company's January 2012 capital raise and must be adjusted to fair value each quarter. As such, there are likely to be fluctuating adjustments in future periods.

Bank-owned life insurance (“BOLI”) income was down slightly from the prior year as BOLI yields declined and the Company did not purchase or liquidate BOLI assets. Other non-interest income totaled $265,000 for 2013, compared to $775,000 for the comparable prior period. The reductions reflect continued decreases in the Company's secured card contract income as this contract terminated in 2013.

The Company continues to pursue efforts to improve future non-interest income. It is particularly focused on expanding revenues from trust, investment and insurance services, where it has strong, experienced staff in place to generate both organic growth and manage potential acquisitions. It also is pursuing expanded card and payment-based revenue sources, but regulatory limitations may limit potential opportunities in these areas.

Operating Expenses

The following table details dollar amount and percentage changes of certain categories of other expense for the two years ended December 31.

	2013 Amount	% of Total	Percent Change Previous Year	2012 Amount	% of Total
	(Dollars in thousands)				
Salaries and employee benefits	$17,619	52 %	8 %	$16,291	48 %
Occupancy expense	4,640	14 %	(6)%	4,911	15 %
Technology	3,718	11 %	4 %	3,583	11 %
Advertising	650	2 %	3 %	633	2 %
Fees and service charges	359	1 %	(40)%	597	2 %
Printing, postage and supplies	727	2 %	(26)%	987	3 %
Legal and accounting	1,709	5 %	(5)%	1,796	5 %
FDIC assessment	627	2 %	(39)%	1,024	3 %
OREO operations(1)	825	2 %	26 %	653	2 %
Other expense	3,209	9 %	8 %	2,958	9 %
Total	$34,083	100 %	2 %	$33,433	100 %

(1) Amount includes chargedowns and gains/losses on sale of OREO

Operating expense for the twelve months ended December 31, 2013 totaled $34.1 million, an increase of $650,000 over the same period one year ago.

At $17.6 million, compensation and benefits expense increased $1.3 million or 8.2% over 2012. 2013 results were impacted by $765,000 in expense associated with the issuance and immediate vesting of restricted stock for key employees to bring compensation levels to market. Merit increases and additional commission expense associated with the improvement in trust and investment service income comprised the rest of the increase from the prior year. The employee full time equivalent ("FTE") number was stable at 271 compared to 270 in the year before. Although the Company has largely completed its staff restructuring efforts, it continues to evaluate opportunities to improve staff efficiency while positioning itself for balance sheet growth.

Occupancy expenses decreased $271,000 from 2012, reflecting lower depreciation, software and rent expense. The Company continues to review asset and software purchases carefully, re-negotiate contracts, and implement energy and other resource conservation measures in its facilities. Technology expenses increased by $135,000 during the year as one-time expenses associated with implementing new core data- and item-processing contracts offset savings achieved by those systems in 2013. The Company anticipates significant savings in future years as these systems become fully functional and old contracts terminate.

Advertising expenses were up slightly in 2013, reflecting more aggressive marketing efforts in the Company's local markets. Lower collection fees and bank service charges resulted in lower fees and service charges in 2013 and savings associated with the new item-processing contract lowered printing and postage expenses. The Company anticipates further savings in both of these areas in the future.

Legal and accounting fees declined moderately over last year, and are expected to decrease further in future years as the Company has resolved many of its more complex legal and accounting issues over the past few years. The reduction in FDIC assessment expense reflects a lower rate paid by the Bank based on its financial performance and changes in the FDIC assessment formula itself.
OREO expense increased moderately as the Company established a $539,000 valuation adjustment on the installment sale of its last remaining OREO property. The Company anticipates recovery of this allowance over a five-year period and does not anticipate significant additional OREO expense in the near future.
Other expenses increased $251,000 from 2012, largely from increased operating losses associated with debit card and internet banking fraud activity in 2013. In response to increasing national and regional fraud threats, the Company introduced a number of new tools in the latter part of the year to reduce its exposures, and will continue to evaluate and develop additional safeguards in 2014. Other expenses in this category, including insurance, telecommunications, armored car and travel expenses were either flat or down for the year. The Company continues to evaluate opportunities for additional expense reduction in many of the categories included in this line item, and anticipates further reductions in 2014.
Annualized operating expense as a percentage of average assets was 3.63% and 3.49% for 2013 and 2012, respectively. The Company’s efficiency ratio (noninterest expense divided by the sum of net interest income and noninterest income) was 84.6% for 2013, compared to 80.5% in 2012. Both 2013 numbers were impacted by the unusual expenses in compensation, technology and OREO operations noted above. With economic conditions likely to remain challenging in the near future, the Company continues to develop and implement additional efficiency and cost-cutting efforts. Management anticipates that as it completes its current initiatives, the efficiency and expense ratios will improve. Stabilization and improvement in economic conditions in the future should also improve efficiency, as the Company grows its asset base, net interest income rebounds and credit-related costs subside further.
Income Tax Provision.
The Company reversed its remaining deferred tax asset valuation allowance in 2013, resulting in a tax benefit of $6.1 million for the year. This compared to an $8,000 tax benefit recorded in 2012. The effective tax rates were (108.2%) for 2013 and 0.0% for 2012. The Company held a net deferred tax asset of $21.7 million at December 31, 2013, as compared to a net deferred tax asset of $12.3 million at the end of 2012. The increase in the net deferred tax asset reflects the reversal of the valuation allowance and the impacts of a decrease in the unrealized market value of the Company's investment securities.
At December 31, 2013, Intermountain assessed whether it was more likely than not that it would realize the benefits of its deferred tax asset. It determined that the positive evidence associated with a three-year cumulative positive income, improving national and regional economic conditions, significantly reduced credit and other balance sheet risk, and improving Company performance offset the negative evidence of losses in 2009 and 2010. Intermountain used an estimate of future earnings, future reversals of taxable temporary difference, and tax planning strategies to determine whether it is more likely than not that the benefit of the deferred tax asset would be realized. In estimating the future earnings, management assumed moderately improving economic conditions. As such, its estimates included continued lower credit losses in 2014 and ensuing years as the Company’s loan portfolio continues to turn over. It also assumed: (1) a compressed but stable net interest margin in 2014, with gradual improvement in future years, as the Company is able to convert some of its cash position to higher yielding instruments; (2) stable other income as increased trust and investment income offsets reductions in mortgage origination income; and (3) stable operating expenses as continued cost reduction strategies offset inflationary increases.
At December 31, 2012, Intermountain assessed whether it was more likely than not that it would realize the benefits of its deferred tax asset. Intermountain determined at that time that the negative evidence associated with a three-year cumulative loss for the period ended December 31, 2011, and challenging economic conditions continued to outweigh the positive evidence. Therefore, Intermountain maintained a valuation allowance of $8.5 million against its deferred tax asset at December 31, 2012.
The Company also considered the effects of Internal Revenue Code Section 382 in its analysis of its deferred tax assets and valuation allowance. The Company experienced an ownership change as defined in Section 382, that resulted from the capital raise that occurred in 2012. As a result, the net operating losses are subject to an annual

limitation. Based on its analysis, the limitation will only affect the timing of when the net operating losses will be utilized, and the Company believes that it will be able to recover all of its tax benefit from the net operating loss carryforward position in the 20-year carryforward period, even given the Section 382 limitations. As with other future estimates, the Company cannot guarantee these future results, however. The Company analyzes the deferred tax asset on a quarterly basis and may establish a new allowance at some future time depending on actual results and estimates of future profitability.

Financial Position

Assets. At December 31, 2013, Intermountain’s assets were $939.6 million, down $32.5 million from $972.1 million at December 31, 2012. The decrease from last year represents the use of cash and marketable securities to redeem the CPP preferred stock and to pay down higher cost liabilities, including brokered and higher rate retail CDs.

Fed Funds Sold & Cash Equivalents. The Bank held $44.9 million in interest-bearing cash equivalents at December 31, 2013, with the bulk of it deposited at the Federal Reserve. This compares to $53.4 million in interest-bearing cash equivalents at December 31, 2012, as funds were deployed to pay down liability balances and redeem the Company's CPP preferred stock in 2013. In 2012 and 2013, excess funds were held at the Federal Reserve as opposed to Fed Funds Sold at a correspondent bank as there was a higher yield on the excess funds at the Federal Reserve.

Non-interest bearing and restricted cash totaled $20.2 million at December 31, 2013, compared to $26.7 million at December 31, 2012. As with interest-bearing cash above, the decrease reflects the use of cash to pay down liabilities.

Investments. Intermountain’s investment portfolio at December 31, 2013 was $279.9 million, a decrease of $15.1 million from the December 31, 2012 balance of $295.0 million. The decrease was primarily due to the sale of available-for-sale securities to redeem the Company's CPP preferred stock. Securities purchases totaled $124.4 million in 2013, but were offset by sales of $67.5 million, and principal payments on mortgage-backed securities and other adjustments of 58.2 million. The sales generated $301,000 in net pre-tax gains. As of December 31, 2013, the balance of the unrealized loss on investment securities, net of federal income taxes, was $1.2 million, compared to an unrealized gain at December 31, 2012 of $3.5 million. The decrease reflected the negative impact on the value of the portfolio resulting from an approximate one percent increase in market interest rates during 2013.

During 2013, the Company held, but sold two residential MBS that were determined to have other than temporary impairments. At the time of sale, impairment for these two securities totaled $3.5 million, of which $1.9 million, including $63,000 in 2013, had been recorded as credit loss impairment in income and the remainder in other comprehensive income. The Company calculated the credit loss charges against earnings by subtracting the estimated present value of future cash flows on the securities from their amortized cost less the total of previous credit loss impairment at the end of each period.