

STERLING FINANCIAL CORP /WA/

Form 10-Q

May 11, 2009

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE QUARTERLY PERIOD ENDED March 31, 2009

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 0-20800

**STERLING FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

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

**111 North Wall Street, Spokane, Washington 99201**

**91-1572822**  
(I.R.S. Employer  
Identification No.)

(Address of principal executive offices) (Zip Code)

**(509) 458-3711**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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.

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Yes  No

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

Class	Outstanding as of May 1, 2009
Common Stock (\$1.00 par value)	52,400,515

**Table of Contents**

**STERLING FINANCIAL CORPORATION**

**FORM 10-Q**

**For the Quarter Ended March 31, 2009**

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I - Financial Information</u></b>	<b>1</b>
Item 1 <b><u>Financial Statements (Unaudited)</u></b>	<b>1</b>
<b><u>Consolidated Balance Sheets</u></b>	<b>1</b>
<b><u>Consolidated Statements of Income</u></b>	<b>2</b>
<b><u>Consolidated Statements of Cash Flows</u></b>	<b>3</b>
<b><u>Consolidated Statements of Comprehensive Income</u></b>	<b>5</b>
<b><u>Notes to Consolidated Financial Statements</u></b>	<b>6</b>
Item 2 <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b>17</b>
Item 3 <b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b>38</b>
Item 4 <b><u>Controls and Procedures</u></b>	<b>38</b>
<b><u>PART II - Other Information</u></b>	<b>39</b>
Item 1 <b><u>Legal Proceedings</u></b>	<b>39</b>
Item 1a <b><u>Risk Factors</u></b>	<b>39</b>
Item 2 <b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b>39</b>
Item 3 <b><u>Defaults Upon Senior Securities</u></b>	<b>39</b>
Item 4 <b><u>Submission of Matters to a Vote of Security Holders</u></b>	<b>39</b>
Item 5 <b><u>Other Information</u></b>	<b>39</b>
Item 6 <b><u>Exhibits</u></b>	<b>39</b>
<b><u>Signatures</u></b>	<b>40</b>

**Table of Contents****PART I Financial Information****Item 1 Financial Statements****STERLING FINANCIAL CORPORATION****Consolidated Balance Sheets****(Unaudited)**

	March 31 2009	December 31, 2008
	(Dollars in thousands)	
<b>ASSETS:</b>		
Cash and cash equivalents:		
Interest bearing	\$ 65,054	\$ 171
Non-interest bearing	101,551	138,631
<b>Total cash and cash equivalents</b>	<b>166,605</b>	<b>138,802</b>
Restricted cash	1,332	1,493
Investment securities and mortgage-backed securities ( MBS ):		
Available for sale	2,733,541	2,639,290
Held to maturity	174,790	175,830
Loans receivable, net	8,683,919	8,807,094
Loans held for sale (at fair value: \$160,261 and \$112,191)	162,148	112,777
Accrued interest receivable	54,333	57,306
Other real estate owned, net ( OREO )	83,557	62,320
Office properties and equipment, net	93,322	93,195
Bank-owned life insurance ( BOLI )	158,944	157,236
Goodwill	227,558	227,558
Other intangible assets	25,501	26,725
Mortgage servicing rights, net	6,256	5,706
Prepaid expenses and other assets, net	247,821	285,384
<b>Total assets</b>	<b>\$ 12,819,627</b>	<b>\$ 12,790,716</b>
<b>LIABILITIES:</b>		
Deposits	\$ 8,488,034	\$ 8,350,407
Advances from Federal Home Loan Bank ( FHLB )	1,573,618	1,726,549
Securities sold subject to repurchase agreements and funds purchased	1,222,162	1,163,023
Other borrowings	248,277	248,276
Cashiers checks issued and payable	4,460	8,762
Borrowers reserves for taxes and insurance	3,217	1,987
Accrued interest payable	39,100	41,631
Accrued expenses and other liabilities	119,127	109,045
<b>Total liabilities</b>	<b>11,697,995</b>	<b>11,649,680</b>
<b>SHAREHOLDERS EQUITY:</b>		
Preferred stock, \$1 par value; \$1,000 stated value; 10,000,000 shares authorized; 303,000 shares issued and outstanding	292,524	291,964
Common stock, \$1 par value; 100,000,000 shares authorized; 52,399,631 and 52,134,030 shares issued and outstanding	52,400	52,134

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

Additional paid-in capital	909,586	909,386
Accumulated other comprehensive loss:		
Unrealized losses on investment securities and MBS available-for-sale, net of deferred income taxes of \$8,417 and \$10,690	(13,504)	(17,866)
Retained earnings (deficit)	(119,374)	(94,582)
Total shareholders' equity	1,121,632	1,141,036
Total liabilities and shareholders' equity	\$ 12,819,627	\$ 12,790,716

See notes to consolidated financial statements.

**Table of Contents****STERLING FINANCIAL CORPORATION****Consolidated Statements of Income (Loss)****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands, except per share data)</b>	
<b>Interest income:</b>		
Loans	\$ 126,923	\$ 162,120
MBS	29,880	24,499
Investments and cash equivalents	3,328	2,364
<b>Total interest income</b>	<b>160,131</b>	<b>188,983</b>
<b>Interest expense:</b>		
Deposits	48,314	62,870
Short-term borrowings	4,651	3,431
Long-term borrowings	18,818	30,595
<b>Total interest expense</b>	<b>71,783</b>	<b>96,896</b>
<b>Net interest income</b>	<b>88,348</b>	<b>92,087</b>
Provision for credit losses	(65,865)	(37,143)
<b>Net interest income after provision for credit losses</b>	<b>22,483</b>	<b>54,944</b>
<b>Non-interest income:</b>		
Fees and service charges	13,840	14,151
Mortgage banking operations	13,308	6,198
Loan servicing fees	(467)	(148)
OREO	(4,478)	(106)
BOLI	1,406	1,466
Securities sales gains (losses)	10,565	(408)
Other	(2,026)	9
<b>Total non-interest income</b>	<b>32,148</b>	<b>21,162</b>
<b>Non-interest expenses</b>	<b>75,510</b>	<b>72,107</b>
<b>Income (loss) before income taxes</b>	<b>(20,879)</b>	<b>3,999</b>
Income tax (provision) benefit	436	(1,123)
<b>Net income (loss)</b>	<b>(20,443)</b>	<b>2,876</b>
Preferred stock dividend	(4,347)	0
<b>Net income (loss) available to common shareholders</b>	<b>\$ (24,790)</b>	<b>\$ 2,876</b>
<b>Earnings per share - basic</b>	<b>\$ (0.48)</b>	<b>\$ 0.06</b>
<b>Earnings per share - diluted</b>	<b>\$ (0.48)</b>	<b>\$ 0.06</b>

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

Weighted average shares outstanding - basic	51,896,149	51,526,332
Weighted average shares outstanding - diluted	51,896,149	51,786,038

See notes to consolidated financial statements.

**Table of Contents****STERLING FINANCIAL CORPORATION****Consolidated Statements of Cash Flows****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (20,443)	\$ 2,876
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses and OREO	69,776	37,143
Accretion of deferred gain on sale of branches	(201)	(202)
Net gain on sales of loans, investments and MBS	(22,712)	(4,192)
Stock based compensation	497	540
Excess tax benefit from stock based compensation	40	(689)
Stock issuances relating to 401(k) match and direct stock purchase	9	830
Loss at foreclosure on OREO	8,976	0
Other (gains) and losses	1,699	974
Increase in cash surrender value of BOLI	(1,542)	(1,466)
Depreciation and amortization	6,756	6,774
Change in:		
Accrued interest receivable	2,973	4,640
Prepaid expenses and other assets	33,157	(7,361)
Cashiers checks issued and payable	(4,302)	10,767
Accrued interest payable	(2,531)	(4,620)
Accrued expenses and other liabilities	9,440	5,000
Proceeds from sales of loans originated for sale	572,574	342,695
Loans originated for sale	(559,883)	(338,503)
<b>Net cash provided by operating activities</b>	<b>94,283</b>	<b>55,206</b>
<b>Cash flows from investing activities:</b>		
Change in restricted cash	161	(10)
Loans funded and purchased	(694,437)	(1,133,883)
Loan principal received	657,125	866,436
Purchase of investment securities	(231,594)	(16,807)
Proceeds from maturities of investment securities	137,323	10,157
Proceeds from sale of investment securities	78,851	0
Proceeds from sale - MBS	108,131	0
Purchase of BOLI	0	(345)
Purchase of MBS	(327,874)	(384,349)
Principal payments on MBS	156,165	69,904
Purchase of office properties and equipment	(3,681)	(2,419)
Sales of office properties and equipment	7	72
Improvements and other changes to OREO	(4,481)	(258)
Proceeds from sales of OREO	15,608	2,334
<b>Net cash used in investing activities</b>	<b>(108,696)</b>	<b>(589,168)</b>

See notes to consolidated financial statements.





**Table of Contents****STERLING FINANCIAL CORPORATION****Consolidated Statements of Cash Flows****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
<b>Cash flows from financing activities:</b>		
Net change in transaction and savings deposits	\$ 84,077	\$ (180,362)
Proceeds from issuance of time deposits	1,267,066	1,522,689
Payments for maturing time deposits	(1,260,977)	(1,242,093)
Interest credited to deposits	47,461	62,778
Advances from FHLB	85,000	714,000
Repayment of advances from FHLB	(237,794)	(486,046)
Net change in securities sold subject to repurchase agreements and funds purchased	59,139	154,660
Repayment of other borrowings	0	(24,000)
Proceeds from stock sales	0	999
Excess tax benefit from stock based compensation	(40)	689
Cash dividends paid to preferred shareholders	(2,946)	0
Cash dividends paid to common shareholders	0	(4,888)
Other	1,230	1,281
<b>Net cash provided by financing activities</b>	<b>42,216</b>	<b>519,707</b>
<b>Net change in cash and cash equivalents</b>	<b>27,803</b>	<b>(14,255)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>138,802</b>	<b>194,478</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 166,605</b>	<b>\$ 180,223</b>
<b>Supplemental disclosures:</b>		
<b>Cash paid during the period for:</b>		
Interest	\$ 74,314	\$ 101,516
Income taxes	(39,104)	325
<b>Noncash financing and investing activities:</b>		
Loans converted into OREO	45,251	4,028
Common stock cash dividends accrued	0	5,200
Preferred stock cash dividend accrued	1,894	0

See notes to consolidated financial statements.

**Table of Contents****STERLING FINANCIAL CORPORATION****Consolidated Statements of Comprehensive Income****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Net income (loss)	\$ (20,443)	\$ 2,876
Other comprehensive income (loss):		
Change in unrealized losses on investments and MBS available-for-sale	6,635	11,704
Less deferred income taxes benefit (provision)	(2,273)	(4,328)
Net other comprehensive income (loss)	4,362	7,376
Comprehensive income (loss)	\$ (16,081)	\$ 10,252

See notes to consolidated financial statements.

---

**Table of Contents**

**Notes to Consolidated Financial Statements**

**1. Basis of Presentation:**

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements as disclosed in the annual report on Form 10-K for the year ended December 31, 2008. In the opinion of management, the unaudited interim consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of Sterling Financial Corporation's (Sterling's) consolidated financial statements; accordingly, it is possible that the actual results could differ from these estimates and assumptions, which could have a material effect on the reported amounts of Sterling's consolidated financial position and results of operations.

In addition to other established accounting policies, the following is a discussion of recent accounting pronouncements:

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (FAS) FAS No. 141 (R), Business Combinations (FAS No. 141 (R)). FAS No. 141 (R) establishes principles and requirements for how the acquirer: 1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree; 2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; 3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS No. 141 (R) applies prospectively to business combinations entered into by Sterling after January 1, 2009. Depending on the level of future acquisitions, FAS No. 141 (R) may have a material effect on Sterling, mainly in regards to the valuation of loans, and the treatment for acquisition costs.

In February 2008, the FASB issued FASB Staff Position (FSP) FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS No. 140-3). The FSP provides implementation guidance for linked transactions under FAS 140. The FSP states that a transferor and transferee shall not separately account for a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. This FSP was effective for Sterling as of January 1, 2009, and did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued FAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FAS 133. FAS 161 requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS 133 and related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. FAS 161 was effective for Sterling as of January 1, 2009, and did not have a material effect on its consolidated financial statements.

In June 2008, the FASB issued FSP EITF 03-06-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. FSP EITF 03-06-1 requires all outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends to be considered participating securities and requires entities to apply the two-class method of computing basic and diluted earnings per share. This FSP was effective for Sterling as of January 1, 2009, and did not have a material impact on its consolidated financial statements.

**Table of Contents**

In April 2009, the FASB issued FSP FAS 115-2 and 124-2, Recognition and Presentation of Other-Than-Temporary Impairment ( OTTI ), FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, and FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments. For debt securities, the guidance differentiates credit driven and market driven OTTI. Only the portion of the impairment loss representing credit losses would be recognized in earnings as an OTTI. The balance of the impairment loss would be recognized as a charge to other comprehensive income. A non-credit related OTTI charge to other comprehensive income for securities classified as held to maturity will be amortized from accumulated other comprehensive income back to the security over the securities remaining life. Financial statement presentation will require segregation of accumulated comprehensive income for non-credit OTTI charges on held to maturity and available for sale securities from other components of accumulated comprehensive income. The standard provided additional guidance for the determination of whether a market for an asset is not active and when a price for a transaction is not distressed. The disclosure requirements of FAS 107 have been extended to interim periods. This guidance is effective for Sterling as of June 30, 2009. The company is currently evaluating the impact of these standards.

**2. Allowance for Credit Losses:**

The following is an analysis of the changes in the allowances for credit losses:

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Allowance for credit losses		
Allowance - loans, January 1	\$ 208,365	\$ 111,026
Provision	65,865	37,143
Charge-offs	(68,290)	(3,453)
Recoveries	3,045	231
Transfers	0	62
<b>Allowance - loans, March 31</b>	<b>208,985</b>	<b>145,009</b>
Allowance - unfunded commitments, January 1	21,334	6,306
Provision	0	21
Transfers	0	(62)
<b>Allowance - unfunded commitments, March 31</b>	<b>21,334</b>	<b>6,265</b>
<b>Total credit allowance</b>	<b>\$ 230,319</b>	<b>\$ 151,274</b>

**Table of Contents**

The increase in the provision stems from higher levels of classified assets and higher loss rates. Classified assets include non-performing loans and OREO. The following is a summary of loans that are not performing in accordance with their original contractual terms:

	March 31, 2009	December 31, 2008	March 31, 2008
	(Dollars in thousands)		
Past due 90 days	\$ 0	\$ 0	\$ 0
Nonaccrual loans	485,158	474,172	209,850
Restructured loans	84,281	56,618	207
<b>Total nonperforming loans</b>	<b>569,439</b>	<b>530,790</b>	<b>210,057</b>
OREO	100,512	79,875	13,027
<b>Total nonperforming assets</b>	<b>669,951</b>	<b>610,665</b>	<b>223,084</b>
Specific reserves	(16,970)	(19,535)	(19,084)
<b>Net nonperforming assets</b>	<b>\$ 652,981</b>	<b>\$ 591,130</b>	<b>\$ 204,000</b>

Cumulatively, Sterling has written down its non-performing assets by \$244.0 million as of March 31, 2009, compared with write-downs of \$207.7 million as of December 31, 2008 and \$4.2 million as of March 31, 2008. At March 31, 2009, non-performing assets include \$46.7 million of restructured loans that are performing in accordance with their new terms and are accruing interest, compared with \$29.5 million as of December 31, 2008, and none as of March 31, 2008.

As of March 31, 2009, the allowance for losses on OREO totaled \$17.0 million. Changes in this allowance are as follows for the periods presented:

	Three Months Ended March 31,	
	2009	2008
	(Dollars in thousands)	
Balance, January 1	\$ 17,555	\$ 0
Provision	3,911	0
Charge-offs	(4,510)	0
<b>Balance, March 31</b>	<b>\$ 16,956</b>	<b>\$ 0</b>

**3. Goodwill and Other Intangible Assets:**

As of March 31, 2009 and December 31, 2008, Sterling had goodwill and other intangible assets totaling \$253.1 million and \$254.3 million, respectively. Goodwill represents the difference between the value of consideration paid and the fair value of the net assets received in a business combination. Other intangible assets represent acquired customer depository relationships. Intangible assets are periodically assessed for impairment. Sterling's management performed an annual test of its goodwill and other intangible assets as of June 30, 2008, and concluded that the recorded values were not impaired, based on present value discounted cash flow analysis as allowed by FAS 142, Goodwill and Other Intangibles (FAS 142). During the fourth quarter of 2008, due to reduced expectations for near term profitability, and the protracted decline in Sterling's stock price and market capitalization, Sterling determined that an impairment had occurred, and wrote off \$223.8 million of its goodwill, following deterioration in its loan portfolio from worsening economic conditions, continued stress on real estate values, increasing levels of both classified and non-performing assets and higher net charge-offs, that resulted in higher credit costs and lower earnings. Dividends on Sterling's newly issued preferred stock also reduced income available to common shareholders. As of March 31, 2009, Sterling evaluated whether events or circumstances had occurred since its most recent impairment test that would be considered triggering events under FAS 142, thus requiring an update to its goodwill impairment test. Sterling determined that no such events had occurred. There are many assumptions and estimates underlying the determination of whether goodwill has been impaired. Future events could cause management to conclude that Sterling's goodwill or other intangible assets have become further impaired, which would result in Sterling recording an additional impairment loss.



**Table of Contents****4. Other Borrowings:**

The components of other borrowings are as follows:

	March 31, 2009	December 31, 2008
	(Dollars in thousands)	
Junior subordinated debentures	\$ 245,277	\$ 245,276
Other	3,000	3,000
<b>Total other borrowings</b>	<b>\$ 248,277</b>	<b>\$ 248,276</b>

Sterling raises capital from time to time through the formation of trust subsidiaries ( Capital Trusts ), which issue capital securities ( Trust Preferred Securities ) to investors. The Capital Trusts are business trusts in which Sterling owns all of the common equity. The proceeds from the sale of the Trust Preferred Securities are used to purchase junior subordinated deferrable interest debentures ( Junior Subordinated Debentures ) issued by Sterling. Sterling's obligations under the Junior Subordinated Debentures and related documents, taken together, constitute a full and unconditional guarantee by Sterling of the Capital Trusts' obligations under the Trust Preferred Securities. The Trust Preferred Securities are treated as debt of Sterling. The Junior Subordinated Debentures and related Trust Preferred Securities generally mature 30 years after issuance and are redeemable at the option of Sterling under certain conditions, including, with respect to certain of the Trust Preferred Securities, payment of call premiums. Interest is paid quarterly or semiannually.

Details of the Trust Preferred Securities are as follows:

Subsidiary Issuer	Issue Date	Maturity Date	Initial Call Date	Rate at March 31, 2009	Amount (in Thousands)
Sterling Capital Trust IX	July 2007	Oct 2037	N/A	Floating 2.84%	\$ 46,392
Sterling Capital Trust VIII	Sept 2006	Sept 2036	N/A	Floating 2.95	51,547
Sterling Capital Trust VII	June 2006	June 2036	N/A	Floating 2.85	56,702
Lynnwood Capital Trust II	June 2005	June 2035	June 2010	Floating 3.12	10,310
Sterling Capital Trust VI	June 2003	Sept 2033	Sept 2008	Floating 4.52	10,310
Sterling Capital Statutory Trust V	May 2003	May 2033	June 2008	Floating 4.48	20,619
Sterling Capital Trust IV	May 2003	May 2033	May 2008	Floating 4.40	10,310
Sterling Capital Trust III	April 2003	April 2033	April 2008	Floating 4.42	14,433
Lynnwood Capital Trust I	Mar 2003	Mar 2033	Mar 2007	Floating 4.38	9,466
Klamath First Capital Trust I	July 2001	July 2031	June 2006	Floating 5.38	15,188
				3.46%*	\$ 245,277

\* Weighted average rate



**Table of Contents****5. Earnings Per Share:**

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

	Three Months Ended March 31,					
	2009			2008		
	Net Income (Loss) Available to Common Shareholders	Weighted Average Shares	Per Share Amount	Net Income	Weighted Average Shares	Per Share Amount
	(Dollars in thousands, except per share amounts)					
Basic computations	\$ (24,790)	51,896,149	\$ (0.48)	\$ 2,876	51,526,332	\$ 0.06
Effect of dilutive securities:						
Common stock options and restricted shares	0	0	0.00	0	259,706	0.00
Common stock warrant	0	0	0.00	0	0	0.00
Diluted computations	\$ (24,790)	51,896,149	\$ (0.48)	\$ 2,876	51,786,038	\$ 0.06

Antidilutive securities not included

in diluted earnings per share:

Common stock options	2,050,418	1,651,087
Common stock warrant	6,437,677	0
Restricted shares	417,377	192,989
Total antidilutive	8,905,472	1,844,076

FSP EITF 03-06-1 proscribes a two-class method for entities that have participating securities such as Sterling's unvested restricted shares that provide the holder of the shares with the right to receive any dividends issued by Sterling. Sterling applied the treasury stock method because it was the most dilutive method of measuring earnings per share.

**Table of Contents****6. Non-Interest Expenses:**

The following table details the components of Sterling's total non-interest expenses:

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Employee compensation and benefits	\$ 40,188	\$ 40,890
Occupancy and equipment	11,242	11,532
Data processing	5,154	5,319
Insurance	4,290	1,711
Depreciation	3,544	3,565
Advertising	2,755	2,798
Legal and accounting	1,521	813
Amortization of core deposit intangibles	1,225	1,226
Travel and entertainment	1,215	1,665
Other	4,376	2,588
<b>Total</b>	<b>\$ 75,510</b>	<b>\$ 72,107</b>

The increase in non-interest expenses was mainly due to an increase in FDIC deposit insurance premiums, which rose by \$2.5 million year over year.

**7. Segment Information:**

For purposes of measuring and reporting financial results, Sterling is divided into five business segments:

The Community Banking segment provides traditional banking and wealth management services through the retail and commercial banking groups of Sterling's subsidiary, Sterling Savings Bank.

The Residential Construction Lending segment originates and services loans through the real estate division of Sterling's subsidiary, Sterling Savings Bank.

The Residential Mortgage Banking segment originates and sells servicing-retained and servicing-released residential loans through loan production offices of Sterling's subsidiary, Golf Savings Bank.

The Commercial Mortgage Banking segment originates, sells and services commercial real estate loans and participation interests in commercial real estate loans through offices in the western region primarily through Sterling Savings Bank's subsidiary INTERVEST-Mortgage Investment Company ( INTERVEST ).

The Other and Eliminations segment represents the parent company expenses and intercompany eliminations of revenue and expenses.

On May 1, 2009, Sterling Savings Bank's subsidiary, Harbor Financial Services, Inc., which provides certain wealth management services, was renamed Sterling Savings Banc Financial Services, Inc.



**Table of Contents**

The following table presents certain financial information regarding Sterling's segments and provides a reconciliation to Sterling's consolidated totals for the periods presented:

	As of and for the Three Months Ended March 31, 2009					Total
	Community Banking	Residential Construction Lending	Residential Mortgage Banking	Commercial Mortgage Banking	Other and Eliminations	
	(Dollars in thousands)					
Interest income	\$ 134,986	\$ 10,846	\$ 7,699	\$ 6,370	\$ 230	\$ 160,131
Interest expense	(62,759)	(3,129)	(3,691)	0	(2,204)	(71,783)
Net interest income (expense)	72,227	7,717	4,008	6,370	(1,974)	88,348
Provision for credit losses	(24,692)	(34,308)	(6,865)	0	0	(65,865)
Noninterest income	20,535	231	14,044	538	(3,200)	32,148
Noninterest expense	(63,388)	(2,164)	(6,709)	(2,194)	(1,055)	(75,510)
Income (loss) before income taxes	\$ 4,682	\$ (28,524)	\$ 4,478	\$ 4,714	\$ (6,229)	\$ (20,879)
Total assets	\$ 10,871,882	\$ 1,416,644	\$ 559,682	\$ 17,800	\$ (46,381)	\$ 12,819,627

	As of and for the Three Months Ended March 31, 2008					Total
	Community Banking	Residential Construction Lending	Residential Mortgage Banking	Commercial Mortgage Banking	Other and Eliminations	
	(Dollars in thousands)					
Interest income	\$ 144,650	\$ 33,018	\$ 8,147	\$ 3,034	\$ 134	\$ 188,983
Interest expense	(68,936)	(19,161)	(4,801)	0	(3,998)	(96,896)
Net interest income (expense)	75,714	13,857	3,346	3,034	(3,864)	92,087
Provision for credit losses	(13,085)	(23,615)	(443)	0	0	(37,143)
Noninterest income	15,374	985	4,965	1,018	(1,180)	21,162
Noninterest expense	(59,093)	(2,937)	(6,447)	(2,435)	(1,195)	(72,107)
Income (loss) before income taxes	\$ 18,910	\$ (11,710)	\$ 1,421	\$ 1,617	\$ (6,239)	\$ 3,999
Total assets	\$ 10,371,758	\$ 1,844,599	\$ 527,413	\$ 12,850	\$ (65,467)	\$ 12,691,153

**Table of Contents****8. Stock-Based Compensation:**

The following is a summary of stock option and restricted stock activity during the three months ended March 31, 2009:

	Stock Options		Restricted Stock	
	Number	Weighted Average Exercise Price	Number	Weighted Average Grant Price
Balance, January 1, 2009	1,977,968	\$ 22.41	284,750	\$ 20.17
Granted	183,500	1.85	260,000	1.85
Exercised/vested	0	0.00	(66,500)	22.70
Cancelled/expired	(146,100)	20.51	0	0.00
Outstanding, March 31, 2009	2,015,368	\$ 20.68	478,250	\$ 9.86
Exercisable, March 31, 2009	1,482,618	\$ 22.10		

At March 31, 2009, the weighted average remaining contractual life and the aggregate intrinsic value of stock options outstanding was 4.5 years and (\$37.5) million, respectively, and of stock options exercisable was 4.2 years and (\$29.7) million, respectively, and at December 31, 2008, was 4.3 years and (\$26.9) million, respectively, and 4.0 years and (\$19.2) million, respectively. As of March 31, 2009, a total of 1,323,785 shares remained available for grant under Sterling's 2001, 2003 and 2007 Long-Term Incentive Plans. The stock options granted under these plans have terms of four, six, eight or ten years. The stock options and restricted shares granted during 2009 have vesting schedules ranging from two to four years. During the three months ended March 31, 2009 and 2008, the intrinsic value of options exercised were \$0 and \$2.2 million, respectively, and fair value of options granted were \$192,000 and \$1.1 million, respectively. The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used were:

	Three Months Ended March 31,	
	2009	2008
Expected volatility	72%	30%
Expected term (in years)	4.4	4.3
Expected dividend yield	0.00%	2.14%
Risk free interest rate	2.07%	2.93%

Stock-based compensation expense recognized during the periods presented was as follows:

	Three Months Ended March 31,	
	2009	2008
<b>(Dollars in thousands)</b>		
Stock based compensation expense:		
Stock options	\$ 271	\$ 246
Restricted stock	453	311
Total	\$ 724	\$ 557

As of March 31, 2009, unrecognized equity compensation expense totaled \$6.7 million, as the underlying outstanding awards had not yet been earned. This amount will be recognized over a weighted average period of 2.4 years. During 2009, no stock options were forfeited. Any increase in forfeitures would lower the amount of future equity compensation expense to be recognized.



**Table of Contents****9. Derivatives and Hedging:**

As part of its mortgage banking activities, Sterling issues interest rate lock commitments to prospective borrowers on residential mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors under both non-binding ( best-efforts ) and binding ( mandatory ) delivery programs. For mandatory delivery programs, Sterling hedges interest rate risk by entering into offsetting forward sale agreements on MBS with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to interest rate lock commitments, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods.

Interest rate lock commitments and loan delivery commitments are off balance sheet commitments that are considered to be derivatives. As of March 31, 2009, Sterling had \$188.8 million of interest rate lock commitments, \$84.4 million of warehouse loans held for sale that were not committed to investors, and held offsetting forward sale agreements on MBS valued at \$225.0 million. In addition Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at \$20.9 million as of March 31, 2009. As of December 31, 2008, Sterling had \$75.4 million of interest rate lock commitments, \$71.8 million of warehouse loans held for sale that were not committed to investors, and held offsetting forward sale agreements on MBS valued at \$114.4 million. In addition, Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at \$1.4 million as of December 31, 2008. As of March 31, 2009 and December 31, 2008, Sterling had entered into best efforts forward commitments to sell \$119.6 million and \$71.0 million of mortgage loans, respectively.

Sterling enters into interest rate swap derivative contracts with customers. The interest rate risk on these contracts is offset by entering into comparable broker dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of March 31, 2009 and December 31, 2008, were \$7.0 million and \$7.5 million, respectively.

**10. Fair Value:**

FAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, gives companies the option of carrying financial assets and liabilities at fair value and can be implemented on all or individually selected financial instruments. Effective January 1, 2008, Sterling elected to apply FAS 159 on newly originated loans held for sale under mandatory delivery programs. After analyzing the effects of FAS 159 on held for sale loans, Sterling elected to apply FAS 159 to all newly originated held for sale loans effective April 1, 2008. The fair value election was made to match changes in the value of these loans with the value of their economic hedges. Loan origination fees, costs and servicing rights, which were previously deferred on these loans, are now recognized as part of the loan value at origination. There was no transition adjustment upon adoption.

The framework for defining and measuring fair value under FAS 157, Fair Value Measurements, requires that one of three valuation methods be used to determine fair market value: the market approach, the income approach or the cost approach. To increase consistency and comparability in fair value measurements and related disclosures, the standard also creates a fair value hierarchy to prioritize the inputs to these valuation methods into the following three levels:

Level 1 inputs are a select class of observable inputs, based upon the quoted prices for identical instruments in active markets that are accessible as of the measurement date, and are to be used whenever available.

Level 2 inputs are other types of observable inputs, such as quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are inactive; or other inputs that are observable or can be derived from or supported by observable market data. Level 2 inputs are to be used whenever Level 1 inputs are not available.

Level 3 inputs are significantly unobservable, reflecting the reporting entity's own assumptions regarding what market participants would assume when pricing a financial instrument. Level 3 inputs are to only be used when Level 1 and Level 2 inputs are unavailable.

**Table of Contents**

*Assets and Liabilities Measured at Fair Value on a Recurring Basis.* The following presents Sterling's financial instruments that are measured at fair value on a recurring basis:

	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
<b>Balance, March 31, 2009:</b>				
Investment securities and mortgage-backed securities available for sale	\$ 2,733,541	\$ 0	\$ 2,733,541	\$ 0
Loans held for sale	160,261	0	160,261	0
Other assets - derivatives	11,700	0	4,651	7,049
<b>Total assets</b>	<b>\$ 2,905,502</b>	<b>\$ 0</b>	<b>\$ 2,898,453</b>	<b>\$ 7,049</b>
Other liabilities - derivatives	\$ 7,049	\$ 0	\$ 0	\$ 7,049
<b>Balance, December 31, 2008:</b>				
Investment securities and mortgage-backed securities available for sale	\$ 2,639,290	\$ 0	\$ 2,639,290	\$ 0
Loans held for sale	112,191	0	112,191	0
Other assets - derivatives	10,085	0	2,625	7,460
<b>Total assets</b>	<b>\$ 2,761,566</b>	<b>\$ 0</b>	<b>\$ 2,754,106</b>	<b>\$ 7,460</b>
Other liabilities - derivatives	\$ 7,709	\$ 0	\$ 249	\$ 7,460

Investments and mortgage-backed securities have been valued using a matrix pricing technique based on quoted prices for similar instruments, while loans held for sale have been valued using investor quoted pricing inputs. Level 2 derivatives represent mortgage banking interest rate lock and loan delivery commitments, while level 3 derivatives represent interest rate swaps. See Note 9 for a further discussion of these derivatives. Changes in the fair value of available-for-sale securities are recorded on the balance sheet under accumulated-other-comprehensive income, while gains and losses from sales are recognized as income. The difference between the aggregate fair value and the aggregate unpaid principal balance of loans held for sale that are carried at fair value under FAS 159 were included in earnings as follows:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Mortgage banking operations	\$ 3,832	\$ 1,201



**Table of Contents**

**Assets and Liabilities Measured at Fair Value on a Non-recurring Basis.** Sterling may be required, from time to time, to measure certain other financial assets at fair value on a non-recurring basis from application of lower of cost or market ( LOCOM ) accounting or write-downs of individual assets. The following table presents the carrying value for these financial assets as of the dates indicated:

	<b>Total Carrying Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
	<b>(Dollars in thousands)</b>			
<b>March 31, 2009</b>				
Loans	\$ 327,531	\$ 0	\$ 0	\$ 327,531
Mortgage servicing rights	6,256	0	6,256	0
OREO	76,646	0	0	76,646
<b>December 31, 2008</b>				
Loans	\$ 296,605	\$ 0	\$ 0	\$ 296,605
Mortgage servicing rights	7,878	0	7,878	0
OREO	60,019	0	0	60,019
Goodwill	227,558	0	0	227,558

The loans disclosed above represent the carrying value of impaired loans at period end. Mortgage servicing rights were written down mainly due to an acceleration of mortgage prepayments. Sterling carries its mortgage servicing rights at LOCOM, and as such, they are measured at fair value on a non-recurring basis. OREO represents the carrying value after write-downs taken at foreclosure that were charged to the loan loss allowance, as well as specific reserves established subsequent to foreclosure due to updated appraisals. The goodwill impairment resulted from a protracted decline in Sterling's stock price and market capitalization. It also reflects the expectation for reduced near-term profitability because of higher credit costs and incorporates anticipation of lower net income available to common shareholders after the payment of dividends on Sterling's preferred stock.

---

**Table of Contents**

**PART I Financial Information (continued)**

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

**STERLING FINANCIAL CORPORATION**

**March 31, 2009**

*This report contains forward-looking statements. For a discussion about such statements, including the risks and uncertainties inherent therein, see Forward-Looking Statements. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes presented elsewhere in this report and in Sterling's 2008 annual report on Form 10-K.*

**General**

Sterling Financial Corporation (Sterling) is a bank holding company, organized under the laws of Washington in 1992. The principal operating subsidiaries of Sterling are Sterling Savings Bank and Golf Savings Bank. The principal operating subsidiary of Sterling Savings Bank is INTERVEST-Mortgage Investment Company (INTERVEST). Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered federally insured stock savings and loan association headquartered in Spokane, Washington. On July 8, 2005, Sterling Savings Bank converted to a commercial bank. The main focus of Golf Savings Bank, a Washington State-chartered savings bank acquired by Sterling in July 2006, is the origination and sale of residential mortgage loans.

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service and relationship banking has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With \$12.82 billion in total assets as of March 31, 2009, Sterling originates loans and attracts Federal Deposit Insurance Corporation (FDIC) insured deposits from the general public through 179 depository banking offices located in Washington, Oregon, California, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Sterling Savings Bank residential loan production offices, and through INTERVEST commercial real estate lending offices throughout the western United States. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through wealth management representatives located throughout Sterling's financial service center network.

Sterling continues to implement its strategy to become the leading community bank in the western United States by increasing its commercial and consumer customer relationships that can provide a wider variety of lending opportunities, as well as increasing its commercial and retail deposits, particularly transaction accounts. Management believes that a community bank mix of assets and liabilities will enhance its net interest income (the difference between the interest earned on loans and investments and the interest paid on deposits and borrowings) and will increase other fee income, although there can be no assurance in this regard. Sterling's revenues are derived primarily from interest earned on loans and mortgage-backed securities (MBS), fees and service charges, and mortgage banking operations. The operations of Sterling, and banking institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Board of Governors of the Federal Reserve System (the Federal Reserve), the FDIC and the Washington State Department of Financial Institutions.

## **Table of Contents**

### **Executive Summary and Highlights**

Sterling's earnings per share and performance ratios continue to be impacted by the economic downturn which has led to higher credit costs as the result of ongoing asset quality concerns surrounding the levels of both classified and non-performing assets, and higher net charge-offs. During the first quarter of 2009, Sterling recorded a \$65.9 million provision for credit losses, compared to a \$37.1 million provision for credit losses recorded during the first quarter of 2008. Revenues, as defined by net interest income plus non-interest income, were up 6% year over year. Income from mortgage banking operations was up 115% from a year ago, reflecting lower prevailing interest rates and new lending initiatives, which led to a significant increase in the volume of residential mortgage originations. Also reflecting the drop in interest rates, Sterling realized \$10.6 million of net gains on the sales of securities. The year over year decrease of 4% in Sterling's net interest income primarily reflects a reduction in Sterling's net interest margin on a tax equivalent basis of 26 basis points to 2.98% from 3.24%. Sterling's higher level of non-performing assets (including non-accrual loans and other real estate owned (OREO)), and its asset sensitivity, during a declining interest rate environment, contributed to the decrease in net interest margin.

First quarter 2009 highlights were as follows:

Total deposits increased 8% from a year ago to a record \$8.49 billion.

Net interest margin improved to 2.98% from 2.80% for the December 31, 2008 quarter.

Income from mortgage banking operations rose 115% year over year.

All capital ratios remain above well-capitalized levels.

Total assets were \$12.82 billion.

Total loans receivable were \$8.68 billion.

Sterling expanded lending initiatives to benefit consumers and businesses.

### **Company Growth**

Sterling intends to continue to pursue a long-term growth strategy to become the leading community bank in the western United States, although, with the current economic slow down, growth opportunities are expected to be limited in the near-term and Sterling is considering various strategies to manage its capital and liquidity levels. In addition to focusing on organic growth, Sterling's long term strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. However, market conditions are having a significant negative impact on the banking industry and there is no assurance that Sterling will be successful in completing any such acquisitions or achieving additional growth in the near term.

### **Critical Accounting Policies**

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

**Income Recognition.** Sterling recognizes interest income by methods that conform to general accounting practices within the banking industry. In the event management believes collection of all or a portion of contractual interest on a loan has become doubtful, which generally occurs when the loan is 90 days past due, Sterling discontinues the

## **Table of Contents**

accrual of interest and any previously accrued interest recognized in income deemed uncollectible is reversed. Interest received on non-performing loans is included in income only if principal recovery is reasonably assured. A non-performing loan is restored to accrual status when it is brought current, has performed in accordance with contractual terms for a reasonable period of time, and the collectability of the total contractual principal and interest is no longer in doubt.

**Allowance for Credit Losses.** The allowance for credit losses is composed of the allowance for loan losses and the reserve for unfunded credit commitments. In general, determining the amount of the allowance requires significant judgment and the use of estimates by management. Sterling maintains an allowance for credit losses to absorb probable losses in the loan portfolio based on a quarterly analysis of the portfolio and expected future losses. This analysis is designed to determine an appropriate level and allocation of the allowance for losses among loan types by considering factors affecting loan losses, including specific and confirmed losses, levels and trends in classified and non-performing loans, historical loan loss experience, current national and local economic conditions, volume, growth and composition of the portfolio, regulatory guidance and other relevant factors. Management monitors the loan portfolio to evaluate the adequacy of the allowance. The allowance can increase or decrease each quarter based upon the results of management's analysis.

During the fourth quarter of 2008, Sterling modified its estimate of the fair value of loans being tested for impairment. The fair value is now estimated excluding the potential cash flows from certain guarantors. To the extent that these guarantors are able to provide repayments, a recovery would be recorded upon receipt. In addition, Sterling re-assessed the accounting for real estate loans treated as collateral dependent. As a result, Sterling now considers any impairment on a collateral-dependent loan to be a confirmed loss and charges off the impairment amount when the impairment is identified, rather than establishing a specific allowance on impaired collateral-dependent loans that would have been charged off when foreclosure was probable.

Individual loan reviews are based upon specific quantitative and qualitative criteria, including the size of the loan, loan quality ratings, value of collateral, repayment ability of borrowers, and historical experience factors. The historical experience factors utilized and allowances for homogeneous loans (such as residential mortgage loans, consumer loans, etc.) are collectively evaluated based upon historical loss experience, trends in losses and delinquencies, growth of loans in particular markets, and known changes in economic conditions in each particular lending market.

While management uses available information to provide for loan losses, the ultimate collectability of a substantial portion of the loan portfolio and the need for future additions to the allowance will be influenced by changes in economic conditions and other relevant factors. The slowdown in economic activity could continue to adversely affect cash flows for both commercial and individual borrowers, as a result of which Sterling could experience further increases in non-performing assets, delinquencies and losses on loans. There can be no assurance that the allowance for credit losses will be adequate to cover all losses, but management believes the allowance for credit losses was adequate at March 31, 2009.

**Investment Securities and MBS.** Assets in the investment securities and MBS portfolios are initially recorded at cost, which includes any premiums and discounts. Sterling amortizes premiums and discounts as an adjustment to interest income over the estimated life of the security. The cost of investment securities sold, and any resulting gain or loss, is based on the specific identification method. Sterling's MBS are primarily in agency securities, with limited investments in non-agency obligations. Municipal bonds that Sterling holds are all general obligation in nature, spread throughout Sterling's footprint. Sterling does not invest in collateralized debt obligations or similar exotic structured investment products.

The loans underlying Sterling's MBS are subject to the prepayment of principal. The rate at which prepayments are expected to occur in future periods impacts the amount of premium to be amortized in the current period. If prepayments in a future period are higher or lower than expected, then Sterling will need to amortize a larger or smaller amount of the premium to interest income in that future period.

**Table of Contents**

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

Management evaluates investment securities for other than temporary declines in fair value on a quarterly basis. If the fair value of investment securities falls below their amortized cost and the decline is deemed to be other than temporary, the securities will be written down to current market value, resulting in a loss. There were no investment securities that management identified to be other-than-temporarily impaired for the period ended March 31, 2009, because the decline in fair value of certain classes of securities was attributable to temporary disruptions of credit markets and the related impact on securities within those classes, not deteriorating credit quality of specific securities. Sterling holds positions in classes of securities negatively impacted by temporary credit market disruptions, including one single-issuer trust preferred security, and 19 private label collateralized mortgage obligations. The trust preferred security is rated A1 by Moody's and has an amortized cost of \$24.6 million compared to a \$10.6 million market value, or an unrealized loss of \$14.0 million. As of March 31, 2009, the private label collateralized mortgage obligations had an amortized cost of \$265.1 million compared to a \$207.8 million market value, or an unrealized loss of \$57.3 million. Their current ratings are: \$122 million AAA- by S&P and Aaa- by Moody's; \$16 million AAA by S&P and A3 by Moody's; \$31 million AAA- by S&P and AA- by Fitch; with balance rated AAA by S&P and Aaa by Moody's. All of the aforementioned positions remain investment grade, and all are stress-tested monthly for both credit quality and collateral strength. As of March 31, 2009, Sterling expects the return of all principal and interest on all securities within the portfolios pursuant to the contractual terms and Sterling has the ability and intent to hold these investments until a recovery in market price occurs, or until maturity. Realized losses could occur in future periods due to a change in management's intent to hold the investments to recovery, a change in management's assessment of credit risk, or a change in regulatory or accounting requirements. See [New Accounting Pronouncements](#).

**Fair Value of Financial Instruments.** Sterling's available-for-sale securities portfolio totaled \$2.73 billion and \$2.64 billion as of March 31, 2009 and December 31, 2008, respectively, and were the most substantial of Sterling's financial instruments that are carried at fair value. These securities are valued using a pricing service's matrix technique based on quoted prices for similar instruments, which Sterling validates with non-binding broker quotes, in-depth collateral analysis and cash flow stress testing.

Loans held for sale are also carried at fair value, as Sterling has applied FAS 159 to these loans in order to match changes in the value of the loans with the value of the economic hedges on the loans without having to apply complex hedge accounting. The fair value of loans held for sale is determined based upon an analysis of investor quoted pricing inputs.

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

Sterling's management performed an annual test of its goodwill and other intangible assets as of June 30, 2008, and concluded that the recorded values were not impaired, based on present value discounted cash flow analysis as allowed by FAS 142, *Goodwill and Other Intangibles* (FAS 142). During the fourth quarter of 2008, due to reduced expectations for near term profitability, and the protracted decline in Sterling's stock price and market capitalization, Sterling determined that an impairment had occurred, and wrote off \$223.8 million of its goodwill, following deterioration in its loan portfolio from worsening economic conditions, continued stress on real estate values, increasing levels of both classified and non-performing assets and higher net charge-offs, resulted in higher credit costs and lower earnings. Dividends on Sterling's newly issued preferred stock also reduce income available to common shareholders. As of March 31, 2009, Sterling evaluated whether events or circumstances had occurred since its most recent impairment test that would be considered triggering events under FAS 142, thus requiring an update to its goodwill impairment test. Sterling determined that no such events had occurred. There are many

## **Table of Contents**

assumptions and estimates underlying the determination of whether goodwill has been impaired. Future events could cause management to conclude that Sterling's goodwill or other intangible assets have become further impaired, which would result in Sterling recording an additional impairment loss. Other intangible assets consisting of core deposit intangibles with definite lives are amortized on a straight line basis over the estimated life of the acquired depositor relationships (generally eight to ten years).

**Loan Purchases.** In accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, loans are recorded at fair value if, when they are acquired, they show evidence of deterioration in terms of credit quality, and a loss is deemed likely to occur. Fair value is defined as the present value of future cash flows, including interest income, to be recognized over the life of the loan. SOP 03-3 prohibits the carryover of an allowance for loan loss on certain acquired loans within its scope that are considered in the future cash flow assessment. Sterling applies this guidance when entering into applicable transactions.

**Other Real Estate Owned.** Property and other assets acquired through foreclosure of defaulted mortgage or other collateralized loans are carried at the lower of cost or fair value, less estimated selling costs. The fair value of OREO is generally determined from appraisals obtained by independent appraisers. Development and improvement costs relating to such property are capitalized to the extent they are deemed to be recoverable.

An allowance for losses on OREO includes amounts for estimated losses as a result of impairment in value of the property after repossession. Sterling reviews its OREO for impairment in value whenever events or circumstances indicate that the carrying value of the property or other assets may not be recoverable. In performing the review, if expected future undiscounted cash flow from the use of the property or other assets, or the fair value, less selling costs, from the disposition of the property or other assets is less than its carrying value, an impairment loss is recognized.

**Loans Held for Sale.** The majority of loans held for sale are carried at fair value, as Sterling has applied FAS 159 to most of these loans in order to match changes in the value of the loans with the value of the economic hedges on the loans without having to apply complex hedge accounting. A small portion of Sterling's held for sale portfolio is reported at the lower of amortized cost or market value, as the fair value of certain loan types cannot be efficiently estimated. Any loan that management determines will not be held to maturity is classified as held for sale. Loan origination fees, costs and servicing rights are recognized as part of the loan value at origination. The fair value of loans held for sale is determined based upon an analysis of investor quoted pricing inputs. This value is based on quoted prices for similar instruments in both active and inactive markets, therefore, these loans are classified as level 2.

**Income Taxes.** Sterling estimates income taxes payable based on the amount it expects to owe various taxing authorities. Accrued income taxes represent the net estimated amount due to, or to be received from, taxing authorities. In estimating accrued income taxes, Sterling assesses the relative merits and risks of the appropriate tax treatment of transactions, taking into account the applicable statutory, judicial and regulatory guidance in the context of Sterling's tax position. Sterling also considers recent audits and examinations, as well as its historical experience in making such estimates. Although Sterling uses available information to record income taxes, underlying estimates and assumptions can change over time as a result of unanticipated events or circumstances. Penalties and interest associated with any potential estimate variances would be included in income tax expense on the Consolidated Statement of Income.

Sterling uses an estimate of future earnings to support its position that the benefit of its net deferred tax assets will be realized. If future taxable income should prove non-existent or less than the amount of temporary differences giving rise to the net deferred tax assets within the tax years to which they may be applied, the assets will not be realized and Sterling's net income will be reduced. As of March 31, 2009 Sterling believes that it is more likely than not that it will be able to fully realize its deferred tax asset and therefore has not recorded a valuation allowance.

**Table of Contents****Results of Operations**

**Overview.** Sterling reported a net loss of \$20.4 million for the first quarter ended March 31, 2009, reflecting a provision for credit losses of \$65.9 million, but not including the payment of \$4.3 million in preferred dividends to the U.S. Department of the Treasury under its Capital Purchase Program. After the payment of preferred dividends, earnings available to common shareholders were a negative \$24.8 million, or \$0.48 per diluted share. Earnings for the first quarter ended March 31, 2008, were \$2.9 million, or \$0.06 per common share, and reflected a provision for credit losses of \$37.1 million. The annualized return on average assets was -0.65% and 0.09% for the three months ended March 31, 2009 and 2008, respectively. The annualized return on average common equity was -11.9% and 1.0% for the three months ended March 31, 2009 and 2008, respectively. The year over year decrease in net income and performance ratios primarily reflected an increased credit provision in response to an increase in the level of classified assets and higher loss rates.

**Net Interest Income.** The most significant component of earnings for a financial institution typically is net interest income, which is the difference between interest income, primarily from loan, MBS and investment securities portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended March 31, 2009 and 2008, net interest income was \$88.3 million and \$92.1 million, respectively, a decrease of 4%. The decrease in net interest income during the three month comparative period was primarily due to the increase in non-performing assets, including non-performing loans and OREO.

Changes in Sterling's net interest income are a function of changes in both rates and volumes of interest-earning assets and interest-bearing liabilities. Net interest margin refers to net interest income divided by total average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities. The following table presents the composition of the change in net interest income, on a tax equivalent basis, for the periods presented. Municipal loan and bond interest income are presented gross of their applicable tax savings. For each category of interest-earning assets and interest-bearing liabilities, the following table provides information on changes attributable to:

Volume changes in volume multiplied by comparative period rate;

Rate changes in rate multiplied by comparative period volume; and

Rate/volume changes in rate multiplied by changes in volume.

	<b>Three Months Ended March 31, 2009 vs. 2008 Increase (Decrease) Due to:</b>			
	<b>Volume</b>	<b>Rate</b>	<b>Rate/ Volume</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>			
<b>Rate/volume analysis:</b>				
<b>Interest income:</b>				
Loans	\$ 454	\$ (34,449)	\$ (1,210)	\$ (35,205)
MBS	5,020	468	(106)	5,382
Investments and cash equivalents	958	62	154	1,174
<b>Total interest income</b>	<b>6,432</b>	<b>(33,919)</b>	<b>(1,162)</b>	<b>(28,649)</b>
<b>Interest expense:</b>				
Deposits	6,972	(19,718)	(1,810)	(14,556)
Borrowings	(2,667)	(8,690)	800	(10,557)
<b>Total interest expense</b>	<b>4,305</b>	<b>(28,408)</b>	<b>(1,010)</b>	<b>(25,113)</b>
<b>Changes in net interest income</b>	<b>\$ 2,127</b>	<b>\$ (5,511)</b>	<b>\$ (152)</b>	<b>\$ (3,536)</b>





**Table of Contents**

Net interest margin for each of the last five quarters was as follows:

Three Months Ended	Tax Equivalent Net Interest Margin
March 31, 2009	2.98%
December 31, 2008	2.80%
September 30, 2008	3.04%
June 30, 2008	3.23%
March 31, 2008	3.24%

Net interest income and net interest margin have been negatively affected by the increase in non-performing assets, and the decline in the prime rate. Sterling has been asset sensitive during recent periods, with a higher level of interest earning assets that were subject to re-pricing faster in the short term than deposits and borrowings. Additionally, when loans reach non-performing status, the reversal and cessation of accruing interest has an immediate negative impact on net interest margin.

**Provision for Credit Losses.** Management's policy is to establish valuation allowances for estimated losses by charging corresponding provisions against income. The evaluation of the adequacy of specific and general valuation allowances is an ongoing process. This process includes information derived from many factors, including historical loss trends and trends in classified assets, delinquency and non-accrual loans, and portfolio volume, diversification as to type of loan, size of individual credit exposure, current and anticipated economic conditions, as well as loan policies, collection policies and effectiveness, quality of credit personnel, effectiveness of policies, procedures and practices, and recent loss experience of peer banking institutions.

Sterling recorded provisions for losses on loans of \$65.9 million and \$37.1 million for the three months ended March 31, 2009 and 2008, respectively. Sterling has increased its provision for credit losses in response to an increase in the level of classified loans, particularly in the construction portfolio, and increases in loss rates due to reduced appraisal values.

The following table summarizes the allowance for credit losses for the periods indicated:

	Three Months Ended March 31,	
	2009	2008
	(Dollars in thousands)	
Allowance - loans, January 1	\$ 208,365	\$ 111,026
Provision	65,865	37,143
Charge-offs	(68,290)	(3,453)
Recoveries	3,045	231
Transfers	0	62
Allowance - loans, March 31	208,985	145,009
Allowance - unfunded commitments, January 1	21,334	6,306
Provision	0	21
Charge-offs	0	0
Transfers	0	(62)
Allowance - unfunded commitments, March 31	21,334	6,265
Total credit allowance	\$ 230,319	\$ 151,274

Sterling modified its methodology for estimating the fair value of loans being tested for impairment during the fourth quarter of 2008. The fair value is now determined excluding the potential cash flows from certain guarantors. To the extent that these guarantors are able to provide repayments, a recovery would be recorded upon receipt. In addition to the higher credit provision recorded during the fourth quarter of 2008, in many cases, Sterling



**Table of Contents**

re-assessed the accounting for real estate loans treated as collateral dependent. As a result, Sterling now considers any impairment on a collateral-dependent loan to be a confirmed loss and charges off the impairment amount when the impairment is identified, rather than establishing a specific allowance on impaired collateral-dependent loans that would have been charged off when foreclosure was probable.

Non-performing assets, a subset of classified assets that includes non-performing loans and OREO, were 5.23% of total assets at March 31, 2009, compared with 1.76% of total assets at March 31, 2008. At March 31, 2009, the delinquency ratio for loans 60 days or more past due was 5.24% of total loans compared to 2.38% of total loans at March 31, 2008. Sterling, like many other financial institutions, has experienced deterioration in the credit quality of residential construction loans and increases in delinquencies due to declining market values and weakness in housing sales in certain of its markets.

At March 31, 2009, Sterling's total classified assets were 8.35% of total assets, compared with 3.17% of total assets at March 31, 2008. The following table describes classified assets by asset type as of the dates indicated:

	March 31, 2009	December 31, 2008	September 30, 2008	June 30, 2008	March 31, 2008
	(Dollars in thousands)				
Residential real estate	\$ 31,400	\$ 34,333	\$ 36,863	\$ 21,848	\$ 5,021
Multifamily real estate	15,814	16,741	7,313	2,289	470
Commercial real estate	41,364	37,890	14,931	6,390	6,277
Construction					
Residential construction	558,170	548,384	405,753	309,556	255,473
Multifamily and commercial construction	145,629	119,348	17,109	19,042	15,182
Total construction	703,799	667,732	422,862	328,598	270,655
Consumer - direct and indirect	6,816	4,556	4,489	3,994	2,949
Commercial banking	170,678	143,748	130,250	111,344	104,394
Total classified loans	969,871	905,000	616,708	474,463	389,766
OREO	100,512	79,875	54,795	22,998	13,027
Total classified assets	\$ 1,070,383	\$ 984,875	\$ 671,503	\$ 497,461	\$ 402,793

At March 31, 2009, 66% of classified assets were related to construction, the majority of which was residential. The commercial construction and commercial banking loan portfolios have also been affected by the downturn in the housing market. The following table summarizes the principal balances of non-performing assets at the dates indicated:

	March 31, 2009	December 31, 2008	March 31, 2008
	(Dollars in thousands)		
Past due 90 days	\$ 0	\$ 0	\$ 0
Nonaccrual loans	485,158	474,172	209,850
Restructured loans	84,281	56,618	207
Total nonperforming loans	569,439	530,790	210,057
OREO	100,512	79,875	13,027
Total nonperforming assets	669,951	610,665	223,084
Specific reserves	(16,970)	(19,535)	(19,084)
Net nonperforming assets	\$ 652,981	\$ 591,130	\$ 204,000

Edgar Filing: STERLING FINANCIAL CORP /WA/ - Form 10-Q

The specific reserve included \$17.0 million, \$17.6 million and \$0 related to OREO as of March 31, 2009, December 31, 2008 and March 31, 2008, respectively. At March 31, 2009, non-performing assets include \$46.7 million of restructured loans that are performing in accordance with their new terms and are accruing interest, compared with \$29.5 million as of December 31, 2008, and \$0 as of March 31, 2008.

**Table of Contents**

The following table describes non-performing assets by asset type at the dates indicated:

	March 31, 2009      2008 (Dollars in thousands)	
Residential real estate	\$ 50,420	\$ 3,900
Multifamily real estate	6,020	2,026
Commercial real estate	19,256	4,556
Construction:		
Residential	453,383	168,429
Multifamily	800	0
Commercial	78,088	9,847
 Total Construction	 532,271	 178,276
Consumer - direct	5,302	2,037
Consumer - indirect	564	808
Commercial banking	56,118	31,481
 Total nonperforming assets	 \$ 669,951	 \$ 223,084

Non-performing assets presented above are gross of their applicable specific loan loss reserve. The following table presents residential construction non-performing assets by market:

	March 31, 2009		December 31, 2008		March 31, 2008	
	(Dollars in thousands)					
Residential construction						
Portland, OR	\$ 118,524	18%	\$ 117,350	19%	\$ 7,567	3%
Puget Sound	83,711	12%	73,878	12%	23,356	10%
Southern California	64,818	10%	67,824	11%	28,032	13%
Boise, ID	37,921	6%	23,356	4%	37,338	17%
Utah	26,823	4%	29,586	5%	15,372	7%
Bend, OR	26,114	4%	22,136	4%	20,927	9%
Vancouver, WA	23,945	4%	14,486	2%	19,943	9%
Other	71,527	10%	61,722	10%	15,894	8%
 Total residential construction	 453,383	 68%	 410,338	 67%	 168,429	 76%
Commercial construction <sup>(1)</sup>	78,888	12%	74,501	12%	9,847	4%
Commercial banking	56,118	8%	61,520	10%	31,481	14%
Residential real estate	50,420	8%	46,043	8%	3,900	2%
Commercial real estate <sup>(1)</sup>	25,276	3%	12,510	2%	6,582	3%
Consumer	5,866	1%	5,753	1%	2,845	1%
 Total nonperforming assets <sup>(2)</sup>	 669,951	 100%	 610,665	 100%	 223,084	 100%
 Specific reserves	 (16,970)		 (19,535)		 (19,084)	
 Total net nonperforming assets <sup>(2)</sup>	 \$ 652,981		 \$ 591,130		 \$ 204,000	

(1) Includes multifamily.

(2) Includes confirmed losses of \$185.0 million for March 31, 2009, \$163.9 million for December 31, 2008, and \$0 for March 31, 2008. The linked-quarter growth of non-performing assets represented a deceleration in the rate of quarterly growth, which had ranged between 36% and 65% over the previous four quarters. Sterling believes that the slowing growth rates of classified and non-performing assets, mainly related to construction, reflects the cumulative efforts of its construction credit team, which has been in place for more than one year, to identify, manage and resolve stressed assets. The process of resolving problem assets involves restructuring loans, obtaining additional collateral, repossessing problem assets and evaluating loans in relation to fair market value.

**Table of Contents**

Cumulatively, Sterling has written down its non-performing assets by \$244.0 million as of March 31, 2009, compared with write-downs of \$207.7 million as of December 31, 2008 and \$4.2 million as of March 31, 2008. OREO, net of allowances, was \$83.6 million at quarter end, compared with \$62.3 million in the linked quarter, and \$13.0 million in the year-ago quarter. OREO is included in non-performing assets. Weakness in the overall economy has contributed to increased levels of nonperforming assets in the construction, commercial banking, commercial real estate and non-owner occupied residential portfolios.

**Non-Interest Income.** Non-interest income was as follows for the periods presented:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Fees and service charges	\$ 13,840	\$ 14,151
Mortgage banking operations	13,308	6,198
Loan servicing fees	(467)	(148)
OREO	(4,478)	(106)
BOLI	1,406	1,466
Securities sales gains (losses)	10,565	(408)
Other	(2,026)	9
<b>Total</b>	<b>\$ 32,148</b>	<b>\$ 21,162</b>

In the first quarter of 2009, non-interest income rose 52% to \$32.1 million from \$21.2 million in the first quarter of 2008. The increase in non-interest income was driven by higher levels of income from mortgage banking operations and gains on the sales of securities. Mortgage banking operations income in the first quarter of 2009 rose 115% over the first quarter of 2008, continuing the trend that started in the fourth quarter of 2008. The mortgage banking segment growth in originations and revenues was driven by lower interest rates and programs designed to spur lending consistent with the U.S. Department of the Treasury's Capital Purchase Program. Favorable market conditions provided the opportunity to realize gains within the securities portfolio during 2009. Fees and service charges income continues to reflect higher analyzed account fees, loan-related fees and transaction fees, offset by a decrease in fees related to Sterling's Balance Shield Program, where the decrease in the volume of overdraft incidents more than offset account growth, and lower commissions from Sterling's Wealth Management group. At quarter end, the total number of transaction accounts exceeded 200,000, an increase of 2% year over year. The elevation in OREO expenses during the first quarter of 2009 reflects a decline in asset values subsequent to acquisition, as well as write-downs to align valuations with pending OREO sales. Other non-interest income for the three months ended March 31, 2009 includes a \$1.1 million loss, which represents Sterling's prorata share of a public funds loss resulting from the failure of a Washington state public depository bank.



**Table of Contents**

The following table summarizes certain information regarding Sterling's residential and commercial mortgage banking activities for the periods indicated:

	As of and for the Three Months Ended March 31,	
	2009	2008
	(Dollars in thousands)	
Originations of residential mortgage loans	\$ 710,564	\$ 411,116
Originations of commercial real estate loans	19,168	64,517
Sales of residential mortgage loans - delivered	601,899	335,510
Sales of commercial real estate loans	0	2,993
Principal balances of residential loans serviced for others	564,547	569,448
Principal balances of commercial real estate loans serviced for others	1,652,334	1,677,898

In addition to sales of residential mortgage loans delivered, there were \$174.6 million of loans to be sold, which are carried at fair value, resulting in a total of \$776.5 million of residential loan sales delivered and carried at fair value during the three months ended March 31, 2009.

**Non-Interest Expenses.** Non-interest expenses were as follows for the periods presented:

	Three Months Ended March 31,	
	2009	2008
	(Dollars in thousands)	
Employee compensation and benefits	\$ 40,188	\$ 40,890
Occupancy and equipment	11,242	11,532
Data processing	5,154	5,319
Insurance	4,290	1,711
Depreciation	3,544	3,565
Advertising	2,755	2,798
Legal and accounting	1,521	813
Amortization of core deposit intangibles	1,225	1,226
Travel and entertainment	1,215	1,665
Other	4,376	2,588
<b>Total</b>	<b>\$ 75,510</b>	<b>\$ 72,107</b>

Non-interest expenses rose 5% to \$75.5 million in the first quarter of 2009 from \$72.1 million in the first quarter of 2008. Excluding FDIC deposit insurance premiums, which rose by \$2.5 million, non-interest expenses for the quarter ended March 31, 2009 increased only 1% year over year despite overall company growth. The small increase in non-interest expenses reflects improved operating efficiencies and tight cost controls. During the quarter, Sterling began realizing the benefits of systemic process improvements relating to the closure of two item processing centers following the complete rollout of the remote teller capture system. On a year over year basis, the number of full-time equivalent employees decreased by 39 to 2,518.

**Income Tax Provision.** Sterling recorded a federal and state income tax benefit of \$436,000 for the three months ended March 31, 2009, and a provision of \$1.1 million for the three months ended March 31, 2008. The effective tax rates for these periods were 2% and 28%, respectively. The elevated level of loan loss provisions has increased the proportional effect of tax credits and tax exempt income, resulting in the decrease in the effective tax rate. As of March 31, 2009, Sterling believes that it is more likely than not that it will be able to fully realize its deferred tax asset and therefore has not recorded a valuation allowance.

**Table of Contents****Financial Position**

**Assets.** At March 31, 2009, Sterling's assets were \$12.82 billion, up \$28.9 million from \$12.79 billion at December 31, 2008. This growth was mainly a result of increases from securities purchases and a longer retention period on held-for-sale loans outweighing decreases in the loan portfolio and the collection of a \$39.0 million federal tax refund.

**Investment Securities and MBS.** Sterling's investment and MBS portfolio at March 31, 2009 was \$2.91 billion, an increase of \$93.2 million from the December 31, 2008 balance of \$2.82 billion. The increase was due to purchases exceeding principal repayments, maturities and sales. On March 31, 2009, the investment and MBS portfolio had an unrealized loss of \$21.9 million versus an unrealized loss of \$28.4 million at December 31, 2008.

**Loans Receivable.** At March 31, 2009, net loans receivable were \$8.68 billion, compared to \$8.81 billion at December 31, 2008, and \$9.12 billion at March 31, 2008. The contraction in Sterling's loan portfolio reflects Sterling's goal of reducing construction loans as a percent of its total loan portfolio, and a lessening of demand for credit in a slowing economy. At the end of the first quarter of 2009, residential construction loans represented 15% of Sterling's loan portfolio, compared with 21% at the end of the first quarter of 2008. Over the last year, residential construction loans decreased by \$611.5 million to \$1.33 billion at March 31, 2009.

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

	March 31, 2009		December 31, 2008	
	Amount	%	Amount	%
(Dollars in thousands)				
Residential real estate	\$ 894,886	10.1	\$ 867,384	9.6
Multifamily real estate	508,799	5.7	477,615	5.3
Commercial real estate	1,386,631	15.6	1,364,885	15.1
Construction:				
Residential	1,326,239	14.9	1,455,860	16.1
Multifamily	290,636	3.3	324,818	3.6
Commercial	740,014	8.3	754,017	8.4
Total Construction	2,356,889	26.5	2,534,695	28.1
Consumer - direct	842,001	9.5	859,222	9.5
Consumer - indirect	378,075	4.2	389,298	4.3
Commercial banking	2,534,836	28.4	2,532,158	28.1
Gross loans receivable	8,902,117	100.0	9,025,257	100.0
Net deferred origination fees	(9,213)		(9,798)	
Allowance for losses on loans	(208,985)		(208,365)	
Loans receivable, net	\$ 8,683,919		\$ 8,807,094	

**Table of Contents**

The following table sets forth Sterling's loan originations for the periods indicated:

	Three Months Ended		
	March 31, 2009	December 31, 2008	March 31, 2008
(Dollars in thousands)			
Residential real estate	\$ 710,564	\$ 341,043	\$ 411,116
Multifamily real estate	36,774	39,026	41,386
Commercial real estate	19,168	74,989	64,517
Construction:			
Residential	7,244	33,984	192,361
Multifamily	0	13,050	0
Commercial	11,035	35,350	71,920
Total construction	18,279	82,384	264,281
Consumer - direct	48,547	48,815	81,603
Consumer - indirect	30,753	30,935	71,681
Commercial banking	106,437	102,672	148,685
Total loans originated	\$ 970,522	\$ 719,864	\$ 1,083,269

Stimulated by historically low mortgage rates and new initiatives to provide affordable housing, residential mortgage originations climbed 73% from the year-ago period. The decrease in construction loan originations, reflects Sterling's goal of reducing construction loans as a percent of its total loan portfolio. Loan originations relative to the fourth quarter of 2008 rose 35%. This sequential increase reflects Sterling's effort, since December 2008, to expand and enhance lending initiatives to support and restore economic growth and development in the communities it serves with capital raised through the U.S. Department of the Treasury's Capital Purchase Program. Sterling's new lending initiatives focus on funding affordable housing, small business loans and financing programs to support business growth.

**Deposits.** The following table sets forth the composition of Sterling's deposits at the dates indicated:

	March 31, 2009		December 31, 2008	
	Amount	%	Amount	%
(Dollars in thousands)				
Interest-bearing checking	\$ 847,064	10.0	\$ 449,060	5.4
Noninterest-bearing checking	935,659	11.0	897,198	10.7
Savings and money market demand accounts	1,767,136	20.8	2,113,425	25.3
Time deposits	4,938,175	58.2	4,890,724	58.6
Total deposits	\$ 8,488,034	100.0	\$ 8,350,407	100.0
Annualized cost of deposits		2.35%		2.91%

During the quarter, there was a shift of uninsured savings and money market account balances to FDIC insured interest bearing transaction accounts. This was related to changes in the collateralization requirements associated with uninsured public funds deposits and Sterling's participation in the FDIC voluntary expanded insurance program, which provides, without charge to depositors, full guarantee on non-interest bearing and certain interest-bearing transaction accounts held by any depositor, regardless of dollar amount.

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank (FHLB), reverse repurchase agreements and other borrowings to fund asset growth and meet deposit withdrawal requirements. During the three months ended March 31, 2009, these funding sources decreased a total of \$93.8 million, with maturing advances from the FHLB being offset with growth in deposits and funds purchased from the Federal Reserve's discount window.



## **Table of Contents**

### **Asset and Liability Management**

The results of operations for financial institutions may be materially and adversely affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values and the monetary and fiscal policies of the federal government. The mismatch between maturities, interest rate sensitivities and prepayment characteristics of assets and liabilities, and the changes in each of these attributes under different interest rate scenarios results in interest-rate risk.

Sterling, like most financial institutions, has material interest-rate risk exposure to changes in both short-term and long-term interest rates as well as variable interest rate indices. Sterling's results of operations are largely dependent upon its net interest income and its ability to manage its interest rate risk.

Sterling's subsidiary banks' Asset/Liability Committees (ALCO) manage their interest-rate risk based on interest rate expectations and other factors within policies and practices approved by the subsidiary banks' Boards of Directors. The principal objective of Sterling's subsidiary banks' asset and liability management activities is to provide maximum levels of net interest income while maintaining acceptable levels of interest-rate risk and liquidity risk while facilitating funding needs. ALCO manages this process at both the subsidiary and consolidated levels. ALCO measures interest rate risk exposure through three primary measurements: management of the relationship between its interest bearing assets and its interest bearing liabilities, interest rate shock simulations of net interest income, and economic value of equity (EVE) simulation.

The difference between a financial institution's interest rate sensitive assets (i.e., assets that will mature or reprice within a specific time period) and interest rate sensitive liabilities (i.e. liabilities that will mature or reprice within the specific time period) is commonly referred to as its interest rate sensitivity gap. An institution having more interest rate sensitive assets than interest rate sensitive liabilities within a given time period is said to be asset sensitive, which generally means that if interest rates increase (other things being equal), a company's net interest income will increase and if interest rates decrease (other things being equal), its net interest income will decrease. The opposite is true for an institution that is liability sensitive. Sterling has been asset sensitive during 2008 and 2009, with a higher level of interest earning assets that were subject to re-pricing faster in the short term than deposits and borrowings.

**Table of Contents**

ALCO uses interest rate shock simulations of net interest income to measure the effect of changes in interest rates on the net interest income for Sterling over a 12 month period. This simulation consists of measuring the change in net interest income over the next 12 months from a base case scenario when rates are shocked, in a parallel fashion, up 100 and 200 basis points and down 100 basis points. The base case uses the assumption of the existing balance sheet and existing interest rates to simulate the base line of net interest income over the next 12 months for the simulation. The simulation requires numerous assumptions, including relative levels of market interest rates, instantaneous and parallel shifts in the yield curve, loan prepayments and reactions of depositors to changes in interest rates, and should not be relied upon as being indicative of actual or future results. Further, the analysis does not contemplate actions Sterling may undertake in response to changes in interest rates and market conditions. The results of this simulation as of March 31, 2009 and December 31, 2008 are included in the following table:

<b>Change in Interest Rate in Basis Points (Rate Shock)</b>	<b>March 31, 2009 % Change in Net Interest Income</b>	<b>December 31, 2008 % Change in Net Interest Income</b>
+200	4.0	3.6
+100	3.7	2.2
Static	0.0	0.0
-100	N/A	N/A

ALCO uses EVE simulation analysis to measure risk in the balance sheet that might not be taken into account in the net interest income simulation analysis. Whereas net interest income simulation highlights exposure over a relatively short time period of 12 months, EVE simulation analysis incorporates all cash flows over the estimated remaining life of all balance sheet positions. The EVE simulation analysis of the balance sheet, at a point in time, is defined as the discounted present value of asset cash flows minus the discounted value of liability cash flows. The discount rates that are used represent an assumption for the current market rates of each group of assets and liabilities. The difference between the present value of the asset and liability represents the EVE. As with net interest income, this is used as the base line to measure the change in EVE when interest rates are shocked, in a parallel fashion, up 100 and 200 basis points and down 100 basis points. As with the net interest income simulation model, EVE simulation analysis is based on key assumptions about the timing and variability of balance sheet cash flows. However, because the simulation represents much longer time periods, inaccuracy of assumptions may increase the variability of outcomes within the simulation. It also does not take into account actions management may undertake in response to anticipated changes in interest rates. The results of this simulation at March 31, 2009 and December 31, 2008 are included in the following table:

<b>Change in Interest Rate in Basis Points (Rate Shock)</b>	<b>At March 31, 2009 % Change in EVE</b>	<b>At December 31, 2008 % Change in EVE</b>
+200	(4.3)	(3.8)
+100	1.0	(2.7)
Static	0.0	0.0
-100	N/A	N/A

Sterling occasionally enters into customer-related financial derivative transactions primarily consisting of interest rate swaps. Risk exposure from customer positions is managed through transactions with other broker dealers. As of March 31, 2009, Sterling has not entered into asset/liability related derivative transactions as part of managing its interest rate risk. However, Sterling continues to consider derivatives, including interest rate swaps, caps and floors, as a viable alternative in the asset and liability management process.

---

**Table of Contents****Liquidity and Capital Resources**

Sterling's primary sources of funds are: customer deposits; wholesale funds from commercial banks, the FHLB, and the Federal Reserve; the collection of principal and interest primarily from loans, as well as from mortgage backed securities; and the sale of loans into the secondary market in connection with Sterling's mortgage banking activities.

Sterling Savings Bank and Golf Savings Bank actively manage their liquidity in an effort to maintain an adequate margin over the level necessary to support expected and potential loan fundings and deposit withdrawals. This is balanced with the need to maximize yield on alternative investments. The liquidity ratio may vary from time to time, depending on economic conditions, deposit fluctuations and loan funding needs.

Sterling uses wholesale funds to supplement deposit gathering for funding the origination of loans or purchasing assets such as MBS and investment securities. These borrowings include advances from the FHLB, reverse repurchase agreements, primary credits and term auction facilities from the Federal Reserve, and federal funds purchased. Sterling had access to \$3.08 billion and \$3.23 billion of additional liquidity from these sources as of March 31, 2009 and December 31, 2008, respectively. In 2009, certain states have either increased or proposed to increase the collateralization requirements for uninsured public funds. The increased collateralization requirements would require that Sterling pledge additional collateral, which would reduce Sterling's collateral available for liquidity. Alternately Sterling could choose to reduce the amount of public deposits accepted in those states to reduce the risk associated with the states' collateral pools. Sterling Savings Bank and Golf Savings Bank have credit lines with FHLB of Seattle that provide for borrowings up to a percentage of each of their total assets, subject to collateralization requirements. At March 31, 2009 and December 31, 2008, these credit lines represented a total borrowing capacity of \$2.49 billion and \$2.92 billion, of which \$1.05 billion and \$1.33 billion was available, respectively. At March 31, 2009 and December 31, 2008, Sterling had \$1.04 billion and \$1.09 billion in outstanding borrowings under reverse repurchase agreements, respectively. Sterling had securities available for additional secured borrowings of approximately \$809.2 million and \$513.7 million as of March 31, 2009 and December 31, 2008, respectively. Reverse repurchase agreements allow Sterling to sell investments (generally U.S. agency securities and MBS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. The use of reverse repurchase agreements may expose Sterling to certain risks not associated with other borrowings, including interest rate risk and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines. Sterling also had \$179.2 million and \$69.0 million of federal funds purchased and discount window borrowings, which are short term borrowings from correspondent banks and the Federal Reserve, as of March 31, 2009 and December 31, 2008, respectively. Through the Federal Reserve's 12th District Bank, Sterling participates in the Borrower in Custody Program ( BIC ) which allows Sterling to borrow against certain pledged loans for terms ranging from overnight to 90 days. Sterling is also eligible to participate in the Term Auction Facility ( TAF ) which allows Sterling to bid on funds to be borrowed for terms of 28 to 84 days.

On December 5, 2008, Sterling completed the sale of 303,000 shares of preferred stock and issued a warrant to purchase 6,437,677 shares of Sterling's common stock to the U.S. Department of the Treasury, raising total proceeds of \$303 million. The \$303 million in proceeds are treated as Tier 1 capital. The 303,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Shares ), issued by Sterling will pay a cumulative compounding dividend of 5% per year for the first five years and will reset to a rate of 9% per year after five years. After three years, the Preferred Shares may be redeemed by Sterling at their issue price, plus all accrued and unpaid dividends. Subject to approval by Sterling's banking regulators, the Preferred Shares may also be redeemed at any time if Sterling chooses to replace them with newly raised equity capital. In addition to the Preferred Shares, the Treasury Department received a warrant to purchase 6,437,677 shares of Sterling common stock at an exercise price of \$7.06 per share.

Notwithstanding the foregoing, the American Recovery and Reinvestment Act of 2009 ( ARRA ), which was signed into law on February 17, 2009, provides that the Secretary of the Treasury shall permit, subject to consultation with the recipient's appropriate Federal banking agency, a recipient of funds under the Troubled Assets

---

## **Table of Contents**

Relief Program ( TARP ) to repay the funds previously provided under the TARP, without regard to whether the recipient has replaced such funds from any other source or to any waiting period. ARRA further provides that when the recipient repays the TARP funds, the Secretary of the Treasury shall liquidate the warrants associated with the funds at the current market price. Although the Treasury Department has not yet issued any regulations or any other guidance, as of the date of this report, as to how this new provision of the ARRA will be implemented, it appears that ARRA will permit Sterling, if it so elects and following consultation with the FDIC, to redeem the Preferred Shares at any time without restriction.

Sterling, on a parent company-only basis, had cash of approximately \$64.4 million and \$86.2 million at March 31, 2009 and December 31, 2008, respectively. Sterling's total investment in Sterling Saving Bank as of March 31, 2009 was \$1.27 billion compared to \$1.02 billion as of December 31, 2008. The increase was due to Sterling purchasing \$25.0 million of Sterling Savings Bank preferred stock during the first quarter of 2009. Sterling's investment in Sterling Savings Bank consisted of \$865.8 million of common stock and \$408.1 million of preferred stock as of March 31, 2009 and \$865.8 million of common stock and \$383.1 million of preferred stock as of December 31, 2008. Sterling's total investment in Golf Savings Bank was \$60.7 million, including \$35.7 million of common stock and \$25.0 million of preferred stock, as of both March 31, 2009 and December 31, 2008. Sterling received cash dividends from Sterling Savings Bank of \$6.4 million and \$9.3 million during the three months ended March 31, 2009 and 2008, respectively, and from Golf Savings Bank of \$240,000 and \$0 for the same respective periods. These resources contributed to Sterling's ability to meet its operating needs, including interest expense on its long-term debt and the payment of dividends. Sterling Savings Bank's and Golf Savings Bank's ability to pay dividends is limited by their earnings, financial condition, capital requirements, and capital distribution regulations.

Sterling has had the ability to secure additional capital through the capital markets. The availability and cost of such capital is partially dependent on Sterling's credit ratings. In January 2009, in response to Sterling's announcement of increased non-performing assets and higher net charge-offs, Fitch Ratings placed Sterling and Sterling Savings Bank's credit ratings on a negative rating watch and downgraded its individual rating to C. There can be no assurance that Sterling will continue to be able to access the capital markets in the future.

### **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

Sterling, in the conduct of ordinary business operations routinely enters into contracts for services. These contracts may require payment for services to be provided in the future and may also contain penalty clauses for the early termination of the contracts. Sterling is also party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Management does not believe that these off-balance sheet arrangements have a material current effect on Sterling's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources but there is no assurance that such arrangements will not have a future effect.

As of both March 31, 2009 and December 31, 2008, the reserve for unfunded commitments was \$21.3 million. The adequacy of the reserve for unfunded commitments is evaluated on a quarterly basis.

As part of its mortgage banking activities, Sterling issues interest rate lock commitments to prospective borrowers on residential mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors under both non-binding ( best-efforts ) and binding ( mandatory ) delivery programs. For mandatory delivery programs, Sterling hedges interest rate risk by entering into offsetting forward sale agreements on MBS with third parties. Risks inherent in mandatory delivery programs include the risk that if Sterling does not close the loans subject to interest rate lock commitments, it is nevertheless obligated to deliver MBS to the counterparty under the forward sale agreement. Sterling could incur significant costs in acquiring replacement loans or MBS and such costs could have a material adverse effect on mortgage banking operations in future periods.



## **Table of Contents**

Interest rate lock commitments and loan delivery commitments are off balance sheet commitments that are considered to be derivatives. As of March 31, 2009, Sterling had \$188.8 million of interest rate lock commitments, \$84.4 million of warehouse loans held for sale that were not committed to investors, and held offsetting forward sale agreements on MBS valued at \$225.0 million. In addition Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at \$20.9 million as of March 31, 2009. As of December 31, 2008, Sterling had \$75.4 million of interest rate lock commitments, \$71.8 million of warehouse loans held for sale that were not committed to investors, and held offsetting forward sale agreements on MBS valued at \$114.4 million. In addition, Sterling had mandatory delivery commitments to sell mortgage loans to investors valued at \$1.4 million as of December 31, 2008. As of March 31, 2009 and December 31, 2008, Sterling had entered into best efforts forward commitments to sell \$119.6 million and \$71.0 million of mortgage loans, respectively.

Sterling enters into interest rate swap derivative contracts with customers. The interest rate risk on these contracts is offset by entering into comparable broker dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of March 31, 2009 and December 31, 2008, were \$7.0 million and \$7.5 million, respectively.

## **Capital**

Sterling's total shareholders' equity decreased \$19.4 million to \$1.12 billion during the three months ended March 31, 2009 from \$1.14 billion at December 31, 2008, reflecting the net loss resulting from higher provisions for credit losses, and the preferred stock dividend under the U.S. Department of the Treasury CPP Program.

At March 31, 2009 and December 31, 2008, Sterling had an unrealized loss of \$21.9 million and \$28.4 million, respectively, on investment securities and MBS classified as available for sale. Fluctuations in prevailing interest rates and other market factors continue to cause volatility in this component of accumulated comprehensive income or loss in shareholders' equity and may continue to do so in future periods. Shareholders' equity was 8.75% of total assets at March 31, 2009 compared with 8.92% at December 31, 2008.

Sterling has outstanding various series of capital securities ( Trust Preferred Securities ) issued to investors. The Trust Preferred Securities are treated as debt of Sterling, and can qualify as Tier 1 capital, subject to certain limitations.

**Table of Contents**

Sterling, Sterling Savings Bank and Golf Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling's management intends to enhance the capital resources and regulatory capital ratios of Sterling and its banking subsidiaries through the retention of an adequate amount of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At March 31, 2009, each of the companies exceeded all such regulatory capital requirements and were well capitalized pursuant to such regulations. The following table sets forth their respective capital positions at March 31, 2009:

	Minimum Capital Requirements		Well-Capitalized Requirements		Actual	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
<b>Tier 1 leverage (to average assets)</b>						
Sterling	\$ 496,723	4.0%	\$ 620,904	5.0%	\$ 1,128,870	9.1%
Sterling Savings Bank	474,491	4.0%	593,113	5.0%	1,005,576	8.5%
Golf Savings Bank	21,874	4.0%	27,342	5.0%	60,938	11.1%
<b>Tier 1 (to risk-weighted assets)</b>						
Sterling	385,587	4.0%	578,381	6.0%	1,128,870	11.7%
Sterling Savings Bank	372,788	4.0%	559,182	6.0%	1,005,576	10.8%
Golf Savings Bank	13,388	4.0%	20,082	6.0%	60,938	18.2%
<b>Total (to risk-weighted assets)</b>						
Sterling	771,174	8.0%	963,968	10.0%	1,253,722	13.0%
Sterling Savings Bank	745,576	8.0%	931,970	10.0%	1,126,402	12.1%
Golf Savings Bank	26,776	8.0%	33,469	10.0%	65,145	19.5%

**Goodwill Litigation**

In the fourth quarter of 2008, following mediation, Sterling settled on the amount of damages owed to Sterling and fully resolved its goodwill lawsuit against the U.S. government for its breach of contract related to past acquisitions of failed savings institutions. Sterling was paid \$1.8 million in January 2009. Sterling is satisfied that it prevailed in the litigation, which now is fully concluded.

**New Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (FAS) FAS No. 141 (R), Business Combinations (FAS No. 141 (R)). FAS No. 141 (R) establishes principles and requirements for how the acquirer: 1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree; 2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; 3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS No. 141 (R) applies prospectively to business combinations entered into by Sterling after January 1, 2009. Depending on the level of future acquisitions, FAS No. 141 (R) may have a material effect on Sterling, mainly in regards to the valuation of loans, and the treatment for acquisition costs.

In February 2008, the FASB issued (FASB Staff Position) FSP FAS 140-3, Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS No. 140-3). The FSP provides implementation guidance for linked transactions under FAS 140. The FSP states that a transferor and transferee shall not separately account for a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. This FSP was effective for Sterling as of January 1, 2009, and did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued FAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FAS 133. FAS 161 requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS 133 and related

---

## **Table of Contents**

interpretations, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. FAS 161 was effective for Sterling as of January 1, 2009, and did not have a material effect on its consolidated financial statements.

In June 2008, the FASB issued FSP EITF 03-06-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. FSP EITF 03-06-1 requires all outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends to be considered participating securities and requires entities to apply the two-class method of computing basic and diluted earnings per share. This FSP was effective for Sterling as of January 1, 2009, and did not have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairment ( OTTI )*, FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. For debt securities, the guidance differentiates credit driven and market driven OTTI. Only the portion of the impairment loss representing credit losses would be recognized in earnings as an OTTI. The balance of the impairment loss would be recognized as a charge to other comprehensive income. A non-credit related OTTI charge to other comprehensive income for securities classified as held to maturity will be amortized from accumulated other comprehensive income back to the security over the securities remaining life. Financial statement presentation will require segregation of accumulated comprehensive income for non-credit OTTI charges on held to maturity and available for sale securities from other components of accumulated comprehensive income. The standard provided additional guidance for the determination of whether a market for an asset is not active and when a price for a transaction is not distressed. The disclosure requirements of FAS 107 have been extended to interim periods. This guidance is effective for Sterling as of June 30, 2009. The company is currently evaluating the impact of these standards.

## **Regulation and Compliance**

Sterling is subject to many laws and regulations applicable to banking activities. As a bank holding company, Sterling is subject to comprehensive examination and regulation by the Federal Reserve. Sterling Savings Bank, as a Washington State-chartered bank, and Golf Savings Bank, as a Washington State-chartered savings bank, are subject to comprehensive regulation and examination by the Washington Supervisor and the FDIC. Sterling Savings Bank and Golf Savings Bank are further subject to Federal Reserve regulations related to deposit reserves and certain other matters.

On October 3, 2008, in response to upheaval within the financial markets, the President signed into law the Emergency Economic Stabilization Act of 2008 (the EESA), which authorized the United States Department of Treasury (the Treasury Department) to establish the Troubled Assets Relief Program (TARP) to purchase troubled assets held by financial institutions. Under the TARP program the Treasury Department is authorized to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Treasury Department. The purpose of this program is to restore confidence and stability to the financial markets and to encourage the flow of credit within the financial system.

On October 14, 2008, the Treasury Department announced the terms of the TARP Capital Purchase Program (CPP), through which the Treasury Department has made capital investments in banking institutions, including Sterling, by purchasing senior preferred shares. On December 5, 2008, in accordance with the CPP, Sterling completed the sale of 303,000 shares of preferred stock and issued a warrant to purchase 6,437,677 shares of Sterling's common stock to the Treasury Department, raising total proceeds of \$303 million.

In February 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted, which contains a comprehensive set of government spending initiatives and tax incentives aimed at stimulating the U.S. economy. The ARRA also amends, among other things, the TARP program legislation by directing the Treasury Department to issue regulations implementing strict limitations on the payment of incentive compensation and any severance or golden parachute payments to certain highly compensated employees of institutions that participate in the CPP. The

---

## **Table of Contents**

ARRA also expands the scope of employees who are subject to a clawback of bonus and incentive compensation that is based on results that are later found to be materially inaccurate, adds additional corporate governance requirements, and requires the Treasury Department to perform a retroactive review of compensation to the five highest compensated employees of all CPP participants.

EESA and ARRA followed, and have been followed by, numerous actions by the Federal Reserve, Congress, Treasury Department, the SEC and others to address the current liquidity and credit crisis that has followed the sub-prime meltdown that commenced in 2007. These measures include homeowner relief that encourage loan restructuring and modification; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the federal funds rate, including two 50 basis point decreases in October of 2008; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector. It is not clear at this time what impact the EESA, ARRA, the CPP, the TARP, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the financial markets, including the extreme levels of volatility and limited credit availability currently being experienced, or on the U.S. banking and financial industries and the broader U.S. and global economies. Further adverse effects could have an adverse effect on Sterling and its business.

Sterling must pay applicable FDIC insurance premiums with respect to its deposits that are eligible for FDIC insurance. After the passage of the EESA, the FDIC also increased deposit insurance for all deposit accounts up to \$250,000 per account as of October 3, 2008 and ending December 31, 2009. Effective April 1, 2009, the FDIC changed the way its assessment system differentiates for risk, making corresponding changes to assessment rates beginning with the second quarter of 2009, and made certain technical and other changes to these rules. The increase in deposit insurance described above, as well as the recent increase and anticipated additional increase in the number of bank failures, is expected to result in an increase in deposit insurance assessments for all banks, including Sterling. The FDIC is required by law to return the insurance reserve ratio to a 1.15 percent ratio no later than the end of 2013. As of December 31, 2008, that ratio was 0.40 percent.

As FDIC-insured depository institutions, our bank subsidiaries may be held liable for any loss incurred or expected to be incurred by the FDIC in connection with another FDIC-insured institution under common control with the institution in default or in danger of default. This liability is commonly referred to as cross-guarantee liability. A default is generally defined as the appointment of a conservator or receiver and in danger of default is defined as certain conditions indicating that a default is likely to occur absent regulatory assistance. An FDIC cross-guarantee claim against a depository institution is generally senior in right of payment to claims of the holding company and its affiliates against the depository institution.

## **Forward-Looking Statements**

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

Forward-looking statements provide management's expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. Sterling does not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond Sterling's control that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

inflation, interest rate levels and market and monetary fluctuations;

**Table of Contents**

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

applicable laws and regulations and legislative or regulatory changes;

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

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

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

technological and management changes;

growth and acquisition strategies;

Sterling's critical accounting policies and the implementation of such policies;

lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;

changes in consumer spending and saving habits;

the strength of the United States economy in general and the strength of the local economies in which Sterling conducts its operations; and

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

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

For a discussion of Sterling's market risks, see Management's Discussion and Analysis - Asset and Liability Management.

**Item 4 Controls and Procedures**

**Disclosure Controls and Procedures**

Sterling's management, with the participation of Sterling's principal executive officer and principal financial officer, has evaluated the effectiveness of Sterling's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, Sterling's principal executive officer and principal financial officer have concluded that, as of the end of such period, Sterling's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by Sterling in the reports that it files or submits under the Exchange Act.

**Changes in Internal Control Over Financial Reporting**

There were no changes in Sterling's internal control over financial reporting that occurred during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, Sterling's internal control over financial reporting.

**Table of Contents**

**STERLING FINANCIAL CORPORATION**

**PART II Other Information**

**Item 1 Legal Proceedings**

There are no material pending legal proceedings to which Sterling is a party, or to which any of its property is subject, other than ordinary routine litigation incidental to the business of banking. No material loss is expected from any of such pending claims or lawsuits.

**Item 1a Risk Factors**

You should carefully consider the risks and uncertainties we describe both in this Report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, before deciding to invest in, or retain, shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about or that we currently believe are immaterial, or that we have not predicted, may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially harmed.

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

Not applicable.

**Item 3 Defaults Upon Senior Securities**

Not applicable.

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

Not applicable.

**Item 5 Other Information**

Not applicable.

**Item 6 Exhibits**

The exhibits filed as part of this report and the exhibits incorporated herein by reference are listed in the Exhibit Index at page E-1.

Table of Contents

**STERLING FINANCIAL CORPORATION**

**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.

**STERLING FINANCIAL CORPORATION**

(Registrant)

May 8, 2009  
Date

By: /s/ Robert G. Butterfield  
**Robert G. Butterfield**  
Senior Vice President, Controller, and

Principal Accounting Officer



**Table of Contents**

**Exhibit Index**

**Exhibit No.**

- 3.1 Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling's registration statement on Form S-3/A filed May 8, 2009 and incorporated by reference herein.
- 3.2 Amended and Restated Bylaws of Sterling. Filed as Exhibit 3.1 to Sterling's registration statement on Form S-3 filed January 6, 2009, and incorporated by reference herein.
- 4.1 Reference is made to Exhibits 3.1 and 3.2.
- 4.2 Sterling has outstanding certain long-term debt. None of such debt exceeds ten percent of Sterling's total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request.
- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.