STERLING FINANCIAL CORP /WA/
Form 10-Q
November 14, 2003

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED September 30, 2003

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)	(I.R.S. Employer Identification No.)

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

(509) 458-2711
(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.

Yes ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ý No o

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 October 31, 2003
Common Stock ($1.00 par value)	14,811,661

STERLING FINANCIAL CORPORATION

FORM 10-Q

For the Quarter Ended September 30, 2003

TABLE OF CONTENTS

-

PART I - Financial Information

Item 1 - Financial Statements

STERLING FINANCIAL CORPORATION

Consolidated Balance Sheets

(Unaudited)

	September 30, 2003	December 31, 2002
	(Dollars in thousands)	
ASSETS:		
Cash and cash equivalents:		
Interest bearing	$ 2,505	$ 2,525
Non-interest bearing and vault	70,986	74,540
Restricted	1,700	1,526
Investments and asset-backed securities (ABS):		
Available for sale	1,010,084	826,692
Held to maturity	2,821	3,476
Loans receivable, net	2,761,174	2,390,263
Loans held for sale	22,754	22,549
Accrued interest receivable	15,794	14,625
Real estate owned, net	3,108	3,953
Office properties and equipment, net	52,385	47,745
Bank-owned life insurance (BOLI)	72,168	59,399
Goodwill	45,075	43,977
Other intangible assets	2,960	0
Mortgage servicing rights, net	3,272	1,680
Prepaid expenses and other assets, net	8,664	13,114
Total assets	$ 4,075,450	$ 3,506,064
LIABILITIES:		
Deposits	$ 2,421,043	$ 2,014,096
Advances from Federal Home Loan Bank of Seattle (FHLB Seattle)	964,140	874,515
Securities sold subject to repurchase agreements and funds purchased	259,107	249,769
Other borrowings	136,782	127,682
Cashiers checks issued and payable	16,393	13,371
Borrowers reserves for taxes and insurance	2,565	1,401
Accrued interest payable	8,377	6,344
Accrued expenses and other liabilities	18,166	15,230
Total liabilities	3,826,573	3,302,408
Commitments and Contingencies		
SHAREHOLDERS EQUITY:		

Preferred stock, $1 par value; 10,000,000 shares authorized; no shares issued and outstanding		0		0
Common stock, $1 par value; 40,000,000 shares authorized; 14,811,661 and 11,958,948 shares issued and outstanding		14,812		11,959
Additional paid-in capital		181,036		125,177
Accumulated other comprehensive income (loss):				
Unrealized gains (losses) on investments and ABS available-for-sale, net of deferred income taxes of $3,919 and ($1,852)		(7,278)		3,439
Retained earnings		60,307		63,081
Total shareholders equity		248,877		203,656
Total liabilities and shareholders equity	$	4,075,450	$	3,506,064

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

1

STERLING FINANCIAL CORPORATION

Consolidated Statements of Income

(Unaudited)

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2002	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
	(Dollars in thousands, except per share data)			
Interest income:				
Loans	$ 43,179	$ 40,260	$ 125,894	$ 118,340
ABS	10,558	8,797	29,744	24,384
Investments and cash equivalents	959	1,052	3,194	3,252
Total interest income	54,696	50,109	158,832	145,976
Interest expense:				
Deposits	9,322	11,175	27,835	34,025
Short-term borrowings	3,260	2,144	8,727	5,419
Long-term borrowings	9,786	10,926	31,331	33,911
Total interest expense	22,368	24,245	67,893	73,355
Net interest income	32,328	25,864	90,939	72,621
Provision for losses on loans	(2,850)	(3,277)	(7,650)	(7,590)
Net interest income after provision for losses on loans	29,478	22,587	83,289	65,031
Other income:				
Fees and service charges	5,052	4,352	14,260	12,281
Mortgage banking operations	2,185	1,307	6,898	3,663
Loan servicing fees	518	271	449	865
Net gains (losses) on sales of securities	(308)	1,399	2,729	1,796
Real estate owned operations	125	(8)	(84)	(202)
Charge related to early repayment of debt	0	0	(1,464)	0
BOLI	979	731	2,769	2,433
Other noninterest income (expense)	(155)	15	(363)	(195)
Total other income	8,396	8,067	25,194	20,641
Operating expenses	24,655	21,119	68,670	60,538
Income before income taxes	13,219	9,535	39,813	25,134
Income tax provision	(4,594)	(2,906)	(13,888)	(7,188)

Net income	$ 8,625	$ 6,629	$ 25,925	$ 17,946
Earnings per share - basic	$ 0.58	$ 0.50	$ 1.80	$ 1.38
Earnings per share - diluted	$ 0.57	$ 0.49	$ 1.75	$ 1.34
Weighted average shares outstanding - basic	14,791,399	13,145,696	14,428,622	12,985,287
Weighted average shares outstanding - diluted	15,220,484	13,439,003	14,818,023	13,398,551

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

STERLING FINANCIAL CORPORATION

Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
	(Dollars in thousands)	
Cash flows from operating activities:		
Net income	$ 25,925	$ 17,946
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for losses on loans and real estate owned	7,830	7,828
Stock dividends on FHLB Seattle stock	(3,590)	(1,808)
Net gain on sales of loans, investments and ABS	(7,659)	(5,074)
Other losses	136	491
Change in cash surrender value of BOLI	(2,769)	(2,555)
Depreciation and amortization	9,176	8,276
Change in:		
Accrued interest receivable	(898)	(170)
Prepaid expenses and other assets	10,940	(6,633)
Cashiers checks issued and payable	1,087	(2,041)
Accrued interest payable	1,542	(159)
Accrued expenses and other liabilities	(1,334)	(3,815)
Proceeds from sales of loans	355,920	184,406
Real estate loans originated for sale	(350,990)	(181,128)
Net cash provided by operating activities	45,316	15,564
Cash flows from investing activities:		
Change in restricted cash	(174)	(290)
Loans funded	(1,690,900)	(1,140,121)
Loan principal received	1,377,648	984,737
Purchase of investments	(11,819)	(32,039)
Proceeds from maturities of investments	1,630	29,929
Proceeds from sales of available-for-sale investments	16,083	1,410
Cash and cash equivalents acquired as part of acquisitions	143,631	0
Purchase of BOLI	(10,000)	(25,000)
Purchase of ABS	(1,053,060)	(592,031)
Principal payments on ABS	243,476	142,560
Proceeds from sales of ABS	612,676	345,290
Purchase of office properties and equipment	(3,880)	(2,216)
Improvements and other changes to real estate owned	69	(866)
Proceeds from sales and liquidation of real estate owned	3,415	6,065

Net cash used in investing activities	(371,205)	(282,572)

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

	Nine Months Ended September 30, 2003	2002
	(Dollars in thousands)	
Cash flows from financing activities:		
Net change in checking, passbook and money market deposits	$ 147,403	$ 157,785
Proceeds from issuance of certificates of deposit	1,147,741	858,652
Payments for maturing certificates of deposit	(1,098,262)	(884,527)
Interest credited to deposits	25,842	32,978
Advances from FHLB Seattle	446,102	221,875
Repayment of FHLB Seattle advances	(365,988)	(116,843)
Net change in securities sold subject to repurchase agreements and funds purchased	9,338	3,410
Proceeds from other borrowings	54,000	0
Repayment of other borrowings	(44,900)	(5,000)
Payments for fractional shares	(30)	(19)
Proceeds from exercise of stock options, net of repurchases	825	851
Deferred financing costs	(732)	0
Other	976	1,382
Net cash provided by financing activities	322,315	270,544
Net change in cash and cash equivalents	(3,574)	3,536
Cash and cash equivalents, beginning of period	77,065	65,654
Cash and cash equivalents, end of period	$ 73,491	$ 69,190
Supplemental disclosures:		
Cash paid during the period for:		
Interest	$ 66,601	$ 49,629
Income taxes	13,805	8,798
Noncash financing and investing activities:		
Loans converted into real estate owned	1,758	7,570
Common stock dividend	28,699	23,809
Common stock issued upon business combination	29,523	0

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

STERLING FINANCIAL CORPORATION

Consolidated Statements of Comprehensive Income

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
	(Dollars in thousands)			
Net income	$ 8,625	$ 6,629	$ 25,925	$ 17,946
Other comprehensive income:				
Change in unrealized gains (losses) on investments and ABS available-for-sale	(9,743)	4,450	(16,488)	13,094
Less deferred income taxes	3,410	(1,558)	5,771	(4,582)
Net other comprehensive income (loss)	(6,333)	2,892	(10,717)	8,512
Comprehensive income	$ 2,292	$ 9,521	$ 15,208	$ 26,458

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

STERLING FINANCIAL CORPORATION

Notes to Consolidated Financial Statements

1. **Basis of Presentation**:

The foregoing unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2002. 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.

2. **Other Borrowings**:

The components of other borrowings are as follows (in thousands):

	September 30, 2003	December 31, 2002
Term note payable(1)	$ 22,000	$ 25,000
Sterling obligated mandatorily redeemable preferred capital securities of subsidiary trusts holding solely junior subordinated deferrable interest debentures of Sterling(2)	78,000	64,000
Floating Rate Notes Due 2006(3)	30,000	30,000
Other(4)	6,782	8,682
Total other borrowings	$ 136,782	$ 127,682

(1) Sterling has a variable-rate term note with U.S. Bank, N.A. (U.S. Bank). This note matures on September 17, 2007. Interest accrues at the 30-day London Interbank Offering Rate (LIBOR) plus 2.50% (3.61% at September 30, 2003) and is payable monthly. Principal payments are due in annual installments of $3.0 million each September, with the entire unpaid balance due at maturity. This note is collateralized by a majority of the Common and Preferred Stock of Sterling Savings Bank.

(2) Sterling raises capital from time to time through the formation of trusts (Sterling Capital Trusts), which issue capital securities (Trust Preferred Securities) to investors. The Sterling 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 Sterling Capital Trusts obligations under the Trust Preferred Securities. The Trust Preferred Securities are treated as debt of Sterling. Although Sterling, as a savings and loan holding company, is not subject to the Federal Reserve capital requirements for bank holding companies, the Trust Preferred Securities have been structured to qualify as Tier 1 capital, subject to certain limitations, if Sterling were to become regulated as a bank holding company. 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. Interest is paid quarterly or semi-annually. Details of the Trust Preferred Securities are as follows:

Subsidiary Issuer	**Issue Date**	**Maturity Date**	**Call Date**	**Mandatorily Redeemable Capital Security**	**Rate at September 30, 2003**	**Amount (in Thousands)**
Sterling Capital Trust VI	June 2003	April 2033	Sept 2008	Floating Rate Capital Securities	4.32%	$ 10,000
Sterling Capital Statutory Trust V	May 2003	May 2033	June 2008	Floating Rate Capital Securities	4.38%	20,000
Sterling Capital Trust IV	May 2003	May 2033	May 2008	Floating Rate Preferred Securities	4.44%	10,000
Sterling Capital Trust III	April 2003	Sept 2033	April 2008	Floating Rate Capital Securities	4.37%	14,000
Sterling Capital Trust II	July 2001	July 2031	June 2006	10.25% Cumulative Capital Securities	10.25%	24,000
						$ 78,000

(3) Sterling has outstanding $30.0 million of Floating Rate Notes Due 2006. These notes are unsecured general obligations of Sterling and are subordinated to certain other existing and future indebtedness. Under the terms of the notes, Sterling is limited in the amount of certain long-term debt that it may incur, and the notes restrict Sterling, under certain circumstances, as to the amount of cash dividends on its preferred or common stock and capital distributions which can be made. At September 30, 2003, Sterling could have incurred approximately $62.1 million of additional long-term debt. At September 30, 2003, Sterling could have paid up to approximately $36.7 million in additional dividends. Interest accrues at the 90-day LIBOR plus 2.50% (3.64% at September 30, 2003) and is adjustable and payable quarterly. The notes mature in 2006 and may be redeemed under certain conditions.

(4) During 2002, Sterling financed the sale of certain loans to an unrelated party. Since the underlying sold loans were collateral on the loan to the purchaser, this sale was accounted for as a financing. At September 30, 2003, $6.8 million remained outstanding on the financing.

3. Earnings Per Share:

The following table presents the basic and diluted earnings per share computations including the effect of the 10% stock dividend which was paid in May 2003:

	Three Months Ended September 30,					
	2003			2002		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
Basic computations	$ 8,625,000	14,791,399	$ 0.58	$ 6,629,000	13,145,696	$ 0.50
Effect of dilutive securities:						
Common stock options	0	429,085	(0.01)	0	293,307	(0.01)
Diluted computations	$ 8,625,000	15,220,484	$ 0.57	$ 6,629,000	13,439,003	$ 0.49
Antidilutive options not included in diluted earnings per share		0			0	

	Nine Months Ended September 30,					
	2003			2002		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
Basic computations	$ 25,925,000	14,428,622	$ 1.80	$ 17,946,000	12,985,287	$ 1.38
Effect of dilutive securities:						
Common stock options	0	389,401	(0.05)	0	302,875	(0.03)
Convertible subordinated debt	0	0	0	43,000	110,389	(0.01)
Diluted computations	$ 25,925,000	14,818,023	$ 1.75	$ 17,989,000	13,398,551	$ 1.34
Antidilutive options not included in diluted earnings per share		0			0	

4. <u>Operating Expenses</u>:

The following table details Sterling s components of total operating expenses:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
	(Dollars in thousands)			
Employee compensation and benefits	$ 13,683	$ 11,076	$ 37,638	$ 32,103
Occupancy and equipment	3,641	3,152	10,805	9,320
Depreciation	1,266	1,047	3,667	3,173
Amortization of identifiable intangible assets	79	0	183	644
Advertising	1,685	1,553	3,734	3,050
Data processing	1,737	1,597	4,963	4,626
Insurance	199	159	549	431
Legal and accounting	773	621	1,686	1,479
Travel and entertainment	622	464	1,881	1,513
Goodwill litigation costs	236	270	550	790
Acquisition and merger costs	167	0	355	0
Other	567	1,180	2,659	3,409
Total operating expenses	$ 24,655	$ 21,119	$ 68,670	$ 60,538

5. <u>Segment Information</u>:

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

The Community Banking segment consists of the operations conducted by 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 in the Spokane and Seattle, Washington; Portland and Bend, Oregon and Boise, Idaho metropolitan areas primarily through Action Mortgage Company.

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 metropolitan areas of Portland, Oregon; Spokane, Washington; and the Puget Sound region primarily through INTERVEST-Mortgage Investment Company.

The Insurance and Retail Brokerage segment markets tax-deferred annuities, mutual funds, insurance and other financial products through sales representatives within the Sterling Savings Bank branch network primarily through Harbor Financial Services, Inc. and Dime Insurance Agency.

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

The following table presents certain financial information regarding Sterling s segments and provides a reconciliation to Sterling s consolidated totals for the three and nine months ended September 30, 2003 and 2002:

	As of and for the Three Months Ended September 30, 2003					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Insurance/ Retail Brokerage	Eliminations and Other	Total
	(Dollars in thousands)					
Interest income	$ 50,674	$ 2,551	$ 1,472	$ (1)	$ 0	$ 54,696
Interest expense	20,667	0	0	0	1,701	22,368
Net interest income (expense)	30,007	2,551	1,472	(1)	(1,701)	32,328
Provision for losses on loans	(2,850)	0	0	0	0	(2,850)
Noninterest income	9,244	2,747	301	555	(4,451)	8,396
Noninterest expense	21,003	2,971	669	418	(406)	24,655
Income before income taxes	$ 15,398	$ 2,327	$ 1,104	$ 136	$ (5,746)	$ 13,219
Total assets	$ 4,123,879	$ 21,240	$ 14,474	$ 1,664	$ (85,807)	$ 4,075,450

	As of and for the Three Months Ended September 30, 2002					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Insurance/ Retail Brokerage	Eliminations and Other	Total
	(Dollars in thousands)					
Interest income	$ 46,742	$ 2,075	$ 1,292	$ 0	$ 0	$ 50,109
Interest expense	22,050	0	0	0	2,195	24,245
Net interest income (expense)	24,692	2,075	1,292	0	(2,195)	25,864
Provision for losses on loans	(3,277)	0	0	0	0	(3,277)
Noninterest income	9,235	1,665	297	520	(3,650)	8,067
Noninterest expense	18,499	1,762	670	318	(130)	21,119
Income before income taxes	$ 12,151	$ 1,978	$ 919	$ 202	$ (5,715)	$ 9,535
Total assets	$ 3,372,420	$ 15,785	$ 14,631	$ 964	$ (74,225)	$ 3,329,575

	As of and for the Nine Months Ended September 30, 2003					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Insurance/ Retail Brokerage	Eliminations and Other	Total
	(Dollars in thousands)					
Interest income	$ 147,643	$ 6,860	$ 4,329	$ 0	$ 0	$ 158,832
Interest expense	62,181	0	0	0	5,712	67,893
Net interest income (expense)	85,462	6,860	4,329	0	(5,712)	90,939
Provision for losses on loans	(7,650)	0	0	0	0	(7,650)
Noninterest income	29,216	7,882	907	1,521	(14,332)	25,194
Noninterest expense	58,733	7,621	2,032	1,143	(859)	68,670
Income before income taxes	$ 48,295	$ 7,121	$ 3,204	$ 378	$ (19,185)	$ 39,813
Total assets	$ 4,123,879	$ 21,240	$ 14,474	$ 1,664	$ (85,807)	$ 4,075,450

	As of and for the Nine Months Ended September 30, 2002					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Insurance/ Retail Brokerage	Eliminations and Other	Total
	(Dollars in thousands)					
Interest income	$ 136,974	$ 5,434	$ 3,568	$ 0	$ 0	$ 145,976
Interest expense	66,637	0	0	0	6,718	73,355
Net interest income (expense)	70,337	5,434	3,568	0	(6,718)	72,621
Provision for losses on loans	(7,590)	0	0	0	0	(7,590)
Noninterest income	23,193	3,870	1,371	1,246	(9,039)	20,641
Noninterest expense	53,020	5,109	1,725	829	(145)	60,538
Income before income taxes	$ 32,920	$ 4,195	$ 3,214	$ 417	$ (15,612)	$ 25,134
Total assets	$ 3,372,420	$ 15,785	$ 14,631	$ 964	$ (74,225)	$ 3,329,575

6. **<u>Stock Options</u>**:

As allowed by SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), Sterling has elected to retain the compensation measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and its related interpretations, for stock options. Under APB No. 25, compensation cost is recognized at the measurement date in the amount, if any, that the quoted market price of Sterling s common stock exceeds the option exercise price. The measurement date is the date at which both the number of options and the exercise price for each option are known.

Sterling has chosen not to record compensation expense using fair value measurement provisions in the statement of income. Had compensation cost for Sterling s plans been determined based on the fair value at the grant dates for awards under the plans, Sterling s reported net income and earnings per share would have been changed to the pro forma amounts indicated below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
	(Dollars in thousands, except per share amounts)			
Reported net income	$ 8,625	$ 6,629	$ 25,925	$ 17,946
Add back: Stock-based employee compensation expense, net of related tax effects	0	0	0	0
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(548)	(387)	(1,644)	(1,159)
Pro forma	$ 8,077	$ 6,242	$ 24,281	$ 16,787
Basic earnings per share:				
Reported earnings per share	$ 0.58	$ 0.50	$ 1.80	$ 1.38
Stock-based employee compensation, fair value	(0.04)	(0.03)	(0.11)	(0.09)
Pro forma earnings per share	$ 0.54	$ 0.47	$ 1.69	$ 1.29
Diluted earnings per share:				
Reported earnings per share	$ 0.57	$ 0.49	$ 1.75	$ 1.34
Stock-based employee compensation, fair value	(0.04)	(0.03)	(0.11)	(0.09)
Pro forma earnings per share	$ 0.53	$ 0.46	$ 1.64	$ 1.25

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in the periods above: dividend yield of 0% in each period, expected stock price volatility of 85% to 132% each period, risk-free interest rates of 2.98% to 6.52% and expected lives of four to ten years, respectively.

7. **New Accounting Policies**:

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 is effective for financial instruments other than minority interests entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. Sterling does not believe that the adoption of SFAS No.150 will have a material effect on Sterling s consolidated financial statements.

8. **Hedging Activities and Derivatives**:

As of January 1, 2001, Sterling adopted the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS Nos. 137 and 138. This Statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The Statement requires that Sterling recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. Changes in the fair value of the derivatives are reported in either earnings or other comprehensive income (loss), depending on the use of the derivative and whether or not it qualifies for hedge accounting.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for all contracts created or modified after June 30, 2003 except for hedging relationships designated after June 30, 2003. In addition, except as stated below, all provisions of SFAS No. 149 should be applied prospectively. Sterling does not believe that the adoption of this standard will have a material effect on Sterling s consolidated financial statements.

Sterling periodically uses financial options and other contractual instruments for the purpose of hedging interest rate risk relative to its investment and ABS portfolios and to its mortgage lending operations. Sterling invests in ABS tranches that perform in concert with the underlying mortgages or assets; i.e., improving in value with falling interest rates and declining in value with rising interest rates. Sterling typically does not invest in derivative products that are structured to perform in a way that magnifies the normal impact of changes in interest rates or in a way dissimilar to the movement in value of the underlying assets. However, Sterling may invest in such products in the future.

As a normal part of its operations, Action Mortgage incurs interest rate risk from the date it closes a loan to the date the loan is sold in the secondary market. Additionally, Action Mortgage incurs interest rate risk from the date it commits to make a loan to the date the loan closes in those cases where it sells interest rate lock commitments (rate locks) to the prospective borrower. Traditionally, Action Mortgage has endeavored to hedge interest rate risk by entering into non-binding (best-efforts) forward sales agreements with third parties. In July 2003, in an effort to improve the spread on loans sold into the secondary market, Action Mortgage began hedging interest rate risk by entering into mandatory forward sales agreements on ABS with third parties.

The risks inherent in such mandatory forward sales agreements include the risk that, if for any reason Action Mortgage does not close and sell the loans in question, it is nonetheless obligated to deliver ABS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement loans or ABS and such costs could have a material adverse impact on mortgage banking operations in future periods, especially in rising interest rate environments.

Rate locks and forward sales agreements are considered to be derivatives under SFAS No. 133. Sterling has recorded the estimated fair values of the rate locks and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in net gain on sales of mortgage loans in the income statement as the changes occur.

9. Business Combinations:

On February 28, 2003, Sterling merged with Empire Federal Bancorp, Inc. (Empire). The results of Empire s operations have been included in the consolidated financial statements since that date. The acquisition allowed Sterling to expand into Montana markets both on a lending and depository basis. The acquisition strengthened Sterling s capital base, adding approximately $29.2 million in capital. Sterling also acquired approximately $143.6 million in cash, $67.3 million in loans and $184.2 million in deposits as a result of the merger.

The aggregate purchase price was $29.2 million which was comprised of 1,401,370 shares of the common stock of Sterling. Sterling recorded a deposit intangible in the amount of $3.1 million related to the acquisition of Empire. The deposit intangible is amortized over an estimated life of 10 years. Sterling also recorded goodwill related to the transaction of $1.0 million. This asset is subject to SFAS No. 142 accounting rules, which include annual impairment testing. Any estimated impairment would result in Sterling recording an impairment loss.

13

On July 15, 2003, Sterling announced that it had entered into an Agreement and Plan of Merger (the Klamath Merger) with Klamath First Bancorp, Inc., an Oregon corporation (Klamath). Klamath will be merged with and into Sterling, with Sterling being the surviving corporation in the merger. Klamath s wholly-owned subsidiary, Klamath First Federal Savings and Loan Association (Klamath First Federal), will be merged with and into Sterling s wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. As of September 30, 2003, Klamath had 59 branches in Oregon and Washington, with a presence in 26 of Oregon s 36 counties. As of September 30, 2003, Klamath reported approximately $1.5 billion in total assets including $557.6 million in loans, $1.1 billion in deposits and $121.1 million of equity. In September 2003, Klamath announced that it had entered into an agreement to sell seven of its branches with aggregate deposits of approximately $66 million. The sale of such branches is expected to be completed in December 2003.

Under the terms of the Klamath Merger, each share of Klamath common stock will be converted into 0.77 shares of Sterling common stock, subject to certain conditions. Based upon the closing price for Sterling on October 31, 2003 of $31.31 per share, the consideration is equivalent to $24.11 per share of Klamath common stock. The merger will be structured as a tax-free reorganization and is expected to be completed in the first quarter of 2004, subject to shareholder and regulatory approval. Additional information on the proposed transaction can be found in Sterling s public filings with the Securities and Exchange Commission at www.sec.gov.

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

STERLING FINANCIAL CORPORATION

Comparison of the Three and Nine Months Ended September 30, 2003 and 2002

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 current annual report on Form 10-K.

General

Sterling Financial Corporation is a unitary savings and loan holding company, the significant operating subsidiary of which is Sterling Savings Bank. The principal operating subsidiaries of Sterling Savings Bank are Action Mortgage Company, INTERVEST-Mortgage Investment Company and Harbor Financial Services, Inc. Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered, federally insured stock savings and loan association headquartered in Spokane, Washington.

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful philosophy. Sterling believes that this dedication to personalized service has enabled it to maintain a stable retail deposit base. With $4.08 billion in total assets at September 30, 2003, Sterling attracts Federal Deposit Insurance Corporation insured deposits from the general public through 84 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices as well as Action Mortgage residential loan production offices in the four-state area and through INTERVEST commercial real estate lending offices in Washington and Oregon. Sterling also markets tax-deferred annuities, mutual funds and other financial products through Harbor Financial and property and casualty insurance coverage through Dime Insurance Agency, a subsidiary of Sterling Savings Bank.

Sterling continues to enhance its presence as a community bank by increasing its commercial real estate, business banking, consumer and construction lending while increasing its retail deposits, particularly transaction accounts. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential loans. 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 liabilities) and other fee income will increase, although there can be no assurance in this regard. Such loans, however, generally involve a higher degree of risk than financing residential real estate. Sterling s revenues are derived primarily from interest earned on loans and asset-backed securities (ABS), from fees and service charges and from mortgage banking operations. The operations of Sterling Savings Bank, and savings institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Office of Thrift Supervision (OTS), the FDIC and the State of Washington Department of Financial Institutions (Washington Supervisor).

On February 28, 2003, Sterling acquired Empire Federal Bancorp, Inc. Empire was merged with and into Sterling, with Sterling being the surviving corporation in the merger. Sterling issued 1,401,370 shares of common stock in exchange for all of the stock of Empire. Sterling acquired approximately $143.6 million of cash, $67.3 million of loans, $184.2 million of deposits and $29.2 million of capital in the transaction. See Note 9 of Notes to Consolidated Financial Statements.

On July 15, 2003, Sterling announced that it had entered into an Agreement and Plan of Merger (the Klamath Merger) with Klamath First Bancorp, Inc., an Oregon corporation (Klamath). Klamath will be merged with and into Sterling, with Sterling being the surviving corporation in the merger. Klamath s wholly-owned subsidiary, Klamath First Federal Savings and Loan Association, will be merged with and into Sterling s wholly-owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

Under the terms of the Klamath Merger, each share of Klamath common stock will be converted into 0.77 shares of Sterling common stock subject to certain conditions. The merger will be structured as a tax-free reorganization and is expected to be completed in the first quarter of 2004, subject to shareholder and regulatory approval. Additional information on the proposed transaction can be found in Sterling s public filings with the Securities and Exchange Commission at www.sec.gov. See Note 9 of Notes to Consolidated Financial Statements.

Sterling intends to continue to pursue an aggressive growth strategy to become the leading community bank in the Pacific Northwest. This strategy may include acquiring other financial businesses or branches thereof or other substantial assets or deposit liabilities. 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 favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

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 after the loan is 90 days past due, Sterling discontinues the accrual of interest and any previously accrued interest recognized in income deemed uncollectible is reversed. Interest received on nonperforming loans is included in income only if principal recovery is reasonably assured. A nonperforming 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 collectibility of the total contractual principal and interest is no longer in doubt.

Allowance For Loan Losses. In general, determining the amount of the allowance for loan losses requires significant judgment and the use of estimates by management. Sterling maintains an allowance for loan 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 losses, levels and trends in impaired and nonperforming 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.

The amount of the allowance for the various loan types represents management s estimate of expected losses from existing loans based upon specific allocations for individual lending relationships and historical loss experience for each category of homogeneous loans. The allowance for loan losses related to impaired loans is based on discounted cash flows using the loan s initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. This evaluation requires management to make estimates of the amounts and timing of future cash flows on impaired loans, which consist primarily of non-accrual and restructured loans.

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 are based upon past loss experience, trends in losses and delinquencies, the growth of loans in particular markets and industries, and known changes in economic conditions in the particular lending markets. Allowances for homogeneous loans (such as residential mortgage loans, personal loans, etc.) are collectively evaluated based upon historical loss experience, trends in losses and delinquencies, growth of loans in particular markets, and known changes in economic conditions in each particular lending market.

There can be no assurance that the allowance for loan losses will be adequate to cover all losses, but management believes the allowance for loan losses was adequate at September 30, 2003. While management uses available information to provide for loan losses, the ultimate collectibility of a substantial portion of the loan portfolio and the need for future additions to the allowance will be based on changes in economic conditions and other relevant factors. A slowdown in economic activity could adversely affect cash flows for both commercial and individual borrowers, as a result of which Sterling could experience increases in nonperforming assets, delinquencies and losses on loans.

***Investments and ABS*.** Assets in the investment and ABS portfolios are initially recorded at cost, which includes any premiums and discounts. Sterling amortizes premiums and discounts as an adjustment to interest income using the level interest yield method 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.

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 others. 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 and the write down will be deducted from earnings under realized losses. There were no investment securities which management identified to be other-than-temporarily impaired for the nine months ended September 30, 2003. Charges to income could occur in future periods due to a change in management s intent to hold the investments to maturity, a change in management s assessment of credit risk, or a change in regulatory or accounting requirements.

***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 driven by the volume of business transacted. A decline in earnings as a result of a lack of growth or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill that could adversely impact earnings in future periods.

Sterling performed the annual test of its goodwill assets as of June 30, 2003, and concluded that the recorded value of goodwill was not impaired. There are many assumptions and estimates underlying the determination of impairment. Another estimate using different, but still reasonable, assumptions could produce a significantly different result. Additionally, future events could cause management to conclude that

Sterling s goodwill is impaired, which would result in Sterling recording an impairment loss. Any resulting impairment loss could have a material adverse impact on Sterling s financial condition and results of operations.

Other intangible assets consisting of core-deposit intangibles with definite lives are amortized over the estimated life of the acquired depositor relationships (generally eight to ten years).

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

An allowance for losses on real estate owned is designed to include amounts for estimated losses as a result of impairment in value of the real property after repossession. Sterling reviews its real estate owned for impairment in value whenever events or circumstances indicate that the carrying value of the property may not be recoverable. In performing the review, if expected future undiscounted cash flow from the use of the property or the fair value, less selling costs, from the disposition of the property is less than its carrying value, an impairment loss is recognized. As a result of changes in the real estate markets in which these properties are located, it is reasonably possible that the carrying values could be reduced in the near term.

Results of Operations

Overview. Sterling recorded net income of $8.6 million, or $0.57 per diluted share, for the three months ended September 30, 2003, compared with net income of $6.6 million, or $0.49 per diluted share, for the three months ended September 30, 2002. Sterling recorded net income of $25.9 million, or $1.75 per diluted share for the nine months ended September 30, 2003, compared with $17.9 million, or $1.34 per diluted share. The increase in net income for both periods reflected an increase in net interest income and other income.

The annualized return on average assets was 0.83% and 0.82% for the three months ended September 30, 2003 and 2002, respectively. For the nine months ended September 30, 2003 and 2002, the annualized return on average assets was 0.89% and 0.77%, respectively. The annualized return on average equity was 13.6% and 13.8% for the three months ended September 30, 2003 and 2002, respectively. The decrease primarily reflected a higher balance of average shareholders equity relative to last years comparable period. The annualized return on average equity was 14.5% and 13.4% for the nine months ended September 30, 2003 and 2002, respectively. The increase in the ratio was primarily due to the increase in net income.

Net Interest Income. The most significant component of earnings for a financial institution typically is NII, which is the difference between interest income, primarily from loan, ABS and investment portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended September 30, 2003 and 2002, NII was $32.3 million and $25.9 million, respectively, an increase of approximately 25%. For the nine months ended September 30, 2003 and 2002, NII was $90.9 million and $72.6 million, an increase of approximately 25%. The increases in NII during the three and nine months ended September 30, 2003, compared to the same periods in 2002, were primarily due to the increases in average loan and ABS volumes and a decrease in the cost of deposits and borrowings.

Changes in NII result from changes in volume, net interest spread and net interest margin. Volume refers to the dollar level of interest-earning assets and interest-bearing liabilities. Net interest spread refers to the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Net interest margin refers to NII divided by total interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

Average interest-earning assets for the three months ended September 30, 2003 and 2002 were $3.88 billion and $2.98 billion, respectively. Average loans increased by $561.9 million, while average investments and ABS increased by $337.5 million over the 2002 amounts. Net interest spread during these periods was 3.26% and 3.44%, respectively. The net interest margin for the three months ended September 30, 2003 and 2002 was 3.31% and 3.44%, respectively. The decrease in net interest margin reflects the decrease in prevailing interest rates and a greater decrease in the yield on loans than in the cost of deposits. Sterling has been asset sensitive during these periods. Net interest spread decreased primarily because the yield on loans declined slightly more than the cost of deposits, reflecting continued refinancing activity in the residential and commercial real estate portfolios and competition for deposits.

Average interest-earning assets for the nine months ended September 30, 2003 and 2002 were $3.66 billion and $2.90 billion, respectively. Average loans increased by $470.8 million, while average investments and ABS increased by $291.2 million over the prior comparable period. The net interest spread for the nine months ended September 30, 2003 and 2002 was 3.28% and 3.35%, respectively, while the net interest margin for the same periods was 3.32% and 3.35%, respectively. Net interest spread decreased due to a greater decrease in the yields on average interest-earning assets relative to the cost of funds, also reflecting continued refinancing activity. However, the increase in the average volume of loans and ABS offset this, generating the increase in NII.

Provision for Losses on Loans. 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, trends in classified assets, trends in delinquency and nonaccrual loans, trends in portfolio volume, diversification as to type of loan, size of individual credit exposure, current and anticipated economic conditions, 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 $2.9 million and $3.3 million for the three months ended September 30, 2003 and 2002, respectively. Sterling recorded provisions for losses on loans of $7.7 million and $7.6 million for the nine months ended September 30, 2003 and 2002, respectively. The current provision reflects the analysis and assessment of the relevant factors mentioned in the preceding paragraph. Management anticipates that its provisions for losses on loans will continue to increase, reflecting Sterling s strategic direction of originating more commercial real estate, construction, business banking and consumer loans which have a somewhat higher loss profile than the traditional thrift institution mix of loans.

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

	Nine Months Ended September 30,			
	2003		2002	
	(Dollars in thousands)			
Balance at January 1	$	27,866	$	20,599
Allowance for loan losses acquired		869		0
Provision for losses on loans		7,650		7,590
Amounts written off net of recoveries and other		(2,644)		(4,074)
Balance at September 30	$	33,741	$	24,115

At September 30, 2003, Sterling s total classified assets were $69.3 million, compared with $72.3 million at September 30, 2002. Total nonperforming assets were $25.5 million at September 30, 2003, compared with $25.9 million at September 30, 2002. The decrease in nonperforming assets and classified assets was primarily attributable to an improvement in the status of certain income property loans. Excluding the nonperforming assets acquired from Empire and the increase in nonperforming assets of Source since the acquisition date, nonperforming assets would have been $17.5 million or 0.43% of total assets. At September 30, 2003, Sterling s loan delinquency rate (60 days or more) as a percentage of total loans was 0.87%, compared with 0.82% at September 30, 2002. Excluding delinquent loans from Empire and Source, the delinquency ratio at September 30, 2003 would have been 0.64%, compared with 0.53% at September 30, 2002.

Other Income. Other income was $8.4 million and $8.1 million for the three months ended September 30, 2003 and 2002, respectively. Other income was $25.2 million and $20.6 million for the nine months ended September 30, 2003 and 2002, respectively. The increase for the three and nine months ended September 30, 2003, compared with the three and nine months ended September 30, 2002 was primarily due to an increase in income from mortgage banking operations and increases in fees and service charges.

Fees and service charge income increased by 16% to $5.1 million for the three months ended September 30, 2003 from $4.4 million for the same period last year. For the nine months ended September 30, 2003 and 2002, fees and service charge income also increased by 16% to $14.3 million from $12.3 million for the same period last year. This increase primarily reflects the increase in corporate banking activities that generate transaction accounts. The number of business checking accounts have increased year over year, along with a wider range of business services being offered for a fee.

The increase in income from mortgage banking operations for the three and nine months ended September 30, 2003 compared to the same periods in 2002, was primarily due to increased refinancing activity and loan sales, reflecting the low interest rate environment. The following table summarizes loan originations and sales of loans and serviced mortgage loans for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
	(Dollars in millions)			
Originations of one- to four-family permanent mortgage loans	$ 146.9	$ 87.6	$ 425.6	$ 203.7
Sales of residential loans	129.5	49.3	317.7	121.7
Sales of commercial real estate loans	11.2	0.0	33.3	59.5
Principal balances of residential loans serviced for others at period end	300.9	94.3	300.9	94.3
Principal balances of commercial real estate loans serviced for others at period end	155.8	271.5	155.8	271.5

As a normal part of its operations, Action Mortgage incurs interest rate risk from the date it closes a loan to the date the loan is sold in the secondary market. Additionally, Action Mortgage incurs interest rate risk from the date it commits to make a loan to the date the loan closes in those cases where it sells a rate lock to the prospective borrower. Traditionally, Action Mortgage has endeavored to hedge interest rate risk by entering into best-efforts forward sales agreements with third parties. In July 2003, in an effort to improve the spread on loans sold into the secondary market, Action Mortgage also began hedging interest rate risk by entering into mandatory forward sales agreements on ABS with third parties.

The risks inherent in such mandatory forward sales agreements include the risk that, if for any reason Action Mortgage does not close and sell the loans in question, it is nonetheless obligated to deliver ABS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement ABS and such costs could have a material adverse impact on mortgage banking operations in future periods, especially in rising interest rate environments.

During the quarter ended September 30, 2003, Sterling Savings Bank sold $37.2 million in investments and ABS, compared with $141.8 million for the quarter ended September 30, 2002. Sterling recognized a net loss of $0.3 million during the quarter ended September 30, 2003, compared to a net gain of $1.4 million for the same period last year. During the nine months ended September 30, 2003, Sterling sold $626.0 million in investments and ABS compared with $373.4 million for the same period in 2002. Sterling recognized a net gain of

$2.7 million for the nine months ended September 30, 2003, compared with $1.8 million for the nine months ended September 30, 2002. The increase in sales of investments and ABS for the nine-month period compared to the prior years comparable period reflected an acceleration of the maturity structure of the portfolio.

Operating Expenses. Operating expenses were $24.7 million and $21.1 million for the three months ended September 30, 2003 and 2002, respectively. Operating expenses were $68.7 million and $60.5 million for the nine months ended September 30, 2003 and 2002, respectively. The higher level of operating expenses was primarily a result of expanded staffing in Sterling s branch delivery network, occupancy costs and advertising.

Employee compensation and benefits were $13.7 million and $11.1 million for the three months ended September 30, 2003 and 2002, respectively. Employee compensation and benefits were $37.6 million and $32.1 million for the nine months ended September 30, 2003 and 2002, respectively. The employee costs reflected increased staffing from Empire, increased mortgage banking staff and additional staff for Sterling s Seattle and Portland Corporate Banking Centers. In addition, Sterling has begun hiring loan officers in anticipation of the pending merger with Klamath. At September 30, 2003, full-time-equivalent employees were 1,104, compared with 940 at September 30, 2002.

Occupancy and equipment expenses were $3.6 million and $3.2 million for the three months ended September 30, 2003 and 2002, respectively. Occupancy and equipment expenses were $10.8 million and $9.3 million for the nine months ended September 30, 2003 and 2002, respectively. The increase was primarily due to expenses associated with the Portland and Seattle Corporate Banking Centers, the new Empire branches, expanded mortgage banking branches and higher equipment costs.

Advertising expenses were $1.7 million and $1.6 million for the three months ended September 30, 2003 and 2002, respectively. Advertising expenses were $3.7 million and $3.1 million for the nine months ended September 30, 2003 and 2002, respectively. The increase was primarily due to an increase in costs associated with Sterling s new image campaign, partially influenced by the pending merger with Klamath.

Other operating expenses were $0.6 million and $1.2 million for the three months ended September 30, 2003 and 2002, respectively. Other operating expenses were $2.7 million and $3.4 million for the nine months ended September 30, 2003 and 2002, respectively. The decrease in other operating expenses was the result of a refund of state excise taxes.

Income Tax Provision. Sterling recorded federal and state income tax provisions of $4.6 million and $2.9 million for the three months ended September 30, 2003 and 2002, respectively. For the nine months ended September 30, 2003 and 2002, Sterling recorded federal and state income tax provisions of $13.9 million and $7.2 million, respectively. The income tax provisions in 2003 reflect an increase in taxable earnings. The effective tax rates for these periods were 34.8%, 30.5%, 34.9% and 28.6%, respectively. The increase in the effective tax rates compared to the September 30, 2002 periods was primarily due to the effect of a lower portion of tax-preferred income in income before taxes.

Financial Position

Assets. At September 30, 2003, Sterling s assets were $4.08 billion, up $0.57 billion from $3.51 billion at December 31, 2002.

Investments and ABS. Sterling s investment and ABS portfolio at September 30, 2003 was $1.01 billion, an increase of $179.8 million from the December 31, 2002 balance of $830.2 million. The increase was primarily due to net purchases of ABS.

Loans Receivable. At September 30, 2003, net loans receivable were $2.76 billion, up $370 million from $2.39 billion at December 31, 2002. The increase was primarily due to $67.3 million in loans from the Empire transaction, as well as net increases in business and private banking, corporate banking, and residential construction loans. During the nine months ended September 30, 2003, total loan originations were $1.74 billion compared with $1.28 billion for the prior year s comparable quarter. Approximately 67% of these were construction, business banking, corporate banking and consumer loans.

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

	September 30, 2003		December 31, 2002	
	Amount	%	Amount	%
	(Dollars in thousands)			
Residential real estate	$ 377,459	13.47	$ 358,359	14.78
Multifamily real estate	161,830	5.78	161,547	6.66
Commercial real estate	478,386	17.07	458,712	18.92
Real estate construction	549,641	19.62	480,919	19.84
Consumer - direct	294,520	10.51	246,578	10.17
Consumer - indirect	91,488	3.27	62,896	2.59
Business and private banking	681,586	24.32	549,593	22.67
Corporate banking	167,123	5.96	105,975	4.37
Gross loans receivable	2,802,033	100.00	2,424,579	100.00
Net deferred origination fees	(7,118)		(6,450)	
Allowance for losses on loans	(33,741)		(27,866)	
Loans receivable, net	$ 2,761,174		$ 2,390,263	
Weighted average yield at end of period	5.86%		6.38%	

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2003	2002	% Change	2003	2002	% Change
	(Dollars in thousands)					
Residential real estate	$ 146,908	$ 87,556	67.8	$ 425,601	$ 203,684	109.0
Multifamily real estate	23,693	14,929	58.7	54,135	32,737	65.4
Commercial real estate	12,435	15,167	(18.0)	97,838	46,892	108.7
Real estate construction	218,072	169,567	28.6	542,363	455,260	19.1
Consumer - direct	69,127	30,593	126.0	163,067	106,573	53.0
Consumer - indirect	24,081	17,059	41.2	53,943	50,345	7.2
Business and private banking	93,014	116,464	(20.1)	290,457	291,719	(0.4)
Corporate banking	16,055	24,318	(34.0)	114,685	92,681	23.7
Total loans originated	$ 603,385	$ 475,653	26.9	$ 1,742,089	$ 1,279,891	36.1

BOLI. Bank-owned life insurance (BOLI) increased to $72.2 million at September 30, 2003 from $59.4 million at

December 31, 2002. The increase was primarily due to the purchase of $10.0 million in BOLI. Sterling purchases BOLI to fund employee benefit costs. Through the purchase of BOLI, Sterling becomes the beneficiary of life insurance policies on certain officers who consent to the issuance of the policies.

Goodwill and Other Intangible Assets. Goodwill and other intangible assets increased to $48.0 million at September 30, 2003 from $44.0 million at December 31, 2002. Sterling recorded $1.0 million in goodwill and $3.1 million in other intangible assets in connection with the business combination with Empire.

Deposits. Total deposits increased $406.9 million to $2.42 billion at September 30, 2003 from $2.01 billion at December 31, 2002, primarily due to the acquisition of $184.2 million in deposits from Empire and to increases in money market accounts and time deposits.

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

	September 30, 2003		December 31, 2002	
	Amount	%	Amount	%
	(Dollars in thousands)			
Noninterest checking	$ 315,235	13.0	$ 239,033	11.9
NOW checking	306,622	12.7	367,391	18.2
Savings and money market	641,771	26.5	401,339	19.9
Certificates of deposit	1,157,415	47.8	1,006,333	50.0
Total deposits	$ 2,421,043	100.0	$ 2,014,096	100.0
Annualized cost of deposits		1.53%		1.91%

The shift in the mix of deposits since December 2002 reflects a shift to money market accounts from NOW checking accounts and a strong increase in new business checking deposits. As of September 30, 2003, the number of business checking accounts has increased by approximately 10% from a year ago.

Borrowings. Deposit accounts are Sterling s primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank of Seattle (FHLB Seattle), reverse repurchase agreements and other borrowings to supplement its funding and to meet deposit withdrawal requirements. At September 30, 2003, the total of such borrowings was $1.36 billion compared with $1.25 billion at December 31, 2002. See Liquidity and Sources of Funds.

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. Like all savings institutions, Sterling s NII and the net present value of assets, liabilities and off-balance sheet contracts (NPV), or estimated fair value, are subject to fluctuations in interest rates. For example, some of Sterling s adjustable-rate mortgages (ARMs) are indexed to the one-year or five-year U.S. Treasury index or periodic fixed-rate LIBOR and swaps curves. When interest-earning assets such as loans are funded by interest-bearing liabilities such as deposits, FHLB Seattle advances and other borrowings, a changing interest rate environment may have a dramatic effect on Sterling s earnings. Currently, Sterling s interest-earning assets mature or reprice more frequently, or on different terms, than do its interest-bearing liabilities. The fact that assets mature or reprice more frequently on average than liabilities may be beneficial in times of increasing interest rates; however, such an asset/liability structure may result in declining NII during periods of falling interest rates.

Additionally, the extent to which borrowers prepay loans is affected by prevailing interest rates. When interest rates increase, borrowers are less likely to prepay loans; whereas when interest rates decrease, borrowers are more likely to prepay loans. Prepayments may affect the levels of loans retained in an institution s portfolio as well as its NII.

Sterling maintains an asset and liability management program intended to manage NII through interest rate cycles and to protect its NPV by controlling its exposure to changing interest rates. Sterling uses a simulation model designed to measure the sensitivity of NII and NPV to changes in interest rates. This simulation model is designed to enable Sterling to generate a forecast of NII and NPV given various interest rate forecasts and alternative strategies. The model is also designed to measure the anticipated impact that prepayment risk, basis risk, customer maturity preferences, volumes of new business and changes in the relationship between long-term and short-term interest rates have on the performance of Sterling. The model calculates the present value of assets, liabilities, off-balance sheet financial instruments, and equity at current interest rates and at hypothetical higher and lower interest rates at various intervals. The present value of each major category of financial instruments is calculated using estimated cash flows based on weighted-average contractual rates and terms, then discounted at the estimated current market interest rate for similar financial instruments. The present value of longer term fixed-rate financial instruments is more difficult to estimate because such instruments are susceptible to changes in market interest rates. Present value estimates of adjustable-rate financial instruments are more reliable since they represent the difference between the contractual and discounted rates until the next interest rate repricing date.

The calculations of present value have certain shortcomings. The discount rates utilized for loans, investments and ABS are based on estimated nationwide market interest rate levels for similar loans and securities, with prepayment assumptions based on historical experience and market forecasts. The unique characteristics of Sterling s loans and ABS may not necessarily parallel those in the model. The discount rates utilized for deposits and borrowings are based upon available alternative types and sources of funds which are not necessarily indicative of the market value of deposits and FHLB Seattle advances since such deposits and advances are unique to and have certain price and customer relationship advantages for depository institutions. The present values are determined based on the discounted cash flows over the remaining estimated lives of the financial instruments on the assumption that the resulting cash flows are reinvested in financial instruments with virtually identical terms.

The total measurement of Sterling s exposure to interest-rate risk (IRR) as presented in the following table may not be representative of the actual values which might result from a higher or lower interest rate environment. A higher or lower interest rate environment most likely will result in different investment and borrowing strategies by Sterling designed to further mitigate the effect on the value of and the net earnings generated from Sterling s net assets from any change in interest rates.

Sterling is continuing to pursue strategies to manage the level of its IRR while increasing its NII and NPV: a) through the origination and retention of variable-rate consumer, business banking, construction and commercial real estate loans, which generally have higher yields than residential permanent loans, b) by the sale of certain long-term fixed-rate loans and investments, and c) by increasing the level of its core deposits, which are generally a lower-cost funding source than wholesale borrowings. There can be no assurance that Sterling will be successful implementing any of these strategies or that, if these strategies are implemented, they will have the intended effect of reducing IRR or increasing NII and NPV.

The following table presents Sterling s estimates of changes in NPV for the periods indicated. The results indicate the potential effects of instantaneous, parallel shifts in the market yield curve. These calculations are highly subjective and technical and are relative measurements of IRR which do not necessarily reflect any expected rate movement.

	At September 30, 2003			At December 31, 2002		
Change in Interest Rate in Basis Points (Rate Shock)	**NPV**	**Ratio of NPV to the Present Value of Total Assets**	**% Change in NPV**	**NPV**	**Ratio of NPV to the Present Value of Total Assets**	**% Change in NPV**
			(Dollars in thousands)			
+300	$ 205,659	5.10%	(23.7)	$ 223,622	6.36%	4.8
+200	230,881	5.66	(14.4)	229,759	6.53	7.6
+100	251,535	6.09	(6.7)	234,577	6.67	9.9
Static	269,613	6.44	0	213,442	6.07	0
-100	216,517	5.19	(19.7)	164,741	4.68	(22.8)
-200	N/A(1)	N/A(1)	N/A(1)	N/A(1)	N/A(1)	N/A(1)
-300	N/A(1)	N/A(1)	N/A(1)	N/A(1)	N/A(1)	N/A(1)

(1) In low interest rate environments, the calculations are not meaningful.

Sterling also uses gap analysis, a traditional analytical tool designed to measure the difference between the amount of interest-earning assets and the amount of interest-bearing liabilities expected to mature or reprice in a given period. Sterling calculated its one-year cumulative gap position to be a positive 1.1% and a positive 5.8% at September 30, 2003 and December 31, 2002, respectively. Sterling calculated its three-year cumulative gap position to be a positive 1.1% and a positive 2.8% at September 30, 2003 and December 31, 2002, respectively. The decrease in the positive readings at the one- and three-year gap positions were primarily due to a shortening of the maturities of certain borrowings impacted by the current interest rate environment. Management attempts to maintain Sterling s gap position between positive 10% and negative 25%. At September 30, 2003, Sterling s gap positions were within limits established by its Board of Directors. Management is pursuing strategies to increase its NII without significantly increasing its cumulative gap positions in future periods. There can be no assurance that Sterling will be successful implementing these strategies or that, if these strategies are implemented, they will have the intended effect of increasing its NII. See Results of Operations *Net Interest Income* and Capital Resources.

Liquidity and Sources of Funds

As a financial institution, Sterling s primary sources of funds are investing and financing activities, including the collection of loan principal and interest payments. Financing activities consist primarily of customer deposits, advances from FHLB Seattle and other borrowings. Deposits increased to $2.42 billion at September 30, 2003 from $2.01 billion at December 31, 2002, primarily due to the acquisition of $184.2 million in deposits from Empire and to an increase in money market accounts and certificates of deposit. The net increase in deposits was primarily used to fund loans, purchase ABS and pay down other borrowings. At September 30, 2003 and December 31, 2002, securities sold subject to repurchase agreements were $259.1 million and $249.8 million, respectively. These borrowings are required to be collateralized by investments and ABS with a market value exceeding the face value of the borrowings. Under certain circumstances, Sterling could be required to pledge additional securities or reduce the borrowings.

During the nine months ended September 30, 2003, cash used in investing activities consisted primarily of the funding of loans and the purchase of ABS. The levels of these payments increase or decrease depending on the size of the loan and ABS portfolios and the general trend and level of interest rates, which influences the level of refinancing and mortgage prepayments. During the same period, cash provided by investing activities consisted primarily of principal payments on loans, proceeds from sales of ABS, principal payments on ABS and cash acquired from the Empire transaction. During the nine months ended September 30, 2003, cash provided by operating activities consisted primarily of proceeds from sales of loans.

Sterling Savings Bank s credit line with FHLB Seattle provides for borrowings up to a percentage of its total assets subject to collateralization requirements. At September 30, 2003, this credit line represented a total borrowing capacity of $1.23 billion, of which $160.2 million was available. Sterling Savings Bank also borrows on a secured basis from major broker/dealers and financial entities by selling securities subject to repurchase agreements. At September 30, 2003, Sterling Savings Bank had $259.1 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately $107.3 million.

Sterling, on a parent company-only basis, had cash and other resources of approximately $27.4 million and a revolving line of credit from U.S. Bank of $5.0 million at September 30, 2003 with no funds drawn on this line of credit. This line of credit as well as a $22.0 million term note are secured by a majority of the Common and Preferred Stock of Sterling Savings Bank. See Note 2 of Notes to Consolidated Financial Statements.

At September 30, 2003 and December 31, 2002, Sterling had an investment of $110.1 million in the Preferred Stock of Sterling Savings Bank. At September 30, 2003 and December 31, 2002, Sterling had an investment in the Common Stock of Sterling Savings Bank of $132.5 million and $106.2 million, respectively. Sterling received cash dividends on Sterling Savings Bank Preferred Stock of $8.7 million during the nine months ended September 30, 2003. These resources were sufficient to meet the operating needs of Sterling, including interest expense on its long-term debt. Sterling Savings Bank s ability to pay dividends is limited by its earnings, financial condition and capital requirements, as well as rules and regulations imposed by the OTS. See Note 2 of Notes to Consolidated Financial Statements.

Sterling Savings Bank actively manages its 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, savings flows and loan funding needs.

Capital Resources

Sterling s total shareholders equity was $248.9 million at September 30, 2003 compared with $203.7 million at December 31, 2002. The increase in total shareholders equity was primarily due to the business combination with Empire and the increase in net income. Shareholders equity was 6.1% of total assets at September 30, 2003 compared with 5.8% at December 31, 2002.

Sterling has outstanding various series of Trust Preferred Securities issued to investors. For a complete description, see Note 2 of Notes to Consolidated Financial Statements.

At September 30, 2003, Sterling had an unrealized loss of $7.3 million, net of related income taxes, on investments and ABS classified as available for sale. At December 31, 2002, Sterling had an unrealized gain of $3.4 million, net of related income taxes, on investments and ABS classified as available for sale. The change since December 31, 2002 primarily reflects sales of ABS and the recent upward trend in interest rates at the end of the quarter. Fluctuations in prevailing interest rates 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.

Sterling Savings Bank is required by applicable regulations to maintain certain minimum capital levels with respect to core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital. Sterling Savings Bank will endeavor to enhance its capital resources and regulatory capital ratios through the retention of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At September 30, 2003, Sterling Savings Bank exceeded all such regulatory capital requirements and was well-capitalized pursuant to OTS regulations.

The following tables set forth Sterling Savings Bank s core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital positions as reported on the quarterly Thrift Financial Report at September 30, 2003.

	Minimum Capital Requirements		Well-Capitalized Requirements		Actual	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)			
Total risk-based capital (to risk-weighted assets)	$ 242,616	8.00%	$ 303,269	10.00%	$ 337,478	11.03%
Core (Tier 1) risk-based capital (to risk-weighted assets)	121,308	4.00	181,962	6.00	306,797	10.12
Core (Tier 1) capital (to adjusted assets)	161,378	4.00	201,722	5.00	307,593	7.62

Goodwill Litigation

In contracts made in connection with Sterling Savings Bank s acquisition of three insolvent savings institutions between 1985 and 1988, the U.S. government agreed that Sterling could use $38.0 million of supervisory goodwill associated with the acquisitions to help meet its regulatory capital requirements. In 1989, Congress enacted FIRREA which provided, among other things, that savings institutions such as Sterling Savings Bank were no longer permitted to include supervisory goodwill in their regulatory capital. Consequently, Sterling Savings Bank was required to discontinue use of its supervisory goodwill in calculating its capital ratios, which resulted in Sterling Savings Bank s failing to comply with its minimum regulatory capital requirements from 1989 through 1991.

In May 1990, Sterling sued the U.S. Government with respect to the loss of the goodwill treatment and other matters relating to Sterling s past acquisitions of troubled thrift institutions (the Goodwill Litigation). In the Goodwill Litigation, Sterling seeks damages for, among other things, breach of contract and for deprivation of property without just compensation.

In September 2002, the U.S. Court of Federal Claims granted Sterling Savings Bank s motion for summary judgment as to liability on its contract claim, holding that the United States government owed contractual obligations to Sterling with respect to its acquisition of three failing regional thrifts during the 1980 s and had breached its contracts with Sterling. Sterling is waiting for a trial date to be set to determine what amount, if any, the government must pay in damages for its breach. The timing and ultimate outcome of the Goodwill Litigation cannot be predicted with certainty. Because of the effort required to bring the case to conclusion, Sterling likely will continue to incur legal expenses at recent levels over the next one to two years.

New Accounting Policies

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for all contracts created or modified after June 30, 2003 except for hedging relationships designated after June 30, 2003. In addition, except as stated below, all provisions of SFAS No. 149 should be applied prospectively. Sterling does not believe that the adoption of this standard will have a material effect on Sterling s consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity SFAS No. 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 is effective for financial instruments other than minority interests entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after

June 15, 2003. Sterling does not believe that the adoption of SFAS No. 150 will have a material effect on Sterling s consolidated financial statements.

Regulation and Compliance

Sterling is subject to many laws and regulations applicable to banking activities. As a thrift holding company, Sterling is subject to comprehensive examination and regulation by the OTS. Sterling Savings Bank, as a Washington State-chartered savings association, is subject to comprehensive regulation and examination by the Washington Supervisor as its chartering authority, the OTS as its primary federal regulator, and by the FDIC, which administers the Savings Association Insurance Fund, which insures Sterling Savings Bank s deposits to the maximum extent permitted by law. Sterling Savings Bank is a member of FHLB Seattle, which is one of the twelve regional banks which comprise the FHLB System. Sterling Savings Bank is further subject to regulations of the Board of Governors of the Federal Reserve System governing reserves required to be maintained against deposits and certain other matters.

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 are contained in this report and may be contained 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, belie anticipate, estimate, seek, expect, intend, plan and similar expressions.

Forward-looking statements provide our expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond our control, 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:

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

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

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

applicable laws and regulations and legislative or regulatory changes;

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

changes in consumer spending and saving habits; 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 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.

PART II - Other Information

Item 1 - Legal Proceedings

Periodically various claims and lawsuits are brought against Sterling and its subsidiaries, such as claims to enforce liens, condemnation proceedings involving properties on which Sterling holds security interests, claims involving the making and servicing of real property loans and other issues incidental to Sterling s business. No material loss is expected from any of such pending claims or lawsuits.

Item 2 - Changes in 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 and Reports on Form 8-K**

(a)

Exhibit No.	Exhibit
3.1	Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling s report on Form 10-Q dated May 15, 2003 and incorporated by reference herein.
3.2	Amended and Restated Bylaws of Sterling. Filed as Exhibit 3.3 to Sterling s Registration Statement on Form S-4 dated December 9, 2002 and incorporated by reference herein.
4.1	Reference is made to Exhibits 3.1 and 3.2.
4.2	The Registrant has outstanding certain long-term debt. None of such debt exceeds ten percent of Registrant 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 Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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.

(b) Reports on Form 8-K. During the quarter ended September 30, 2003, there were 3 reports filed on Form 8-K.

On July 15, 2003, Sterling filed a report on Form 8-K containing an Agreement and Plan of Merger dated July 14, 2003 by and among Sterling and Klamath. Also included as Exhibits were a joint press release and a slide presentation related to the Agreement and Plan of Merger.

On July 22, 2003, Sterling filed a report on Form 8-K containing a press release announcing results of operations for the second quarter of 2003.

On September 9, 2003, Sterling filed a report on Form 8-K containing a press release announcing the realignment of executive management at Sterling Savings Bank.

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)

November 14, 2003 Date	By:	/s/ Daniel G. Byrne **Daniel G. Byrne** Senior Vice President Finance, Assistant Secretary, and Principal Financial Officer
November 14, 2003 Date	By:	/s/ William R. Basom **William R. Basom** Vice President, Treasurer, and Principal Accounting Officer