

FIRST INTERSTATE BANCSYSTEM INC

Form 10-Q

April 26, 2007

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**☐ Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2007**

**OR**

**○ Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**COMMISSION FILE NUMBER 000-49733**

**First Interstate BancSystem, Inc.**

(Exact name of registrant as specified in its charter)

Montana

81-0331430

(State or other jurisdiction of  
incorporation or organization)

(IRS Employer  
Identification No.)

401 North 31st Street, Billings, MT

59116-0918

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

406/255-5390

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer \_\_\_\_\_ Accelerated filer \_\_\_\_\_ Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes \_\_\_\_\_ No

The Registrant had 8,183,412 shares of common stock outstanding on March 31, 2007.

FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES  
Quarterly Report on Form 10-Q

| Index   | Page |
|---|------|
| <b>Part I. Financial Information</b>  |      |
| Item 1 Financial Statements (unaudited)<br><u>Consolidated Balance Sheets March 31, 2007 and December 31, 2006</u>        | 3    |
| <u>Consolidated Statements of Income Three months ended March 31, 2007 and 2006</u>                                       | 4    |
| <u>Consolidated Statements of Stockholders Equity and Comprehensive Income Three months ended March 31, 2007 and 2006</u> | 5    |
| <u>Consolidated Statements of Cash Flows Three months ended March 31, 2007 and 2006</u>                                   | 6    |
| <u>Notes to Unaudited Consolidated Financial Statements</u>   | 7    |
| Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                       | 11   |
| Item 3 <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 19   |
| Item 4T <u>Controls and Procedures</u>  | 19   |
| <b>Part II. Other Information</b>   |      |
| Item 1 <u>Legal Proceedings</u>   | 20   |
| Item 1A <u>Risk Factors</u>   | 20   |
| Item 2 <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 20   |
| Item 3 <u>Defaults Upon Senior Securities</u>   | 20   |
| Item 4 <u>Submission of Matters to a Vote of Security Holders</u>   | 21   |
| Item 5 <u>Other Information</u>   | 21   |
| Item 6 <u>Exhibits</u>  | 21   |
| <b>Signatures</b>   | 23   |
| <u>Certification by Chief Executive Officer</u>   |      |
| <u>Certification by Chief Financial Officer</u>   |      |
| <u>Section 906 Certifications</u>   |      |

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Consolidated Balance Sheets***(In thousands, except share data)*

(Unaudited)

|  | March 31,<br>2007 | December<br>31,<br>2006 |
|--|-------------------|-------------------------|
| Assets   |                   |                         |
| Cash and due from banks  | \$ 152,028        | 187,555                 |
| Federal funds sold   | 162,515           | 55,427                  |
| Interest bearing deposits in banks   | 19,063            | 12,809                  |
| Total cash and cash equivalents  | 333,606           | 255,791                 |
| Investment securities:   |                   |                         |
| Available-for-sale   | 870,282           | 1,012,658               |
| Held-to-maturity (estimated fair values of \$114,337 as of March 31, 2007 and \$112,391 as of December 31, 2006) | 113,963           | 111,940                 |
| Total investment securities  | 984,245           | 1,124,598               |
| Loans  | 3,363,981         | 3,310,363               |
| Less allowance for loan losses   | 48,621            | 47,452                  |
| Net loans  | 3,315,360         | 3,262,911               |
| Premises and equipment, net  | 119,923           | 120,280                 |
| Accrued interest receivable  | 31,786            | 30,913                  |
| Company-owned life insurance   | 65,261            | 64,705                  |
| Mortgage servicing rights, net of accumulated amortization and impairment reserve                                | 20,359            | 22,644                  |
| Goodwill   | 37,380            | 37,380                  |
| Net deferred tax asset   | 7,179             | 8,297                   |
| Other assets   | 44,756            | 46,615                  |
| Total assets   | \$ 4,959,855      | 4,974,134               |
| Liabilities and Stockholders Equity  |                   |                         |
| Deposits:  |                   |                         |
| Noninterest bearing  | \$ 872,272        | 888,694                 |
| Interest bearing   | 2,990,952         | 2,819,817               |
| Total deposits   | 3,863,224         | 3,708,511               |
| Securities sold under repurchase agreements  | 568,042           | 731,548                 |
| Accrued interest payable   | 20,325            | 18,872                  |
| Accounts payable and accrued expenses  | 33,952            | 36,295                  |
| Other borrowed funds   | 220               | 5,694                   |

Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|   |              |           |
|---|--------------|-----------|
| Long-term debt  | 11,237       | 21,601    |
| Subordinated debenture held by subsidiary trust   | 41,238       | 41,238    |
| Total liabilities   | 4,538,238    | 4,563,759 |
| Stockholders' equity:   |              |           |
| Nonvoting noncumulative preferred stock without par value; authorized 100,000 shares; no shares issued or outstanding as of March 31, 2007 or December 31, 2006         |              |           |
| Common stock without par value; authorized 20,000,000 shares; issued and outstanding 8,183,412 shares as of March 31, 2007 and 8,144,788 shares as of December 31, 2006 | 46,215       | 45,477    |
| Retained earnings   | 380,164      | 372,039   |
| Accumulated other comprehensive loss, net   | (4,762)      | (7,141)   |
| Total stockholders' equity  | 421,617      | 410,375   |
| Total liabilities and stockholders' equity  | \$ 4,959,855 | 4,974,134 |

*See accompanying notes to unaudited consolidated financial statements.*

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Consolidated Statements of Income***(In thousands, except per share data)*

(Unaudited)

|   | For the three months<br>ended March 31, |            |
|---|---|------------|
|   | 2007                                    | 2006       |
| Interest income:  |   |            |
| Interest and fees on loans                                  | \$ 65,260                               | 55,762     |
| Interest and dividends on investment securities:            |   |            |
| Taxable   | 11,257                                  | 9,168      |
| Exempt from Federal taxes                                   | 1,154                                   | 1,073      |
| Interest on deposits in banks                               | 106                                     | 96         |
| Interest on Federal funds sold                              | 859                                     | 870        |
| <br>Total interest income                                   | <br>78,636                              | <br>66,969 |
| Interest expense:   |   |            |
| Interest on deposits  | 22,595                                  | 14,984     |
| Interest on Federal funds purchased                         | 43                                      | 7          |
| Interest on securities sold under repurchase agreements     | 6,745                                   | 5,000      |
| Interest on other borrowed funds                            | 38                                      | 46         |
| Interest on long-term debt                                  | 185                                     | 515        |
| Interest on subordinated debenture held by subsidiary trust | 886                                     | 802        |
| <br>Total interest expense                                  | <br>30,492                              | <br>21,354 |
| Net interest income   | 48,144                                  | 45,615     |
| Provision for loan losses                                   | 1,875                                   | 1,753      |
| <br>Net interest income after provision for loan losses     | <br>46,269                              | <br>43,862 |
| Noninterest income:   |   |            |
| Other service charges, commissions and fees                 | 5,493                                   | 5,028      |
| Technology services revenues                                | 4,348                                   | 3,628      |
| Service charges on deposit accounts                         | 4,339                                   | 4,100      |
| Financial services revenues                                 | 2,736                                   | 2,693      |
| Income from origination and sale of loans                   | 2,158                                   | 1,861      |
| Other income  | 2,623                                   | 1,983      |
| <br>Total noninterest income                                | <br>21,697                              | <br>19,293 |
| Noninterest expense:  |   |            |
| Salaries, wages and employee benefits                       | 24,061                                  | 21,342     |
| Furniture and equipment                                     | 4,071                                   | 3,977      |
| Occupancy, net  | 3,433                                   | 3,443      |
| Mortgage servicing rights amortization expense              | 1,168                                   | 943        |
| Mortgage servicing rights impairment expense (recovery)     | 793                                     | (170)      |

Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|                                   |           |        |
|-----------------------------------|-----------|--------|
| Outsourced technology services    | 755       | 621    |
| Professional fees                 | 690       | 781    |
| Other expenses                    | 7,799     | 7,430  |
| Total noninterest expense         | 42,770    | 38,367 |
| Income before income taxes        | 25,196    | 24,788 |
| Income tax expense                | 8,700     | 8,654  |
| Net income                        | \$ 16,496 | 16,134 |
| Basic earnings per common share   | \$ 2.01   | 1.99   |
| Diluted earnings per common share | \$ 1.97   | 1.95   |

*See accompanying notes to unaudited consolidated financial statements.*

4

---

**Table of Contents**

**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity and Comprehensive Income**  
(In thousands, except share and per share data)  
(Unaudited)

|   | Common<br>shares<br>outstanding | Common<br>stock | Retained<br>earnings | Unearned<br>compensation-<br>restricted<br>stock | Accumulated<br>other<br>comprehensive<br>loss | Total<br>stockholders'<br>equity |
|---|---------------------------------|-----------------|----------------------|--|---|----------------------------------|
| Balance at December 31,<br>2006   | 8,144,788                       | \$45,477        | 372,039              |  | (7,141)                                       | 410,375                          |
| Comprehensive income:   |                                 |                 |                      |  |   |                                  |
| Net income  |                                 |                 | 16,496               |  |   | 16,496                           |
| Unrealized gains on<br>available-for-sale<br>investment securities, net<br>of income tax expense of<br>\$1,543                  |                                 |                 |                      |  | 2,379   | 2,379                            |
| Other comprehensive<br>income   |                                 |                 |                      |  |   | 2,379                            |
| Total comprehensive<br>income   |                                 |                 |                      |  |   | 18,875                           |
| Common stock<br>transactions:   |                                 |                 |                      |  |   |                                  |
| Common shares retired   | (63,711)                        | (5,587)         |                      |  |   | (5,587)                          |
| Common shares issued  |                                 |                 |                      |  |   |                                  |
| Stock options exercised,<br>net of 6,044 shares<br>tendered in payment of<br>option price and income<br>tax withholding amounts | 102,335                         | 4,122           |                      |  |   | 4,122                            |
| Stock option tax benefit  |                                 | 1,676           |                      |  |   | 1,676                            |
| Stock-based compensation<br>expense   |                                 | 527             |                      |  |   | 527                              |
| Cash dividends declared:<br>Common (\$1.02 per share)   |                                 |                 | (8,371)              |  |   | (8,371)                          |
| Balance at March 31,<br>2007  | 8,183,412                       | \$46,215        | 380,164              |  | (4,762)                                       | 421,617                          |
|   |                                 | =               |                      |  |   |                                  |
| Balance at December 31,<br>2005   | 8,098,933                       | \$43,569        | 314,843              | (330)  | (8,235)                                       | 349,847                          |
| Comprehensive income:   |                                 |                 |                      |  |   |                                  |
| Net income  |                                 |                 | 16,134               |  | (1,988)                                       | 16,134<br>(1,988)                |



|  |           |          |         |          |         |
|--|-----------|----------|---------|----------|---------|
| Unrealized losses on<br>available-for-sale<br>investment securities, net<br>of income tax benefit of<br>\$4,897                  |           |          |         |          |         |
| Other comprehensive<br>income  |           |          |         |          | (1,988) |
| Total comprehensive<br>income  |           |          |         |          | 14,146  |
| Common stock<br>transactions:  |           |          |         |          |         |
| Common shares retired  | (45,804)  | (3,228)  |         |          | (3,228) |
| Common shares issued   | 5,115     | 347      |         |          | 347     |
| Stock options exercised,<br>net of 13,366 shares<br>tendered in payment of<br>option price and income<br>tax withholding amounts | 49,750    | 1,675    |         |          | 1,675   |
| Stock option tax benefit   |           | 661      |         |          | 661     |
| Stock-based compensation<br>expense  |           | 250      |         |          | 250     |
| Reclassification of<br>unearned compensation<br>upon<br>adoption of SFAS<br>No. 123R   |           | (330)    |         | 330      |         |
| Cash dividends declared:<br>Common (\$0.50 per share)  |           |          | (4,051) |          | (4,051) |
| Balance at March 31,<br>2006   | 8,107,994 | \$42,944 | 326,926 | (10,223) | 359,647 |

=

*See accompanying notes to unaudited consolidated financial statements.*

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows***(In thousands)**(Unaudited)*

|   | For the three months<br>ended March 31, |           |
|---|---|-----------|
|   | 2007                                    | 2006      |
| Cash flows from operating activities:   |   |           |
| Net income  | \$ 16,496                               | 16,134    |
| Adjustments to reconcile net income to net cash provided by operating activities:   |   |           |
| Provision for loan losses   | 1,875                                   | 1,753     |
| Depreciation  | 3,218                                   | 3,302     |
| Amortization of mortgage servicing rights   | 1,168                                   | 943       |
| Net discount accretion on investment securities                                     | (2,361)                                 | (938)     |
| Net gain on sale of mortgage servicing rights                                       | (1,147)                                 |           |
| Net loss on sale of property and equipment  |   | 17        |
| Net impairment charges (reversal of impairment) on mortgage servicing rights        | 793                                     | (170)     |
| Net increase in cash surrender value of company-owned life insurance                | (556)                                   | (511)     |
| Stock-based compensation expense related to stock options & restricted stock awards | 527                                     | 250       |
| Excess tax benefits from stock-based compensation                                   | (1,653)                                 | (648)     |
| Deferred income taxes   | (427)                                   | (1,247)   |
| Changes in operating assets and liabilities:  |   |           |
| Increase in loans held for sale   | (1,805)                                 | (4,836)   |
| Increase in interest receivable   | (873)                                   | (1,584)   |
| Decrease (increase) in other assets   | 1,606                                   | (2,526)   |
| Increase (decrease) in accrued interest payable                                     | 1,453                                   | (503)     |
| Increase (decrease) in accounts payable and accrued expenses                        | (2,343)                                 | 5,185     |
| Net cash provided by operating activities   | 15,971                                  | 14,621    |
| Cash flows from investing activities:   |   |           |
| Purchases of investment securities:   |   |           |
| Held-to-maturity  | (5,884)                                 | (5,348)   |
| Available-for-sale  | (1,337,333)                             | (667,704) |
| Proceeds from maturities and paydowns of investment securities:                     |   |           |
| Held-to-maturity  | 3,795                                   | 1,970     |
| Available-for-sale  | 1,486,060                               | 692,781   |
| Purchases and originations of mortgage servicing rights                             | (1,427)                                 | (1,382)   |
| Proceeds from sale of mortgage servicing rights                                     | 2,898                                   |           |
| Extensions of credit to customers, net of repayments                                | (52,987)                                | (79,484)  |
| Recoveries of loans charged-off   | 439                                     | 531       |
| Proceeds from sales of other real estate  | 281                                     | 389       |
| Net capital expenditures  | (2,869)                                 | (2,778)   |
| Sale of banking office, net of cash   |   | (2,547)   |
| Net cash provided by (used in) investing activities                                 | 92,973                                  | (63,572)  |

Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|   |            |          |
|---|------------|----------|
| Cash flows from financing activities:               |            |          |
| Net increase (decrease) in deposits                 | 154,713    | (31,932) |
| Net increase (decrease) in repurchase agreements    | (163,506)  | 99,589   |
| Net decrease in other borrowed funds                | (5,474)    | (8,353)  |
| Borrowings of long-term debt                        |            | 600      |
| Repayments of long-term debt                        | (10,364)   | (963)    |
| Net decrease in debt issuance costs                 | 9          | 10       |
| Proceeds from issuance of common stock              | 5,798      | 2,683    |
| Excess tax benefits from stock-based compensation   | 1,653      | 648      |
| Payments to retire common stock                     | (5,587)    | (3,228)  |
| Dividends paid on common stock                      | (8,371)    | (4,051)  |
| Net cash provided by (used in) financing activities | (31,129)   | 55,003   |
| Net increase in cash and cash equivalents           | 77,815     | 6,052    |
| Cash and cash equivalents at beginning of period    | 255,791    | 240,977  |
| Cash and cash equivalents at end of period          | \$ 333,606 | 247,029  |

*See accompanying notes to unaudited consolidated financial statements.*

**Table of Contents**

**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES**

**Notes to Unaudited Consolidated Financial Statements**

*(In thousands, except share and per share data)*

**(1) Basis of Presentation**

In the opinion of management, the accompanying unaudited consolidated financial statements of First Interstate BancSystem, Inc. (the Parent Company or FIBS ) and subsidiaries (the Company ) contain all adjustments (all of which are of a normal recurring nature) necessary to present fairly the financial position of the Company at March 31, 2007 and December 31, 2006 and the results of operations and cash flows for each of the three month periods ended March 31, 2007 and 2006, in conformity with U.S. generally accepted accounting principles. The balance sheet information at December 31, 2006 is derived from audited consolidated financial statements. Certain reclassifications, none of which were material, have been made to conform prior year financial statements to the March 31, 2007 presentation.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

**(2) Recent Accounting Pronouncements**

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140, requiring entities to evaluate and identify whether interests in securitized financial assets are freestanding derivatives, hybrid financial instruments that contain an embedded derivative requiring bifurcation, or hybrid financial instruments that contain embedded derivatives that do not require bifurcation. Adoption of the provisions of SFAS No. 155 on January 1, 2007, did not impact the consolidated financial statements, results of operations or liquidity of the Company.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, requiring separate recognition of a servicing asset or liability whenever an entity undertakes an obligation to service financial assets. Under SFAS No. 156, all separately recognized servicing assets or liabilities are initially measured at fair value with subsequent measurements of each class of separately recognized servicing assets and liabilities using either the amortization method or a fair value measurement method. The Company elected to continue to follow the amortization method for subsequent measurement of servicing assets. Adoption of SFAS No. 156 on January 1, 2007, did not impact the Company s consolidated financial statements, results of operations or liquidity.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (an interpretation of SFAS No. 109) ( FIN 48 ). Under FIN 48, tax positions shall initially be recognized in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. The adoption of FIN 48 on January 1, 2007 did not have a material impact on the Company s consolidated financial statements, results of operations or liquidity. See Note 6 included herein for additional information regarding the Company s income taxes.

In September 2006, the Emerging Issues Task Force ( EITF ) reached a final consensus on Issue No. 06-4 ( EITF 06-4 ), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 requires employers to recognize a liability for future benefits provided

through endorsement split-dollar life insurance arrangements that extend into postretirement periods in accordance with SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions or APB Opinion No. 12, Omnibus Opinion 1967. The provisions of EITF 06-4 are effective for the Company on January 1, 2008 and are to be applied as a change in accounting principle either through a cumulative-effect adjustment to retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption; or through retrospective application to all prior periods. The Company does not expect adoption of EITF 06-4 to have a significant impact on its consolidated financial statements, results of operations or liquidity.

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(In thousands, except share and per share data)*

In September 2006, the EITF reached a final consensus on Issue No. 06-5 ( EITF 06-5 ), Accounting for Purchase of Life Insurance Determining the Amount That Could be Realized in Accordance with FASB Technical Bulletin No. 85-4, requiring that the cash surrender value and any amounts provided by the contractual terms of an insurance policy that are realizable at the balance sheet date be considered in determining the amount that could be realized under Technical Bulletin No. 85-4. The adoption of EITF 06-5 on January 1, 2007 did not impact the Company's consolidated financial statements, results of operations or liquidity.

In March 2007, the EITF reached a final consensus on Issue No. 06-10 ( EITF 06-10 ), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements. EITF 06-10 requires employers to recognize a liability for the post-retirement benefit related to collateral assignment split-dollar life insurance arrangements in accordance with SFAS No. 106 or APB Opinion No. 12. EITF 06-10 also requires employers to recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. The provisions of EITF 06-10 are effective for the Company on January 1, 2008, with earlier application permitted, and are to be applied as a change in accounting principle either through a cumulative-effect adjustment to retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption; or as a change in accounting principle through retrospective application to all prior periods. The Company does not expect adoption of EITF 06-10 to have a significant impact on its consolidated financial statements, results of operations or liquidity.

**(3) Computation of Earnings per Share**

Basic earnings per common share is calculated by dividing net income by the weighted average number of common shares outstanding during the period presented. Diluted earnings per common share is calculated by dividing net income by the weighted average number of common shares and potential common shares outstanding during the period.

The following table sets forth the computation of basic and diluted earnings per share for the three month periods ended March 31, 2007 and 2006.

|                                       | Three Months Ended March 31, |           |
|---------------------------------------|------------------------------|-----------|
|                                       | 2007                         | 2006      |
| Net income basic and diluted          | \$ 16,496                    | 16,134    |
| Average outstanding shares-basic      | 8,188,031                    | 8,108,490 |
| Add: effect of dilutive stock options | 193,827                      | 164,723   |
| Average outstanding shares-diluted    | 8,381,858                    | 8,273,213 |
| Basic earnings per share              | \$ 2.01                      | 1.99      |
| Diluted earnings per share            | \$ 1.97                      | 1.95      |

**(4) Financial Instruments with Off-Balance Sheet Risk**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. At March 31, 2007, commitments to extend credit to existing and new borrowers approximated \$1,322,225, which includes \$310,669 on unused credit card lines and \$294,748 with commitment maturities beyond one year.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. At March 31, 2007, the Company had outstanding standby letters of credit of \$94,434. The estimated fair value of the obligation undertaken by the Company in issuing the standby letters of credit is included in other liabilities in the Company's consolidated balance sheet.

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(In thousands, except share and per share data)***(5) Supplemental Disclosures to Consolidated Statement of Cash Flows**

The Company paid cash of \$29,039 and \$21,869 for interest during the three months ended March 31, 2007 and 2006, respectively. The Company paid cash for income taxes of \$5,679 and \$2,000 during the three months ended March 31, 2007 and 2006, respectively.

**(6) Income Taxes**

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions, including Montana. With few exceptions, the Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2003.

As a result of the implementation of FIN 48 on January 1, 2007, the Company reclassified its balance sheet to record a liability for income taxes associated with uncertain tax positions of \$400. Of this total, \$303 represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods. There have been no significant changes to these amounts during the quarter ended March 31, 2007 and the Company does not expect that there will be any significant increase or decrease within the next 12 months.

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense. The Company had accrued approximately \$97 for the payment of interest and penalties at March 31, 2007.

**(7) Segment Reporting**

The Company has two operating segments, Community Banking and Technology Services. Community Banking encompasses commercial and consumer banking services offered to individuals, businesses and municipalities. Technology Services encompasses technology services provided to affiliated and non-affiliated financial institutions.

The Other category includes the net funding cost and other expenses of the Parent Company, the operational results of non-bank subsidiaries (except the Company's technology services subsidiary) and intercompany eliminations.

Selected segment information for the three month periods ended March 31, 2007 and 2006 follows:

|   | Three Months Ended March 31, 2007 |                     |         | Total  |
|---|-----------------------------------|---------------------|---------|--------|
|   | Community Banking                 | Technology Services | Other   |        |
| Net interest income (expense)                 | \$ 48,800                         | 46                  | (702)   | 48,144 |
| Provision for loan losses                     | 1,875                             |                     |         | 1,875  |
| Net interest income (expense) after provision | 46,925                            | 46                  | (702)   | 46,269 |
| Noninterest income:                           |                                   |                     |         |        |
| External sources                              | 16,933                            | 4,348               | 416     | 21,697 |
| Internal sources                              |                                   | 3,230               | (3,230) |        |



Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|  |           |       |         |        |
|--|-----------|-------|---------|--------|
| Total noninterest income                               | 16,933    | 7,578 | (2,814) | 21,697 |
| Noninterest expense                                    | 37,574    | 6,184 | (988)   | 42,770 |
| Income (loss) before income taxes                      | 26,284    | 1,440 | (2,528) | 25,196 |
| Income tax expense (benefit)                           | 9,248     | 570   | (1,118) | 8,700  |
| Net income (loss)                                      | \$ 17,036 | 870   | (1,410) | 16,496 |
| Depreciation and core deposit intangibles amortization | \$ 3,199  |       | 63      | 3,262  |

**Table of Contents****FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(In thousands, except share and per share data)*

|  | Three Months Ended March 31, 2006 |                        |         |        |
|--|-----------------------------------|------------------------|---------|--------|
|  | Community<br>Banking              | Technology<br>Services | Other   | Total  |
| Net interest income (expense)                          | \$ 46,486                         | 31                     | (902)   | 45,615 |
| Provision for loan losses                              | 1,753                             |                        |         | 1,753  |
| Net interest income (expense) after provision          | 44,733                            | 31                     | (902)   | 43,862 |
| Noninterest income:                                    |                                   |                        |         |        |
| External sources                                       | 15,374                            | 3,628                  | 291     | 19,293 |
| Internal sources                                       |                                   | 3,537                  | (3,537) |        |
| Total noninterest income                               | 15,374                            | 7,165                  | (3,246) | 19,293 |
| Noninterest expense                                    | 34,828                            | 5,187                  | (1,648) | 38,367 |
| Income (loss) before income taxes                      | 25,279                            | 2,009                  | (2,500) | 24,788 |
| Income tax expense (benefit)                           | 8,896                             | 793                    | (1,035) | 8,654  |
| Net income (loss)                                      | \$ 16,383                         | 1,216                  | (1,465) | 16,134 |
| Depreciation and core deposit intangibles amortization | \$ 3,485                          |                        | 61      | 3,546  |

**Table of Contents**

**Item 2.**

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

The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006, including the audited financial statements contained therein, filed with the Securities and Exchange Commission.

When we refer to we, our, and us in this report, we mean First Interstate BancSystem, Inc. and our consolidated subsidiaries, unless the context indicates that we refer only to the parent company, First Interstate BancSystem, Inc. When we refer to the Bank in this report, we mean First Interstate Bank, our only bank subsidiary.

**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, and Rule 3b-6 promulgated thereunder, that involve inherent risks and uncertainties. Any statements about our plans, objectives, expectations, strategies, beliefs, or future performance or events constitute forward-looking statements. Such statements are identified as those that include words or phrases such as believes, expects, anticipates, plans, trend, objective, continue or similar expressions or future or conditional verbs such as will, would, should, could, might, may or similar expressions. Forward-looking statements involve known and unknown risks, uncertainties, assumptions, estimates and other important factors that could cause actual results to differ materially from any results, performance or events expressed or implied by such forward-looking statements. All forward-looking statements are qualified in their entirety by reference to the factors discussed in this report and the following risk factors discussed more fully in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006: (i) credit risk; (ii) business concentration and economic conditions in Montana and Wyoming; (iii) declines in real estate values; (iv) changes in interest rates; (v) inability to meet liquidity requirements; (vi) competition; (vii) failure of technology; (viii) breach in information system security; (ix) ineffective internal operational controls; (x) difficulties in execution of business strategy; (xi) disruption of vital infrastructure and other business interruptions; (xii) litigation pertaining to fiduciary responsibilities; (xiii) changes in or noncompliance with governmental regulations; (xiv) restrictions on dividends and stock redemptions; (xv) capital required to support our bank subsidiary; and (xvi) investment risks affecting holders of common stock. Because the foregoing factors could cause actual results or outcomes to differ materially from those expressed or implied in any forward-looking statements, undue reliance should not be placed on any forward-looking statements. Further, any forward-looking statement speaks only as of the date on which it is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of future events or developments.

**CRITICAL ACCOUNTING ESTIMATES AND SIGNIFICANT ACCOUNTING POLICIES**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow general practices within the industries in which we operate. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ significantly from those estimates.

Our accounting policies are fundamental to understanding Management's Discussion and Analysis of Financial Condition and Results of Operations. The most significant accounting policies we follow are presented in Note 1 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

Our critical accounting estimates are summarized below. Management considers an accounting estimate to be critical if: (1) the accounting estimate requires management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain, and (2) changes in the estimate that are reasonably likely to occur from period to period, or the use of different estimates that management could have reasonably used in the current period, would have a material impact on our consolidated financial statements, results of operations or liquidity.

*Allowance for Loan Losses*

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it

**Table of Contents**

requires significant judgment and the use of subjective measurements, including management's assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on our consolidated financial statements, results of operations or liquidity. The allowance for loan losses is maintained at an amount we believe is sufficient to provide for estimated losses inherent in our loan portfolio at each balance sheet date. Management continuously monitors qualitative and quantitative trends in the loan portfolio, including changes in the levels of past due, internally classified and non-performing loans. As a result, our historical experience has provided for an adequate allowance for loan losses. Note 1 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2006 describes the methodology used to determine the allowance for loan losses. A discussion of the factors driving changes in the amount of the allowance for loan losses is included herein under the heading *Asset Quality*.

*Valuation of Mortgage Servicing Rights*

We recognize as assets the rights to service mortgage loans for others, whether acquired or internally originated. Mortgage servicing rights are initially recorded at fair value and are amortized over the period of estimated servicing income. Mortgage servicing rights are carried on the consolidated balance sheet at the lower of amortized cost or fair value. We utilize the expertise of a third-party consultant to estimate the fair value of our mortgage servicing rights quarterly. In evaluating the mortgage servicing rights, the consultant uses discounted cash flow modeling techniques, which require estimates regarding the amount and timing of expected future cash flows, including assumptions about loan repayment rates, costs to service, as well as interest rate assumptions that contemplate the risk involved. Management believes the valuation techniques and assumptions used by the consultant are reasonable.

Determining the fair value of mortgage servicing rights is considered a critical accounting estimate because of the assets' sensitivity to changes in estimates and assumptions used, particularly loan prepayment speeds and discount rates. Changes in these estimates and assumptions are reasonably possible and may have a material impact on our consolidated financial statements, results of operations or liquidity. Notes 1 and 7 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006 describe the methodology we use to determine fair value of mortgage servicing rights.

**EXECUTIVE OVERVIEW**

Net income of \$16.5 million, or \$1.97 per diluted share, increased \$362 thousand, or 2.2%, for the quarter ended March 31, 2007, as compared to \$16.1 million, or \$1.95 per diluted share, for the same period in 2006. Net interest income on a fully taxable-equivalent basis of \$49.2 million during the first quarter 2007, increased \$2.6 million from \$46.5 million for the same period in 2006, due to organic growth in earning assets, primarily loans. Average earning assets grew 8.7% and comprised a larger percentage of total assets during the three months ended March 31, 2007, as compared to the same period in 2006. In addition, interest-free funding sources, including noninterest-bearing deposits, other liabilities and common equity, contributed an additional \$87.9 million of our funding base during first quarter 2007, compared to the same period in 2006. Net income during first quarter 2007 was also positively impacted by a \$1.1 million gain on the sale of mortgage servicing rights. These increases in net income were significantly offset by higher salaries, wages and benefits expenses and impairment of mortgage servicing rights.

Although we experienced significant growth in earning assets, our net interest margin on a fully taxable equivalent basis decreased 13 basis points to 4.46% for the three months ended March 31, 2007 from 4.59% during the same period in the prior year. This decline is primarily the result of a continuing inverted yield-rate environment in which short-term interest rates are higher than long-term interest rates. In addition, competitive pressure induced us to increase interest rates paid on deposit accounts and repurchase agreements during the last half of 2006, further constraining our net interest margin.

**RESULTS OF OPERATIONS**

*Net Interest Income.* Net interest income, our largest source of operating income, is derived from interest, dividends and fees received on interest earning assets, less interest expense incurred on interest bearing liabilities. The most significant impact on our net interest income between periods is derived from the interaction of changes in the volume of and rates earned or paid on interest earning assets and interest bearing liabilities (spread). The volume of

loans, investment securities and other interest earning assets, compared to the volume of interest bearing deposits and indebtedness, combined with the spread, produces changes in the net interest income between periods.

Noninterest-bearing sources of funds, such as demand deposits and stockholders' equity, also support earning assets.

The impact of free funding sources is captured in the net interest margin, which is calculated as net interest income divided by average earning assets. Given the interest free nature of free funding sources, the net interest margin is generally higher than the spread.

**Table of Contents**

The following table presents, for the periods indicated, condensed average balance sheet information, together with interest income and yields earned on average interest earning assets and interest expense and rates paid on average interest bearing liabilities.

**Average Balance Sheets, Yields and Rates**

(Dollars in thousands)

|   | Average<br>Balance | Three Months Ended March 31, |                  | Average<br>Balance | Average<br>Rate |       |
|---|--------------------|------------------------------|------------------|--------------------|-----------------|-------|
|   |                    | 2007<br>Interest             | 2006<br>Interest |                    |                 |       |
| Interest earning assets:                  | \$                 |                              |                  |                    |                 |       |
| Loans (1)                                 | 3,322,149          | 65,652                       | 8.01%            | \$ 3,059,385       | 56,099          | 7.44% |
| Investment securities (1)                 | 1,075,443          | 13,032                       | 4.91             | 966,262            | 10,819          | 4.54  |
| Federal funds sold                        | 63,418             | 859                          | 5.49             | 77,863             | 870             | 4.53  |
| Interest bearing deposits in banks        | 8,329              | 106                          | 5.16             | 9,793              | 96              | 3.98  |
| Total interest earning assets             | 4,469,339          | 79,649                       | 7.23%            | 4,113,303          | 67,884          | 6.69% |
| Noninterest earning assets                | 414,989            |                              |                  | 435,660            |                 |       |
| Total assets                              | \$ 4,884,328       |                              |                  | \$ 4,548,963       |                 |       |
| Interest earning liabilities:             |                    |                              |                  |                    |                 |       |
| Demand deposits                           | \$ 965,834         | 5,712                        | 2.40%            | 805,622            | 2,778           | 1.40% |
| Savings deposits                          | 823,390            | 4,858                        | 2.39             | 880,474            | 3,780           | 1.74  |
| Time deposits                             | 1,067,337          | 12,025                       | 4.57             | 987,118            | 8,426           | 3.46  |
| Federal funds purchased                   | 3,449              | 43                           | 5.06             | 602                | 7               | 4.72  |
| Borrowings (2)                            | 668,147            | 6,783                        | 4.12             | 572,332            | 5,046           | 3.58  |
| Long-term debt                            | 19,962             | 185                          | 3.76             | 54,473             | 515             | 3.83  |
| Subordinated debenture                    | 41,238             | 886                          | 8.71             | 41,238             | 802             | 7.89  |
| Total interest earning liabilities        | 3,589,357          | 30,492                       | 3.45%            | 3,341,859          | 21,354          | 2.59% |
| Noninterest bearing deposits              | 823,643            |                              |                  | 809,122            |                 |       |
| Other noninterest bearing liabilities     | 56,826             |                              |                  | 42,655             |                 |       |
| Stockholders equity                       | 414,502            |                              |                  | 355,327            |                 |       |
| Total liabilities and stockholders equity | \$ 4,884,328       |                              |                  | \$ 4,548,963       |                 |       |
| Net FTE interest                          |                    | \$ 49,157                    |                  |                    | \$ 46,530       |       |
| Less FTE adjustments                      |                    | (1,013)                      |                  |                    | (915)           |       |
|   |                    | \$ 48,144                    |                  |                    | \$ 45,615       |       |

Net interest income from consolidated statements of income

|  |       |       |
|--|-------|-------|
| Interest rate spread                         | 3.78% | 4.10% |
| Net FTE yield on interest earning assets (3) | 4.46% | 4.59% |

(1) Interest income and average rates for tax exempt loans and securities are presented on a fully-taxable equivalent, or FTE, basis.

(2) Includes interest on securities sold under repurchase agreements and other borrowed funds. Excludes long-term debt.

(3) Net FTE yield on interest earning assets during the period equals (i) the difference between annualized interest income on interest earning assets and annualized interest expense on interest bearing liabilities, divided by (ii) average interest earning assets for the period.





**Table of Contents**

Net interest income, on a fully taxable equivalent, or FTE, basis, increased \$2.6 million, or 5.6%, to \$49.2 million for the three months ended March 31, 2007 as compared to \$46.5 million for the same period in 2006 primarily due to organic growth in earning assets, primarily loans. Average earning assets grew 8.7% and comprised a larger percentage of total assets during the three months ended March 31, 2007, as compared to the same period in 2006. Despite growth in earning assets, our net interest margin on a fully taxable equivalent basis decreased 13 basis points to 4.46% for the three months ended March 31, 2007 from 4.59% during the same period in the prior year. This decline is primarily the result of a continuing inverted yield-rate environment in which short-term interest rates are higher than long-term interest rates. In addition, competitive pressure induced us to increase interest rates paid on deposit accounts and repurchase agreements during the last half of 2006, further constraining our net interest margin.

The table below sets forth, for the periods indicated, a summary of the changes in interest income and interest expense resulting from estimated changes in average asset and liability balances (volume) and estimated changes in average interest rates (rate). Changes which are not due solely to volume or rate have been allocated to these categories based on the respective percent changes in average volume and average rate as they compare to each other.

**Analysis of Interest Changes Due To Volume and Rates**

*(Dollars in thousands)*

|  | Three Months Ended March 31,<br>2007 Compared with 2006 |         |        |
|--|---|---------|--------|
|  | Volume  | Rate    | Net    |
| Interest earnings assets:                      |   |         |        |
| Loans (1)                                      | \$ 4,818  | 4,735   | 9,553  |
| Investment securities (1)                      | 1,222   | 991     | 2,213  |
| Interest bearing deposits in banks             | (14)  | 24      | 10     |
| Federal funds sold                             | (161)   | 150     | (11)   |
| Total change                                   | 5,865   | 5,900   | 11,765 |
| Interest bearing liabilities:                  |   |         |        |
| Demand deposits                                | 552   | 2,382   | 2,934  |
| Savings deposits                               | (246)   | 1,324   | 1,078  |
| Time deposits                                  | 686   | 2,913   | 3,599  |
| Federal funds purchased                        | 33  | 3       | 36     |
| Borrowings (2)                                 | 845   | 892     | 1,737  |
| Long-term debt                                 | (326)   | (4)     | (330)  |
| Subordinated debenture                         |   | 84      | 84     |
| Total change                                   | 1,544   | 7,594   | 9,138  |
| Increase (decrease) in FTE net interest income | \$ 4,321  | (1,694) | 2,627  |

(1) Interest income and average rates for tax exempt loans and securities are presented on a FTE basis.

- (2) Includes interest on securities sold under repurchase agreements and other borrowed funds.

*Noninterest Income.* Our principal sources of noninterest income include other service charges, commissions and fees; technology services revenues; service charges on deposit accounts; revenues from financial services; and, income from the origination and sale of loans. Noninterest income increased \$2.4 million, or 12.5%, to \$21.7 million for the three months ended March 31, 2007, as compared to \$19.3 million for the same period in 2006. Significant components of the increase are discussed below.

Other service charges, commissions and fees primarily include debit and credit card interchange income, mortgage servicing fees and ATM service charge revenues. Other service charges, commissions and fees increased \$465 thousand, or 9.2%, to \$5.5 million for the three months ended March 31, 2007, as compared to \$5.0 million for the same period in 2006. This increase is primarily due to additional fee income from higher volumes of credit and debit card transactions and increases in mortgage servicing revenues resulting from increases in the principal balances of loans serviced.

**Table of Contents**

Technology services revenues increased \$720 thousand, or 19.8%, to \$4.3 million for the three months ended March 31, 2007, as compared to \$3.6 million for the same period in 2006 primarily due to increases in the number of customers using core data processing services and the volume of core data and debit card transactions processed.

Income from the origination and sale of loans includes origination and processing fees on residential real estate loans held for sale and gains on residential real estate loans sold to third parties. Fluctuations in market interest rates have a significant impact on the level of income generated from the origination and sale of loans. Higher interest rates can reduce the demand for home loans and loans to refinance existing mortgages. Conversely, lower interest rates generally stimulate refinancing and home loan origination. Income from the origination and sale of loans increased \$297 thousand, or 16.0%, to \$2.2 million for the three months ended March 31, 2007, as compared to \$1.9 million for the same period in 2006.

Other income primarily includes increases in the cash surrender value of company-owned life insurance, check printing income, agency stock dividends and gains of sales of assets other than investment securities. Other income increased \$640 thousand, or 32.3%, to \$2.6 million during the three months ended March 31, 2007, as compared to \$2.0 million for the same period in 2006, primarily due to a \$1.1 million gain on the sale of mortgage servicing rights recorded during first quarter 2007.

*Noninterest Expense.* Noninterest expense increased \$4.4 million, or 11.5%, to \$42.8 million for the three months ended March 31, 2007, as compared to \$38.4 million for the same period in 2006. Significant components of the increase are discussed below.

Salaries, wages and employee benefits expense increased \$2.7 million, or 12.7%, to \$24.1 million for the three months ended March 31, 2007, as compared to \$21.3 million for the same period in 2006, primarily due to inflationary wage increases, increased staffing levels, higher stock-based compensation expense and increases in group medical insurance costs.

Mortgage servicing rights are amortized in proportion to and over the period of estimated net servicing income. Changes in estimated servicing period and growth in the serviced loan portfolio cause amortization expense to vary between periods. Mortgage servicing rights amortization increased \$225 thousand, or 23.9%, to \$1.2 million for the three months ended March 31, 2007, as compared to \$943 thousand for the same period in 2006.

Mortgage servicing rights are evaluated quarterly for impairment by discounting the expected future cash flows, taking into consideration the estimated level of prepayments based on current industry expectations and the predominant risk characteristics of the underlying loans. Impairment adjustments are recorded through a valuation allowance. The valuation allowance is adjusted for changes in impairment through a charge to current period earnings. We recorded impairment of \$793 thousand during the three months ended March 31, 2007, as compared to the reversal of previously recorded impairment of \$170 thousand during the same period in 2006.

Other expenses primarily include advertising and public relations costs; office supply, postage, freight, telephone and travel expenses; donations expense; board of director fees; and, other losses. Other expenses increased \$369 thousand, or 5.0%, to \$7.8 million for the three months ended March 31, 2007, as compared to \$7.4 million for the same period in 2006, primarily due to inflationary expense increases and higher non-recurring fraud and other losses in the current year.

*Income Tax Expense.* Our effective federal income tax rate was 30.7% for the three months ended March 31, 2007, and 30.8% for the three months ended March 31, 2006. State income tax applies primarily to pretax earnings generated within Montana, Colorado, Idaho and Oregon. Our effective state tax rate was 3.8% for the three months ended March 31, 2007, and 4.1% for the three months ended March 31, 2006.

**OPERATING SEGMENT RESULTS**

Our primary operating segment is Community Banking. The Community Banking segment represented over 90% of our combined revenues and income during the three months ended March 31, 2007 and 2006, and our consolidated assets as of March 31, 2007 and December 31, 2006.

**Table of Contents**

The following table summarizes net income (loss) for each of our operating segments.

**Operating Segment Results**

(Dollars in thousands)

|                     | Net Income (Loss)            |         |
|---------------------|------------------------------|---------|
|                     | Three Months Ended March 31, |         |
|                     | 2007                         | 2006    |
| Community banking   | \$ 17,036                    | 16,383  |
| Technology services | 870                          | 1,216   |
| Other               | (1,410)                      | (1,465) |
| Total               | 16,496                       | 16,134  |

Net income from the Community Banking operating segment increased \$653 thousand, or 4.0%, to \$17.0 million for the three months ended March 31, 2007, as compared to \$16.4 million for the same period in 2006. Significant components of this increase are discussed in Results of Operations included herein.

**FINANCIAL CONDITION**

*Loans.* Our loan portfolio consists of a mix of real estate, consumer, commercial, agricultural and other loans, including fixed and variable rate loans. Fluctuations in the loan portfolio are directly related to the economies of the communities we serve. The following table presents the composite of our loan portfolio as of the dates indicated:

**Loan Portfolio**

(Dollars in thousands)

|                                    | March 31,<br>2007 | December 31,<br>2006 |
|------------------------------------|-------------------|----------------------|
| Real estate loans:                 |                   |                      |
| Residential                        | \$ 395,193        | \$ 402,469           |
| Agricultural                       | 141,115           | 137,659              |
| Commercial                         | 958,993           | 937,694              |
| Construction                       | 581,143           | 579,603              |
| Mortgage loans originated for sale | 27,165            | 25,360               |
| Total real estate loans            | 2,103,609         | 2,082,785            |
| Consumer:                          |                   |                      |
| Indirect consumer loans            | 365,524           | 370,016              |
| Credit card loans                  | 58,504            | 60,569               |
| Other consumer loans               | 175,289           | 175,273              |
| Total consumer loans               | 599,317           | 605,858              |
| Commercial                         | 576,570           | 542,325              |
| Agricultural                       | 82,799            | 76,644               |
| Other loans, including overdrafts  | 1,686             | 2,751                |
| Total loans                        | \$ 3,363,981      | \$ 3,310,363         |

Total loans increased \$54 million, or 1.6%, to \$3,364 million as of March 31, 2007 from \$3,310 million as of December 31, 2006, with the most significant growth occurring in commercial and commercial real estate loans. Management attributes our loan growth to generally favorable economic conditions and growth in our existing market areas and an increase in overall borrowing activity.

*Investment Securities.* We manage our investment portfolio to obtain the highest yield possible, while meeting our risk tolerance and liquidity guidelines and satisfying the pledging requirements for deposits of state and political subdivisions and securities sold under repurchase agreements. Investment securities decreased \$140 million, or 12.5%, to \$984 million as of March 31, 2007 from \$1,125 million as of December 31, 2006. This decrease occurred principally in short-term available-for-sale investment securities used as collateral for securities sold under repurchase agreements. For further information, see *Deposits and Repurchase Agreements* below.

**Table of Contents**

We evaluate our investment portfolio quarterly for other-than-temporary declines in the market value of individual investment securities. This evaluation includes monitoring credit ratings; market, industry and corporate news; volatility in market prices; and, determining whether the market value of a security has been below its cost for an extended period of time. As of March 31, 2007, we had investment securities with fair values of \$517 million that had been in a continuous loss position more than twelve months. Gross unrealized losses on these securities totaled \$9 million as of March 31, 2007, and were primarily attributable to changes in interest rates. No impairment losses were recorded during the three months ended March 31, 2007 or 2006.

*Mortgage Servicing Rights.* We recognize the rights to service mortgage loans for others whether acquired or internally originated. Net mortgage servicing rights decreased \$2 million, or 10.1%, to \$20 million as of March 31, 2007 from \$23 million as of December 31, 2006, primarily due to the sale of mortgage servicing rights to a third party in February 2007.

*Deferred Tax Asset.* Deferred tax asset of \$7 million as of March 31, 2007 decreased \$1 million, or 13.5%, from \$8 million as of December 31, 2006, primarily due to fluctuations in net unrealized losses on available-for-sale investment securities.

*Deposits.* Total deposits increased \$155 million, or 4.2%, to \$3,863 million as of March 31, 2007 from \$3,709 million as of December 31, 2006, primarily due to the introduction of a new money market cash sweep deposit product during first quarter 2007. The money market cash sweep deposit product is available to commercial customers as an alternative to traditional repurchase agreements. The money market cash sweep product allows customers to invest on a daily basis excess demand deposit funds into a higher yielding money market savings account held by the Bank. Customer balances invested in the money market cash sweep product are insured by the Federal Deposit Insurance Corporation up to statutory limits.

*Repurchase Agreements.* In addition to deposits, repurchase agreements with commercial depositors provide an additional source of funds. Under repurchase agreements, deposit balances are invested in short-term U.S. government agency securities overnight and are then repurchased the following day. All outstanding repurchase agreements are due in one day. Repurchase agreements decreased \$164 million, or 22.5%, to \$568 million as of March 31, 2007 from \$732 million as of December 31, 2006, primarily due to the introduction of the money market cash sweep product described above.

*Other Borrowed Funds.* Other borrowed funds decreased \$5 million, or 96.1% to \$220 thousand as of March 31, 2007 from \$6 million as of December 31, 2006. Fluctuations in other borrowed funds are generally due to timing of tax deposits made by customers and the subsequent withdrawal of funds by the federal government.

*Long Term Debt.* Long term debt decreased \$10 million, or 48.0%, to \$11 million as of March 31, 2007 from \$22 million as of December 31, 2006 due the scheduled March 2007 maturity of a \$10 million, 3.03% fixed rate Federal Home Loan Bank note.

**ASSET QUALITY**

*Non-performing Assets.* Non-performing assets include loans past due 90 days or more and still accruing interest, nonaccrual loans, loans renegotiated in troubled debt restructurings and other real estate owned, or OREO.

The following table sets forth information regarding non-performing assets as of the dates indicated:

**Non-Performing Assets**

(Dollars in thousands)

|   | March<br>31,<br>2007 | December<br>31,<br>2006 | September<br>30,<br>2006 | June 30,<br>2006 | March<br>31,<br>2006 |
|---|----------------------|-------------------------|--------------------------|------------------|----------------------|
| Non-performing loans:                   |                      |                         |                          |                  |                      |
| Nonaccrual loans                        | \$ 15,536            | 14,764                  | 15,984                   | 15,519           | 15,949               |
| Accruing loans past due 90 days or more | 9,298                | 1,769                   | 5,033                    | 7,674            | 4,375                |
| Restructured loans                      | 1,056                | 1,060                   | 1,056                    | 1,075            | 1,089                |

Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|   |           |        |        |        |        |
|---|-----------|--------|--------|--------|--------|
| Total non-performing loans                    | 25,890    | 17,593 | 22,073 | 24,268 | 21,413 |
| OREO  | 258       | 529    | 498    | 558    | 806    |
| Total non-performing assets                   | \$ 26,148 | 18,122 | 22,571 | 24,826 | 22,219 |
| Non-performing assets to total loans and OREO | 0.78%     | 0.55%  | 0.69%  | 0.76%  | 0.71%  |



**Table of Contents**

Non-performing assets increased \$8 million, or 44.3%, to \$26 million as of March 31, 2007, as compared to \$18 million as of December 31, 2006. Approximately \$4 million of the increase is related to the adequately secured loans of two commercial borrowers past due 90 days or more and in the process of renewal or refinance. The remaining increase is primarily due to the loans of two additional commercial borrowers currently past due 90 days or more and in the process of being placed on nonaccrual status.

*Provision/Allowance for Loan Losses.* We perform a quarterly assessment of the risks inherent in our loan portfolio, as well as a detailed review of each significant asset with identified weaknesses. Based on this analysis, we record a provision for loan losses in order to maintain the allowance for loan losses at appropriate levels. In determining the allowance for loan losses, we estimate losses on specific loans, or groups of loans, where the probable loss can be identified and reasonably determined. The balance of the allowance for loan losses is based on internally assigned risk classifications of loans, historical loan loss rates, changes in the nature of the loan portfolio, overall portfolio quality, industry concentrations, delinquency trends, current economic factors and the estimated impact of current economic conditions on certain historical loan loss rates. Fluctuations in the provision for loan losses result from management's assessment of the adequacy of the allowance for loan losses. Ultimate loan losses may vary from current estimates. For additional information concerning the provision for loan losses, see *Critical Accounting Estimates and Significant Accounting Policies* above.

The provision for loan losses increased \$122 thousand, or 7.0%, to \$1.9 million for the three months ended March 31, 2007, as compared to \$1.8 million for the same period in the prior year. The allowance for loan losses was \$49 million, or 1.45% of total loans, as of March 31, 2007, as compared to \$47 million, or 1.43% of total loans, at December 31, 2006.

The following table sets forth information regarding our allowance for loan losses as of and for the periods indicated.

**Allowance for Loan Losses***(Dollars in thousands)*

|   |              | Three Months Ended |           |           |           |
|---|--------------|--------------------|-----------|-----------|-----------|
|   | March 31,    | December           | September | June 30,  | March 31, |
|   | 2007         | 31,                | 30,       | 2006      | 2006      |
|   |              | 2006               | 2006      |           |           |
| Balance at beginning of period                      | \$ 47,452    | 46,957             | 45,721    | 43,633    | 42,450    |
| Provision charged to operating expense              | 1,875        | 1,401              | 2,029     | 2,578     | 1,753     |
| Less loans charged off                              | (1,145)      | (1,487)            | (1,322)   | (1,300)   | (1,101)   |
| Add back recoveries of loans previously charged off | 439          | 581                | 529       | 810       | 531       |
| Net loans charged-off                               | (706)        | (906)              | (793)     | (490)     | (570)     |
| Balance at end of period                            | \$ 48,621    | 47,452             | 46,957    | 45,721    | 43,633    |
| Period end loans                                    | \$ 3,363,981 | 3,310,363          | 3,288,470 | 3,256,500 | 3,116,927 |
| Average loans                                       | 3,322,149    | 3,208,102          | 3,272,203 | 3,190,310 | 3,059,385 |
| Annualized net loans charged off to average loans   | 0.09%        | 0.09%              | 0.08%     | 0.07%     | 0.08%     |
| Allowance to period end loans                       | 1.45%        | 1.43%              | 1.43%     | 1.40%     | 1.40%     |

Although we believe that we have established our allowance for loan losses in accordance with accounting principles generally accepted in the United States and that the allowance for loan losses was adequate to provide for known and inherent losses in the portfolio at all times, future provisions will be subject to on-going evaluations of the risks in the loan portfolio. If the economy declines or asset quality deteriorates, material additional provisions could be required.

**CAPITAL RESOURCES AND LIQUIDITY MANAGEMENT**

*Capital Resources.* Stockholders' equity is influenced primarily by earnings, dividends and, to a lesser extent, sales and redemptions of common stock and changes in the unrealized holding gains or losses, net of taxes, on available-for-sale investment securities. Stockholders' equity increased \$11 million, or 2.7%, to \$422 million as of March 31, 2007 from \$410 million as of December 31, 2006, primarily due to retention of earnings. We paid aggregate cash dividends to stockholders of \$8.4 million during the three months ended March 31, 2007, including a special dividend of \$0.41 per share paid in January 2007. As of March 31, 2007 and December 31, 2006, we exceeded the well-capitalized requirements established by the federal banking agencies.

## **Table of Contents**

*Liquidity.* Liquidity is our ability to meet current and future cash flow needs on a timely basis and at a reasonable cost. We manage our liquidity position to meet the daily cash flow needs of customers, while maintaining an appropriate balance between assets and liabilities to meet the return on investment objectives of our shareholders. Our liquidity position is supported by management of liquid assets and liabilities. Liquid assets include cash, interest bearing deposits in banks, federal funds sold, available-for-sale investment securities and maturing or prepaying balances in our held-to-maturity investment and loan portfolios. Liquid liabilities include core deposits, federal funds purchased, securities sold under repurchase agreements and borrowings. We do not engage in derivatives or hedging activities to support our liquidity position.

Our short-term and long-term liquidity requirements are primarily to fund on-going operations, including payment of interest on deposits and debt, extensions of credit, capital expenditures and shareholder dividends. These liquidity requirements are met primarily through cash flow from operations, redeployment of prepaying and maturing balances in our loan and investment portfolios, debt obligations and increases in customer deposits.

Other sources of liquidity are available should they be needed. These sources include the drawing of additional funds on our unsecured revolving term loan, the sale of loans, the ability to acquire additional national market, non-core deposits, the issuance of additional collateralized borrowings such as FHLB advances, the issuance of debt securities and the issuance of preferred or common securities. The Bank also can borrow through the Federal Reserve's discount window.

As a holding company, we are a corporation separate and apart from our subsidiary Bank and, therefore, we provide for our own liquidity. A significant amount of our revenues are obtained from management fees and dividends declared and paid by the Bank and other non-bank subsidiaries. There are statutory and regulatory limitations that affect the ability of the Bank to pay dividends to us. Our debt instruments also include dividend limitations. Management believes that such limitations will not have an impact on our ability to meet our ongoing short-term cash obligations.

### **ASSET LIABILITY MANAGEMENT**

The goal of asset liability management is the prudent control of market risk, liquidity and capital. Asset liability management is governed by policies, goals and objectives adopted and reviewed by the Bank's board of directors. The board delegates its responsibility for development of asset liability management strategies to achieve these goals and objectives to the Asset Liability Committee, or ALCO, which is comprised of members of senior management.

We target a mix of interest earning assets and interest bearing liabilities such that no more than 5% of the net interest margin will be at risk over a one-year period should short-term interest rates shift gradually up or down 2%. As of March 31, 2007, our income simulation model predicted net interest income would decrease \$1.2 million, or 0.6%, assuming a gradual 2% increase in short-term market interest rates and gradual 1.0% increase in long-term interest rates. This scenario predicts our funding sources will reprice faster than our interest earning assets, thereby reducing interest rate spread and net interest margin. Conversely, assuming a gradual 2% decrease in short-term market interest rates and gradual 1.0% decrease in long-term interest rates, our income simulation model predicted net interest income would decrease \$1.9 million, or 1.0%. This scenario predicts that interest rates on non-maturing demand and savings deposits will not decrease in direct proportion to a simulated downward shift in interest rates, thereby reducing interest rate spread and net interest margin.

The preceding interest rate sensitivity analysis does not represent a forecast and should not be relied upon as being indicative of expected operating results.

### **Item 3.**

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As of March 31, 2007, there have been no material changes in the quantitative and qualitative information about market risk provided pursuant to Item 305 of Regulation S-K as presented in our Annual Report on Form 10-K for the year ended December 31, 2006.

### **Item 4T.**

### **CONTROLS AND PROCEDURES**

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Exchange Act. As of March 31, 2007, an evaluation was performed, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial

**Table of Contents**

Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of March 31,

2007, were effective in ensuring that information required to be disclosed in this Quarterly Report on Form 10-Q was recorded, processed, summarized, and reported within the time period required by the SEC's rules and forms.

There were no changes in our internal controls over financial reporting for the quarter ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, such controls.

The effectiveness of our disclosure controls and procedures and our internal control over financial reporting is subject to various inherent limitations, including cost limitations, judgments used in decision-making, assumptions about the likelihood of future events, the soundness of our systems, the possibility of human error, and the risk of fraud. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions and the risk that the degree of compliance with policies or procedures may deteriorate over time. Because of these limitations, any system of disclosure controls and procedures or internal control over financial reporting may not be successful in preventing all errors or fraud or in making all material information known in a timely manner to the appropriate levels of management.

**PART II.**  
**OTHER INFORMATION**

**Item 1. Legal Proceedings**

There have been no material changes in legal proceedings as described in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 1A. Risk Factors**

There have been no material changes in risk factors described in our Annual Report on Form 10-K for the year-ended December 31, 2006.

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

(a) There were no unregistered sales of equity securities during the three months ended March 31, 2007.

(b) Not applicable.

(c) The following table provides information with respect to purchases made by or on behalf of us or any affiliated purchases (as defined in Rule 10b-18(a)(3) under the Exchange Act), of our common stock during the three months ended March 31, 2007.

| Period        | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or Programs<br>(1) | Maximum<br>Number<br>of Shares<br>that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|---------------|---|--|---|---|
| January 2007  | 12,528                                    | \$ 82.50                                 | 0   | Not Applicable  |
| February 2007 | 38,854                                    | 88.96                                    | 0   | Not Applicable  |
| March 2007    | 12,329                                    | 89.00                                    | 0   | Not Applicable  |
| Total         | 63,711                                    | \$ 87.70                                 | 0   | Not Applicable  |

(1)

Our common stock is not actively traded, and there is no established trading market for the stock. There is only one class of common stock. As of March 31, 2007, approximately 90% of our common stock was subject to contractual transfer restrictions set forth in shareholder agreements. We have a right of first refusal to repurchase the restricted stock. Additionally, under certain conditions we may call restricted stock held by our officers, directors and employees. We have no obligation to purchase restricted or unrestricted stock, but have historically purchased such stock. All purchases indicated in the table above were effected pursuant to private transactions.

**Item 3. Defaults upon Senior Securities**

None.

20

---

**Table of Contents**

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable or required.

**Item 5. Other Information**

Not applicable or required.

**Item 6. Exhibits**

- 3.1(1) Restated Articles of Incorporation dated February 27, 1986
- 3.2(2) Articles of Amendment to Restated Articles of Incorporation dated September 26, 1996
- 3.3(2) Articles of Amendment to Restated Articles of Incorporation dated September 26, 1996
- 3.4(6) Articles of Amendment to Restated Articles of Incorporation dated October 7, 1997
- 3.5(18) Restated Bylaws of First Interstate BancSystem, Inc. dated July 29, 2004
- 4.1(4) Specimen of common stock certificate of First Interstate BancSystem, Inc.
- 4.2(1) Shareholder s Agreement for non-Scott family members
- 4.3(12) Shareholder s Agreement for non-Scott family members dated August 24, 2001
- 4.4(14) Shareholder s Agreement for non-Scott family members dated August 19, 2002
- 4.5(9) First Interstate Stockholders Agreements with Scott family members dated January 11, 1999
- 4.6(9) Specimen of Charity Shareholder s Agreement with Charitable Shareholders
- 4.7(15) Junior Subordinated Indenture dated March 26, 2003 entered into between First Interstate and U.S. Bank National Association, as Debenture Trustee
- 4.8(15) Certificate of Trust of First Interstate Statutory Trust dated as March 11, 2003
- 4.10(15) Amended and Restated Trust Declaration of First Interstate Statutory Trust
- 4.11(15) Form of Capital Security Certificate of First Interstate Statutory Trust (included as an exhibit to Exhibit 4.10)
- 4.12(15) Form of Common Security Certificate of First Interstate Statutory Trust (included as an exhibit to Exhibit 4.10)
- 4.13(15) Guarantee Agreement between First Interstate BancSystem, Inc. and U.S. Bank National Association
- 10.1(19) Credit Agreement dated June 30, 2005, between First Interstate BancSystem, Inc., as borrower, and Wells Fargo Bank, N.A.
- 10.2(19) Revolving Line of Credit Note dated June 30, 2005 between First Interstate BancSystem, Inc. and Wells Fargo Bank, N.A.
- 10.4(2) Note Purchase Agreement dated August 30, 1996, between First Interstate BancSystem, Inc. and the Montana Board of Investments
- 10.5(1) Lease Agreement Between Billings 401 Joint Venture and First Interstate Bank Montana and addendum thereto
- 10.7(1) Stock Option and Stock Appreciation Rights Plan of First Interstate BancSystem, Inc., as amended
- 10.8(8) 2001 Stock Option Plan
- 10.9(16) Employee Stock Purchase Plan of First Interstate BancSystem, Inc., as amended and restated effective April 30, 2003
- 10.10(3) Trademark License Agreements between Wells Fargo & Company and First Interstate BancSystem, Inc.
- 10.12(10) Employment Agreement between First Interstate BancSystem, Inc. and Lyle R. Knight
- 10.13(10) First Interstate BancSystem, Inc. Executive Non-Qualified Deferred Compensation Plan dated November 20, 1998
- 10.14(7) First Interstate BancSystem s Deferred Compensation Plan dated December 6, 2000
- 10.15(12) First Interstate BancSystem, Inc. 2004 Restricted Stock Award Plan
- 10.16(17) Form of First Interstate BancSystem, Inc. Restricted Stock Award Agreement
- 10.17(17) Form of First Interstate BancSystem, Inc. Restricted Stock Award Notice of Restricted Stock Award
- 10.18(21) First Interstate BancSystem, Inc. 2006 Equity Compensation Plan
- 31.1



Edgar Filing: FIRST INTERSTATE BANCSYSTEM INC - Form 10-Q

|      |   |
|------|---|
|      | Certification of Annual Report on Form 10-K pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer    |
| 31.2 | Certification of Quarterly Report on Form 10-Q pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer |
| 32   | Certification of Quarterly Report on Form 10-Q pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                            |
|      | Management contract or compensatory plan or arrangement.  |

**Table of Contents**

- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-1, No. 33-84540.
- (2) Incorporated by reference to the Registrant's Form 8-K dated October 1, 1996.
- (3) Incorporated by reference to the Registrant's Registration Statement on Form S-1, No. 333-25633.
- (4) Incorporated by reference to the Registrant's Registration Statement on Form S-1, No. 333-3250.
- (5) Incorporated by reference to the Post-Effective Amendment No. 2 to the Registrant's Registration Statement on Form S-1, No. 33-84540.
- (6) Incorporated by reference to the Registrant's Registration Statement on Form S-1, No. 333-37847.
- (7) Incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 2002.
- (8) Incorporated by reference to the Registrant's Registration Statement on Form S-8, No. 333-106495.
- (9) Incorporated by reference to the Registrant's Registration Statement on Form S-8, No. 333-76825.
- (10) Incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 1999.
- (11) Incorporated by reference to the Registrant's Registration Statement on Form S-8, No. 333-69490.
- (12) Incorporated by reference to the Registrant's Post-Effective Amendment No. 1 to Registration Statement on Form S-8, No. 333-76825.
- (13) Incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 2000.
- (14) Incorporated by reference to the Registrant's Post-Effective Amendment No. 2 to Registration Statement on Form S-8, No. 333-76825.
- (15) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
- (16) Incorporated by reference to the Registrant's Post-Effective Amendment No. 3 to Registration Statement on Form S-8, No. 333-76825.
- (17) Incorporated by reference to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.
- (18) Incorporated by reference to Registrant's Post-Effective Amendment No. 4 to Registration Statement of Form S-8, No. 333-76825.
- (19) Incorporated by reference to Registrant's Form 8-K dated June 30, 2005.
- (20) Incorporated by reference to the Registrant's Form 10-K for the fiscal year ended December 31, 2004.
- (21) Incorporated by reference to the Registrant's Proxy Statement on Schedule 14A related to the Registrant's Annual Meeting of Shareholders held May 5, 2006.

**Table of Contents**

**SIGNATURES**

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

FIRST INTERSTATE BANCSYSTEM, INC.

Date April 25, 2007

/s/ LYLE R. KNIGHT

Lyle R. Knight  
President and Chief Executive Officer

Date April 25, 2007

/s/ TERRILL R. MOORE

Terrill R. Moore  
Executive Vice President and  
Chief Financial Officer