STERLING FINANCIAL CORP /WA/
Form 10-K
February 28, 2008

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

FORM 10-K

(Mark One)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the year ended DECEMBER 31, 2007** **OR**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

COMMISSION FILE NUMBER 0-20800

STERLING FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

WASHINGTON	91-1572822
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*

111 North Wall Street, Spokane, Washington 99201
(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code: (509) 458-3711

Securities registered pursuant to Section 12(b) of the Act:

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock ($1.00 par value)
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

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

As of June 30, 2007, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by The NASDAQ National Market, was $1.12 billion.

The number of shares outstanding of the registrant's common stock, par value $1.00 per share, as of January 31, 2008 was 51,667,030.

DOCUMENTS INCORPORATED BY REFERENCE

Specific portions of the registrant's Proxy Statement for its 2008 annual meeting of shareholders are incorporated by reference into Part III hereof.

STERLING FINANCIAL CORPORATION

DECEMBER 31, 2007 ANNUAL REPORT ON FORM 10-K
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PART I

Item 1. Business

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. During 2007, the principal operating subsidiaries of Sterling Savings Bank were Action Mortgage Company ("Action Mortgage"), INTERVEST-Mortgage Investment Company ("INTERVEST") and Harbor Financial Services, Inc. ("Harbor Financial"). 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 has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With $12.15 billion in total assets as of December 31, 2007, Sterling originates loans and attracts Federal Deposit Insurance Corporation ("FDIC") insured deposits from the general public through 178 depository banking offices located in Washington, Oregon, California, Idaho and Montana. In addition, Sterling originates loans through Golf Savings Bank and Action Mortgage 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 Harbor Financial service 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 real estate, commercial banking, consumer and construction lending, which generally produce higher yields than residential loans, as well as increasing its retail deposits, particularly transaction accounts. Such loans generally involve a higher degree of risk than financing residential real estate. Management believes that a community bank mix of assets and liabilities will enhance its net interest income ("NII") (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 ("MBO"). 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 ("FRB"), the FDIC and the Washington State Department of Financial Institutions ("WDFI").

Company Growth

Sterling intends to continue to pursue a long-term aggressive growth strategy to become the leading community bank in the western United States. In addition to continued organic growth, this strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. There is no assurance that Sterling will be successful in completing any such acquisitions.

On February 28, 2007, Sterling completed its acquisition of Northern Empire Bancshares, a California corporation ("Northern Empire") by issuing $30.0 million in cash, and 8,914,815 shares of Sterling common stock valued at

$290.4 million in exchange for all outstanding Northern Empire shares. Northern Empire options totaling 646,018 were converted into 573,212 Sterling options, valued at $12.3 million. The total value of the transaction was $332.8 million. Northern Empire merged into Sterling, with Sterling being the surviving corporation in the merger. Northern Empire's financial institution subsidiary, Sonoma National Bank, merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

On November 30, 2006, Sterling completed its acquisition of FirstBank NW Corp., a Washington corporation ("FirstBank"), by issuing cash of $15.6 million and 4,821,913 shares of Sterling common stock valued at $145.3 million in exchange for all outstanding FirstBank shares. The total value of the transaction, including options converted, was $165.4 million. FirstBank was merged with and into Sterling, with Sterling being the surviving corporation in the merger. FirstBank's financial institution subsidiary, FirstBank Northwest, was merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

On July 5, 2006, Sterling completed its acquisition of Lynnwood Financial Group, Inc. ("Lynnwood"), the parent company of Golf Savings Bank, by issuing $15.8 million in cash and 1,799,961 shares of Sterling common stock valued at $48.8 million in exchange for all outstanding Lynnwood shares. The total value of the transaction, including options converted, was $66.3 million. Lynnwood merged with and into Sterling, with Sterling being the surviving entity in the merger. Lynnwood's wholly owned subsidiaries, Golf Savings Bank and Golf Escrow Corporation, have become subsidiaries of Sterling.

On July 31, 2006, a wholly owned subsidiary of INTERVEST acquired the mortgage banking operations, including the commercial servicing portfolio, brand name and investor/customer list, of Mason-McDuffie Financial Corporation ("Mason-McDuffie"), located in northern California. INTERVEST's mortgage banking business in northern California is now being conducted by Mason-McDuffie. The transaction was valued at $2.7 million, including $1.8 million in cash paid at closing, with the remainder to be paid in Sterling common stock, subject to the terms of a three-year earnout. Mason-McDuffie is dedicated to commercial loan originations and loan servicing.

Sterling may not be successful in identifying further acquisition candidates, integrating acquisitions or preventing such acquisitions from having an adverse effect on Sterling. There is significant competition for acquisitions in Sterling's market area, and Sterling may not be able to acquire other businesses on attractive terms. Furthermore, the success of Sterling's growth strategy will depend on increasing and maintaining sufficient levels of regulatory capital, obtaining necessary regulatory approvals, generating appropriate growth and the existence of favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

Profitability Drivers

We expect to increase our profitability in the future by:

- continuing to increase the volume of our loans and change the mix of our loan portfolio to higher-yielding commercial banking and consumer loans.
- growing our core deposits, particularly commercial, consumer and public sector transaction deposits.
- expanding products and services for commercial and public sector customers, including depository and treasury management services such as lockbox, on-line net banking, merchant services, analyzed and sweep accounts, remote deposit capture and international services.
- diversifying and growing our fee income through existing and new fee income sources, including deposit fees, transaction fees, fees from mortgage banking and other fees.
- maintaining strong asset quality through robust underwriting and credit approval functions.
- managing interest rate risk to protect net interest margin in a changing interest rate environment.

Together, we believe these strategies will contribute to increasing high quality earnings and maximizing shareholder value. The effect of these strategies on our financial results is discussed further in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").

Lending Activities

Focus on Community Lending. In recent years, Sterling repositioned its loan portfolio and operations to be more like that of a community bank. Commercial real estate, commercial banking, consumer and construction loans generally produce higher yields than residential permanent mortgage loans. Such loans, however, generally involve a higher degree of risk than financing residential real estate.

Commercial Lending. Sterling has structured its commercial lending in four groups: Commercial Banking, Corporate Banking, Correspondent Banking and Private Banking. Sterling's Commercial Banking Group provides a full range of credit products to small-and medium-sized businesses and to individuals. Credit products include lines of credit, receivable and inventory financing, equipment loans, and permanent and construction real estate financing. Loans may be made unsecured, partially secured or fully secured based on certain credit criteria. The credit product line for both businesses and individuals includes standardized products, as well as customized accommodations.

Sterling's Corporate Banking Group provides a full line of financial services to middle market companies in its service area. Credit products include lines of credit, receivable and inventory financing, equipment loans and permanent and construction financing. Loans may be made on an unsecured, partially secured or fully secured basis. The Corporate Banking Group also serves the needs of the owners and key employees of its business customers.

Sterling's Correspondent Banking Group offers advanced credit and operational products to other financial institutions. These products include loan participations, image processing, net banking, treasury management, letters of credit, foreign exchange, cash vault, and other services for our business partners.

Sterling's Private Banking Group provides services to higher-net-worth and higher-income borrowers by originating a variety of consumer and commercial banking loans. Such loans generally, but do not always, meet the same underwriting requirements or have the same terms as general consumer loans of the same type.

Sterling has established minimum underwriting standards, which delineate criteria for sources of repayment, financial strength and credit enhancements such as guarantees. Typically, the primary source of repayment is recurring cash flow of the borrower or cash flow from the business or project being financed. Depending on the type of loan, underwriting standards include minimum financial requirements, maximum loan-to-collateral value ratios, minimum cash flow coverage of debt service, debt-to-income ratios and minimum liquidity requirements. Exceptions to the minimum underwriting standards may be made depending upon the type of loan and financial strength of the borrower. Exceptions are reported to the appropriate level of authority up to and including the board of directors. Common forms of collateral pledged to secure commercial banking loans include real estate, accounts receivable, inventory, equipment, agricultural crops or livestock and marketable securities. Most loans have maximum terms of one to ten years and loan-to-value ratios in the range of 65% to 80%, based on an analysis of the collateral pledged.

Commercial, corporate and private banking loans generally involve a higher degree of risk than financing real estate, primarily because collateral is more difficult to appraise, the collateral may be difficult to obtain or liquidate following an uncured default and it is difficult to accurately predict the borrower's ability to generate future cash flows. These loans, however, typically offer relatively higher yields and variable interest rates. The availability of such loans enables potential depositors to establish full-service banking relationships with Sterling.

Multifamily Residential and Commercial Real Estate Lending. Sterling offers multifamily residential and commercial real estate loans as both construction and permanent loans collateralized by real property. Construction loans on such properties typically have terms of 12 to 24 months and have variable interest rates. Permanent fixed- and adjustable-rate loans on existing properties typically have maturities of three to ten years. Multifamily residential and commercial real estate loans generally involve a higher degree of risk than one- to four-family residential real estate loans, because they typically involve large loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically is dependent on the successful operation of the real estate project and is subject to certain risks not present in one- to four-family residential mortgage lending. These risks include excessive vacancy rates or inadequate operating cash flows. Construction lending is subject to risks such as construction delays, cost overruns, insufficient values and an inability to obtain permanent financing in a timely manner. Sterling attempts to reduce its exposure to these risks by limiting loan amounts to the amounts readily accepted in the secondary market, by closely monitoring the construction disbursement process, by investigating the borrowers' finances and, depending on the circumstances, requiring annual financial statements

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from the borrowers, requiring operating statements on the properties or acquiring personal guarantees from the borrowers.

One- to Four-Family Residential Lending. Sterling originates fixed- and adjustable-rate residential mortgages ("ARMs"), which have interest rates that adjust annually or every three, five or seven years and are indexed to a variety of market indices, as well as interest only residential mortgages. Sterling focuses its residential lending on traditional amortizing loans for owner occupied borrowers, 2nd homes and investment properties per guidelines. Sterling also has interest only programs available that are underwritten to fully amortized payments.

Sterling continues to originate conventional and government-insured residential loans for sale into the secondary mortgage market. Within the secondary mortgage market for conventional loans, Sterling sells its residential loans both on a servicing-released and servicing-retained basis to correspondent institutions that include the Federal Home Loan Mortgage Corporation ("FHLMC") and to the Federal National Mortgage Association ("FNMA"). Sterling endeavors to underwrite residential loans in compliance with these agencies' underwriting standards. Loans sold into the secondary market are all sold with limited recourse to Sterling, meaning that Sterling may be obligated to repurchase any loans that are not underwritten in accordance with these agencies' or applicable investor underwriting guidelines. Sterling continues to originate residential loans to be held in its portfolio. The maximum loan to value on these products is 80%.

Conventional residential mortgage loans are originated for up to 100% of the appraised value or selling price of the mortgaged property, whichever is less. Borrowers must purchase private mortgage insurance from approved third parties so that Sterling's risk is limited to approximately 80% of the appraised value on most loans with loan-to-value ratios in excess of 80%. Sterling's residential lending programs are designed to comply with all applicable regulatory requirements. For a discussion of Sterling's management of interest rate risk ("IRR") on conventional loans, see " Secondary Market Activities."

Sterling originates residential construction loans on presold and spec homes, as well as townhouses and condominiums. Sterling also provides land, lot, and acquisition and development loans for residential subdivisions. Construction financing is generally considered to involve a higher degree of risk than long-term financing on improved, occupied real estate. Sterling's risk of loss on construction loans depends largely upon the accuracy of the initial estimate of the property's value at completion of construction or development and the estimated cost (including interest) of construction. If the estimate of construction costs proves to be inaccurate, Sterling might have to advance funds beyond the amount originally committed to permit completion of the development and to protect its security position. Sterling also might be confronted, at or prior to maturity of the loan, with a project with insufficient value to ensure full repayment. Sterling's underwriting, monitoring and disbursement practices with respect to construction financing are intended to ensure that sufficient funds are available to complete construction projects. Sterling endeavors to limit its risk through its underwriting procedures by using only approved, qualified appraisers and by dealing only with qualified builders/borrowers. See " Classified and Nonperforming Assets."

Consumer Lending. Consumer loans and lines of credit are originated directly through Sterling's retail branches and Private Banking Group, and indirectly through Sterling's Dealer Banking Department. Sterling finances purchases of consumer goods including automobiles, boats and recreational vehicles, and lines of credit for personal use. Generally, consumer loans are originated for terms ranging from six months to ten years. Interest rates may be either fixed or adjustable based on a contractual formula tied to established external indices. Sterling also makes loans secured by borrowers' savings accounts and equity loans collateralized by residential real estate. Equity loans may have maturities of up to 20 years.

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The following table sets forth information on loan originations for the periods indicated:

	Years Ended December 31,					
	2007		2006		2005	
	Amount	%	Amount	%	Amount	%
	(Dollars in thousands)					
Mortgage:						
One- to four-family residential	$ 1,492,026	27.2	$ 830,619	16.7	$ 461,414	11.9
Multifamily residential	35,870	0.7	4,215	0.1	57,571	1.5
Commercial real estate	163,315	3.0	131,001	2.6	218,396	5.6
Total mortgage loans	1,691,211	30.9	965,835	19.4	737,381	19.0
Construction:						
One- to four-family residential	1,584,449	28.9	1,425,248	28.7	1,106,632	28.5
Multifamily residential	118,799	2.2	156,932	3.2	175,018	4.5
Commercial real estate	488,372	8.9	752,458	15.1	519,893	13.4
Total construction loans	2,191,620	40.0	2,334,638	47.0	1,801,543	46.4
Total mortgage and construction loans	3,882,831	70.9	3,300,473	66.4	2,538,924	65.4
Commercial and consumer:						
Commercial banking	995,732	18.2	1,154,304	23.2	898,768	23.1
Consumer direct	359,338	6.6	327,027	6.6	353,840	9.1
Consumer indirect	242,309	4.3	189,505	3.8	90,096	2.4
Total commercial and consumer loans	1,597,379	29.1	1,670,836	33.6	1,342,704	34.6
Total loans originated	$ 5,480,210	100.0	$ 4,971,309	100.0	$ 3,881,628	100.0

Loan Portfolio Analysis. The following table sets forth the composition of Sterling's loan portfolio by type of loan at the dates indicated:

	December 31,								
	2007		2006		2005		2004		200
	Amount	%	Amount	%	Amount	%	Amount	%	Amount
	(Dollars in thousands)								
r-family									
	$ 703,826	7.8	$ 654,661	9.2	$ 488,633	9.9	$ 794,632	18.4	$ 407,999
residential	389,388	4.3	263,053	3.7	332,211	6.7	184,754	4.3	167,220
l real estate	1,223,036	13.5	795,386	11.2	792,219	16.0	699,879	16.3	463,191

age loans	2,316,250	25.6	1,713,100	24.1	1,613,063	32.6	1,679,265	39.0	1,038,410	
n:										
r-family										
	1,933,125	21.3	1,429,772	20.1	591,362	11.9	356,644	8.3	271,480	
residential	263,873	2.9	189,819	2.7	143,272	2.9	102,166	2.4	127,424	
l real estate	747,913	8.2	671,291	9.4	286,868	5.8	194,085	4.5	154,061	
uction loans	2,944,911	32.4	2,290,882	32.2	1,021,502	20.6	652,895	15.2	552,965	
age and										
n loans	5,261,161	58.0	4,003,982	56.3	2,634,565	53.2	2,332,160	54.2	1,591,375	
l and										
l banking	2,639,196	29.1	2,069,086	29.1	1,531,079	30.9	1,311,197	30.4	948,304	
direct	798,519	8.8	749,626	10.5	618,528	12.5	543,895	12.6	309,931	
indirect	376,937	4.1	288,704	4.1	166,143	3.4	120,894	2.8	99,697	
ercial and										
oans	3,814,652	42.0	3,107,416	43.7	2,315,750	46.8	1,975,986	45.8	1,357,932	
receivable	9,075,813	100.0	7,111,398	100.0	4,950,315	100.0	4,308,146	100.0	2,949,307	
es, net	(16,480)		(12,308)		(8,916)		(6,907)		(7,276)	
receivable	9,059,333		7,099,090		4,941,399		4,301,239		2,942,031	
for loan										
	(111,026)		(77,849)		(52,033)		(47,352)		(34,139)	
vable, net	$ 8,948,307		$ 7,021,241		$ 4,889,366		$ 4,253,887		$ 2,907,892	

Contractual Principal Payments. The following table sets forth the scheduled contractual principal repayments for Sterling's loan portfolio at December 31, 2007. Demand loans, loans having no stated repayment schedule and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, deferred loan origination costs and fees, or allowances for credit losses.

	Balance Outstanding at December 31, 2007	Principal Payments Contractually Due in Fiscal Years 2008	2009-2012	Thereafter
		(In thousands)		
Mortgage:				
Fixed rate	$ 854,661	$ 44,245	$ 176,421	$ 633,995
Variable rate	1,461,589	66,296	320,237	1,075,056
Construction	2,944,911	2,172,912	656,751	115,248
Consumer direct	798,519	266,338	146,808	385,373
Consumer indirect	376,937	75,550	268,942	32,445
Commercial banking	2,639,196	1,092,377	519,881	1,026,938
	$ 9,075,813	$ 3,717,718	$ 2,089,040	$ 3,269,055

Loan Servicing. Sterling services its own loans, as well as loans owned by others. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, holding escrow funds for the payment of real estate taxes and insurance premiums, contacting delinquent borrowers and supervising foreclosures in the event of unremedied defaults. For loans serviced by others, Sterling generally receives a fee based on the unpaid principal balance of each loan to compensate for the costs of performing the servicing function.

For residential mortgage loans serviced for other investors, Sterling receives a fee, generally ranging from 5 to 25 basis points of the unpaid principal balance. At December 31, 2007 and 2006, Sterling serviced for itself and for other investors, residential mortgage loans totaling $1.22 billion and $1.17 billion, respectively. Of such mortgage loans, $598.5 million in 2007 and $621.6 million in 2006 were primarily serviced for FHLMC and FNMA. Sterling's ability to continue as a seller/servicer for these agencies is dependent upon meeting their qualifications. Sterling currently meets all applicable requirements.

Sterling receives a fee for servicing commercial and multifamily real estate loans for other investors. This fee generally ranges from 5 to 25 basis points of the unpaid principal balance. At December 31, 2007 and 2006, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling $3.19 billion and $2.57 billion, respectively.

Secondary Market Activities. Sterling has developed correspondent relationships with a number of mortgage companies and financial institutions to facilitate the origination or purchase and sale of mortgage loans in the secondary market on either a participation or whole loan basis. Substantially all of these loans are secured by real estate. Those agents who present loans to Sterling for purchase are required to provide a processed loan package prior to commitment. Sterling then underwrites the loan in accordance with its established lending standards.

In 2007, 94% of Sterling's sales of residential mortgage loans were sold into the secondary market on a loan-by-loan, servicing-released basis, compared with 99% in 2006. Sterling generally receives a fee of approximately 100 to 200 basis points of the principal balance of mortgage loans for releasing the servicing. For sales of loans on a servicing-retained basis, Sterling records a valuation of approximately 100 to 115 basis points of the principal balance. At December 31, 2007 and 2006, Sterling had recorded $9.0 million and $7.3 million in servicing rights, respectively. See Note 4 of "Notes to Consolidated Financial Statements."

Sterling, from time to time, sells participations in certain commercial real estate loans to investors on a servicing-retained basis. During the years ended December 31, 2007, 2006 and 2005, Sterling sold approximately $56.0 million, $54.9 million and $125.5 million in loans under participation agreements, resulting in net gains of $3.0 million, $747,000 and $449,000, respectively.

Loan Commitments. Sterling makes written commitments to individual borrowers and mortgage brokers for the purposes of originating and purchasing loans. These loan commitments establish the terms and conditions under which Sterling will fund the loans. Sterling had outstanding commitments to originate or purchase loans, the undisbursed portion of which aggregated $1.40 billion and $1.45 billion at December 31, 2007 and 2006, respectively. Sterling also had secured and unsecured commercial and personal lines of credit, the undisbursed portion of which was approximately $1.13 billion and $1.03 billion at December 31, 2007 and 2006, respectively. See Note 16 of "Notes to Consolidated Financial Statements."

Derivatives and Hedging. Sterling, in the conduct of ordinary business operations routinely enters into contracts that 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 part of its mortgage banking activities, Sterling issues interest rate lock commitments ("rate locks") to prospective borrowers on residential one-to-four family mortgage loan applications. Pricing for the sale of these loans is fixed with various qualified investors, such as FNMA, under both non-binding ("best-efforts") and binding ("mandatory") delivery programs at or near the time the interest rate is locked with the borrowers. For mandatory delivery programs, Sterling hedges IRR 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 rate locks, 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. As of December 31, 2007 and 2006, Sterling did not have any loans subject to rate locks under mandatory delivery programs.

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of December 31, 2007 and 2006, Sterling had entered into best efforts forward commitments to sell $41.3 million and $142.6 million, respectively, of mortgage loans. As of December 31, 2007 and 2006, the estimated fair value of rate locks issued and delivery commitments received on the unfunded portion were valued at $400,000 and $482,000, respectively.

Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering into comparable dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of December 31, 2007 and 2006, were $1.6 million and $404,000, respectively.

Classified and Nonperforming Assets. To measure the quality of loans and real estate owned ("REO"), Sterling has established guidelines for classifying and determining provisions for anticipated losses. Sterling's system employs the classification categories of "substandard," "doubtful" and "loss" for its classified assets. Substandard assets have deficiencies, which give rise to the distinct possibility that Sterling will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets, and on the basis of currently existing facts, there is a high probability of loss. An asset classified as loss is considered uncollectible and of such little value that it should not be included as an asset of Sterling. Total classified assets increased to $234.3 million at December 31, 2007, from $48.4 million at December 31, 2006. As a percentage of total assets, classified assets increased to 1.93% at December 31, 2007 from 0.49% at December 31, 2006, reflecting the decline in certain residential construction markets.

Sterling's classified assets as of December 31, 2007, included seven borrowers who each held loans that in aggregate exceeded $8.0 million. As of December 31, 2007, Sterling had not established a specific credit loss allowance against these loans, although they are included in Sterling's evaluation of its general credit loss allowance. These loans together constitute 34% of classified assets and include the following:

Sterling holds a discretionary construction line and lot loan financing for 3 subdivisions. The aggregate carrying value of these loans at December 31, 2007 was $14.0 million. These loans have been classified due to delinquency as a result of slow sales of standing inventory. These loans are currently in default.

Sterling holds a line of credit for a single family development that consists of 10 completed homes and 115 lots. The aggregate carrying value of these loans at December 31, 2007 was $12.6 million. These loans have been classified due to the borrower experiencing cash flow problems and a recent appraisal indicates a decrease in the overall project value. These loans are currently in default.

Sterling holds a line of credit and two acquisition and development loans on residential lots. The aggregate carrying value of these loans at December 31, 2007 was $12.4 million. These loans have been classified due to delinquency as a result of the softening real estate market. These loans are currently in default.

Sterling holds multiple acquisition and development loans on 86 lots in three subdivisions. The aggregate carrying value of these loans at December 31, 2007 was $11.8 million. These loans have been classified due to delinquency as a result of the deteriorating market conditions. These loans are currently in default.

Sterling holds two loans consisting of one land loan on 125 lots and one vertical construction loan on 79 lots. The aggregate carrying value of these loans at December 31, 2007 was $11.1 million. These loans have been classified due to delinquency as a result of the borrower experiencing cash flow problems. These loans are currently in default.

Sterling holds commercial loans for auto dealership flooring lines secured by auto inventory and commercial real estate. The aggregate carrying value of these loans at December 31, 2007 was $9.2 million. These loans have been classified due to the borrower's year end losses and lack of operating profits. These loans are current with respect to principal and interest.

Sterling holds participation loans for residential land acquisition secured by first deeds of trust on land parcels. The aggregate carrying value of these loans at December 31, 2007 was $9.1 million. The loans have been classified due to cash flow difficulties and the softening of the residential real estate market. These loans remain current with respect to principal and interest.

Non-performing assets are loans and other assets that are no longer performing in accordance with the terms of the original loan agreement. Non-performing assets are a subset of classified assets, and consist of nonaccrual loans, restructured loans and real estate owned. The following table summarizes the principal balances of nonperforming assets at the dates indicated:

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Nonaccrual loans	$ 115,112	$ 7,107	$ 6,542	$ 10,738	$ 16,208
Restructured loans	350	0	1,081	1,305	1,164
Total nonperforming loans	115,462	7,107	7,623	12,043	17,372
Real estate owned	11,075	4,052	779	1,865	4,226

Total nonperforming assets	$ 126,537	$ 11,159	$ 8,402	$ 13,908	$ 21,598
Ratio of total nonperforming assets to total assets	1.04%	0.11%	0.11%	0.20%	0.50%
Ratio of total nonperforming loans to loans	1.27%	0.10%	0.15%	0.28%	0.59%
Ratio of allowance for estimated losses on loans to total nonperforming loans	101.8%	1437.0%	975.9%	538.3%	216.6%

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

	December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Residential real estate	$ 1,616	$ 1,713	$ 840	$ 1,302	$ 1,131
Multifamily real estate	2,205	3,356	3,061	5,853	9,280
Commercial real estate	13,987	1,340	2,331	2,254	8,269
Construction	96,815	96	0	350	224
Consumer direct	1,219	621	470	1,057	899
Consumer indirect	631	140	149	132	191
Commercial banking	10,064	3,893	1,551	2,960	1,604
Total nonperforming assets	$ 126,537	$ 11,159	$ 8,402	$ 13,908	$ 21,598

The increase in non-performing assets is primarily the result of the softening of the residential construction market in some of Sterling's market areas. As of December 31, 2007, residential construction loans accounted for 75 percent, or $94.5 million of non-performing assets. The majority of Sterling's non-performing residential construction loans are concentrated in three markets: Boise, Idaho consisting of 30 relationships with total outstanding balances of $26.9 million, which account for 28% of the non-performing residential construction loans; southern California, consisting of two relationships, with total outstanding balances of $23.6 million, which account for 25% of the non-performing residential construction loans; and Bend, Oregon, consisting of two relationships with total outstanding balances of $18.5 million, which account for 20% of the non-performing residential construction loans. As of December 31, 2007 Sterling had $417.6 million of residential construction commitments in the Boise, Idaho; southern California and Bend, Oregon markets. The residential construction commitments in these three markets represent 16% of Sterling's total residential construction commitments.

As of December 31, 2007 and 2006, Sterling had established a specific credit loss allowance of $8.7 million and $1.4 million on nonperforming loan balances of $24.5 million and $2.5 million, respectively. Nonperforming loans that do not have a specific credit loss allowance have a general credit loss allowance. Sterling regularly reviews the collectability of accrued interest and generally ceases to accrue interest on a loan when either principal or interest is past due by 90 days or more. Any accrued and uncollected interest is reversed from income at that time. Loans may be placed in nonaccrual status earlier if, in management's judgment, the loan may be uncollectible. Interest on such a loan is then recognized as income only if collected or if the loan is restored to performing status. Interest income of $1.5 million, $249,000, and $258,000 was recorded on these loans during the years ended December 31, 2007, 2006 and 2005, respectively. Additional interest income of $4.5 million, $321,000 and $693,000 would have been recorded during the years ended December 31, 2007, 2006 and 2005, respectively, if nonaccrual and restructured loans had been current in accordance with their original contractual terms.

REO is recorded at the lower of estimated fair value, less estimated selling expenses, or carrying value at foreclosure. Fair value is defined as the amount in cash or other consideration that a real estate asset would yield in a current sale between a willing buyer and a willing seller. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable upon disposal. The carrying value of REO is continuously evaluated and, if necessary, an allowance is established to reduce the carrying value to net realizable value, which considers, among other things, estimated direct holding costs and selling expenses.

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The following table sets forth the activity in Sterling's REO for the periods indicated:

	Years Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Balance at beginning of period	$ 4,052	$ 779	$ 1,865
Loan foreclosures and other additions	8,252	4,581	2,271
Improvements and other changes	119	(244)	331
Sales	(1,348)	(894)	(3,665)
Provisions for losses	0	(170)	(23)
Balance at end of period	$ 11,075	$ 4,052	$ 779

Allowance for Credit Losses. Generally, Sterling establishes specific allowances for the difference between the anticipated fair value (market value less selling costs, foreclosure costs and projected holding costs), adjusted for other possible sources of repayment, and the book balance (loan principal and accrued interest or carrying value of REO) of its loans classified as loss and REO. Assets classified as substandard or doubtful require the establishment of a general allowance. Each classified asset is reviewed at least monthly. Allowances are established or periodically adjusted, if necessary, based on the review of information obtained through on-site inspections, market analysis, appraisals and purchase offers.

The allowance for credit losses is maintained at a level deemed appropriate by management to adequately provide for probable losses related to specifically identified loans, probable losses in the remaining portfolio, as well as unfunded commitments. The allowance is based upon historical loss experience, delinquency trends, portfolio size, concentrations of risk, prevailing and anticipated economic conditions, industry experience, estimated collateral values, management's assessment of credit risk inherent in the portfolio, specific problem loans and other relevant factors. The portfolio is grouped into standard industry categories for homogeneous loans based on characteristics such as loan type, borrower and collateral. Multiple years of historical loss experience are used to develop loss emergence periods and expected losses for each loan category.

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to have occurred. Because the allowance for credit losses is based on estimates, ultimate losses may materially differ from the estimates. See Note 3 of "Notes to Consolidated Financial Statements."

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Management believes that the allowance for credit losses is adequate given the composition and risks of the loan portfolios, although there can be no assurance that the allowance will be adequate to cover all contingencies. The following table sets forth information regarding changes in Sterling's allowance for estimated credit losses for the periods indicated:

	Years Ended December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Allowance loans, January 1	$ 77,849	$ 52,034	$ 47,352	$ 34,139	$ 26,677
Charge-offs:					
Residential real estate	(30)	(32)	(37)	(59)	(165)
Multifamily real estate	0	0	(3)	(2)	0
Commercial real estate	(70)	(902)	(2,315)	(1,824)	(802)
Construction	(3,430)	(12)	(19)	(645)	(106)
Consumer direct	(1,268)	(619)	(1,107)	(1,373)	(1,146)
Consumer indirect	(1,884)	(823)	(449)	(370)	(445)
Commercial banking	(1,000)	(2,017)	(5,721)	(1,210)	(1,589)