

STERLING FINANCIAL CORP /WA/

Form 10-Q

May 09, 2007

**Table of Contents**

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

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007  
OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.  
Commission File Number 0-20800  
STERLING FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)**

Washington  
(State or other jurisdiction of  
incorporation or organization)

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

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

99201  
(Zip Code)

(509) 458-3711

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated Filer  Non-accelerated filer

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

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

Class  
Common Stock (\$1.00 par value)

Outstanding as of May 1, 2007  
51,265,711

**STERLING FINANCIAL CORPORATION**  
**FORM 10-Q**  
**For the Quarter Ended March 31, 2007**  
**TABLE OF CONTENTS**

	Page
<u>PART I Financial Information</u>	1
<u>Item 1 Financial Statements (Unaudited)</u>	1
<u>Consolidated Balance Sheets</u>	1
<u>Consolidated Statements of Income</u>	2
<u>Consolidated Statements of Cash Flows</u>	3
<u>Consolidated Statements of Comprehensive Income</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
<u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>	31
<u>Item 4 Controls and Procedures</u>	31
<u>PART II Other Information</u>	32
<u>Item 1 Legal Proceedings</u>	32
<u>Item 1a Risk Factors</u>	32
<u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
<u>Item 3 Defaults Upon Senior Securities</u>	32
<u>Item 4 Submission of Matters to a Vote of Security Holders</u>	33
<u>Item 5 Other Information</u>	33
<u>Item 6 Exhibits</u>	33
<u>Signatures</u>	34
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

---

**Table of Contents**

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

	March 31, 2007	December 31, 2006
(Dollars in thousands)		
<b>ASSETS:</b>		
Cash and cash equivalents:		
Interest bearing	\$ 57,481	\$ 13,846
Non-interest bearing and vault	159,193	164,719
<b>Total cash and cash equivalents</b>	<b>216,674</b>	<b>178,565</b>
Restricted cash	1,150	1,150
Investment securities and mortgage-backed securities ( MBS ):		
Available for sale	1,782,947	1,820,583
Held to maturity	101,150	93,063
Loans receivable, net	8,370,625	7,021,241
Loans held for sale	71,446	91,469
Accrued interest receivable	60,504	55,519
Real estate owned and other collateralized assets, net	4,076	4,052
Office properties and equipment, net	97,629	93,796
Bank-owned life insurance ( BOLI )	145,182	139,206
Goodwill	452,540	247,244
Other intangible assets	35,304	28,570
Mortgage servicing rights, net	10,537	7,335
Prepaid expenses and other assets, net	49,857	52,699
<b>Total assets</b>	<b>\$ 11,399,621</b>	<b>\$ 9,834,492</b>
<b>LIABILITIES:</b>		
Deposits	\$ 7,574,058	\$ 6,746,028
Advances from Federal Home Loan Bank ( FHLB )	1,605,060	1,308,617
Securities sold subject to repurchase agreements and funds purchased	707,733	616,354
Other borrowings	252,230	240,226
Cashiers checks issued and payable	7,595	18,144
Borrowers reserves for taxes and insurance	2,818	2,348
Accrued interest payable	41,702	39,863
Accrued expenses and other liabilities	94,696	79,496
<b>Total liabilities</b>	<b>10,285,892</b>	<b>9,051,076</b>

Commitments and Contingencies

SHAREHOLDERS EQUITY:

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

Preferred stock, \$1 par value; 10,000,000 shares authorized; no shares issued and outstanding	0	0
Common stock, \$1 par value; 60,000,000 shares authorized; 51,245,273 and 42,042,740 shares issued and outstanding	51,245	42,043
Additional paid-in capital	887,961	590,218
Accumulated other comprehensive loss:		
Unrealized losses on investment securities and MBS available-for-sale, net of deferred income taxes of \$16,861 and \$19,531	(28,795)	(33,350)
Retained earnings	203,318	184,505
Total shareholders' equity	1,113,729	783,416
Total liabilities and shareholders' equity	\$ 11,399,621	\$ 9,834,492

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

**Table of Contents**

**STERLING FINANCIAL CORPORATION**  
**Consolidated Statements of Income**  
**(Unaudited)**

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands, except per share data)	
Interest income:		
Loans	\$ 152,763	\$ 92,111
MBS	20,468	23,345
Investments and cash equivalents	1,671	723
 Total interest income	 174,902	 116,179
 Interest expense:		
Deposits	63,720	34,810
Short-term borrowings	9,675	6,365
Long-term borrowings	20,891	16,048
 Total interest expense	 94,286	 57,223
 Net interest income	 80,616	 58,956
Provision for losses on loans	(4,225)	(4,650)
 Net interest income after provision for losses on loans	 76,391	 54,306
 Non-interest income:		
Fees and service charges	12,192	9,079
Mortgage banking operations	8,858	2,271
Loan servicing fees	683	269
Real estate owned and other collateralized assets operations	(45)	307
BOLI	1,547	1,183
Other non-interest expense	213	(192)
 Total non-interest income	 23,448	 12,917
 Non-interest expenses	 65,669	 44,240
 Income before income taxes	 34,170	 22,983
Income tax provision	(11,249)	(7,567)
 Net income	 \$ 22,921	 \$ 15,416

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

Earnings per share	basic	\$	0.51	\$	0.44
Earnings per share	diluted	\$	0.50	\$	0.44
Weighted average shares outstanding	basic		45,238,924		34,946,649
Weighted average shares outstanding	diluted		45,833,530		35,255,602

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

2

---

**Table of Contents**

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Cash flows from operating activities:		
Net income	\$ 22,921	\$ 15,416
Adjustments to reconcile net income to net cash provided by operating activities:		
Provisions for losses on loans and real estate owned	4,225	4,670
Accretion of deferred gain on sale of branches	(175)	0
Net gain on sales of loans, investment securities and MBS	(5,340)	(591)
Stock based compensation	250	0
Excess tax benefit from stock based compensation	(933)	0
Stock issuances relating to 401(k) match	607	820
Other gains and losses	262	(15)
Increase in cash surrender value of BOLI	(1,547)	(1,183)
Depreciation and amortization	5,597	4,586
Change in:		
Accrued interest receivable	2,055	(1,157)
Prepaid expenses and other assets	1,092	3,367
Cashiers checks issued and payable	(15,248)	1,216
Accrued interest payable	1,706	5,367
Accrued expenses and other liabilities	3,937	(2,278)
Proceeds from sales of loans originated for sale	312,381	31,376
Loans originated for sale	(308,199)	(30,785)
Net cash provided by operating activities	23,591	30,809
Cash flows from investing activities:		
Change in restricted cash	0	(105)
Loans funded and purchased	(1,084,329)	(1,013,695)
Loan principal received	910,602	638,276
Proceeds from sales of other loans	72,613	0
Purchase of investment securities	(21,952)	(12,359)
Proceeds from maturities of investment securities	19,060	647
Net cash and cash equivalents acquired	92,419	0
Principal payments on mortgage-backed securities	60,427	68,028
Purchase of office properties and equipment	(2,990)	(3,664)
Sales of office properties and equipment	1,588	77
Improvements and other changes to real estate owned	(101)	(229)
Proceeds from sales and liquidation of real estate owned	77	371
Net cash provided by (used in) investing activities	47,414	(322,653)

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

**Table of Contents**

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Cash flows from financing activities:		
Net change in transaction and savings deposits	\$ 93,863	\$ 63,201
Proceeds from issuance of time deposits	637,875	883,864
Payments for maturing time deposits	(952,966)	(697,332)
Interest credited to deposits	54,604	29,268
Advances from FHLB	557,744	573,747
Repayment of advances from FHLB	(528,046)	(646,036)
Net change in securities sold subject to repurchase agreements and funds purchased	91,379	48,744
Net proceeds from other borrowings	12,000	20,000
Proceeds from stock purchases	2,401	2,838
Excess tax benefit from stock based compensation	933	0
Cash dividends paid to shareholders	(3,153)	(1,917)
Other	470	915
 Net cash provided by (used in) financing activities	 (32,896)	 277,292
 Net change in cash and cash equivalents	 38,109	 (14,552)
Cash and cash equivalents, beginning of period	178,565	131,307
 Cash and cash equivalents, end of period	 \$ 216,674	 \$ 116,755
 Supplemental disclosures:		
Cash paid during the period for:		
Interest	\$ 90,607	\$ 51,855
Income taxes	1,243	0
 Noncash financing and investing activities:		
Loans converted into real estate owned and other collateralized assets	0	4,227
Common stock issued upon business combination	302,754	0
Common stock cash dividends accrued	4,108	2,106
Deferred gain on sale of branches	266	0
Modification of purchase price allocation	2,344	0
The accompanying notes are an integral part of the consolidated financial statements.		

**Table of Contents**

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Net income	\$ 22,921	\$ 15,416
Other comprehensive income:		
Change in unrealized gains (losses) on investment securities and MBS available-for-sale	7,225	(23,708)
Less deferred income taxes	(2,670)	8,775
Net other comprehensive income (loss)	4,555	(14,933)
Comprehensive income (loss)	\$ 27,476	\$ 483

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

**Table of Contents**

**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 as disclosed in the annual report on Form 10-K for the year ended December 31, 2006. 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):

	March 31, 2007	December 31, 2006
Junior Subordinated Debentures	\$ 236,776	\$ 236,772
Other	15,454	3,454
Total	\$ 252,230	\$ 240,226

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

**Table of Contents**

Subsidiary Issuer	Issue Date	Maturity Date	Call Date	Rate at		Carrying Value (in thousands)
				March 31, 2007		
Sterling Capital Trust VIII	Sept 2006	Sept 2036	N/A	Floating	6.98%	\$ 51,547
Sterling Capital Trust VII	June 2006	June 2036	N/A	Floating	6.88	56,702
Lynnwood Financial Statutory Trust II	June 2005	June 2035	N/A	Floating	7.15	10,310
Sterling Capital Trust VI	June 2003	Sept 2033	Sept 2008	Floating	8.55	10,310
Sterling Capital Statutory Trust V	May 2003	May 2033	June 2008	Floating	8.60	20,619
Sterling Capital Trust IV	May 2003	May 2033	May 2008	Floating	8.51	10,310
Sterling Capital Trust III	April 2003	April 2033	April 2008	Floating	8.61	14,433
Lynnwood Financial Statutory Trust I	Mar 2003	Mar 2033	Mar 2007	Floating	8.50	9,482
Klamath First Capital Trust II	April 2002	April 2032	April 2007	Floating	9.09	13,156
Klamath First Capital Trust I	July 2001	July 2031	June 2006	Floating	9.15	15,164
Sterling Capital Trust II	July 2001	July 2031	June 2006	Fixed	10.25	24,743
					8.00%*	\$ 236,776

\* weighted average rate

Sterling has entered into a \$40.0 million revolving credit agreement (the "Credit Facility") with Wells Fargo Bank, N.A., with amounts advanced on the Credit Facility included in the "Other" caption of other borrowings. As of March 31, 2007, \$12.0 million was drawn on the Credit Facility. Amounts loaned pursuant to the Credit Facility bear interest, at Sterling's election, either floating at two percent below prime or fixed at LIBOR plus 90 basis points. The Credit Facility contains representations and warranties, and negative and affirmative covenants by Sterling, including financial covenants and restrictions on certain actions by Sterling, such as Sterling's ability to incur debt, make investments and merge into or consolidate with other entities. The Credit Facility may be terminated and loans under the Credit Facility may be accelerated if an event of default occurs, as defined in the Credit Facility. The Credit Facility matures and is payable in full unless renewed in August 2007.

Subsequent to March 31, 2007, Sterling elected to exercise its early redemption right to call the Klamath First Capital Trust II debenture. The redemption occurred on April 23, 2007.

**Table of Contents****3. Income Taxes:**

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). This pronouncement requires a certain methodology for measuring and reporting uncertain tax positions, as well as disclosures regarding such tax positions. FIN No. 48 became effective for Sterling as of January 1, 2007. The following were estimated amounts as of the effective date:

	January 1, 2007 (Dollars in thousands)
Unrecognized Tax Benefit	\$1,553
Potential Effective Tax Rate Impact	1,245
Recognized Penalties and Interest	308

Sterling does not expect unrecognized tax benefits to significantly change within the next twelve months. Sterling's tax positions for the years 2003 through 2006 remain subject to review by the Internal Revenue Service. Penalties and interest associated with any potential estimate variances would be included in income tax expense on the Consolidated Statement of Income.

**4. Earnings Per Share:**

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

	Three Months Ended March 31,					
	2007			2006		
	Net Income	Weighted Avg. Shares	Per Share Amount	Net Income	Weighted Avg. Shares	Per Share Amount
(Dollars in thousands, except per share amounts)						
Basic computations	\$ 22,921	45,238,924	\$ 0.51	\$ 15,416	34,946,649	\$ 0.44
Effect of dilutive securities:						
Common stock options and restricted shares	0	582,602	(0.01)	0	308,953	0.00
Contingently issuable shares	0	12,004	0.00	0	0	0.00
Diluted computations	\$ 22,921	45,833,530	\$ 0.50	\$ 15,416	35,255,602	\$ 0.44
Antidilutive options not included in diluted earnings per share		305,000			0	

**Table of Contents****5. Non-Interest Expenses:**

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Employee compensation and benefits	\$ 38,072	\$ 25,089
Occupancy and equipment	10,467	6,916
Data processing	4,197	3,332
Depreciation	3,195	2,283
Advertising	2,677	1,921
Travel and entertainment	1,508	1,142
Amortization of core deposit intangibles	1,041	556
Legal and accounting	676	535
Merger and acquisition costs	1,207	0
Insurance	395	283
Goodwill litigation costs	180	85
Other	2,054	2,098
<b>Total</b>	<b>\$ 65,669</b>	<b>\$ 44,240</b>

**6. Segment Information:**

For purposes of measuring and reporting financial results, Sterling is divided into 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 of Golf Savings Bank and Sterling Savings Bank's subsidiary Action Mortgage Company ( Action Mortgage ).

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

The Retail Brokerage segment markets fixed income and equity products, mutual funds, fixed and variable annuities, insurance and other financial products within the Sterling Savings Bank financial service center network through sales representatives of Sterling Savings Bank's subsidiary Harbor Financial Services, Inc.

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

**Table of Contents**

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

	As of and for the Three Months Ended March 31, 2007					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 162,050	\$ 10,812	\$ 2,191	\$ 0	\$ (151)	\$ 174,902
Interest expense	(87,251)	(2,874)	0	0	(4,161)	(94,286)
Net interest income (expense)	74,799	7,938	2,191	0	(4,312)	80,616
Provision for loan losses	(4,150)	(75)	0	0	0	(4,225)
Noninterest income	18,083	7,214	2,207	817	(4,873)	23,448
Noninterest expense	(50,929)	(10,279)	(2,912)	(839)	(710)	(65,669)
Income before income taxes	\$ 37,803	\$ 4,798	\$ 1,486	(22)	\$ (9,895)	\$ 34,170
Total assets	\$ 11,178,327	\$ 323,878	\$ 11,670	\$ 925	\$ (115,179)	\$ 11,399,621

	As of and for the Three Months Ended March 31, 2006					
	Community Banking	Residential Mortgage Banking	Commercial Mortgage Banking	Retail Brokerage	Other and Eliminations	Total
	(Dollars in thousands)					
Interest income	\$ 110,540	\$ 3,467	\$ 1,857	\$ 0	\$ 315	\$ 116,179
Interest expense	(55,082)	0	0	0	(2,141)	(57,223)
Net interest income (expense)	55,458	3,467	1,857	0	(1,826)	58,956
Provision for loan losses	(4,650)	0	0	0	0	(4,650)
Noninterest income	11,454	2,087	1,237	828	(2,689)	12,917
Noninterest expense	(37,440)	(3,816)	(1,868)	(711)	(405)	(44,240)
Income before income taxes	\$ 24,822	\$ 1,738	\$ 1,226	\$ 117	\$ (4,920)	\$ 22,983
Total assets	\$ 7,891,077	\$ 12,752	\$ 8,581	\$ 705	\$ (68,611)	\$ 7,844,504

**7. Stock Based Compensation:**

On January 1, 2006, Statement of Financial Accounting Standard No. 123 (R), Share Based Payment, became effective for Sterling. As a result, stock options issued as compensation are recorded as an expense at their estimated fair value.

During the three months ended March 31, 2007, stock option activity and related information was as follows:

		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding, December 31, 2006	Number 1,485,661	\$ 19.72		
Granted	306,000	33.17		
Exercised	(185,936)	13.23		
Acquisitions	573,212	12.67		
Cancelled	(7,123)	18.04		
Outstanding, March 31, 2007	2,171,814	\$ 20.31	5.20	\$ 28,190
Exercisable, March 31, 2007	1,866,814	\$ 18.21	4.92	\$ 24,218

As of March 31, 2007, a total of 45,249 shares remained available for grant under Sterling's 2001 and 2003 Long-Term Incentive Plans. The options granted under these plans have terms of four, six or ten years. Subsequent to March 31, 2007, Sterling adopted the 2007 Long-Term Incentive Plan at the Annual Meeting of Shareholders on

**Table of Contents**

April 24, 2007. This plan permits for the issuance of up to an aggregate of 2.0 million options to purchase shares of Sterling's common stock.

During the three months ended March 31, 2007 and 2006, the fair value of options granted were \$3.2 million and \$171,000, respectively, and the intrinsic value of options exercised were \$3.7 million and \$2.3 million, respectively. Stock compensation expense recognized during the three months ended March 31, 2007 was \$250,000. The Black-Scholes option-pricing model was used in estimating the fair value of option grants. The weighted average assumptions used are presented in the table below.

	Three Months Ended	
	March 31,	
	2007	2006
Expected volatility	29%	31%
Expected term (in years)	4.7 - 6.0	5.5
Expected dividend yield	0.90%	0.87%
Risk free interest rate	4.81%	4.36%

Other stock based compensation during the three months ended March 31, 2007 included the issuance to management of 85,000 shares of restricted stock. These shares vest evenly over a four year period.

**8. New Accounting Policies:**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 provides a fair value measurement election for many financial instruments, on an instrument by instrument basis. SFAS No. 159 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 159 to have a material effect on Sterling.

In September 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. Under the provisions of EITF Issue No. 06-4, Sterling will recognize the amount, if any, that is owed current or former employees under split dollar BOLI. EITF 06-4 is effective January 1, 2008. Sterling is currently assessing the potential impact of this standard.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 157 to have a material effect on Sterling.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140 ( SFAS No. 156 ). This pronouncement requires the recognition of a servicing asset or liability under specified circumstances, and if practicable, all separately recognized servicing assets and liabilities to be initially measured at fair value. Additionally, the pronouncement allows an entity to choose one of two methods when subsequently measuring its servicing assets and liabilities: the amortization method or the fair value method. The amortization method provided under SFAS No. 140, employs lower of cost or market ( locom ) valuation. The new fair value method allows mark ups, in addition to the mark downs under locom. SFAS No. 156 permits a one-time reclassification of available-for-sale securities to the trading classification. SFAS No. 156 became effective for Sterling as of January 1, 2007, and did not have a material effect on Sterling, as Sterling continued to recognize servicing assets initially at fair value and to employ the amortization method.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133 and SFAS No. 140. This statement addresses the accounting for certain hybrid financial instruments (a financial instrument with an embedded derivative) and also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133. SFAS No. 155 allows

**Table of Contents**

combined valuation and accounting. This statement became effective for Sterling as of January 1, 2007 and did not have a material impact on the consolidated financial results.

**9. Derivatives and Hedging:**

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

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of March 31, 2007, Sterling had entered into best efforts forward commitments to sell \$164.9 million of mortgage loans, with the estimated fair value of rate locks issued and delivery commitments received on the unfunded portion valued as an offsetting asset and liability of approximately \$927,000. As of December 31, 2006, these rate locks and delivery commitments were valued at \$482,000. As of March 31, 2007, Sterling had loans locked with investors under mandatory delivery programs valued at \$53,000, and held offsetting forward sale agreements on MBS valued at \$16,000, with a net loss position reflected in mortgage banking income. As of December 31, 2006, Sterling did not have any loans subject to rate locks under mandatory delivery programs. Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering comparable broker dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of March 31, 2007 and December 31, 2006, were \$424,000 and \$404,000, respectively.

**10. Cash Dividends:**

The board of directors of Sterling from time to time evaluates the payment of cash dividends. The timing and amount of any future dividends will depend upon earnings, cash and capital requirements, the financial condition of Sterling and its subsidiaries, applicable government regulations and other factors deemed relevant by Sterling's board of directors. During 2006 to 2007, Sterling paid the following cash dividends:

Date Paid	Per Share Amount	Total
January 2006	0.055	1.9 million
April 2006	0.060	2.1 million
July 2006	0.065	2.3 million
October 2006	0.070	2.6 million
January 2007	0.075	3.2 million
April 2007	0.080	4.1 million

**11. Business Combination:**

On February 28, 2007, Sterling completed its acquisition of Northern Empire Bancshares, a California corporation ( Northern Empire ) by issuing \$30.0 million in cash, and 8,914,815 shares of Sterling common stock valued at \$290.4 million in exchange for all outstanding Northern Empire shares. Northern Empire options totaling 646,018 were converted into options to purchase an aggregate of 573,212 shares of Sterling's common stock, valued at \$12.3 million. The total value of the transaction was \$332.8 million. Northern Empire merged with and into Sterling, with Sterling being the surviving corporation in the merger. Northern Empire's financial institution subsidiary, Sonoma National Bank, merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution. The Sonoma National Bank acquisition provided Sterling Savings

**Table of Contents**

Bank entry into the northern California market, enhanced the products and services available to the customers of both companies and strengthened Sterling's leadership position in the West.

The following summarizes the fair values of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

	February 28, 2007
Cash and cash equivalents	\$ 110,775
Investments and MBS	22,574
Loans receivable, net	1,231,310
Goodwill	206,399
Core deposit intangible	7,775
Other assets	18,834
<b>Total assets acquired</b>	<b>\$ 1,597,667</b>
Deposits	\$ 987,694
Other borrowings	266,853
Other liabilities	10,353
<b>Total liabilities assumed</b>	<b>1,264,900</b>
<b>Net assets acquired</b>	<b>\$ 332,767</b>

The following summarizes the unaudited pro forma results of operations as if Sterling acquired Northern Empire on January 1, 2006 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2007	2006
Pro forma interest income	\$ 191,985	\$ 133,060
Pro forma interest expense	103,255	62,920
Pro forma net interest income	88,730	70,140
Pro forma net income	21,854	19,441
Pro forma earnings per share basic	\$ 0.40	\$ 0.44
Pro forma earnings per share diluted	\$ 0.40	\$ 0.44

**12. Subsequent Events:**

On April 11, 2007, Sterling announced the signing of a definitive agreement to acquire North Valley Bancorp (North Valley), headquartered in Redding, California. This pending acquisition is subject to North Valley shareholder and regulatory approval, and satisfaction of other customary closing conditions. The integration of North Valley into Sterling is expected to increase Sterling's total assets by approximately \$900 million, and would complement the recent growth of its business in northern California, increasing its presence there by 25 depository branches. The transaction was valued at \$196.2 million as of the date the parties agreed to merge.

In April 2007, Sterling announced a quarterly cash dividend of \$0.085 per share, payable on July 11, 2007 to shareholders of record as of June 29, 2007.

**Table of Contents**

**PART I Financial Information (continued)**

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

**STERLING FINANCIAL CORPORATION**

**March 31, 2007**

*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 2006 annual report on Form 10-K.*

**General**

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

Sterling provides personalized, quality financial services and Perfect Fit banking products to its customers consistent with its Hometown Helpful philosophy. Sterling believes that its dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the western United States. With \$11.4 billion in total assets at March 31, 2007, Sterling originates loans and attracts Federal Deposit Insurance Corporation ( FDIC ) insured deposits from the general public through 171 financial service centers throughout Washington, Oregon, Idaho, California and Montana. In addition, Sterling originates loans through Golf Savings Bank and Action Mortgage residential loan production offices and through INTERVEST commercial real estate lending offices in the western United States. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and other financial products through Harbor Financial service representatives located throughout Sterling's financial service center network.

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

**Table of Contents**

**Executive Summary and Highlights**

During the last twelve months, Sterling completed four acquisitions: Lynnwood Financial Group, Inc. on July 5, 2006; Mason-McDuffie Financial Corporation on July 31, 2006; FirstBank NW Corp. on November 30, 2006; and Northern Empire Bancshares on February 28, 2007. As a result, comparability among particular amounts may be affected. The increase in net income over 2006 was mainly due to the increase in net interest income from growth in loan balances causing a change in the mix of interest earning assets.

Highlights for the first quarter of 2007 were as follows:

Net Income was \$22.9 million, an increase of 49 percent over the first quarter of 2006; earnings per diluted share were \$0.50, an increase of 14 percent over the first quarter of 2006.

Total loan originations of \$1.28 billion increased 19 percent over the first quarter of 2006.

Total loans receivable increased to a record \$8.37 billion, while total deposits increased to a record \$7.57 billion.

Total assets increased to a record \$11.40 billion, an increase of 16 percent since year end.

Sterling's Board of Directors approved a cash dividend of \$0.08 per common share, paid on April 11, 2007, to shareholders of record as of March 30, 2007.

Sterling completed the acquisition of Northern Empire Bancshares and its wholly owned subsidiary, Sonoma National Bank, and celebrated its 20<sup>th</sup> anniversary on NASDAQ.

**Table of Contents****Company Growth**

Sterling intends to continue to pursue an aggressive growth strategy to become the leading community bank in the western United States. 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 the existence of favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

On April 11, 2007, Sterling announced the signing of a definitive agreement to acquire North Valley Bancorp (North Valley), headquartered in Redding, California. This pending acquisition is subject to North Valley shareholder and regulatory approval, and satisfaction of other customary closing conditions. The integration of North Valley into Sterling is expected to increase Sterling's total assets by approximately \$900 million, and would complement the recent growth of its business in California, increasing its presence there by 25 depository branches.

On February 28, 2007, Sterling completed its acquisition of Northern Empire Bancshares, a California corporation (Northern Empire) by issuing \$30.0 million in cash, and 8,914,815 shares of Sterling common stock valued at \$290.4 million in exchange for all outstanding Northern Empire shares. Northern Empire options totaling 646,018 were converted into 573,212 Sterling options, valued at \$12.3 million. The total value of the transaction was \$332.8 million. Northern Empire merged into Sterling, with Sterling being the surviving corporation in the merger. Northern Empire's financial institution subsidiary, Sonoma National Bank, merged with and into Sterling's subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

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

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

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

**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

**Table of Contents**

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 and 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.

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 influenced by changes in economic conditions and other relevant factors. A slowdown in economic activity could adversely affect cash flows for both commercial and individual borrowers, which may result in increases in nonperforming assets, delinquencies and losses on loans. 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 March 31, 2007.

***Investment Securities and MBS.*** Assets in the investment securities and MBS portfolios are initially recorded at cost, which includes any premiums and discounts. Sterling amortizes premiums and discounts as an adjustment to interest income 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.

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

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



**Table of Contents**

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, resulting in a loss recorded in the income statement and the establishment of a new basis. During the three months ended March 31, 2007, there were no investment securities that management identified to be other-than-temporarily impaired, because the decline in fair value was attributable to changes in interest rates and not credit quality, and because Sterling has the ability and intent to hold these investments until a recovery in market price occurs, or until maturity. Realized losses could occur in future periods due to a change in management's intent to hold the investments to 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 generated 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's management performed the annual test of its goodwill and other intangible assets as of June 30, 2006, and concluded that the recorded values were 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 and Other Collateralized Assets.*** Property and other assets acquired through foreclosure of defaulted mortgage or other collateralized loans are carried at the lower of cost or fair value, less estimated costs to sell. Development and improvement costs relating to such property are capitalized to the extent they are deemed to be recoverable.

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

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

Sterling uses an estimate of future earnings to support its position that the benefit of its net deferred tax assets will be realized. If future taxable income should prove nonexistent or less than the amount of temporary differences



**Table of Contents**

giving rise to the net deferred tax assets within the tax years to which they may be applied, the assets will not be realized and Sterling's net income will be reduced.

**Results of Operations**

**Overview.** Sterling recorded net income of \$22.9 million, or \$0.50 per diluted share, for the three months ended March 31, 2007, compared with net income of \$15.4 million, or \$0.44 per diluted share, for the three months ended March 31, 2006. The increase in net income mainly reflected an increase in net interest income generated by margin expansion and growth in interest earning assets.

The annualized return on average assets ( ROA ) was 0.91% and 0.81% for the three months ended March 31, 2007 and 2006, respectively. The annualized return on average equity ( ROE ) was 10.3% and 12.1% for the three months ended March 31, 2007 and 2006, respectively. The increase in ROA compared to 2006 was due to growth of net income outpacing the increase in assets, while dilution from recent acquisitions drove the decrease in ROE.

**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, MBS and investment securities portfolios, and interest expense, primarily on deposits and borrowings. During the three months ended March 31, 2007 and 2006, NII was \$80.6 million and \$59.0 million, respectively, an increase of 37%. The increase in NII was mainly influenced by the increase in loans as a percentage of interest earning assets.

Changes in Sterling's NII are a function of changes in both rates and volumes of interest-earning assets and interest-bearing liabilities. 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 average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

The following table presents the composition of the change in NII, on a tax equivalent basis, for the periods presented. Municipal loan and bond interest income are presented gross of their applicable tax savings. For each category of interest-earning assets and interest-bearing liabilities, the following table provides information on changes attributable to:

Volume changes in volume multiplied by comparative period rate;

Rate changes in rate multiplied by comparative period volume; and

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

	Three Months Ended March 31, 2007 vs. 2006			Total
	Volume	Rate	Rate/ Volume	
	Increase (Decrease) Due to:			
	(Dollars in thousands)			
Rate/volume analysis:				
Interest income:				
Loans	\$ 46,559	\$ 9,171	\$ 4,951	\$ 60,681
MBS	(2,936)	67	(8)	(2,877)
Investments and cash equivalents	460	506	229	1,195
Total interest income	44,083	9,744	5,172	58,999
Interest expense:				
Deposits	16,206	8,709	3,995	28,910

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

Borrowings	2,461	5,129	563	8,153
Total interest expense	18,667	13,838	4,558	37,063
Net changes in NII	\$ 25,416	\$ (4,094)	\$ 614	\$ 21,936

**Table of Contents**

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

Three Months Ended	Tax Equivalent Net Interest Margin
March 31, 2007	3.41%
December 31, 2006	3.37%
September 30, 2006	3.34%
June 30, 2006	3.26%
March 31, 2006	3.32%

Average interest-earning assets for the three months ended March 31, 2007 were \$9.66 billion reflecting growth of \$2.41 billion over the comparative 2006 amounts. Acquisition related, as well as internal growth in the loan portfolio contributed to the increase in interest-earning assets, resulting in an improvement of the net interest margin.

**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 and trends in classified assets, delinquency and nonaccrual loans, and portfolio volume, diversification as to type of loan, size of individual credit exposure, current and anticipated economic conditions, as well as loan policies, collection policies and effectiveness, quality of credit personnel, effectiveness of policies, procedures and practices, and recent loss experience of peer banking institutions.

Sterling recorded provisions for losses on loans of \$4.2 million and \$4.7 million for the three months ended March 31, 2007 and 2006, 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 may increase, reflecting Sterling's strategic direction of originating more commercial real estate, construction, business banking and consumer loans that have a somewhat higher loss profile than Sterling's historical mix of loans.

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Allowance loans, January 1	\$ 77,849	\$ 52,034
Acquired	12,535	0
Provision	4,225	4,650
Charge offs, net of recoveries	(832)	(1,434)
Transfers	60	(770)
Allowance loans, March 31	93,837	54,480
Allowance unfunded commitments, January 1	5,840	3,449
Acquired	266	0
Transfers	(60)	770
Allowance unfunded commitments, March 31	6,046	4,219
Total credit allowance	\$ 99,883	\$ 58,699

**Table of Contents**

During the three months ended March 31, 2007, Sterling acquired an allowance for losses on loans in the amount of \$12.5 million as a result of the Northern Empire acquisition. These acquired loans were determined to not have exhibited a deterioration in credit quality since origination, and thus were not included within the scope of the American Institute of Certified Public Accountants Statement of Position 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer.

At March 31, 2007, Sterling's total classified assets were 0.69% of total assets, compared with 0.70% of total assets at March 31, 2006. Nonperforming assets were 0.17% of total assets at March 31, 2007, compared with 0.13% of total assets at March 31, 2006. Sterling does not anticipate significant losses in these classified assets, although there can be no assurances in this regard. At March 31, 2007, the loan delinquency ratio was 0.27% of total loans compared to 0.08% of total loans at March 31, 2006. Asset quality remained strong over the periods presented.

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Fees and service charges	\$ 12,192	\$ 9,079
Mortgage banking operations	8,858	2,271
Loan servicing fees	683	269
Real estate owned operations	(45)	307
BOLI	1,547	1,183
Other non-interest expense	213	(192)
Total	\$ 23,448	\$ 12,917

The increase in non-interest income for the three months ended March 31, 2007, over the three months ended March 31, 2006, was primarily due to an increase in income from mortgage banking operations and fees and service charges. The increased income from mortgage banking operations was primarily a result of the acquisition of Golf Savings Bank, and the sale of \$70.7 million of loans received in acquisitions. Golf Savings Bank is engaged in mortgage banking. Loans that are originated and held for sale by Golf Savings Bank are sold into the secondary market. Gains on the sale of these loans are recorded as income from mortgage banking operations.

Fees and service charges for the three months ended March 31, 2007 increased primarily due to the success of Sterling's Balance Shield program, commercial banking fees, debit and CheckCard services, and analyzed account fees that include cash management and merchant services.

During the three months ended March 31, 2007 and 2006, Sterling did not sell any investment securities or MBS. The activity for both periods was a result of management's response to market conditions and portfolio management needs.

**Table of Contents**

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

	As of and for the Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Originations of residential mortgage loans	\$ 344,617	\$ 71,097
Originations of commercial real estate loans	11,210	33,975
Sales of residential mortgage loans	372,728	34,732
Sales of commercial real estate loans	6,926	0
Principal balances of residential loans serviced for others	672,049	594,110
Principal balances of commercial real estate loans serviced for others	1,744,863	820,845

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Employee compensation and benefits	\$ 38,072	\$ 25,089
Occupancy and equipment	10,467	6,916
Data processing	4,197	3,332
Depreciation	3,195	2,283
Advertising	2,677	1,921
Travel and entertainment	1,508	1,142
Amortization of core deposit intangibles	1,041	556
Legal and accounting	676	535
Merger and acquisition costs	1,207	0
Insurance	395	283
Goodwill litigation costs	180	85
Other	2,054	2,098
Total	\$ 65,669	\$ 44,240

The increases in non-interest expenses were primarily due to continued company growth. Full-time equivalent employees increased year-over-year by 738 to 2,570 at March 31, 2007. The acquisition of Sonoma National Bank added approximately 180 full-time equivalent employees.

**Income Tax Provision.** Sterling recorded federal and state income tax provisions of \$11.2 million and \$7.6 million for the three months ended March 31, 2007 and 2006, respectively, with an effective tax rate of 33% for both periods.

**Financial Position**

**Assets.** At March 31, 2007, Sterling's assets were \$11.40 billion, up \$1.57 billion from \$9.83 billion at December 31, 2006. This growth was mainly a result of increases in the loan portfolio through originations and acquisitions.

**Table of Contents**

**Investment Securities and MBS.** Sterling's investment and MBS portfolio at March 31, 2007 was \$1.88 billion, a decrease of \$29.5 million from the December 31, 2006 balance of \$1.91 billion. The decrease was mainly due to principal repayments and maturities. On March 31, 2007, the investment and MBS portfolio had an unrealized loss of \$45.6 million versus an unrealized loss of \$52.8 million at December 31, 2006, with the fluctuation due to interest rate movements, combined with the lower balance of the portfolio.

**Loans Receivable.** At March 31, 2007, net loans receivable were \$8.37 billion, up \$1.35 billion from \$7.02 billion at December 31, 2006. The increase was due to loan originations during the period and the Northern Empire acquisition, net of loan repayments.

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

	March 31, 2007		December 31, 2006	
	Amount	%	Amount	%
	(Dollars in thousands)			
Residential real estate	\$ 639,326	7.5	\$ 654,661	9.2
Multifamily real estate	248,590	2.9	263,053	3.7
Commercial real estate	1,401,248	16.5	795,386	11.2
Construction	2,515,392	29.7	2,290,882	32.2
Consumer direct	749,183	8.8	749,626	10.5
Consumer indirect	318,426	3.8	288,704	4.1
Commercial banking	2,608,482	30.8	2,069,086	29.1
Gross loans receivable	8,480,647	100.0	7,111,398	100.0
Net deferred origination fees	(16,185)		(12,308)	
Allowance for losses on loans	(93,837)		(77,849)	
Loans receivable, net	\$ 8,370,625		\$ 7,021,241	

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

	Three Months Ended March 31,	
	2007	2006
	(Dollars in thousands)	
Residential real estate	\$ 344,617	\$ 71,097
Commercial real estate	11,210	33,975
Construction	534,821	563,592
Consumer direct	63,568	78,849
Consumer indirect	64,913	29,535
Commercial banking	259,203	295,960
Total loans originated	\$ 1,278,332	\$ 1,073,008

**Table of Contents**

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

	March 31, 2007		December 31, 2006	
	Amount	%	Amount	%
	(Dollars in thousands)			
Interest-bearing checking	\$ 524,492	6.9	\$ 483,551	7.2
Noninterest-bearing checking	896,506	11.8	834,140	12.4
Savings and MMDA	2,045,493	27.0	1,830,313	27.1
Time deposits	4,107,567	54.3	3,598,024	53.3
Total deposits	\$ 7,574,058	100.0	\$ 6,746,028	100.0

Total deposits increased to \$7.57 billion at March 31, 2007 from \$6.75 billion at December 31, 2006. Deposit growth was primarily in time and money market demand accounts ( MMDA ), mainly as a result of deposits acquired in the Northern Empire acquisition.

**Borrowings.** Deposit accounts are Sterling's primary source of funds. Sterling does, however, rely upon advances from the Federal Home Loan Bank ( FHLB ), reverse repurchase agreements ( REPOs ) and other borrowings to fund asset growth and meet deposit withdrawal requirements. During the three months ended March 31, 2007, these funding sources increased a total \$399.8 million, with the aggregate net total of FHLB advances, REPOs and Fed funds purchased increasing \$387.8 million. As a result of the Northern Empire acquisition, Sterling assumed \$266.9 million of advances from FHLB of San Francisco. Currently, Sterling does not anticipate additional advances from this source. See Liquidity and Capital Resources.

**Asset and Liability Management**

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

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

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

The difference between a financial institution's interest rate sensitive assets (e.g., assets that will mature or reprice within a specific time period) and interest rate sensitive liabilities (i.e. liabilities that will mature or reprice within the specific time period) is commonly referred to as its interest rate sensitivity gap ( GAP ). An institution having more interest rate sensitive assets than interest rate sensitive liabilities within a given time period is said to be asset sensitive, which generally means that if interest rates increase (other things being equal), a company's net interest income will increase and if interest rates decrease (other things being equal), its net interest income will decrease. Likewise, an institution having more interest rate sensitive liabilities than interest rate sensitive assets within a given time period is said to be liability sensitive, which generally means that if interest rates increase, a company's net interest income will decrease and if interest rates decrease, its net interest income will increase.

**Table of Contents**

ALCO uses interest rate shock simulations of net interest income to measure the effect of changes in interest rates on the net interest income for Sterling over a 12 month period. This simulation consists of measuring the change in net interest income over the next 12 months from a base case scenario when rates are shocked, in a parallel fashion, up and down 100 and 200 basis points. The base case uses the assumption of the existing balance sheet and existing interest rates to simulate the base line of net interest income over the next 12 months for the simulation. The simulation requires numerous assumptions, including relative levels of market interest rates, instantaneous and parallel shifts in the yield curve, loan prepayments and reactions of depositors to changes in interest rates, and should not be relied upon as being indicative of actual or future results. Further, the analysis does not contemplate actions Sterling may undertake in response to changes in interest rates and market conditions. The results of this simulation as of March 31, 2007 and December 31, 2006 are included in the following table:

Change in Interest Rate in Basis Points (Rate Shock)	March 31, 2007 % Change in NII	December 31, 2006 % Change in NII
+200	(3.6)	(1.5)
+100	(1.8)	(0.8)
Static	0.0	0.0
-100	0.9	(0.4)
-200	1.2	(1.6)

ALCO uses NPV simulation analysis to measure risk in the balance sheet that might not be taken into account in the net interest income simulation analysis. Whereas net interest income simulation highlights exposure over a relatively short time period of 12 months, NPV simulation analysis incorporates all cash flows over the estimated remaining life of all balance sheet positions. The NPV simulation analysis of the balance sheet, at a point in time, is defined as the discounted present value of asset cash flows minus the discounted value of liability cash flows. The discount rates that are used represent an assumption for the current market rates of each group of assets and liabilities. The difference between the present value of the asset and liability represents the NPV. As with net interest income, this is used as the base line to measure the change in NPV when interest rates are shocked, in a parallel fashion, up and down 100 and 200 basis points. As with the net interest income simulation model, NPV simulation analysis is based on key assumptions about the timing and variability of balance sheet cash flows. However, because the simulation represents much longer time periods, inaccuracy of assumptions may increase the variability of outcomes within the simulation. It also does not take into account actions management may undertake in response to anticipated changes in interest rates. The results of this simulation at March 31, 2007 and December 31, 2006 are included in the following table:

Change in Interest Rate in Basis Points (Rate Shock)	At March 31, 2007 % Change in NPV	At December 31, 2006 % Change in NPV
+200	(5.4)	(5.0)
+100	(1.9)	(1.5)
Static	0.0	0.0
-100	(3.1)	(4.6)
-200	(14.1)	(17.9)

**Table of Contents**

Sterling occasionally enters into customer-related financial derivative transactions primarily consisting of interest rate swaps. Risk exposure from customer positions is managed through transactions with other broker dealers. As of March 31, 2007, Sterling has not entered into asset/liability related derivative transactions as part of managing its interest rate risk. However, Sterling continues to consider derivatives, including interest rate swaps, caps and floors, as a viable alternative in the asset and liability management process. See Results of Operations *Net Interest Income* and Capital.

**Liquidity and Capital Resources**

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 and other borrowings. Deposits increased 12.3 percent to \$7.57 billion at March 31, 2007 from \$6.75 billion at December 31, 2006, mainly due to increases of \$509.5 million and \$215.2 million, respectively, in time deposits and savings accounts. These increases mainly reflected deposits acquired in the Northern Empire acquisition.

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, deposit fluctuations and loan funding needs.

During the three months ended March 31, 2007, net cash provided by investing activities was \$45.1 million, which consisted mainly of funds acquired from Northern Empire and runoff in the MBS portfolio. During this period, net cash used in financing activities was \$32.9 million, which consisted primarily of net outflows within time deposits reflecting the cost shift among wholesale funding sources.

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 March 31, 2007, this credit line represented a total borrowing capacity of \$2.31 billion, of which \$916.3 million was available. The FHLB Seattle has been undergoing organizational and operational changes for more than two years pursuant to a written agreement with its regulator, the Federal Housing Finance Board (Finance Board). During this time, FHLB Seattle continued to provide Sterling with ready sources of liquidity. Based on FHLB Seattle's recent earnings and capital position, the Finance Board permitted the FHLB Seattle to resume dividend payments in December 2006, and on January 12, 2007, terminated the written agreement. Also, the Standard & Poor's rating outlook for FHLB Seattle improved to stable. As a result of the Northern Empire acquisition, Sterling assumed \$266.9 million of advances from FHLB of San Francisco. Currently, Sterling does not anticipate additional advances from this source.

Sterling Savings Bank also borrows funds under reverse repurchase agreements pursuant to which it sells investments (generally U.S. agency securities and MBS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. Sterling Savings Bank uses these borrowings to supplement deposit gathering for funding the origination of loans. At March 31, 2007, Sterling Savings Bank had \$707.3 million in outstanding borrowings under reverse repurchase agreements and had securities available for additional secured borrowings of approximately \$115.0 million. The use of reverse repurchase agreements may expose Sterling to certain risks not associated with other borrowings, including IRR and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines.

Sterling, on a parent company-only basis, had cash of approximately \$9.5 million and \$21.1 million at March 31, 2007 and December 31, 2006, respectively. At March 31, 2007 and December 31, 2006, Sterling had an investment of \$175.1 million for both periods in the preferred stock of Sterling Savings Bank. At March 31, 2007 and December 31, 2006, Sterling had an investment in the common stock of Sterling Savings Bank of \$837.1 million and \$512.6 million, respectively. Sterling's investment in the common stock of Sterling Savings Bank increased as a result of the acquisition and merger of Sonoma National Bank into Sterling Savings Bank. Sterling received cash dividends from Sterling Savings Bank of \$8.6 million and \$4.9 million during the three months ended March 31, 2007 and 2006, respectively. These resources contributed to Sterling's ability to meet its operating needs,



**Table of Contents**

including interest expense on its long-term debt. Sterling Savings Bank's ability to pay dividends is limited by its earnings, financial condition, capital requirements, and capital distribution regulations. See Note 2 of Notes to Consolidated Financial Statements.

Sterling has the ability to secure additional capital through the capital markets. The availability and cost of such capital is partially dependent on Sterling's credit ratings, which as of March 31, 2007 were as follows:

	Rating	Sterling Long-Term Debt	Sterling Short-Term Debt	Sterling Savings Bank Long-Term Deposits	Outlook
Fitch	Institution	BBB-	F3	BBB	Stable

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

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

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

Rate lock commitments to borrowers and best-effort loan delivery commitments from investors are off-balance-sheet commitments that are considered to be derivatives. Sterling accounts for these commitments by recording their estimated fair value on its balance sheet. As of March 31, 2007, Sterling had entered into best efforts forward commitments to sell \$164.9 million of mortgage loans, with the estimated fair value of rate locks issued and delivery commitments received on the unfunded portion valued as an offsetting asset and liability of approximately \$927,000. As of December 31, 2006, these rate locks and delivery commitments were valued at \$482,000. As of March 31, 2007, Sterling had loans locked with investors under mandatory delivery programs valued at \$53,000, and held offsetting forward sale agreements on MBS valued at \$16,000, with a net loss position reflected in mortgage banking income. As of December 31, 2006, Sterling did not have any loans subject to rate locks under mandatory delivery programs. Sterling enters into interest rate swap derivative contracts with customers. The IRR on these contracts is offset by entering comparable dealer swaps. These contracts are carried as an offsetting asset and liability at fair value, and as of March 31, 2007 and December 31, 2006, were \$424,000 and \$404,000, respectively.

**Table of Contents****Capital**

Sterling's total shareholders' equity was \$1.11 billion at March 31, 2007, compared to \$783.4 million at December 31, 2006. The increase in total shareholders' equity was primarily from the issuance of Sterling's common stock in connection with the purchase of Northern Empire, as well as the retention of earnings. Shareholders' equity was 9.8% of total assets at March 31, 2007 compared with 8.0% at December 31, 2006.

At March 31, 2007, Sterling had an unrealized loss of \$45.6 million on investment securities and MBS classified as available for sale. 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 has outstanding various series of capital securities ( Trust Preferred Securities ) issued to investors. The Trust Preferred Securities are treated as debt of Sterling, and can qualify as Tier 1 capital, subject to certain limitations. For a complete description, see Note 2 of Notes to Consolidated Financial Statements.

Sterling, Sterling Savings Bank and Golf Savings Bank are required by applicable regulations to maintain certain minimum capital levels. Sterling's management intends to enhance the capital resources and regulatory capital ratios of Sterling and its banking subsidiaries through the retention of an adequate amount of earnings and the management of the level and mix of assets, although there can be no assurance in this regard. At March 31, 2007, each of the companies exceeded all such regulatory capital requirements and were well capitalized pursuant to such regulations. The following table sets forth their respective capital positions at March 31, 2007:

	Minimum Capital Requirements		Well-Capitalized Requirements		Actual	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)			
Tier 1 leverage (to average assets)						
Sterling	\$396,508	4.0%	\$495,635	5.0%	\$ 910,611	9.2%
Sterling Savings Bank	385,793	4.0%	482,241	5.0%	889,132	9.2%
Golf Savings Bank	10,233	4.0%	12,792	5.0%	24,243	9.5%
Tier 1 (to risk-weighted assets)						
Sterling	369,563	4.0%	554,345	6.0%	910,611	9.9%
Sterling Savings Bank	362,403	4.0%	543,605	6.0%	889,132	9.8%
Golf Savings Bank	7,914	4.0%	11,871	6.0%	24,243	12.3%
Total (to risk-weighted assets)						
Sterling	739,127	8.0%	923,908	10.0%	1,010,494	10.9%
Sterling Savings Bank	724,807	8.0%	906,009	10.0%	987,770	10.9%
Golf Savings Bank	15,828	8.0%	19,785	10.0%	25,487	12.9%

**Goodwill Litigation**

In May 1990, Sterling initiated a lawsuit against 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 is seeking damages for, among other things, breach of contract and 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 U.S. Government owed contractual obligations to Sterling with respect to the company's acquisition of three failing regional thrifts during the 1980s and had breached its contracts with Sterling. On March 31, 2005, a hearing was held in the U.S. Court of Federal Claims on the U.S. Government's motion to reconsider part of the September 2002 liability judgment, relating to Sterling's acquisition of the largest of the three thrifts it acquired, Central Evergreen Savings & Loan. Sterling opposed the motion.

On August 30, 2006, the Court of Federal Claims granted the U.S. Government's motion to reconsider, and held that the U.S. Government was not liable for breach of the contract for Sterling's acquisition of Central Evergreen Savings

**Table of Contents**

and Loan. The Court set a trial date of June 25, 2007 to determine what amount, if any, the U.S. Government must pay in damages for its breach of the contracts for the acquisition of the two smaller thrifts, Lewis Federal Savings & Loan and Tri-Cities Savings & Loan. The ultimate outcome of the Goodwill Litigation cannot be predicted with certainty. The U.S. Government will likely appeal any award of damages in favor of Sterling, and Sterling may appeal the adverse ruling as to Central Evergreen Savings & Loan. Because of the effort required to bring the case to conclusion, Sterling will likely continue to incur legal expenses as the case progresses.

**New Accounting Policies**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 provides a fair value measurement election for many financial instruments, on an instrument by instrument basis. SFAS No. 159 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 159 to have a material effect on Sterling.

In September 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. Under the provisions of EITF Issue No. 06-4, Sterling will recognize the amount, if any, that is owed current or former employees under split dollar BOLI. EITF 06-4 is effective January 1, 2008. Sterling is currently assessing the potential impact of this standard.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 will be effective for Sterling as of January 1, 2008. Sterling is currently assessing the impact of this standard and does not expect SFAS No. 157 to have a material effect on Sterling.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140 ( SFAS No. 156 ). This pronouncement requires the recognition of a servicing asset or liability under specified circumstances, and if practicable, all separately recognized servicing assets and liabilities to be initially measured at fair value. Additionally, the pronouncement allows an entity to choose one of two methods when subsequently measuring its servicing assets and liabilities: the amortization method or the fair value method. The amortization method provided under SFAS No. 140, employs lower of cost or market ( locom ) valuation. The new fair value method allows mark ups, in addition to the mark downs under locom. SFAS No. 156 permits a one-time reclassification of available-for-sale securities to the trading classification. SFAS No. 156 became effective for Sterling as of January 1, 2007, and did not have a material effect on Sterling, as Sterling continued to recognize servicing assets initially at fair value and to employ the amortization method.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133 and SFAS No. 140. This statement addresses the accounting for certain hybrid financial instruments (a financial instrument with an embedded derivative) and also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133. SFAS No. 155 allows combined valuation and accounting. This statement became effective for Sterling as of January 1, 2007 and did not have a material impact on the consolidated financial results.

**Regulation and Compliance**

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

**Table of Contents**

**Forward-Looking Statements**

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

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

inflation, interest rate levels and market and monetary fluctuations;

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

applicable laws and regulations and legislative or regulatory changes;

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

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

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

technological and management changes;

growth and acquisition strategies;

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

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

changes in consumer spending and saving habits;

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

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

**Table of Contents**

**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.

**Table of Contents**

**STERLING FINANCIAL CORPORATION**  
**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 1a Risk Factors**

You should carefully consider the risks and uncertainties we describe both in this Report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, before deciding to invest in, or retain, shares of our common stock. These are not the only risks and uncertainties that we face. Additional risks and uncertainties that we do not currently know about or that we currently believe are immaterial, or that we have not predicted, may also harm our business operations or adversely affect us. If any of these risks or uncertainties actually occurs, our business, financial condition, operating results or liquidity could be materially harmed.

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

Not applicable.

**Item 3 Defaults Upon Senior Securities**

Not applicable.

**Table of Contents**

**STERLING FINANCIAL CORPORATION**  
**PART II Other Information**

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

A Special Meeting of Shareholders of Sterling (the Meeting) was held on February 21, 2007. The following matters were submitted to a vote of the security holders of Sterling at the Meeting:

- (1) The proposal to approve the Agreement and Plan of Merger dated September 17, 2006, by and between Sterling and Northern Empire received the following votes:

	Votes	Percentage of For & Against
For	33,241,798	78.98%
Against	168,190	0.40%
Abstain	88,621	0.21%

The foregoing proposal was approved.

- (2) The proposal to authorize Sterling's Board of Directors to adjourn or postpone the Special Meeting received the following votes:

	Votes	Percentage of For & Against
For	28,716,426	68.23%
Against	4,584,856	10.89%
Abstain	197,327	0.47%

The foregoing proposal was approved.

**Item 5 Other Information**

Not applicable.

**Item 6 Exhibits**

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

**Table of Contents**

**STERLING FINANCIAL CORPORATION**

**Signatures**

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

**STERLING FINANCIAL  
CORPORATION**

(Registrant)

May 9, 2007

Date

By: /s/ Robert G. Butterfield

**Robert G. Butterfield**

Vice President, Controller, and  
Principal Accounting Officer

34

---

**Table of Contents**

<b>Exhibit No.</b>	<b>Exhibit Index</b>
2.1	Agreement and Plan of Merger by and between Sterling and North Valley Bancorp dated April 10, 2007, filed as Exhibit 2.1 to Sterling Current Report on Form 8-K dated April 11, 2007 and incorporated by reference herein.
3.1	Restated Articles of Incorporation of Sterling. Filed as Exhibit 3.1 to Sterling's registration statement on Form S-3 dated December 20, 2005, and incorporated by reference herein.
3.2	Articles of Amendment of Restated Articles of Incorporation of Sterling. Filed as Exhibit 4.2 to Sterling's registration statement on Form S-3 dated December 20, 2005 and incorporated by reference herein.
3.3	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, 3.2 and 3.3.
4.2	Sterling has outstanding certain long-term debt. None of such debt exceeds ten percent of Sterling's total assets; therefore, copies of the constituent instruments defining the rights of the holders of such debt are not included as exhibits. Copies of instruments with respect to such long-term debt will be furnished to the Securities and Exchange Commission upon request.
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. Filed herewith.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Furnished herewith.

E-1